ENVESTNET PMC

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.

John Parsons

Is This the New Normal?

Given our conversations with asset managers, many have differing views on the length of the bear market but most generally agree that our world could look a lot different in the years to come. The challenge for investors is how to best position portfolios in this changing climate – this new "normal."

There have been some obvious winners due to the pandemic – Zoom, Peloton, Netflix, etc. Companies like these have seen increased market share and brand awareness in the near-term out of consumer and business necessity following widespread shelter-in-place policies. However, much of the societal changes in behavior will likely evolve slowly. They will not be as apparent until years from now, when we can reflect on how we used to do things prior to the outbreak. Nevertheless, the longer this goes on, the more long-lasting the changes will be and the greater the societal impact will be.

There had already been trends occurring toward things like home delivery and other alternative consumption habits; but consumer traffic patterns will likely shift permanently, as shoppers who are now experiencing the convenience these services provide. There are also broad implications across technology, employment, and commercial real estate, as workers and employers gain greater acceptance of the ability to work from home and appreciate less time commuting. In response to the economic crisis, we may also see new government regulations around required business continuity insurance, new labor guidelines, and changes to social programs.

The emergence of a "new normal" in behavior among consumers, businesses, and governments will present opportunities for asset managers and investors, but the timing and form of the change is not as clear. Innovation and disruption is continuing at a rapid pace in the US, creating winners and losers in a variety of industries. Rather than making predictions as to where these changes will occur, many active managers are instead relying on investment practices that allocate to companies with strong balance sheets and business models, which have management teams who have proven they can execute in all scenarios and take advantage of the change occurring around them.

Parina Sharma

Who Moved My Income? A Parable of Change.

The COVID-19 induced global lockdown has brought the operations of many companies to a grinding halt, and their focus has shifted towards conserving cash. Add in the oil crisis, and US companies are cutting dividends at a rate not seen since the Global Financial Crisis. A growing number of investors, who had turned to dividends for income in recent years as bond yields have sunk to historic lows, are now wondering how this is going to affect them. A Goldman Sachs study estimates the S&P 500 dividend per share to fall by about 25% during 2020, a sharp contrast to the 9% rise in the first quarter of this year. Companies in the Energy, Aerospace, Auto, and Tourism industries could be the worst hit while Consumer Staples, Utilities, and Pharmaceuticals sectors should be more resilient. US banks might reduce their distributions also, although their balance sheets are in much better shape than during the financial crisis.

The dividend yield of the S&P 500 was about 1.80% at the beginning of the year. If the yield decreased by 25%, US equities would yield about 1.35% for the year, which would still be attractive when compared to many other asset classes. As more and more companies cut dividends, prudent questions include what motivated these companies to cut their dividend and how strong are their balance sheets moving forward? Companies with high leverage or those that have been funding their dividends by means other than free cash flow are more likely to announce cuts or suspensions. Additionally, companies accepting aid as part of the CARES Act will have no choice but to suspend their dividend. On the flipside, it is also important to be aware of dividend traps and extremely attractive yields that may be unsustainable in the long run.

Dividend-focused portfolios holding high quality companies diversified across sectors are more likely to weather these markets. It remains to be seen if these conservative dividend policies are here to stay or if firms revert to their earlier behavior. However, what will be in focus for PMC in the coming months is our managers' ability to identify quality firms that can sustain dividend payouts even in troubled times, and thereby ensure investors continue to receive a steady income stream.

Michael Manning

Why Did My "Quality" Equity Manager Underperform?

It is true that many quality-biased active managers have underperformed so far amid 2020's pandemic-driven volatility, which at its surface seems counterintuitive. However, you need to dissect how portfolios are allocated from a P/E perspective to start to understand why. Quality managers typically have some form of a valuation discipline, generally looking for cheap or attractively valued stocks, meaning they typically are underweight ultra-high P/E (highest valued/priced) stocks. That bias has helped in most corrections historically, as highly valued stocks often correct the most as things get choppy, but that proved problematic during Q1's downturn.

In Q1, using a core large cap benchmark like the Russell 1000 Index, the highest quintile of P/Es in the index (P/Es of about 35X and above) were only down 10%, while the returns for the subsequent four quintiles, P/Es of about 23-35X, 16-23X, 9-16X, and <16X, were down about 13%, 19%, 29%, and 39%, respectively. This clearly created a massive gap in returns between high P/E and low P/E stocks. Similar trends occurred in small and mid-cap stocks. Because many quality managers simply do not want to "pay up" for stocks, they tend to be significantly underweight that top tier of P/Es. This is where names like Netflix, Amazon, Costco, and NVIDIA reside, along with many other tech related or health care names that are arguably benefiting amid COVID-19. This P/E bucket also includes the few stocks that posted positive returns in Q1. Lower P/E tiers tend to be where you find more cyclical sectors such as retailers, banks, hotels, airlines, etc. that are struggling in the current environment.

Without this context, investors would assume in a sharp down market like Q1, a quality, downside focused, lower valuation biased manager would surely outperform a high growth, high P/E biased manager, but exactly the opposite happened due to the types of stocks that occupy different P/E tiers. And so far in Q2, the dominance of high P/E stocks has persisted, albeit not to the same degree as Q1, but it seems this trend may continue to weigh on performance for quality biased managers.

Navaneeth Krishnan

High Yield Bonds: Caught between two bases – Fed buying & Energy sell-off

Enter the second quarter, corporate high yield (HY) investors already have two strikes against them. First being the covid-19 induced economic disruptions, which is expected to show-up in the fragile balance sheets of many high yield issuers, and the second one is the crude oil prices which has tanked well below the breakeven rates for most of the producers. However, when the pandemic threw a curve ball at HY investors, Fed stood true to its whatever-it-takes pledge by expanding its corporate bond-buying program to include 'fallen angels', bonds that have been downgraded from investment grade to HY and announcing its intentions to buy HY ETFs.

Let's take a re-look at the events that unfolded which prompted Fed to take this unprecedented step. While January passed uneventful, risk-on assets started to sell-off in February as the virus cases outside China started to spike. Meanwhile, drop in oil prices started to take toll on HY bonds. Sell-off in HY peaked in March which resulted in HY option-adjusted spreads (OAS) falling to 95th percentile (looking at history from 1994). The sell-off in Q12020 was so severe that OAS moved from the 9th percentile to 95th in a matter of 41 trading days. The market ended Q12020 with higher-quality BB-rated sector returning -10.15%, followed by the B-rated sector, which returned -12.97%. CCC-rated sector returned -20.55% in Q1.

Investor appetite started to return to HY markets almost a week before the Fed's intervention. Investors put on a record $7.1 billion in high yield funds in the week through April 1. Fed's action had an immediate impact on HY ETFs as they saw large inflows and NAVs swung back to premium. It also lend some floor to fallen angel's prices. Primary issue market, which was dead in March, sprung back to life in April and HY spreads retreated somewhat from its highs.

Even though there are some green shoots and signs of an early turnaround in HY markets, investors need to be prepared for additional volatility caused by quarterly earnings and potentially lower for longer oil prices posing challenges to energy issuers. HY default rates are expected to climb to north of 10% and the volume of fallen angels has already surpassed $150 billion this year. These conditions make us believe that, while Fed's support lends some temporary tailwind to ETFs, for long term investors, investing through active managers with proven capabilities in bottom-up credit selection seems to be the right approach to cut down on strikeouts.

Christine Kirk

Predicting the Shape of the Economic Recovery

As states and businesses start opening up again, there is a lot of discussion surrounding what is next for the economy. People often look to the market as a place to start. Earlier in the spring, initial ideas were surfacing that if the market had already hit bottom, then we were hopefully in for a quick V-shaped recovery. Improving market conditions may have initially been top of mind when setting expectations for the future of the economy, but many asset managers warn not to focus solely on the stock market or even look to it as a viable indicator.

The market is too heavily influenced by emotions and can falsely signal the underlying health of the economy creating a significant dislocation in the current state of the market compared to that of the economy. In fact, some managers are cautioning that the deterioration of the economy is significantly lagging what has already been priced in the markets and that the true damage from closing down the U.S. economy has yet to be seen. The April 2020 job report stated a U.S. unemployment rate of 14.7% and the number for May is expected to jump to over 20%. Numbers like this haven't been seen since the Great Depression. This is the kind of data that needs to be emphasized when predicting what the recovery will look like.

It should also be noted that even when the U.S. economy starts to re-open, we will be entering into a different world and facing a new normal. For many months to come, restaurants and retail stores will not be operating at full capacity. Social distancing will still be relevant as normal activities resume. Even with the re-opening of the economy, some people may feel safer staying at home. The tourism and airline industry are sure to continue to take a hit. Things will not operate like they previously did for quite some time, causing businesses to continue to suffer. A lot of damage has already been done, and it may not be completely reversible. Due to this, a U-shape recovery seems to be most likely. The optimistic views of a speedy recovery are losing popularity as more reliable data unfolds, but only time will tell.

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