Premise Capital
STAY ON THE CURVE™

4th Quarter 2020 Market Commentary

Premise Investors,

2020 will stand out in people's memories for decades to come. The markets began the year at all-time highs with only the distant election as a source of potential future risk. The pandemic was unimaginable and would cause market movements that were unprecedented in both scale and duration. As discussed in previous updates, the swiftness of the sell off from extended market highs caused an exit near 20% down in a market pullback that would eventually reach 35%. While that is nearly double the 10-12% drawdown we usually see before an exit, it was not unheard of when looking at historical price action. This is the main reason we keep a diversified portfolio and recommend using tactical strategies that allow you to control your exposure. With any strategy, the market can drop very quickly and what you are holding on any given day defines the riskiness of the portfolio. In a disaster, it is impossible to get out of risky assets quickly enough to protect the downside.

Almost all market pundits, fund managers, TV traders, and business news personalities were not only caught by surprise by the swiftness of the selloff but were convinced that lows would be retested after the March bottom. All through the summer, the market marched higher and investors were bombarded with calls for a retest of lows. Business stations spread gloom and doom. Reports stated that the almost complete economic shut down in the 2nd quarter, and the likely 2nd wave of infections and deaths would surely bring the rising market back to reality.

That did not happen. After a sell off that contained the largest and quickest down moves on record, the recovery gave us unparalleled movement back up. First it was the tech stocks. As the initial dust settled, companies like Zoom and Amazon were benefiting from the stay-at-home orders. The virus sped the adoption of all things "online" and some market segments showed strength. Still, no one wanted to be invested. FAANG stocks were hitting highs and pundits said that the market capitalization of the mega cap stocks was allowing the indices to go higher, but the economy was still in trouble. Reality would surely set in and the FAANG's would fall as the true economic woes became apparent. That also did not happen. As we moved into fall, the election loomed and many investors remained on the sidelines as the political risk outweighed the desire for return, especially considering the sizable bounce that just occurred. The market marched right through the post-election turmoil to new highs.

Looking back at that price action and tying it to allocation decisions can help in understanding tactical decision making. As the market rallied, each call to "have some dry powder" would have been the wrong move as you would trail the market as it moved upward. Each dollar not invested would be a dollar that did not enjoy the subsequent up move, and therefore, cause a reduction in return. Every business personality that clamored for holding cash would end up in two categories. They either underperformed the markets by the amount of cash they held, or they had to take more risk on the upside when they decided to get back to full exposure. At our inception, we decided that taking that extra risk was not a technique we would follow and therefore, fell into the first bucket. This is not to say one is better than the other. We just felt investors needed a tactical option that allowed for risk control as most other managers choose to take concentration bets or employ other risky behavior to make up the spread. We looked at it as doubling down after being wrong. That works great if you are right the second time. It is not so good if you are not.

In 2020, there was always a reason to not be invested. Buying and holding outperformed trend following strategies, but it always does when the market bounces back to highs after a sell off. Buying the dips would have worked great as well but requires you to have cash uninvested upfront and shares the same risk profile as buy and hold in a disaster. If you end up having a major down move like the one in 2000, which did not see new highs until 2013, you will get destroyed.

We know that most markets tend to go up most of the time, and over time, which is why we recommend our strategy as a piece of a majority buy and hold portfolio. Tactical management is for the times that it does not. That does not mean that it protects in all down moves. A system that never loses money when the market goes down but always wins when it goes up does not exist. There is always a tradeoff. It is a balancing act that asks, "what do I want to avoid and what is the cost for that avoidance."

The event we are trying to avoid is the devastation of a prolonged down market and its effect on wealth and lifestyle. The type that was experienced in 2000 and 2008. If you were 20 years old in 2000, you could have ridden it out and never thought about it. What if you were 55 with a few more years to retirement? Would you have been able to watch your nest egg get cut in half twice and finally get back to even at age 68? Is there some portion of your portfolio that would get out in case 20% turns into 50%, or 50% goes even lower? Of course, there is a cost to that. The cost is underperformance when a disaster does not occur.

With our methodology, tactical management defines the amount of money you want to take off the table when the market is down 20%. Its value would be easily understood if the virus is deadlier and more transmittable as was expected, and instead of stopping at 35% it drops 50% or more. It is even more apparent if the lingering economic destruction takes years to reverse. Trend following tactical is a buffer for prolonged pullbacks that, instead of bouncing to highs in three or four months, take 13 years to recover and have multiple pullbacks of 50% as happened in 2000.

It really is all about process and sticking to the plan made before the turmoil. You make the decision ahead of time about the maximum equity exposure you desire, and how much of those equities you would like moved to the side if it looks like a disaster is on the horizon. When the market was down 20%, we exited. When it was down 35%, you had cash on the sidelines and a predetermined amount of buy and hold money that was still at risk. It could have easily run down 50% or more.

Now is a great time to do the exercise with your investment portfolio. Take the amount of your portfolio in equities and chop it in half. What does that do to the value of the nest egg? If that number is too much to digest, you have two choices: hold less equities, or do something different. That 'different' can come in the form of many types of alternative investments like tactical strategies, structured notes, or buffered ETFs. They approach the issue in different ways but, like reducing equity exposure, all share the common characteristic of exchanging upside for downside protection. The trade-off table is different for each product and all can play a part in good portfolio construction that diversifies styles as well as asset classes. For portfolios, the amount of 'different' that requires a daily liquid product with a clear execution price, uncapped upside that can act like a diversified basket with respect to risk and return, and diversification across many asset categories, we think our tactical is the best answer.

Over the nine years we have managed these models, the returns have been very close to the benchmarks, while at the same time having moved money aside during every major potential disaster. Over that period the market always came back, but in those nine years when markets were on the shakiest ground, our investors had money on the sidelines.

Ask yourself this. If you received 1,000,000 dollars a week before the November election that needed to be invested would you buy the SP500 or would you wait for the results and then buy. You know that at the end of the year you will have a definitive result for the SP500 and can judge the decision on whether it worked or not, but is that really a sign of underperformance? It is simple to look at the potential outcomes since it is a fixed period and a single piece of event driven risk. You do not look at that decision the same as other performance decisions because it is not just about making money at that point. There is something else at play.

If you believe that buy and hold is the only management style needed, you will buy 1,000,000 worth of the SP500 before the election.

If any part of you thinks that you should wait for the result and then invest, you are accepting some level of underperformance for removing risk. This is not the risk that shows up in traditional portfolio analysis in statistics like standard deviation, although it could. Also, you are not exchanging underperformance for over performance, even though that could happen if the election result caused the market to go lower and you entered at a price lower than on the initial day. You are looking at the potential for a disastrous event that could dramatically affect your nest egg and simply waiting for it to pass without caring about the resulting consequence to return.

Having a portion of your money invested tactically, or in other alternatives, can be like making that type of decision. In the real world, risk events can occur at any time and everyone's time horizon is different, so the makeup of everyone's portfolio is different. A portfolio should have a set equity to fixed income ratio along with varying types and amounts of alternative investments that meet the needs of the investor. For our piece, we use an algorithm that tries to predict when prolonged down moves could occur based on the price action of significant moves away from the current uptrend. We look at the results of combining our model with a majority buy and hold portfolio and see benefits over the long term when these disaster events are more likely present. Since each component of a portfolio has a differing payoff model and are included for the way those models interact with each other, calculating the piece that performed best in the short-term market environment is possible, but as defined above, does not reflect the reasons you are holding them to begin with.

While large drops can occur overnight, we looked at the major prolonged market pullbacks and formed a trend following methodology that acknowledges it will get wiggled, but also will not sit blind as the market slowly deteriorates. The sell off, and subsequent bounce, were the fastest on record. It was an interesting time because no one had the 'information advantage'. When information on the virus was a complete unknown, the market dropped. At some point, bets were made that it would not be the disaster people were predicting, but those were bets. It was a huge gamble to stand in the face of the 35% pullback and start to buy. It was a bet, but not a bet on the market. It was a bet that the virus would not be as bad as predicted, because if the death rates were even close to the millions that were predicted, the market would have looked very different. This was the dilemma facing investors at the beginning of the year. Most of the time, you will find smart people on both sides of every market move. This time, most were wrong. Following the process and having a large, predetermined portion of your portfolio in buy and hold, and a defined slice that will exit is how we suggest dealing with the dilemma.

The truth is markets can fall very quickly as seen in 1987, and now 2020. They can also roll over slowly as they did in 2000 and 2008. We know that getting out from extended market highs will cause our drawdown to be more than we like but taking money off the table still has a value regardless of its effect on return. Most analysts were saying it was going to get worse, both from an economic and human standpoint. They began looking past the dot com bubble and housing crisis and started comparing the potential move to the Great Depression. Unbelievably, it was back near highs 5 months later. Our system does not do well in fast dropping markets, but the fast upward movement while being underweight equites was the main cause of underperformance. The cost of trying to protect from prolonged down moves and the market malaise that sometimes follows, is underperformance in fast dropping markets that incredibly are sitting at new highs within a few months. The movement in both directions was not the type of activity we saw in 2000 or 2008. While the selloff in 1987 was rather quick like 2020, it took almost 2 years to reach new highs. Incidentally, the Great Depression took about 3 years to reach the bottom and fell over 89% from its high in 1929. It did not reach highs again until 1954.

As far as returns for the 4th quarter, our models have been very strong compared to the SP500. We followed our process and unemotionally increased equity exposure in June of 2020 even as everyone hated the idea of being in the markets. The benefit of following a process is that it also tells you when to get back in the markets and that made all the difference at the end of the year. Our diversified equity did well against the SP500 as emerging markets, small cap, and mid cap equities all reverted to the longer-term expectations of providing more return to compensate for their increased risk. While diversified equity baskets have underperformed the SP500 juggernaut in recent years, having a diversified equity basket is a long-term decision that was made at the onset to reduce concentration risk, and should also outperform over the long run.

If there are ever any questions, we are always available for deeper look through and thanks for your continued confidence in Premise.

The Premise Team