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.

Rebalance Reminder

In light of the current volatile markets, a quick reminder that Envestnet does not automatically rebalance strategist models based on drift parameters set within the Manager Console. If you are a strategist manager on the Envestnet platform, please don't hesitate to reach out to your ***Relationship Manager*** *with any questions around your responsibilities as a model manager on our platform.*

Michael Manning

Are Big Tech Stocks a Risk for the Market?

Technology stocks are on pace for yet another blockbuster year in 2020. And not only that, they continue to account for an increasing proportion of major indices such as the S&P 500 Index. In fact, tech companies now comprise about 40% of that index (including both the Information Technology and Communication Services sectors), more than the roughly 35% they represented in 1999 prior to the dot-com bubble. So is there cause for concern given this high level of concentration where a decline in just a few of these stocks could spell trouble for markets?

Historically, peaks in a sector's dominance in the market have been followed by sharp declines. In 2000, the tech sector sold off after the dot com bubble and prior to 2008-2009's financial crisis bank stocks peaked within the index.

However, today's tech stocks are far different than the burgeoning internet and online shopping companies of the 90s. Besides the fact that tech companies today have very significant revenues compared to their earlier predecessors, they do everything from making phones, computers, television content, and semiconductors to cloud computing and social media platforms. They also provide cashless payments, facilitate travel, create videogames, and manage web-based communications, just to name a fraction of the services these firms provide. And with the current work from home environment and growth of cloud computing amid COVID-19, a lot of these tech companies are in the fortunate position of growing their business while many others are struggling.

Furthermore, with strong earnings amid an environment where earnings are fuzzy at best for many companies, as well as being the beneficiaries of low interest rates which lower the discount rate in analysts' modeling, it is no surprise that tech stocks have continued their rise. However, the sheer size of tech stocks in the market, the likely volatility amid a contentious election, and looming regulation in a sector accustomed to a light touch remain concerns. But it is fair to say tech stocks continue to have a strong tailwind at their back due to their sturdy business models, revenue, and earnings, despite the uncertainty currently in the market.

Tanner Howard

The 2020 Zombie Apocalypse

The term "zombie company" first popped up in Japan during The Lost Decade. Following the Japanese asset price bubble collapse in 1991, many Japanese companies were entirely propped up by Japanese banks throughout the '90s. These companies remained in business, but were so debt-laden that their cash flow generation seemed unlikely to ever dig them out of insolvency. Yet they carried on despite concerns, stumbling along like zombies for decades, and plaguing investors in the Japanese equity market (the Nikkei 225 Index still has not made new highs since its 1989 peak over three decades ago).

The term has been recycled over the years, most notably in reference to zombie banks perpetually bailed out by the US government following the Great Financial Crisis. In 2020, a new zombie outbreak is emerging. In nearly every conversation I've had with small cap money managers during the second half of this year, zombie companies are referenced at least once. However, it appears the definition of a zombie company has been altered slightly, and investors' appetite for these companies has ballooned.

Today's US small cap zombie company is highly leveraged, similar to the Japanese zombies of the '90s, but most are in a different stage of their life cycle. These are upstart companies that are unprofitable (oftentimes with zero revenue and/or no clear path to profitability), but carry explosive growth potential. While the exact definition is imprecise, a lot of managers use non-earners (companies with zero or negative profits) as a proxy for the present day zombies.

Unlike the mass aversion to the Japanese zombies of the '90s, retail investors and Robinhood day traders have been pouring money into these present day zombies that don't even make any money or generate positive cash flow. 10 years ago, non-earners accounted for less than 25% of the Russell 2000 Index. As of September 30, 2020, they account for over 40%. Some of this phenomenon is attributable to new IPOs, but the majority is due to the dramatic outperformance of this group in recent years, particularly 2020 year-to-date, a period in which non-earners in the Russell 2000 have returned +8.3%, while profitable companies have returned -14.4%.

Small cap asset managers are having a hard time justifying this outperformance or arguing how it can sustain itself. You could try articulating that the price multiples have become too high, but the multiples don't even exist. P/E is meaningless when the E is negative; P/R is incalculable when the R equals zero. We are hearing loud and clear that, even in a historically low interest rate environment, the zombie run has to revert to the mean at some point. Investing in high quality, profitable, low debt companies will have its day in the sun again. At least active small cap managers hope so, but that's where their money remains. One of the portfolio managers I regularly speak with probably put it best. When asked if he could define the term "zombie company", he said he could: "It's the opposite of what we look for".

Parina Sharma

Dawn of Value Investing?

Amid fears of COVID-19, election excitement, improving economic data, and hopes for a vaccine, there have been increasing discussions around a possible rotation into cyclical and value-focused sectors which has bought "Value Investing" into the limelight once again. With the Russell 1000 Growth Index returning 24.3% for the year as of Q3 2020, and the Russell 1000 Value Index yet to venture into a positive territory with a decline of -11.6%, growth stocks continue to significantly outpace their value peers. Despite the improving macroeconomic data combined with supportive monetary policy, value stocks have continued to face challenges, especially in a low interest rate environment which typically helps growth-oriented stocks.

However, the gap between the growth and value narrowed in third quarter with the growth index rising by 13.2%, while value stocks returned around 5.6%. Cyclical sectors, which tend to tilt toward value, did well in the quarter. It's also worth noting that Russell 1000 Growth Index, with its historically high concentration, has been predominantly driven by a handful of large cap growth stocks within the Technology sector. With the current P/Es standing at 30.5X for the growth index and 17.2X for value as of the third quarter, the valuation spreads between value and growth stocks are also at historical highs.

According to many managers, the huge dispersion in valuations is unsustainable and represents potential opportunities for investors looking to enhance portfolio returns over the long term. Many Technology growth stocks are currently trading at all-time highs and there is a possibility of EPS revision kicking in, which could trigger further rotations into other sectors offering all-time low valuations. In addition, value stocks historically tend to perform better when the market emerges out of recession. That said many of the "deep value" names, from big oil to financials, continue to struggle as they face secular challenges. Finally, the prospect of a "blue wave," a Biden Presidency with Democrats taking control of the Senate, could result in a greater fiscal stimulus that would likely broaden market returns and benefit the cyclical and value stocks. However, growth stocks may continue to dominate in the case of a split Congress.

Whether the decade long dry spell for the value investors might actually come to a halt, or at least slowdown post-election, is anyone's guess. What is becoming evident is that Wall Street is likely no longer a growth only arena. While many expect that growth will continue to outperform amid low interest rates, some of the strongest performing growth stocks in 2020 have slowed down lately. Looking forward, opportunities are likely to arise in growth as well as value, and it would be prudent for investors to broaden their portfolios to factor in current valuations.

Mike Wedekind

As Elections Approach, the Only Certainty is a Muni Wave

There have always been strong linkages between politics and markets. The United States' municipal market is no exception, with recent developments suggesting issuers in particular are responding to the deep uncertainty surrounding the outcome of the elections for President, US House of Representatives, and 35 seats in the US Senate.

Most notably, municipal issuance reached its 2020 peak of $55 billion in September, according to BlackRock. AB Asset Management forecasts October will be an even bigger month for issuance, which the firm expects to total $76 billion. This would outpace the previous monthly record of $71 billion in December 2017, immediately prior to the implementation of the GOP's Tax Cuts and Jobs Act of 2017, which eliminated tax-exempt advance refunding and threatened to curtail the use of private-activity bonds. In both instances, the expected volatility associated with a change in legal regime pulled issuance forward as issuers and underwriters sought to get ahead of any disruptions to their financing operations.

Many issuers are clearly opting for the relative certainty of today's markets versus the divergent potential orientations of power in Washington D.C. come 2021. As Breckinridge Capital Advisors notes, the most likely outcome of next week's elections is a Democratic trifecta, which the firm associates with more federal aid to state and local governments, substantial green infrastructure stimulus, higher benchmark rates, and potential changes to muni-related policies (e.g. SALT and the muni exemption). Breckinridge forecasts that less likely outcomes, such as the current status quo divided government or a scenario with a Democratic White House and House of Representatives along with a Republican Senate, would result in less significant infrastructure spending and a continuation of the current rate and regulatory regime as it applies to municipal debt.

Beau Noeske

How Investment Managers are Dealing with Pandemic Fatigue

"I need something to look forward to."

"It's a lot of stuff, and it's really exhausting."

"No one's not bored of this."

These quotes from a recent *Wall Street Journal* article (https://www.wsj.com/articles/pandemic-fatigue-is-realand-its-spreading-11603704601) from interviewees in the United States and Europe illustrate the strain felt across the globe brought on by the coronavirus. Risks have continued to mount in the increasingly monumental effort to balance social connection with adherence to best practices such as social distancing, mask wearing, and avoiding visiting friends and family. The emerging trend is what is known as pandemic fatigue, wherein even the most stringent rule followers from the onset of the COVID-19 pandemic can let their guard down. "The only way right now to handle this is political mandates on social lockdowns," an equity manager on Envestnet | PMC's Select List said. "But unlike South Korea or China, that's not how America does things. We're not built that way."

Much like this manager's perspective on America, investment managers cannot be evaluated with a uniform black box checklist. We must be mindful that there is great deal of psychology involved with studying investment management shops in addition to facts, figures, and track records. How are they coping with pandemic fatigue? What trends are they identifying within their portfolios distinguishing those companies which have weathered the pandemic well versus those which have not? A common response has been technology. One investment manager noted, "We are fortunate this is happening in the era we live in right now. This would have been an unmitigated disaster if it had happened 25 years ago." That said, technology has come at a price, as this manager also admitted, "People are getting burned out from working from home because they don't know when to stop."

Others have drawn parallels to the Financial Crisis and subsequent recovery. Namely, doing more with less. "It leads us to the question of, 'how did we get here?'" a large-cap equity manager explained. "When we look at our portfolio of companies, we can see now that some of these hidden costs accumulated during the good times and now are getting weeded out. Similarly, we've looked in the mirror and found that certain people have really stepped up and done more. For others, our senior team has asked what we can do differently to better engage those people."

When asked if these managers expect a vaccine to return a sense of normalcy, interestingly, most said no. Rather, the nearly uniform theme moving forward has been adaptability and the power to pivot. "Companies doing business today the same way they did ten or twenty years are in trouble," said one principal, going on to cite how rigid initiatives like General Electric's Six Sigma program improved efficiency but contributed to the company losing their edge in innovation and market share. Another

stressed the importance of a quality management team, be it understanding how supply chains could be disrupted to taking care of the firm's employees. Likewise, investment managers have found silver linings and crucial pivot points from cost saving on unnecessary office space, travel, and physical capital to better recruitment opportunities in hiring new employees with little regard to geographical location. As one longtime portfolio manager stated, "We'll be a different and better company in some respects after the pandemic."

Much like all of us impacted by pandemic fatigue, perhaps it is unsurprising to expect that those flexible investment managers with a willingness to self-examine and adopt new ideas may come out better on the other side.

David Hawal

Outperformance of Growth and Technology not Just a U.S. Phenomenon

By now, US investors are well aware of the dynamics that have shaped equity market performance in the decade-plus following the Global Financial Crisis. Growth stocks have dominated their value counterparts, much of which has been driven by a small number of technology stocks better known as the FAANGs. However, the average investor may be less aware that similar trends are developing among emerging markets (EM) equities.

In recent years, investors in emerging equity markets have witnessed growth dominate value by an extraordinary margin. Through the first three quarters of this year, EM growth stocks have outperformed value stocks by an astounding 26.6%, and over the trailing five years the cumulative return gap is a staggering 62%. This performance has been driven by a small handful of countries (China, Korea, and Taiwan) and companies (for example, Chinese internet stocks TenCent and Alibaba which represent nearly 14% of the MSCI EM Index). Just this past quarter, EM performance was so narrow that out of nearly 1,400 companies in the index, just two stocks (Alibaba and Taiwain Semiconductor) accounted for approximately 40% of the index's total return.

This market trend has created a massive tailwind for active EM managers who adhere to a growth-centric investment philosophy. There are certainly a number of demographics in place that argue for a skew towards growth in EM, and one could argue North Asian countries should be rewarded for having the most robust technology industries. However, such narrow market leadership introduces idiosyncratic risk in the event of a trend reversal. With that in mind, it would behoove investors to have a good understanding of where their EM exposure lies, particularly as it relates to high-flying technology names elsewhere in their portfolio.

Michael Pajak

Diversify With Tactical Asset Allocation

As market volatility has increased with concerns of a second wave of COVID-19 across Europe and the United States and political uncertainty remaining, we have seen an uptick in advisor inquiries for more flexible, tactical asset allocation strategies. Proponents of such investment strategies believe that the financial markets are never entirely in equilibrium. As a result, they attempt to add value through relative attractiveness or temporary market anomalies among asset classes or by mitigating risk. Understanding their nuances and differences is crucial to implementing them in an investor's portfolio effectively.

Tactical strategies typically leverage rules-based, quantitative models that use indicators such as the business cycle, fundamentals, momentum, and sentiment to forecast, trend follow, or identify regime changes within their investment processes. While there is often portfolio manager oversight and discretion on top of the quantitative models, each model's complexity, variables, parameters, and investment time

horizons can significantly impact timing decisions and the amount of trading. Therefore, for most tactical strategies, whipsaw, timing risk, and taxes due to high portfolio turnover are key items to note. We believe its best to complement a highly flexible, tactical manager with a more traditional, risk-based asset allocation. When implemented correctly, tactical managers with a consistent timing edge can help lower the correlation across an investor's portfolio and provide another layer of diversification.

The market environment has generally been a headwind for many tactical managers. Market trends have been quick to reverse, and traditional asset classes that tend to hold up better like, value and dividend-paying equities, have been down more and continue to trail their growth counterparts. Over longer periods, factors like these should diminish as market cycles change, and markets revert to their long-term averages, providing tactical managers opportunities. Tactical strategies require patience and are not for all investors, but they can provide further diversification and, in some cases, risk mitigation if used appropriately.

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