ENVESTNET PMC

What We Are Hearing And Seeing

Envestnet offers one of the largest asset manager networks in the industry. Given the current environment, we want to share what we are seeing and hearing – perspectives from our trading & operations and Envestnet | PMC teams.

Michael Pajak

Multi-Asset Research Analyst

Using a Flexible, Professionally Managed Approach Through Uncertain Times

The second quarter of 2023 was an impressive one, driven by high-flying U.S. mega-cap technology names leading the way and most asset classes witnessing positive performance. Yet there continues to be a significant level of market uncertainty as the yield curve still is deeply inverted and leading economic indicators are showing signs of cracking. Challenging as this may seem, this current environment serves as a backdrop for how professionally managed portfolios can help advisors and their clients navigate the challenging markets.

The effectiveness of dynamic and tactical asset allocation has been challenged by academia and others who believe that you can't consistently outperform the market. However, because asset price correlations have varied over time, there are periods when a more dynamic or tactical asset allocation approach might be more effective in accounting for the changing correlations and managing through market volatility. Through our analysis, we have found that, on average, managers with a seasoned investment team and a sound, repeatable investment process may adapt to the changing market environments. This type of approach can help investors navigate volatility and the changing market leadership throughout different market cycles. Year-to-date as of June 30, 2023, the average Rep as a PM moderate portfolio on the Envestnet platform returned 7.76%, trailing the peer group comprised of dynamic and tactical Approved – Qualitative Fund Strategists portfolios, which returned 9.95% and 9.31%, respectively, over the same time.

For the most part, these Fund Strategist managers were adept at capturing the market's rotation back to domestic equities and growth. Many successful managers also benefited by reducing their commodities and alternative exposures at the beginning of 2023 after capturing the outsized gains from commodities and the uncorrelated performance of alternatives in 2022. Furthermore, some managers were able to reduce equity allocations to limit drawdowns when the stock market showed weakness during 2022 and the banking crisis in the first quarter of 2023. In contrast, when they expected continued market gains after the banking crisis in March, certain managers were able to increase their equity exposures above their benchmarks to capture the rebound in the second quarter. While these more active approaches can experience specific periods of underperformance, the long-term benefits of professionally managed portfolio solutions and parsing out the emotions from investing can outweigh short periods of underperformance.

David Chandler, CFA
Senior Investment Analyst – Equity Research

Benchmark Oddities

One aspect of active manager research is performance attribution. This comparison is typically against a standard benchmark that is ideally representative of the style and/or asset class of the manager. Although we recognize that benchmarks change, we also tend to have an assumption of some stability. This stability can be an illusion, though. Current conditions in domestic large cap stocks highlight this fact.

The Russell 1000 Value Index, for example, is the benchmark we use to evaluate Large Cap Value (LCV) managers. However, the effect of growth's dominance over the last fifteen years has resulted in the value benchmark being significantly core--biased. If looked at on a holdings-based style map, one could be forgiven for thinking the Russell 1000 Value should be reclassified to core. This was certainly the case as of March 2023. Presently, the value index is representative of value investing in a relative sense, but it's a bit of a stretch to say it is so in the traditional sense.

Russell Investments' index methodology seeks to have the Russell 1000 Growth and Russell 1000 Value Indices represent an equal amount of aggregate market cap. Basically, each gets one half of the Russell 1000. 25% of that market cap is now concentrated in seven large growth stocks, though. If those seven all go into the growth index, then two thirds of the Russell 1000's remaining market cap must go into the value index. This results in the Russell 1000 Value Index holding significantly more stocks, many of which still have high absolute valuations even if they have but moderate relative ones. As of March 2023, 847 stocks were in the value benchmark but only 518 were in the growth benchmark. (351 stocks were included in both.)

Exacerbating this situation is the effect of 2022's market decline followed by the mega growth stock rally of this year. Many of 2022's fallen growth stocks ended up being added to the Russell 1000 Value Index when it was rebalanced in 2022. The 2023 rally, though, resulted in them being removed this June. The methodology requires it, but a one year holding period isn't characteristic of most value investing.

Meta Platforms is a perfect encapsulation of present oddities. The company was added to the Russell 1000 Value Index in June 2022. At that time, it was the 5th largest holding in the index with a 1.7% weight. This year, the stock is up 133%. This resulted in it being the 2nd largest holding with a 2.6% weight at the end of May 2023. It was then rebalanced out of the index in June. Many LCV managers did not own the company and their stock selection both overall and within the Communication Services sector looked horrible in Q1. However, it's difficult to take them to task for not holding a stock generally considered more of a growth stock than a value stock and simultaneously only being in the value benchmark for one year. Home Depot was also similarly added in 2022 and subsequently removed in 2023.

In any event, investors should be aware that the concentration of so much market cap into so few names doesn't just affect the growth benchmark. The value benchmark is greatly affected, too. Performance attribution needs to keep current distortions and oddities in mind.

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Joe Samuel
Investment Analyst

Amid Weakening Demand and Recessionary Fears, Is the Energy Sector a Viable Contrarian Bet?

In 2022, the Energy sector was the best performing sector in both the S&P 500 and the Russell 1000 Value indexes, posting positive returns while most other sectors fell amid rising interest rates and inflation. The sector was buoyed by rising oil prices and supply constraints caused by the war in Ukraine, plus an uptick in demand post Covid-19. The sector was the largest contributor to earnings in the S&P 500 Index in 2022. The exploration and production segment stood out among the Energy sub-industries, with ExxonMobil's market capitalization surpassing Tesla's at the end of the year.

However, in 2023, the S&P 500 Energy Sector Index has lost nearly 4% year-to-date, versus the S&P 500 Index which has returned about 18%. So far this year, investors have favored quality names with performance concentrated among a few highly valued companies in the S&P 500. Declining demand for energy from Europe and China this year has also weighed on oil prices. Despite this, Energy companies produced strong earnings in Q1, with refiners or "midstream" companies benefiting from lower oil prices.

Looking ahead, managers expect the near-term demand for energy to decline and excess inventories to impact earnings in 2023, especially in developed economies. A turnaround in demand for energy would also have to come from the Eurozone area, where manufacturing and services growth remain in decline. However, if a large-scale economic downturn can be avoided, valuations in the sector look extremely attractive. Recently in late June, the S&P 500 Energy Index traded at a forward P/E ratio of 11x versus a historical median of 15x. Longer term, the balance sheets of most large energy companies are healthy, with debt ratios at low levels and substantial cash reserves. However, they are under pressure to expand investments into clean energy projects, with the International Energy Agency (IEA) expecting $2.8 trillion to be invested in the energy space in 2023 of which $1.7 trillion is expected to be invested in clean energy projects. So, while the short-term prospects of the Energy sector may be less than ideal, these cheap valuations and robust fundamentals along with the expansion into clean energy could be catalysts for a comeback in the longer term.

Parina Sharma
Investment Analyst

Muni Land: Moving Pieces this Mid-Year

After posting its worst return in more than 30 years in 2022, the municipal market has started to recover some its lost ground in the first half of 2023, with the Bloomberg Municipal Bond Index returning 2.67% through June 30. Municipal managers are more optimistic for the latter half of the year in the face of struggling economy. But will this optimism translate to investment flows reversing course and turning positive in the second half of the year?

There are minor signs of weakness creeping in for state and local governments. State tax revenues, which at present are at record highs, are likely to slow down soon as the US economy continues to grow at a below-trend rate. States that are highly dependent on tax revenue from capital gains and income taxes, like California and New York, are already witnessing headwinds. However, managers don't foresee a major increase in defaults or downgrades, as most states have a deeper pool of financial reserves built with the Federal government's Covid-19 financial aid.

Municipal sectors, especially the Healthcare and Education sectors, are also witnessing significant secular changes. Despite the recent negative outlook for the hospital sector, which represents around 13% of the Bloomberg Municipal Bond Index, managers anticipate improving margins in 2023 and believe there will be opportunities in the sector with credit selection playing a pivotal role. Higher education is seeing many colleges grapple with falling enrollment and rising costs. Flagship universities with healthy balance sheets and national demand are better situated to continue operating at a healthy level, but smaller state and private schools are showing signs of vulnerability. While both sectors will continue to see mergers and wind-downs, managers are aiming to identify entities with strong competitive advantages that can sail through the headwinds well.

The two-to-ten-year segment of the municipal-bond yield curve also calls for attention. For the first time in history, this segment has inverted. With high short-term yields currently and with the market expecting the Federal Reserve to end their hiking cycle by year-end, managers believe a barbell approach, with a focus on bonds maturing in less than five years and bonds maturing beyond 12 years, is best suited for today's environment. However, going forward, as the yield curve moves toward a normal upward slope, they expect the long end of the curve to provide better total returns.

Despite many moving pieces in place, the real game changer for the municipal bonds continues to be the asset flows. Record outflows witnessed in 2022 (of around $143 billion) have continued in 2023. Will this improved yield environment and benign fundamental backdrop entice investors to return to the municipal market? Time will tell, but managers are seeing greater opportunity compared to years past.

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