INTEGRITY COMMITMENT EXPERIENCE

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Global Equities

5 investment lessons from the pandemic

As an investor with more than three decades of experience, the past 16 months stand out in my career as both intensely painful and incredibly instructive. On or about March 23, 2020, the Standard & Poor's 500 Composite Index and MSCI All Country World Index hit bottom, establishing the fastest bear market in history as the COVID-19 pandemic spread across the globe.

Last week, in stark contrast, equity markets hit new record highs, bringing us full circle from the depths of 2020 to the heights of 2021. Given these remarkable milestones, I thought this would be an opportune moment to share some of my learnings from this most unusual time in history.

I'll start with a brief summary of my mindset as we entered the plague year. In late 2019, I felt confident that the markets were well positioned for a period of strong returns. Inflation and interest rates were low and looked likely to remain so. Banks were eager to lend, and companies seemed willing to invest in productive capacity again — as opposed to share buybacks and questionable acquisitions.

True to my beliefs, I entered 2020 invested as suggested above, with little cash and plenty of cyclicality reflected in my largest holdings. In less than three months, as the global economy came to a virtual standstill and fear gripped the markets, my pro-cyclical positioning looked problematic to say the least. But context is important. And to understand that, it helps to understand my investment style.

Investors move from courage to fear

Source: The Leuthold Group. As of 6/30/21. The Courage/Fear Investor Ratio is developed by The Leuthold Group and shows the relative return of a "Courage Portfolio" over a "Fear Portfolio." The Courage Portfolio averages returns of the Russell 2000 Small Cap Index, MSCI Emerging Markets Index, CRB Raw Industrials Index and S&P 500 cyclical sectors. The Fear Portfolio averages returns for the U.S. Dollar Index, gold prices, S&P 500 Low Volatility Index and 10-year Treasury.

Friends and colleagues sometimes say, “Steve is the kind of guy who runs into burning buildings.” I find that a bit extreme, but it’s true that I am a contrarian investor at heart. As long as I’ve been in this business, I have believed that the market swings from excessive enthusiasm to extreme pessimism. An investor with a reasonable degree of objectivity can benefit from selling the former and buying the latter.

It’s an approach that has served me well for the past 30-plus years, but it also frequently causes pain and tends to pay off mostly during the early stages of market upturns, as pessimism gives way to optimism. Warren Buffett said it best: Be fearful when others are greedy and greedy when others are fearful.

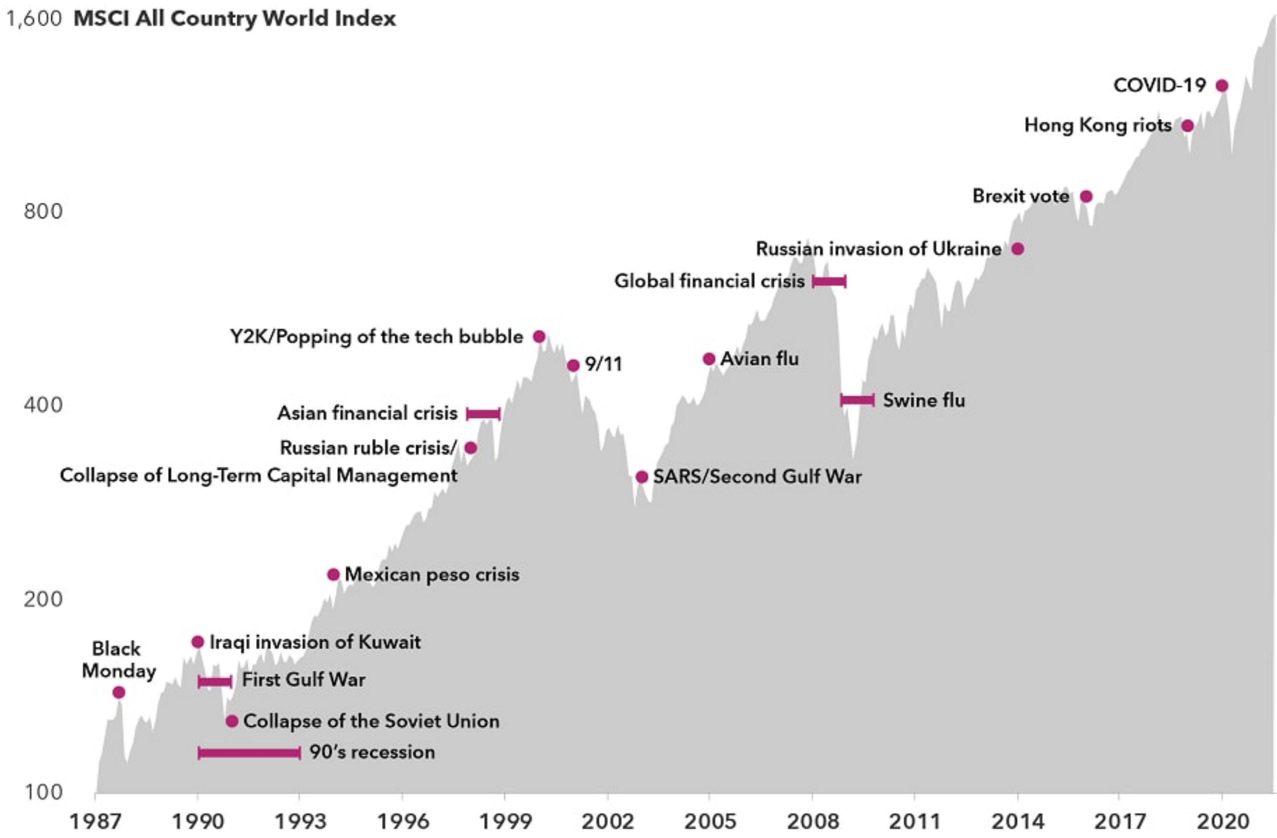
That’s me in a nutshell. Now, here are five lessons I learned or relearned in the pandemic that I’m using in my portfolios today:

1. Market crises are inevitable

The advent of the pandemic-driven stock market crisis led me to think of past market traumas I have experienced. I counted 21, including the collapse of the Soviet Union, the bursting of the technology bubble, the global financial crisis and now COVID-19.

I offer this list of events only to highlight the fact that market disruptions are a fact of life for investors. It’s just a matter of time before the train runs off the rails. My list suggests we get one of these events every 18 months or so.

Market disturbances are a fact of life for investors



Sources: MSCI, RIMES. As of 6/30/21. Data is indexed to 100 on 1/1/87, based on MSCI World Index from 1/1/87-12/31/87, MSCI ACWI gross returns from 1/1/88-12/31/00, and MSCI ACWI net returns thereafter. Shown on a logarithmic scale.

No one could have predicted the pandemic but, in hindsight, it would have been wise to consider the chance that something would come along and disrupt the incredible bull market of the previous decade. If history is any indication, it would also be wise to believe that we'd get through it and emerge stronger on the other side. And, indeed, we have so far.

2. Interpreting history isn't an exact science

This relatively short list of events offers other important lessons, as well, including the fact that history does not necessarily repeat itself in ways you might expect. It's easy to draw false parallels, and I did exactly that during the early months of the COVID crisis.

For instance, I lived in Hong Kong through the dark days of the SARS (Severe Acute Respiratory Syndrome) epidemic in 2003. I was quick to make overly simplistic comparisons between SARS and COVID. But while SARS was terribly frightening to live through, relatively speaking, it was a fairly minor event. Drawing conclusions about COVID from the SARS experience proved to be a mistake, leaving investors unprepared for the extent and duration of this pandemic.

I will add that I was also similarly surprised by the swiftness and power of the governmental response – both fiscal and monetary – to the COVID crisis. That response arguably helped minimize some of the damage to my pro-cyclical positions during the early months of 2020.

3. Growth or value? Both, at the right entry point

While I acknowledge some discomfort with the overly broad and vague labels "growth" and "value," I'm going to use them here even as I agree that they lack nuance. The fact is, my fairly limited selection of growth-oriented stocks saved my skin during the worst days of 2020. These included some technology shares, particularly in the semiconductor industry, as well as some consumer-oriented internet and e-commerce companies.

Despite my value bent, I remain a strong believer in the resilience of the tech sector. Entry point is important to me; therefore, many of my tech-related investments are long-term holdings initially added before the market recognized their potential. I like to purchase shares when they are down and out, but I also like to hang on long enough to let the market catch up with what I think is the true value of the company in question. As a result, some of my holdings today don't look contrarian, but they likely did at one time.

As these stocks rallied amid the pandemic, I gradually trimmed some of them to make room for more unloved areas of the market, including energy, financials and travel.

4. Dividends help pay the rent

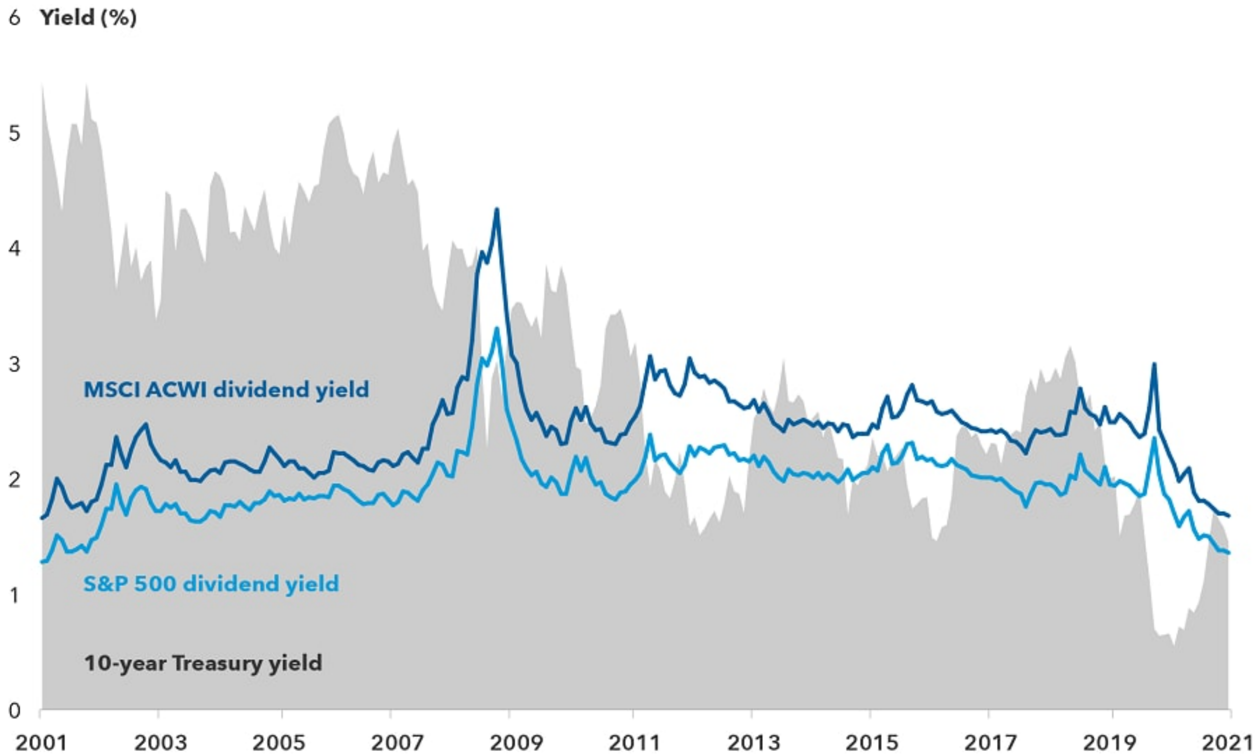
Speaking of unloved areas, I have long placed an emphasis on dividends as the principal mechanism for the transfer of value from a company to its investors. I've also maintained the expectation that dividends will continue to serve as a stabilizing factor during times of market turbulence.

Sadly, the latter characteristic has been weakened over the last decade and seemed to fall away completely at times in 2020. But I'm not willing to say that yield is useless. Our current unprecedented monetary conditions, coupled with the market's devotion to fast-growing, society-changing companies, have tossed aside lots of historical norms.

That said, I do not think the value of the dividend as a wealth-transfer mechanism linking companies and investors has ended. In my view, it is more important than ever. And I continue to hold a number of high dividend payers, as well as dividend growers, in my portfolios.

Simply put, I loved dividends before the pandemic and continue to love them now. The shares in my portfolios, like my own children, should pay rent to live with me.

Dividend-paying companies are an important source of income



Sources: MSCI, Refinitiv Datastream, Standard & Poor's. As of 6/30/21.

5. Dr. Copper delivers a healthy diagnosis

My outlook, as wrong as it was in the first quarter of 2020, hasn't changed much today.

Just as the markets have come full circle, I find myself feeling much like I did in late 2019: I am still fully invested and I expect global markets to be higher a year from now. My portfolios are still characterized by a pro-cyclical tint, meaning I favor companies that I believe will benefit from a reacceleration of global economic growth.

I could be wrong, of course, but I feel heartened by the diagnosis of Dr. Copper. Copper, as you may have heard, is the commodity with a PhD in economics, given its keen ability to help predict the path of the global economy. Copper prices bottomed in late March. They are suggesting now that the economy is mounting a strong recovery and will likely continue to do so. Copper may also be warning about mounting inflationary pressures, but for the time being, I do not see inflation, or higher interest rates, as a threat to global equity markets.

Copper prices indicate the economy is in good shape

Source: Refinitiv Datastream. As of 6/30/21.

I am also finding more attractive opportunities outside the U.S. In my view, the rest of the world, particularly emerging markets, are currently far more attractive from a valuation perspective than the U.S., and my portfolios generally reflect that view.

In short, we now have all the elements, once again, that I was so confidently wrong about in late 2019 and early 2020. A critic might say that I have trouble learning my own lessons. But I would respond that perhaps the plague year was an anomaly. And perhaps we can now live again with investment styles influenced by market history, and place a greater emphasis on the expectation of a return to historical norms.

It's possible even — dare I say it — that growth is ready to pass the baton back to value and non-U.S. markets are poised to outpace the U.S. in the years ahead.

We shall see.

Steve Watson *is an equity portfolio manager with 33 years of investment experience. He has an MBA and an MA in French studies from New York University as well as a bachelor's in French from the University of Massachusetts.*

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The market indexes are unmanaged and, therefore, have no expenses. Investors cannot invest directly in an index.

Standard & Poor's 500 Composite Index is a market capitalization-weighted index based on the results of approximately 500 widely held common stocks.

MSCI All Country World Index is a free float-adjusted market capitalization-weighted index that is designed to measure equity market results in the global developed and emerging markets, consisting of more than 40 developed and emerging market country indexes.

MSCI Emerging Markets Index is a free float-adjusted market capitalization-weighted index that is designed to measure equity market results in the global emerging markets, consisting of more than 20 emerging market country indexes.

MSCI World Index is a free float-adjusted market capitalization-weighted index that is designed to measure equity market results of developed markets. The index consists of more than 20 developed market country indexes, including the United States.

Russell 2000 Small Cap Index measures the performance of 2,000 small cap stocks.

CRB Raw Industrials Index is a price index constructed from a basket of various industrial commodities.

S&P 500 Low Volatility Index measures the performance of the 100 least volatile stocks in the S&P 500.

U.S. Dollar Index is a measure of the value of the U.S. dollar relative to the value of a basket of currencies of the majority of the U.S.'s most significant trading partners.

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