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.

Eric Halverson

Opportunities Ahead in an Unsupported Corner of the Market

Entering the latter part of the second quarter, investors have seen quite the recovery in broad market asset prices. And while not quite back to February peaks, asset levels are further away from the late-March lows than many would have expected at this point. But not every area of the market has seen such a recovery, which depending on your viewpoint, could present opportunity or risk.

The high yield municipal market, a sliver of the already inefficient and liquidity-challenged municipal market, is one of the areas that hasn't received much love from investors or policy makers during the crisis and might be an area ripe for active management to add value. Puerto Rico and Tobacco bonds might be top of mind in this space, but in reality its sectors are diverse, and being able to pick through the rubble might prove fruitful.

With the broad high yield municipal market currently sitting at spreads roughly 350 basis points over investment-grade municipals (150 basis points above the historical average), market participants are pricing in a higher rate of defaults than has historically been witnessed. Default rates for high yield municipals have undoubtedly been higher than investment grade municipals, but roughly only a third to a half that of high yield corporates. Taken together, these two aspects seem to suggest a disconnect in expectations within a market where active management has maintained its edge.

There's no doubt allocating to lower quality areas of the market presents risks, but history tells us long-term investors have been rewarded, particularly in the wake of market selloffs where active managers have shown the ability to identify winners and losers.

Ed Zablan

EU Integration or Fragmentation

As we tally the economic impacts from global shutdowns, the Eurozone saw their Gross Domestic Product (GDP) contract by 3.8% during the first quarter, the worst quarterly drop since the bloc began collecting data in 1995. Although, by comparison, the US reported an even more grim contraction of 4.8%. Economists estimate that the EU's GDP is expected to contract by double-digits, in annualized terms, during the first half of 2020. While the near-term GDP decline will most likely exceed figures last seen during World War II, Europe's pandemic-induced lockdowns are widely anticipated to throw the continent into a deep recession.

The European Central Bank (ECB), like other central banks around the globe, is intent on expanding its balance sheet to restore market function and reduce volatility. The ECB's policy rate has been negative since 2014, when it was cut below zero to nudge banks to lend, rather than leaving deposits at the central bank. This negative interest rate policy has already handcuffed any further rate cuts since the global financial crisis of 2008. Instead, the ECB has responded with a new QE program called The Pandemic Emergency Purchase Program. The goal of this policy is to provide relief to banks and boost loans to businesses and households, as well as to support production and employment. This program earmarks €750 billion for corporate and sovereign bond-buying until the end of the year, in addition to the €120 billion decided on in March 2020. Together this amounts to 7.3% of euro area GDP.

The European Commission, the EU's executive branch, unveiled its latest plan to have the EU borrow up to €750 billion to distribute to member states as grants and loans. This plan would involve joint debt issuance by EU member nations, and would represent the first time that the Euro Bloc raised large amounts of common debt in capital markets, taking the EU one step closer to a shared budget, potentially paid for through common taxes. This proposal requires unanimous approval from member countries and their parliaments.

Drawing on the insights of one of our active managers, they believe a failure to pass this proposal to help the EU's most impacted members would hurt not only their economies, but also regional politics, and societal attitudes, ultimately causing the bloc to lose clout on the world stage. With Britain already gone from the EU, the calamity brought on by the virus has accelerated political discord and brings the potential to splinter the union. Anything less than a bold response from EU leaders risks inviting another kind of crisis, one of legitimacy.

Deepankuran Kumarapuram

Small Caps – Can the Past Be a Prologue?

Despite rebounding by nearly for 45% from their March 18 low, small cap stocks, represented by the Russell 2000 Index, are down around 15% for the year and have underperformed large cap stocks (the Russell 1000 index) by roughly 10% (as of June 3). This is not a surprise as small cap stocks tend to be more vulnerable to recessions due to their higher leverage, volatile cash flows, and dependency on the domestic economy. However, historically small caps also have been the leading asset class when markets recover, for example, in the rebound phases following the dot.com bubble (Oct 2002 - Sep 2003) and the financial crisis (March 2009 – February 2010), the Russell 2000 Index outperformed the Russell 1000 Index by around 11% and 8%, respectively. Perhaps it is a little counterintuitive, but small cap stocks have also historically tended to outperform large caps in periods of slower and negative economic growth.

So how are active small cap managers responding to the COVID-19 pandemic? Many managers have used the sell-off as a buying opportunity. They believe that their companies are actually better positioned for the future because weaker competitors are going to be more negatively affected by this crisis. Of course,

they are also reassessing their investment premises to determine if their original investment thesis remains intact. Amid these times where a company's capacity to raise capital is severely challenged, managers are focusing on companies with solid balance sheets that do not need to raise capital in the near term, and are also stress-testing companies' leverage ratios. Managers with larger cash positions coming into the sell-off have been in a more comfortable position with regard to meeting redemptions and have more ammunition to take advantage of attractive buying opportunities. As for liquidity, managers don't see any issues getting in and out of stocks at the moment, but do see a lack of depth in trading that can result in big price swings.

There is high probability of a permanent change in consumer behavior and market landscapes post COVID-19. The current recession is an opportunity for active managers in a number of industries, those that can adapt quickly to this new normal. In the meantime, Envestnet will continue to monitor our managers' discipline, long-term focus, as well as their flexibility to take advantage of new opportunities as they emerge. If history is a guide, when the markets recover, small cap stocks have a good shot at leading the way.

Navaneeth Krishnan

Preferred Securities: Still Preferred, but the Recent Sell-Off Warrants a 'Look Under the Hood'

Preferred securities have been an attractive asset class for 'yield starved' investors as these instruments generally offer higher yields than traditional fixed income securities. Moreover, being 'hybrid' investments, they exhibit the characteristics of both common equities and bonds. The typical investment universe for asset managers in the preferred stock category comprises traditional/hybrid preferreds and contingent capital (CoCo) securities issued by US and non-US issuers, the majority of which are banks and insurers. Preferred securities have attracted meaningful investor assets in recent years, most notably in 2019, which marked the most significant year of inflows into the category over the past two decades at nearly $5.5 billion.

Returns in Q1 of 2020 ranged from -8% to -16%, with sectors like CoCos exhibiting higher drawdowns than US high yield bond markets. $25-par securities were adversely impacted by the sudden sell-off from retail investors and ETFs, while a sharp drop in interest rates hit the values of $1000-par securities. The COVID-19 battering of Eurozone countries resulted in especially large negative returns in CoCos, many of which are issued by European firms. Although a sharp rebound in broad equity markets in April supported a strong recovery in $25-par and $1000-par preferreds, continued weakness in the European banking sector dampened the recovery in CoCos.

The forward outlook of the active managers we cover in this space is mostly positive. Although the economic toll of the pandemic is expected to adversely impact banks' earnings, most managers believe things are much different from the last recession in 2008. Since the 2008-2009 Global Financial Crisis, banks are better capitalized and regulated, and are subject to periodic stress testing. In order to preserve capital and support borrowers, large banks across the globe have stopped or cut dividend payments on their common stock and have refrained from repurchasing shares. However, most managers believe that banks will not halt scheduled payments on their preferred stock as such measures are taken only during extreme solvency situations. Additionally, insurance companies, which generally boast strong balance sheets, are expected to be adequately capitalized despite the adverse economic conditions caused by the pandemic.

Although preferreds and CoCos have managed to recoup some of their losses in April and May, their susceptibility to larger drawdowns relative to traditional fixed income assets (as witnessed in Q1), coupled with a muddled economic outlook, serves as a reminder for investors to take a deeper look into their portfolio exposures to determine whether preferred stocks fit their risk profile and investment goals. While

many of the larger banks and insurance companies are adequately capitalized, risks lurk in regions like peripheral Europe, especially if the pandemic proves to have prolonged effects. Investors should also keep in mind that capital securities like CoCos are prone to regulatory risks that could potentially result in equity conversions or principal write-downs. For these reasons, we advocate for active management in the space as security selection could play a pivotal role in performance over the near-term.

Suresh Ramasamy

Does Diversification Have Benefits or Is It a Myth?

The recent pandemic-induced market crash saw an unprecedented rise in correlations between multiple asset classes. This has rightly brought back into focus the benefits of diversification. As markets started to unwind in March, the correlation among different asset classes started to increase as almost all assets, including alternative assets, started to decline. Even gold, the traditional "safe heaven", also tumbled alongside the traditional asset classes. However, this phenomenon of converging correlations and the resulting ineffectiveness of diversification isn't new. During the great financial crisis in 2008, similar observations were made when correlations converged.

Typically, when equity markets correct, the Fed intervenes with interest rate reductions, which supports fixed income markets. However, this time around, with interest rates already at historic lows, the Fed was left with less monetary policy influence. To add to this, credit events or concerns about potential credit events acted as a further headwind for fixed income investments that increased the overall correlation between equities and fixed income.

One of the most puzzling problems in investment management is that diversification seems to disappear when investors need it the most, during a market crash. Historically, there is evidence of increased correlations in global financial markets' returns during bear markets. The past couple of months have served as an unpleasant reminder of this. However, history has also shown that correlations drop when volatility in the market comes down. Many managers believe that the market dysfunction caused by the impact of COVID-19 is short term in nature and this is not the right time to let your behavioral biases take over and sell assets. Correlations may spike during market corrections, but this is the time to stay invested and focus on your long-term financial goals.