OBSERVATIONS

Tandem Investment Advisors | William "Billy" Little, Jr., CFA

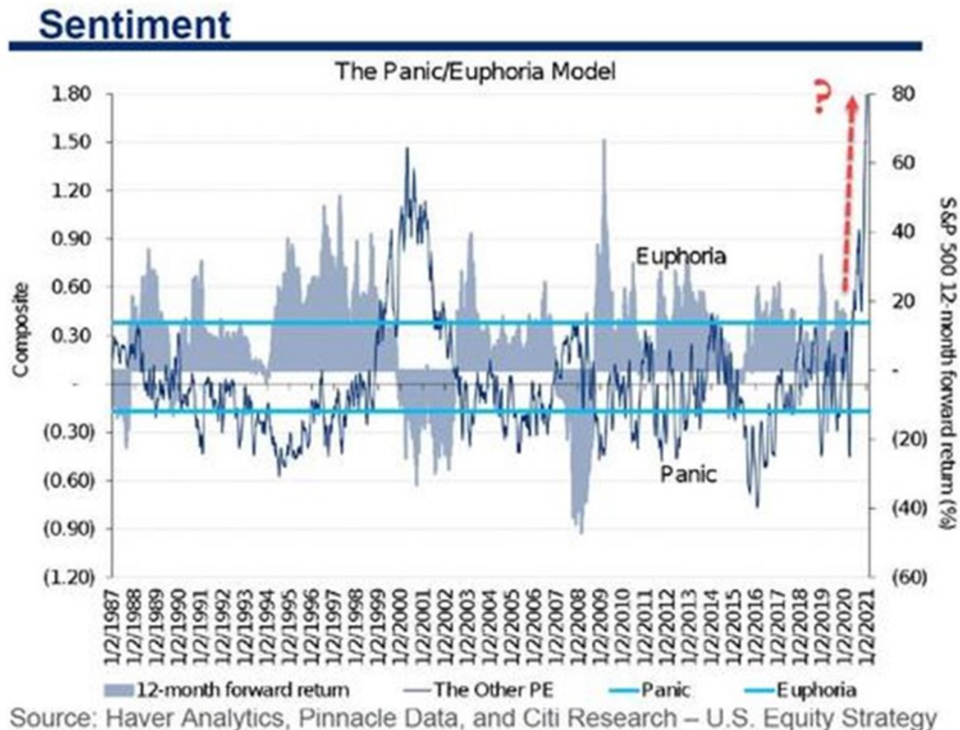
January | 2021

Financial Markets Review

In the past, I have used my first column of the New Year to encapsulate the events of the previous 12 months. This year, I have decided to switch it up a bit. There is no reason to rehash the events of 2020, so I do not think I am speaking out of place when I say – it is time to move forward. If you truly desire to relive or simply review the history made last year within global financial markets, you can access all of our commentary on our website (http://tandemadvisors.com).

U.S. equity markets started the year off on the wrong foot with the S&P 500 falling 1.5% on the first day of trading in 2021. However, since then, equity markets have gotten back on track and continue to grind higher, as they have done for much of the past two months. The S&P 500, Nasdaq and Russell 2000 have all posted gains in the New Year of 1.3%, 1.1% and 5.5%, respectively.

There is a lot to like about current market dynamics, which has been the underpinning for much of the recent advance in equity prices. Whether you agree or disagree with the direction of the future political landscape, one thing is for certain, there is a sense of "you know what you're getting" for the next four years. There are many aspects of business where leaders need to plan for the mid and long-term and it is impossible to plan for anything if you are completely uncertain of future fiscal policy. However, now that we have the Presidential and Congressional elections completely out of the way, we can move forward. We know there will be a push for an even larger fiscal stimulus bill than what was debated during the previous administration. We know the incoming Treasury Secretary, Janet Yellen, is a huge advocate for prioritizing increased fiscal spending to support individuals and local governments over any future sovereign balance sheet worry. And lastly, we know the Federal Reserve has a penchant for monetizing the U.S. deficit. These three certainties have led financial pundits to dub the recent rally as the "global reflation trade."



Source: Haver Analytics, Pinnacle Data, and Citi Research – U.S. Equity Strategy

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So, what works in a period of reflation? Pretty much everything, except for fixed income. You would expect the most economically sensitive assets to perform the best – commodities and small-caps. The securities that suffered the worst during the "deflationary" phase will usually be the ones that bounce back the most. During a period of reflation, inflation expectations rise, which leads to underperformance in fixed income and interest rate sensitive companies – utilities and REITs. This is the type of market action you see coming out of a recession, which makes all the sense in the world. Typically, investor sentiment and valuations are depressed giving equity prices ample runway toward recovery.

However, what makes the "reflation" moniker so head-scratching is where we sit in the market cycle. Valuations are certainly not depressed, with the S&P 500 trading at 23x 2021 EPS estimates and 20x 2022 EPS estimates, which place today's valuations in the 100th percentile, historically. The market is essentially saying that current estimated earnings growth of 23% in 2021 and 17% in 2022 is far too low. Investor sentiment is also not low, as measured by the Citi Panic/Euphoria model on the previous page.

The current composite sentiment reading of 1.83 blew past the previous record set back during the height of the Tech Bubble. Based on historical readings of Citi's model, it is reading a 100% probability that the S&P 500 is lower within the next 12 months. But wait, there's more! Citi also runs a S&P 500 earnings yield gap analysis model. That model is reading 1.56 standard deviations below its 40-year average, which says there is an 88% probability of the S&P 500 being higher within the next 12 months!

So, what is it? No one knows for certain because we have never been here before. The difference in Citi's models above show why the equity market has experienced increasing volatility over the past couple of years – faster and deeper selloffs with sharper and more extended recoveries. However, the recent chatter and certainty regarding global reflation sounds eerily similar to what we heard in late 2017 and early 2018 – global synchronized growth. That just so happened to be the start of the heightened volatility regime we find ourselves in today.

"When share prices are low, as they were in the fall of 2008 into early 2009, actual risk is usually quite muted while perception of risk is very high. By contrast, when securities prices are high, as they are today, the perception of risk is muted, but the risks to investors are quite elevated."

– Seth Klarman, Founder, CEO, and Portfolio Manager of Baupost Group

Willing to be Different

At Tandem, we are *Willing to Be Different*. This is not a catch phrase we market haphazardly, but rather a belief, a discipline, and an experience that we have worked hard to create. When you truly are *Willing to Be Different*, you are not concerned with conforming to an industry norm; you are not concerned with being a solution for all. We take great pride in not conforming or changing who we are to fit the most recent narrative.

In trending markets, those who sometimes go against the grain are slapped with the label of being "contrarian." We are not a contrarian investment manager who purposefully seeks to do the opposite of the masses. We are market agnostic and view the equity markets as a market of stocks rather than a stock market. This belief allows us to do our job – buy low and sell high. And rarely do the best times to buy and sell occur simultaneously.

One of the questions we often get after a significant run up in the market is about cash levels within our strategies. It is understandable and logical to question why our strategies are not fully invested as the market creeps higher every day, especially when the industry norm is to always be fully invested. Remember though, we are not like everyone else; we are *Willing to Be Different*.

Cash is a byproduct of our process; it is not an allocation decision. As an investment team, we might opine on what we think about financial markets or the economy, but by no means do we make investment decisions off those thoughts and conversations. Because if we did, it would inherently bring emotion and individual biases to the investment process, which is exactly what our process is designed to shield us from. Our investment process is driven

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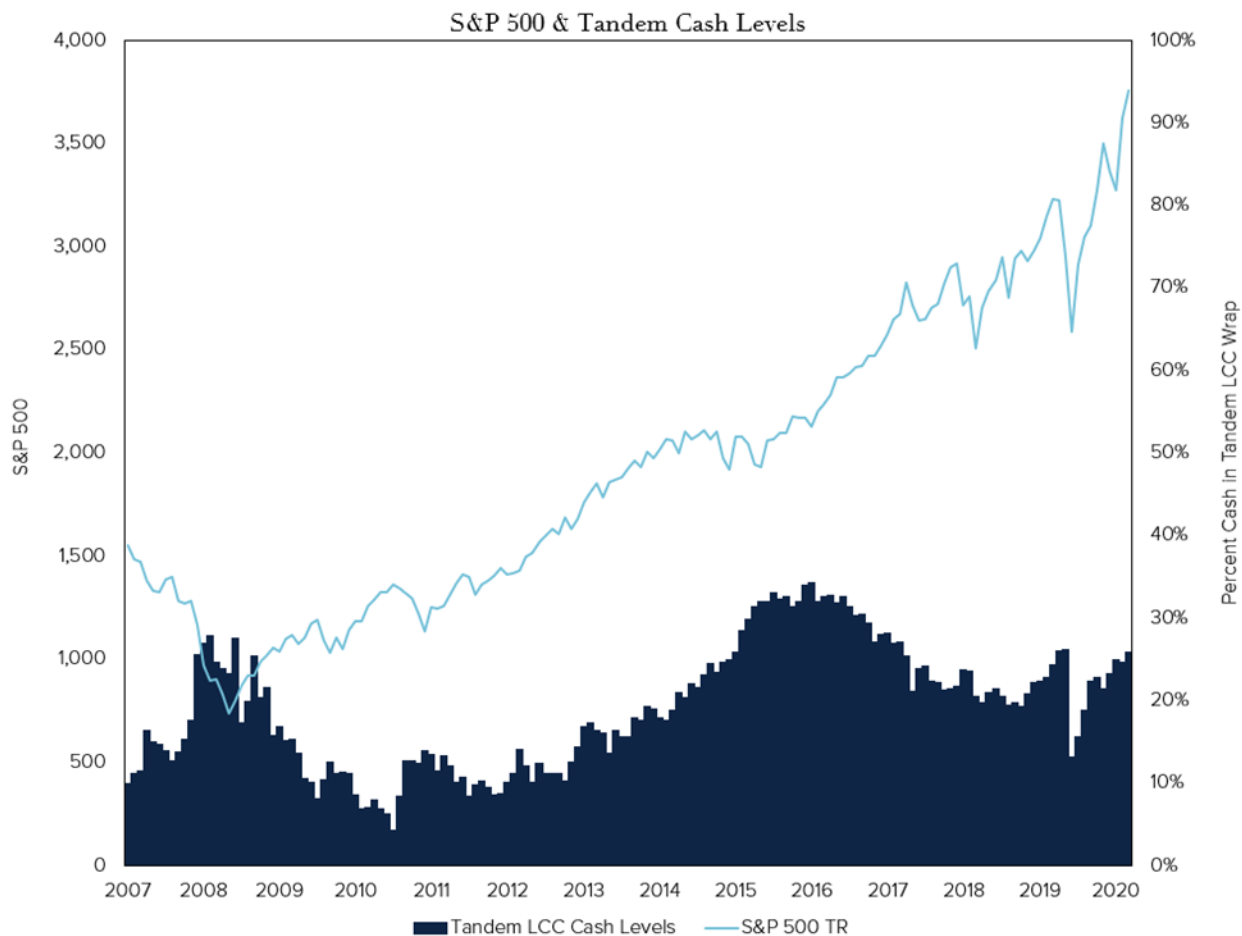
by numbers and math. When our quantitative model signals more stocks to buy than to sell – cash goes down. And, when the number of stocks ranked a sell outnumber those ranked a buy – cash goes up. It is never a "market" call, but rather action based on quantitative signals at the individual company level. For a frame of reference, the following chart shows our historic cash levels within our Large Cap Core strategy over time.

As you can see, cash is dynamic in our strategy. It rarely stays in the same place for too long. Because in every market, there are companies that offer an attractive value and are worth purchasing, and there are over-valued companies worth trimming. In any event, we will never invest cash for the sake of investing. Eventually cash will once again come down, but it will do so when our quantitative model signals an attractive opportunity to take a stake in a new company or add to an existing position, not before we get that signal.

We are *Willing to Be Different*, because we believe our approach to managing money is understandable, relatable and makes sense to our clients. We are *Willing to Be Different*, because we believe our clients matter; our clients are not just a number or viewed as AUM and will never be treated as such. If you too want to provide a *Different* experience for your client, please contact Elaine Natoli at enatoli@tandemadvisors.com to learn how we can be *Different* together.



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Billy Little is a shareholder, Vice President and the Lead Portfolio Manager for Tandem Investment Advisors, Inc. Mr. Little began his career in the investment industry in 2004, as a Financial Advisor with Ameriprise Financial in Baltimore, Maryland. Mr. Little joined Tandem in 2006 where he directs Tandem's quantitative research. He is a regular member of the CFA Institute and past President of the CFA Society South Carolina. Mr. Little graduated from the College of Charleston with a Bachelor of Arts in Business Administration with a concentration in Finance.

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