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.

Tanner Howard

Regime Change for US Small Caps

US small cap equities have been on a decidedly downward trajectory since mid-November 2021. While the Russell 1000 Index was making new highs around the holidays, the Russell 2000 was already down nearly 10% from its November 8 peak. It is now nearly 20% off of that high water mark. While few investors will be pleased with this development in absolute terms, many active managers in the small cap realm are flourishing in relative terms.

While inflationary concerns, supply chain issues, the Omicron variant of the Covid-19 virus and, most recently, fears of a Russian invasion of Ukraine have pushed markets lower, it was the Federal Reserve's early November announcement that they would begin tapering asset purchases that has driven a substantial regime shift beneath the surface. Several risk-on pockets of the small cap market ruled the day during the initial bounce off the March 2020 nadir. Those same pockets have come crashing back to Earth over the past several weeks, while higher-quality small caps have fared far better.

In our recent discussions, small cap portfolio managers have consistently pointed to three groups in particular that have bogged down the small cap asset class: micro caps, biotech, and unprofitable companies (better known as non-earners). Each of these groups was down substantially more than the broad index in Q4 2021, and the trend has not waned quarter-to-date. While each group has its own underlying dynamics (i.e. biotechs have been hurt by a reduction in drug trials), the three of them combined represent what one PM calls "the speculative stuff". The Fed's November signal that it would begin to reduce asset purchases, and its December follow-up that accelerated the timeline, has clearly triggered a change in attitude among small cap investors.

Most active managers seek out some element of "high quality" within their portfolios, and in the small cap space that typically results in underweighting these speculative pockets. While there are exceptions, most small cap managers are enjoying a stretch of substantial outperformance. Not only are they beating the index, but the median Small Cap Blend separate account beat the Russell 2000 by over 400 basis points in the fourth quarter, with many outperforming by far greater margins. This trend has persisted, thus far, into the first quarter of 2022.

Divya Jain

Green Bonds – All That Is Issued Is Not Green!

Green bonds are rapidly gaining popularity as governments and corporations leverage these bonds to finance the transition to a low-carbon global economy. According to Bloomberg, green bond issuance in Q4 2021 was approximately $137 billion. For 2021, total issuance was approximately $540 billion, more than double overall issuance in 2020. Most of the money raised flowed into renewable energy, energy efficiency, and electric vehicles, providing investors an avenue to accelerate the transition to a more sustainable economy. However, despite its rapid growth, the green bond market faces challenges to its further evolution that must be addressed by regulators and private market participants.

Many of the portfolios Envestnet | PMC Research covers include green bonds, and the investment teams managing these strategies have had to grapple with the promise and peril of these securities given the lack of uniform regulation. According to our managers, "greenwashing"[1] has been, and will continue to be, a major risk as opportunistic issuers seek to exploit booming demand for green bonds to finance general operations or dubiously sustainable projects. For example, based on a recent Climate Bond Initiative (CBI) study, cumulative issuance under the Climate Bonds Standard stood at just over $200 billion in late 2021 – substantially less than the figure in Bloomberg, reflecting the widely divergent standards for what should be classified as a legitimate green bond. The lack of uniform standards in turn makes it exceedingly difficult for benchmarks and passive portfolios to create credible guidelines to filter out greenwashed bonds.

Considering that there is no easy way to identify greenwashed bonds without rigorous analysis, PMC believes that active managers with experience incorporating ESG factors into their fundamental analysis are well placed to address this challenge. In our view, successful managers in this space are now focusing on bonds with clear and relevant use of proceeds language, clear alignment with an entity's overall sustainability strategy, and verifiable reporting on the impact of financed projects. While the absence of a universally adopted standard for green bonds remains a major challenge, PMC believes that it is one experienced active managers can surmount.

1 Greenwashing is the process of conveying a false impression or providing misleading information about the sustainability of a company's products, services, or business practices.

Sarah Abernathy

Is the 60/40 Portfolio Going to Make It?

You'd be forgiven for thinking the 60/40 balanced portfolio was on its last leg. An ebb and flow of reports on its demise has grabbed headlines for several years. But with bellwether Goldman Sachs now joining the fray, the roar of the crowd may have finally reached its crescendo.

The arguments for the 60/40's demise mostly center on future expectations. It's hard to argue that bond yields can go anywhere but up from here. Inflation, a bond holder's nemesis, also looks to be sticking around much longer than the transitory crowd suggested. An all-around less accommodative Fed and sky-high equity valuations point to a painful path for stocks too, even if valuations reverted only partway to historical means. Some point out that the recent correlations for stocks and bonds have indeed been negative, but that has not been the case over longer-term history. Thus, perhaps the diversification benefit from holding a mix of stocks and bonds going forward will disappear, or at the very least offer little protection. And who knows what the future holds as we teeter on the edge of a multi-decade secular bull market in bonds and equities.

But those defenders of the approach have been just as quick to fire back in support of the 60/40. Many point to the short-sighted nature of the current arguments against the long-respected blend. Sure inflation, interest rates, and a hawkish Fed are problems for the 60/40, but they are a problem for any diversified portfolio over the short term. Yes, the negative correlation between stocks and bonds has given serious teeth to the value of diversification over the last two decades, but even over historical periods where these correlations weren't negative, they have been substantially less than one. The 60/40 has delivered on its core promise, the benefit of diversification. Amid the volleys between the opposing sides, there is still that common ground to be had – diversification works and it's critical over the long-term.

Even the pundits railing against the 60/40 generally coalesce around some commonalities in their proposed remedies – investors may need to broaden allowable asset classes in their portfolios to achieve their goals, they may need to further diversify. Return and yield won't be easy to come by in the traditional asset classes, so look beyond to emerging market debt, global real estate, commodities, bank loans, the list goes on. But the benefits of broad diversification, whatever your target stock/bond mix, remain intact, and that is the crux of the value of the 60/40 portfolio.

Joe Samuel

Corporate Earnings: Uncertainty Lies Ahead, Can Active Managers Capitalize?

After the pandemic-induced earnings lull of 2020, 2021 has seen record profitability across sectors off the low base of 2020, largely driven by companies benefitting from the restart of many activities that are now reflected in higher earnings growth. With the fourth quarter earnings season currently underway, the 2021 earnings for the S&P 500 Index is expected to grow by 45.1%, according to FactSet, which would be the highest earnings growth rate since 2010. All 11 GICS sectors are expected to see positive earnings growth this year, with cyclical sectors like Energy and Industrials set to see the highest figures.

However, looking forward to 2022, many active managers expect that the record earnings we saw last year will not be sustainable as companies grapple with new challenges that have arisen as a result of the pandemic. The biggest impact on earnings is expected to be rising input costs which, so far, companies have been able to pass on to their customers as demand has remained robust for most goods and services. However, as the pandemic-fueled stimulus and savings deteriorate, demand could see a slowdown which would impact revenues. On a positive note, companies are taking steps to mitigate the impact of supply chain disruptions by moving manufacturing closer to home. Companies are also increasing their capital spending towards digitizing processes and improving productivity. However, the current inflation scenario and labor shortages have also led to rising wage costs. Another factor is the uncertainty regarding the future course of the ongoing pandemic. While the Omicron variant may not be as lethal as the previous variants, it has nevertheless disrupted travel and labor availability.

Given the ongoing concerns around inflation and its potential impact on earnings, the environment should be favorable for active manages, whose ability to identify high-quality companies using bottom-up research will likely play a larger role in generating positive outcomes.