What We Are Hearing And Seeing

Envestnet | PMC (PMC) performs the research and due diligence that drives the selection of asset managers on the Envestnet platform. This gives PMC tremendous visibility and insight into the broadest possible range of asset managers and investment types.

Our daily commutes to the office, Starbucks coffee runs, and adhoc team discussions have changed to a remote work environment. However, the roles and responsibilities of Envestnet | PMC's research team hasn't. PMC's analyst team, consisting of 28 members, is divided among four teams: Equity, Fixed Income, Liquid Alternatives, and Multi-Asset. Here is what the team is hearing and seeing in their discussions with some of the world's top asset managers.

Brooks Friederich

Back to Target

Being diversified across global asset classes (equities, fixed income, real assets, etc.) has historically provided buoyancy during market volatility. However, over the past few weeks, a traditional "balanced" global diversified portfolio has experienced a drawdown near 20%. A majority of this drawdown was driven by the quick sell-off in global equities over the past few weeks. As a result, model portfolio allocations have drifted to underweight equities relative to their equity/fixed income targets. Most would think this is an opportune time to rebalance. Through our conversations with many multi-asset strategist managers, the feedback on rebalancing has sparked some interesting conversations as to when to rebalance. The short answer is that there is not a perfect answer—or a perfect time.

For those strategist managers that are more strategic in their asset allocation and long-term investment views, a common theme here has been to "buy-and-hold," holding-off on rebalancing (for the time being). Others are waiting for markets to normalize a bit more before implementing their rebalance. And, as expected, the more active strategist managers are dynamically managing their asset allocation models throughout the volatility.

There are no hard-and-fast rules on rebalancing. I was quickly reminded during a manager call that the purpose of rebalancing is really to maintain a portfolio's risk and return, not to maximize returns. What we know is every manager has a different view and approach. We continue to focus our due diligence conversations on the strategist manager's investment philosophy and process (rebalancing is just one element). We are keenly watching for managers that are straying from their approach in attempts of taking advantage of short-term opportunities.

Michael Wedekind

Opportunities in the Municipal Market

Since the novel coronavirus (COVID-19) careened into our collective consciousness in February, municipal bond markets have convulsed wildly and distinctly to the downside. Investors have since sold much of their intermediate- and long-dated holdings in a mad rush for liquidity, and municipal bond funds were no exception, witnessing some of their largest outflows in the history of the asset class.

In fact, Baird Advisors noted that the $12.3 billion net outflow from municipal mutual funds and ETFs (source: Lipper) was not only the largest weekly outflow in history, but was three times larger than the last record. This sell-off was reflected in terms of both price and the muni-Treasury ratio, which, for bonds with maturities less than ten years, has typically averaged below 100%. According to Thompson Reuters MMD, AAA-rated municipals at the two-, five-, and ten-year tenors yielded an unheard-of 787.5%, 533.3%, and 320.7% of their duration-matched Treasurys last Friday (3/20/2020).

Fed support for the Treasury market and legitimate fundamental concerns about state and municipal budgets undoubtedly played their role in this dislocation, and there is likely to be more volatility to come. However, with muni-Treasury ratios still over 300% out to the ten-year tenor on March 24, the market has rarely presented such attractive relative valuations.

Michael Manning

Has the Dominance of Growth Stocks Finally Sputtered?

Well, not exactly. Growth stocks are certainly down, as are all major indices so far in 2020. And higher beta stocks, which by definition are more exposed to a market downturn and tend to be held in a lot of growth portfolios, have significantly underperformed as investors have de-risked broadly in recent weeks. However, value or cyclical stocks have actually performed worse and momentum stocks have held in better.

To dig into it a bit, growth indices are dominated by a few big sectors, including Information Technology, Consumer Discretionary, Healthcare, and the newer Communication Services sector. And while the market is down about 25% so far in 2020 (as of March 24), these four sectors are down between 15% and 22%, showing some strong resiliency in this downturn. As a further boost, growth indices also have a very minor stake in the Energy sector, which is really struggling and down about 50%, and are also less exposed to cyclical stocks like manufacturers and retailers.

If you talk to growth managers, they will point to their companies' differentiated business models and strong competitive advantages that provide protection in a struggling market. Thus far this has largely played out, and the dominance of growth over value that we have seen for a decade plus has continued even amid the coronavirus pandemic.

David Hawal

Finding Equilibrium in the Bond Market?

In the recent panic triggered by the COVID-19 pandemic, credit markets have witnessed a liquidity freeze as corporate and municipal bond managers face waves of redemptions. Even the most liquid government bonds have traded at record wide bid-ask spreads, while a number of fixed income ETFs are pricing at significant discounts to the NAV of their underlying holdings. ETFs had been touted as bastions of liquidity given their intra-day trading flexibility. However, just last week, Vanguard's Total Market Bond ETF (BND) closed at a 6% discount to NAV, highlighting a dislocation in the liquidity of the ETF's shares and its underlying securities. These effects have been even more amplified in less liquid segments of the market, like high yield. But how did we get here and what happens next?

The answer may lie in the aftermath of the Financial Crisis and the enactment of the Volcker Rule, which aims to limit the financial risks banks can take by eliminating proprietary trading. While one can argue the steps the federal government took to bolster the solvency of the nation's banks has our financial system much better positioned entering the current crisis, we may also be seeing some unintended consequences.

In the years following, PMC repeatedly asked the question of fixed income managers: Without bank prop desks to provide liquidity, who would be the buyer of last resort in the event of a mass exodus from credit? While we received a variety of speculation, the one response we never heard was the reality we've now ultimately seen play out – for the first time in history, the Federal Reserve would step in and intervene in the corporate bond market. Perhaps now, with the Fed as a backstop, fixed income markets that have seen spreads approaching Financial Crisis levels will return to normalcy.

Eric Halverson

Dry Powder Gone Sour?

In recent periods, the term "dry powder" has been more prevalent in conversations with value-focused fixed income investment managers, and refers to the move to high-quality issuance, or even cash, when areas of the market appear overvalued. In theory, this "dry powder" can be put to use during market dislocations when valuations become more attractive. But when managers utilize comingled vehicles (such as mutual funds and ETFs) and redemptions start piling up during periods of market stress, does all of that dry powder go to waste as they are forced to meet withdrawals?

This begs the question, should investors stick to separate accounts instead of comingled funds in liquidity-constrained asset classes like fixed income? Redemptions and forced sales still occur within separate accounts, but the decentralized nature of their management limits the negative impact to other investors, and more importantly retains the book yield of other accounts. Another factor to consider is the manner in which mutual fund managers choose to handle these redemptions. Are they selling their highest quality and most liquid holdings, leaving remaining shareholders with a portfolio of less liquid securities? This is something we are monitoring closely as we engage with our managers.

John Parsons

Panic Selling Creates Opportunity

As confirmation that corporate leaders do not feel the world is coming to an end quite yet, insider-buying in the small cap market is at an all-time high, far exceeding levels ever seen before. There have been three pockets of significant insider-buying in the last eighteen months, which have coincided with increased market volatility – Dec. 2018, Aug. 2019, and Mar. 2020. The largest recent activity has been disproportionately focused in the cyclical areas where stock prices have been crushed, especially in the regional banks space. Banks are far better positioned this time around than was the case during the 2008 financial crisis, but their stock prices are trading as if they will never make money again. This will probably not be the case. They likely won't all be going out of business. Today, banks are not levered to the same extent they were in 2008, capital and liquidity is far higher, and fiscal stimulus is being better received by the public than were the bank bailouts a decade ago.

On the other hand, insider buying in Utilities has been muted relative to historical trends, as investors have flocked to the sector for safety, pushing up prices, and reducing relative valuations. Nevertheless, value stocks continue to be underappreciated compared to their growth counterparts. Value stocks, especially small cap value, are trading at p/e multiples far below their 20-year averages – approximately 65% in the case small cap value. This compares to an average near 100% across the growth market cap spectrum. This valuation disparity between growth and value is entering its tenth year. While the "chicken trade" in low volatility stocks (e.g. utilities, REITs, insurance companies) has worked the last couple of years, valuations are also being stretched. Maybe some of the more beaten down areas of the market will finally have their day.

David Chandler

Being Greedy When Others are Fearful

The best value investments are quality companies suffering fixable problems. This is easy to say, but solvable problems are only obvious in retrospect and almost never so in the present. And so we come to the present state of the Energy sector.

Energy is currently suffering the worst industry fundamentals in its modern history, even worse than the mid-80s. Oil demand is way down due to the coronavirus outbreak. China's shutdown got the ball rolling on the demand decline, and now that we are all quarantined, it's in a freefall. To add to the industry's problems, a price war was kicked off between Saudi Arabia and Russia after an OPEC meeting earlier month. The end result is a glut of supply oil prices in the mid $20s, and everybody losing money. The red ink flows.

We expect our managers have lost or probably will lose money in these stocks near term. How should we judge them though? If value managers believe the words they say, both with regard to buying cheap stocks AND being long-term investors, it's hard to argue with them adding to their holdings at current prices. If one believes in reversion to the mean and that modern life will go on, it's not hard to envision the oil pendulum swinging the other way. The hard part is predicting the "when", not the "if" of this reversal.

Ultimately, if we believe our managers are good at picking investments but bad at timing, then we should not penalize them for losing money in this sector in the near term. We want value managers buying stocks that are cheap. If cyclical companies at generational lows are not cheap stocks, it's hard to know what is. We should not be surprised to see value managers increasing their allocation to this sector. Indeed, we should be encouraged by it.

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