

# What We Are Hearing And Seeing

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**Michael P. Manning, CFA**

*Senior Investment Analyst – Equity Research*

## The Mounting Hazards of Passive Growth Investing

Despite last year's challenging environment, the market has successfully maneuvered through major events in the past decade. Big tech-related names have catapulted the market to new heights nearly each year. However, because of this exuberance, the past decade has been among the most challenging periods for active large cap growth strategies. As evidence, for the decade ending in 2022, the Russell 1000 Growth Index placed in the 17th percentile among large growth separate account peers, meaning over 80% of active managers underperformed in that decade.

This level of underperformance may not seem surprising when you understand its root causes. Today, the top five constituents of the Russell 1000 Growth Index—Apple (AAPL), Microsoft (MSFT), Amazon (AMZN), Google (GOOG), and Tesla (TSLA)—account for over 34% of the index. By comparison, a decade ago, the top five names totaled less than half of what they do today. This level of concentration severely limits an active manager's ability to outperform with standard position size limits. For example, an active manager today who is bullish on these five names but has a common 5% position size limit would be over 12% underweight. And when these names perform well (today's top five names accounted for over 50% of the index's return in the past five years), it costs active managers alpha.

However, the environment is far cloudier now than in recent years, with higher volatility, mounting geopolitical concerns, high inflation, tight labor markets, and a possible upcoming recession. While there are no concerns that these stocks will experience a 2000-esque tech bubble implosion, it is logical to question whether, in this increasingly challenging environment, it is wise for investors to be as concentrated as the index. This is especially true as these few mega-cap, tech-related names are more exposed to macro events, and stocks with their characteristics typically correct harder in an inflationary cycle.

Active management, particularly in large cap growth, may be more attractive now than at any point in recent history, given its ability to manage concentration risk and not just blindly bend to the will of the index. However, investors will have to wait and see if the big five continue to dominate or if this environment is the final straw that brings them back down to reasonable valuation.



## Adithya Narayanan, FRM

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### **2023: A Year for Thoughtful Asset Allocation**

Advisors often recommend the 60/40 portfolio for its ability to provide steady returns across different market conditions. The low correlation historically witnessed between stocks and bonds has helped balance these portfolios over the long term. This approach did not hold water in 2022, however, as both equities and bonds tumbled due to surging inflation and rising interest rates. The Bloomberg Aggregate Bond Index was down 13%, while the S&P 500 was down even further, losing 18%, as a cocktail of geopolitical tensions, high inflation, and aggressive Federal Reserve tightening impacted both asset classes.

We entered 2023 with the Federal Reserve signaling further hikes and markets anticipating a slowdown in economic growth. Many strategist managers we cover favor bonds over equities, considering the historical outperformance of bonds in a high-inflation/low-growth environment. Among equities, these strategist managers anticipate a slowdown in corporate earnings and a decline in stock valuation multiples which could extend the equity sell-off that began last year. Managers are overweight sectors that have historically been relatively resilient to economic challenges like Healthcare, Consumer Staples, and Utilities. On the fixed income side, a steep sell-off last year has led to bonds now paying their highest yields in more than a decade. Despite a rising rate backdrop, these higher yields have brought back appeal to fixed income, especially toward high quality investment grade corporates and mortgage-backed bonds. Managers are also elevating the interest rate sensitivity of their strategies, as the increased levels of yields from fixed income can help offset some of the interest rate sensitivity. They expect long-term treasury rates to decline in line with the Fed's tight policy stance at the expense of economic growth.

The challenging macroeconomic environment has also witnessed managers increasing their allocation towards alternative assets as diversifiers. Alternatives like Gold have had renewed interest last quarter as a fall in the 10-year TIPS yield, weaker US dollar, and expectations of higher demand in China helped boost interest in Alternatives. This situation made gold mining companies appealing for some strategist managers. Other precious metals like silver and platinum have also added about 25% and 15% over the past 3 months, respectively. They continue to benefit from EV automobile industry demand. Some strategist managers are also overweight on Infrastructure, which might benefit from tailwinds associated with the passing of a major infrastructure bill last year and continued investments in sustainable energy and energy security.

While last year's double-digit negative returns in equities and fixed income questioned the relevance of a 60/40 portfolio, investors need to keep in mind that such periods are rare, and 60/40 portfolios still have a place in long-term asset allocations. A short-term bet on single asset/sub-asset class, if proven correct, might pay off, but this success might be extremely difficult to replicate on a consistent basis. Diversification across asset classes and investment styles, achieved via a 60/40 allocation, can provide consistency and still help investors navigate this economic environment characterized by high inflation, rising interest rates, and geopolitical issues. While alternative investments can be relatively illiquid and a complex realm for a retail investor, adequate exposures which complement the 60/40 allocation via a well-researched strategist manager can add further diversification.



## **Eric Halverson, CFA**

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# **Optimism Abounds for Fixed Income Returns in 2023**

After fixed income markets plunged last year and notched their worst returns in over 30 years, we've noticed the bond managers still standing have a bit of "pep in their step" with the most attractive yield levels seen in over 20 years. Such optimism comes in the face of an uncertain economic outlook with a looming possibility of recession, but resilient and sound corporate balance sheets seem to be dampening those concerns.

The numbers behind fixed income manager confidence are compelling. For example, at the end of 2022, the Bloomberg US Aggregate Index had a yield-to-worst of 4.68% and a duration of 6.17 years. A 100-basis point parallel downward shift in rates would translate to a roughly 10.3% return for 2023, a 4.7% return if rates remain unchanged, or -60 basis point return if rates rise 100 basis points. With the market expecting the Federal Reserve to reduce the size and frequency of interest rate hikes in 2023, and perhaps even cut rates toward the end of the year, the bond math is clearly positively skewed this year.

The optimism isn't limited to just the investment grade segment of the fixed income market either. Treasury, municipal, and even high-yield corporate bond yields are at multi-decade highs. At the end of 2022, the yield on a 10-year Treasury was just under 4%, while municipal and US high yield corporate credit yields were 3.55% and 8.96%, respectively, and all offering double, or even triple, what they were at the end of 2021.

At current yields, income becomes a greater component of total return and should dampen the negative effects of any further upward move in rates. This dynamic is likely to offer greater diversification benefits as well and regain fixed income's traditional place as a ballast in portfolios.



## Divya Jain

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# Corporate Bonds Bounce Back

2022 was quite a bumpy year for corporate bonds, which witnessed a steep decline beginning in the first quarter that lasted most of the year. As rising inflation prompted numerous rate hikes by the Fed, investor demand fizzled, and many companies were reluctant to come to market and issue new debt at higher yields. In fact, gross issuance totaled just 16% and 33% of 2021 and 2020 levels, respectively.

Despite limited supply and relatively cheap valuations making corporate credits appear attractive, secondary market liquidity was constrained as investors were reluctant to allocate to fixed income in a rising rate environment. However, the tide turned in the fourth quarter as inflation prints moderated and interest rate volatility peaked in mid-October. Expectations of a milder recession also lifted investor sentiment, resulting in positive corporate bond market performance for Q4 2022. US investment grade corporate bonds returned 3.63% in the quarter and high-yield bonds returned 4.17%, although both asset classes still produced sharply negative returns for the calendar year.

Historically, negative returns for credit have been followed by strong bounce-backs in the twelve months following the lows. Corporate bonds appear to be continuing their comeback in early 2023. So far, through January, issuance has been robust, and returns have been positive. The credit market has witnessed net inflows for four consecutive weeks, and despite heavy supply, new deals have been oversubscribed. While it remains to be seen if this trend will continue amid economic uncertainty, many fixed income managers are constructive on corporate valuations and fundamentals, especially if a potential recession is more modest or avoided. In particular, the Energy and Industrial sectors are areas where managers feel credits are poised to outperform in 2023.



## John Parsons, CIMA

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### Small Caps—Is Now the Time to Buy?

Despite falling roughly in line with their large cap counterparts in 2022 (-20.44% vs. -19.13%), small caps at the end of last year were trading at valuations that were significantly lower than their long-term average. The Russell 2000's relative value compared to the Russell 1000, whether measured by P/E or other metrics such as EV/EBIT, had fallen more than two standard deviations below its average over the last 20 years. Large caps had trounced small caps in 2021, but their valuations had grown by a sizable amount coming into the 2022 bear market, so they had further to fall—and have only now reached their long-term average. Small cap's weighting in the broad-based Russell 3000 is also at its lowest level in more than 20 years. Other than a brief period during the depth of the pandemic-related market decline, the weighting is even lower than it was following the bursting of the internet bubble that preceded a multi-year period of small cap outperformance.

These factors seem to indicate that a rebound in small caps could be on the horizon. Market bottoms are usually the most bullish time for small caps. They are typically the first to recover during a recession, and then tend to really come on strongly as the economy exits the economic downturn. In fact, the average return for small caps from the market low to the recession's end is roughly 33%. Performance comes quickly, so waiting for a recession to pass has proven to be a mistake. The two years immediately following the market decline in the early 2000s (2003 and 2004) saw the Russell 2000 handily outperform the Russell 1000 by 17.4% and 6.9% in those years, respectively. Since periods of small cap outperformance have historically averaged a decade or more, we could be near the beginning of another stretch of sustained market leadership from the group.

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