

# INVESTMENT REPORT



**LYNCH FINANCIAL GROUP LLC**  
— Retirement Wealth Management —

October, 2020

[www.LynchFinancialGroup.com](http://www.LynchFinancialGroup.com)

## Investment Review and Outlook

**The S&P 500 Index rose 8.9% in the quarter and has recovered all its losses for the year.**

**Mega-cap growth names continue to lead the U.S. market.**

**Developed international stocks gained 6.0% this quarter.**

**Emerging-market stocks outperformed U.S. stocks with a return of 10.2%.**

**With Treasury yields unchanged, core investment-grade bonds gained 0.6% in the third quarter.**

**Our watchwords for portfolio construction and positioning remain balance and resilience.**

*We welcome questions or comments regarding this newsletter at [dlynch@lynchfinancialgroup.com](mailto:dlynch@lynchfinancialgroup.com). Lynch Financial Group provides Retirement Wealth Management Services to individuals within 15 years of retirement, retirees, and surviving spouses. We also provide specialized assistance to professionals, fiduciaries and heirs in wealth transfer situations.*

### Third Quarter 2020 Market Recap

Despite some choppiness in September, equity investors were treated to solid gains during the third quarter. The S&P 500 Index rose 8.9% in the quarter and has recovered all its losses for the year. Underneath the surface, mega-cap growth names continue to lead the U.S. market. Without the astonishing 42.5% year-to-date price return of the six so-called FANMAG stocks (Facebook, Amazon.com, Netflix, Microsoft, Apple, and Google/Alphabet), the S&P 500 would still be down for the year.

The outperformance of these top names means they now dominate the index. Market concentration is not unusual, but with the top 10 stocks in the S&P 500 making up 28% of the index, it's extreme today. The important investment takeaway is to not be lured into chasing the returns of what has worked well in the recent past. These companies' outsized past returns have come from their ascension to the top, not from owning them once they were already there. Owning the largest stocks has badly lagged owning the diversified index over time.

Nevertheless, this U.S. mega-cap growth effect is driving the outperformance of U.S. stocks versus foreign stocks this year. Developed international stocks gained 6.0% this quarter, almost three percentage points behind U.S. stocks, though, emerging-market stocks outperformed U.S. stocks with a return of 10.2%. Both groups still trail U.S. stocks year to date.

Some of this relative performance is deserved. Unlike in the dot-com era, today's large

### Maintaining Balance & Resilience Amid the Uncertainty

Given this macro and market backdrop, the risks and unknowns, and the wide range of potential outcomes, our watchwords for portfolio construction and positioning remain "balance and resilience."

Maintaining broad portfolio balance and diversification across multiple dimensions is particularly important right now. In doing so, we believe our portfolios provide the potential for strong returns in our base case and more optimistic economic scenarios,

*Continued on Page 4*

### Benchmark Returns (Periods Ended 9/30/2020)

	Quarter	12 Months
<b>Large-Cap Benchmarks</b>		
Vanguard 500 Index	8.9%	15.0%
Russell 1000 Growth iShares	13.2%	37.2%
Russell 1000 Value iShares	5.5%	-5.1%
<b>Mid-Cap Benchmarks</b>		
Russell Midcap iShares	7.4%	4.4%
Russell Midcap Growth iShares	9.3%	23.0%
Russell Midcap Value iShares	6.4%	-7.5%
<b>Small-Cap Benchmarks</b>		
Russell 2000 iShares	4.9%	0.3%
Russell 2000 Growth iShares	7.1%	15.6%
Russell 2000 Value iShares	2.6%	-15.0%
<b>Other Benchmarks</b>		
Vanguard Developed Mkts Idx	5.6%	2.0%
Vanguard Emerging Markets	9.0%	9.6%
Vanguard REIT Index	1.3%	-12.3%
Vanguard Total Bond Mkt Index	0.6%	6.9%
Credit Suisse High Yield Index	4.9%	2.0%

## Investment Review and Outlook (Cont.)

U.S. growth firms have created real economic value. This has come at a time when growth has been scarce and interest rates low, so investors have been willing to pay up for their growth. That said, a durable economic recovery taking hold could be the catalyst for investors to turn away from these highflyers and favor undervalued stocks in out-of-favor industries and overseas markets.

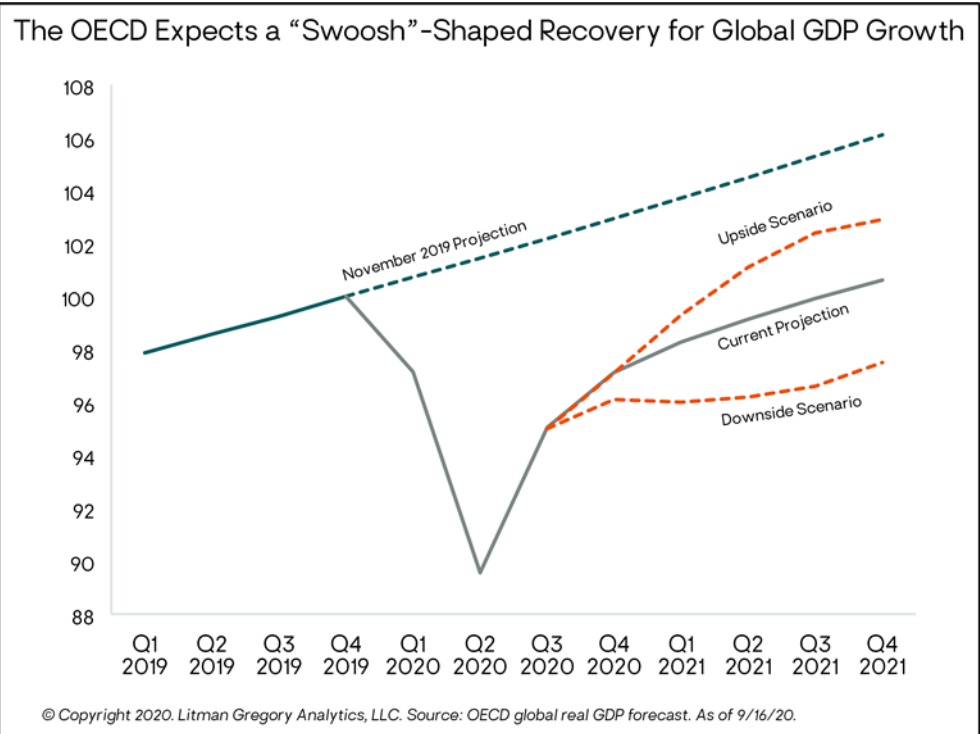
Bond markets were calm throughout the summer, thanks in large part to the Federal Reserve's extremely accommodative monetary policy. Treasury yields were unchanged, and core investment-grade bonds gained 0.6% in the third quarter. Fed officials say they are now targeting "average inflation" of 2% and have signaled that they do not expect to raise rates at least through the end of 2023. Since inflation has not topped the Fed's target in a decade, many market participants expect low rates and supportive policy to continue for a long time. In riskier segments of the bond market, high-yield bonds and floating-rate loans were each up over 4% but remain slightly negative for the year.

Going into the final quarter of 2020, multiple crosscurrents and uncertainties are presenting both investment opportunities and risks, over the near term and medium to longer term. A unique U.S. election approaches in November. The market doesn't like uncertainty, so the weeks leading up to the election and afterward may be volatile. But history shows any election-year declines are usually short-lived and the political party in power is not a significant driver of investment returns. Political views have no place in our investment process, and we don't attempt to predict the short-term market reaction to elections (or any short-term event). There are simply too many *other* factors that impact markets over time. Instead, we stick to our longer-term analytical framework in which we consider and weigh multiple macro scenarios and assess the potential risks and returns for numerous asset classes and investments in each scenario. The fundamentals are what really drive long-term market performance.

Looking through the election, there are reasons to be cautiously optimistic about the investment prospects for global equities and corporate bonds. And there are reasons for caution.

### Reasons for Optimism

An economic recovery *is* underway. Economic data and forecasts are improving (see the growth projections from the Organisation for Economic Co-operation and Development, or OECD, in the chart above). All else equal, rebounding economic growth here and abroad should support equity and corporate bond markets.



On the virus front, the speed of progress in vaccine development is promising. An effective and widely distributed vaccine would allow economic activity to return to its full pre-pandemic potential.

And this year's extraordinarily supportive monetary policy (asset purchases and lower interest rates) and huge fiscal stimulus, both here and abroad, were key drivers of the speedy recovery in markets and the glob-

## Investment Review and Outlook (Cont.)

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al economy. Central bank actions and government spending don't *guarantee* the absence of volatility, another bear market, or recession. But there are programs now in place, especially in the United States, that could step in to help the functioning of markets and the economy in case volatility returns or setbacks occur.

### Reasons for Caution

It remains to be seen how strong the actual economic recovery is and how much of it is already discounted in current prices. In our view, there is as much room for disappointments as there is for positive surprises.

While vaccine development steams ahead, the potential remains for a large resurgence of COVID-19 in the fall and winter months. We are seeing this already in Europe, and the infection rate has popped up slightly here in the United States recently. This raises the risk of renewed shutdowns and another economic downturn.

Monetary policy is supportive, but more fiscal support from Congress is likely needed to further protect citizens, help businesses survive, and shore up state finances. If it doesn't happen, it will be a hit to fourth quarter economic growth, which could in turn impact markets.

Finally, there is always the potential for a negative geopolitical shock. The U.S.-China conflict and Brexit come to mind, but a new development could emerge that no one is considering (like the pandemic did earlier this year).

### Portfolio Positioning

We are very comfortable with how our portfolios are constructed, as detailed below. The watchwords of our current positioning remain *balance* and *resilience*. Our portfolios are balanced across multiple dimensions: domestic versus international stock exposure, growth versus value strategies, interest rate risk versus credit risk, traditional versus alternative investments. And we've designed our portfolios with the goal of generating potentially strong returns in our base-case and more optimistic economic scenarios, while maintaining resilience in a more challenging scenario.

On the equity side of our portfolios, as a reminder, we were underweight to U.S. stocks and stocks in general going into the pandemic due to unattractive valuations. In March after an initial large decline, we added to U.S. equity exposure at more attractive prices. Since that time, U.S. stocks have appreciated strongly, outperforming most other investments. They have soared more than 50% from the March low and again look historically overvalued. Forward price-to-earnings (P/E) and median P/E ratios are approaching dot-com-bubble highs. Nothing prevents valuations from rising even further near term, but we know high starting point valuations have a strong *inverse* relationship with future long-term returns. Overvaluation tends to not matter ... until it does.

But while U.S. stock valuations look expensive relative to history, they look cheap relative to bonds. Bond yields are extremely low, which forces investors to allocate more to stocks, pushing stock valuations even higher or keeping them higher for longer. Cheap relative valuations, in addition to a supportive Fed and plausible optimistic scenarios in which U.S. stocks *can* deliver decent returns, keep us from a larger underweight. We don't want to be too underweight to U.S. stocks as there could be a significant opportunity cost if they continue to perform well.

Our overweight to emerging-market stocks offsets some of our underweight to U.S. stocks. And we hold a full strategic weight to developed international stocks. Thus, portfolios are still slightly underweight to stocks in general. We don't want to reduce our global diversification right now as stock valuations are cheaper in non-U.S. stock markets. We continue to see superior five-year expected returns there across most of our macroeconomic scenarios. Stocks being cheap compared to bonds is even more true in international markets. Plus, in a sustained global economic recovery with Fed-repressed U.S. interest rates, the odds are that foreign currencies will appreciate against the U.S. dollar. This would further enhance the returns of international assets for U.S. dollar-based investors.

On the fixed-income side, core bonds are an important shock absorber in a negative economic or geopolitical shock. However, as mentioned before, yields are very low and even a modest increase in interest rates could lead to negative short-term returns. To better diversify our fixed-income allocations, we have invested in actively managed flexible bond strategies with higher expected returns and lower interest rate risk. The tradeoff is they will not hold up as well as core bonds in a deflationary event. But we have taken this into account when setting your portfolios' total equity risk, hence the slight underweight to stocks.

### ***Special report - Maintaining Balance & Resilience Amid the Uncertainty (continue from page 1)***

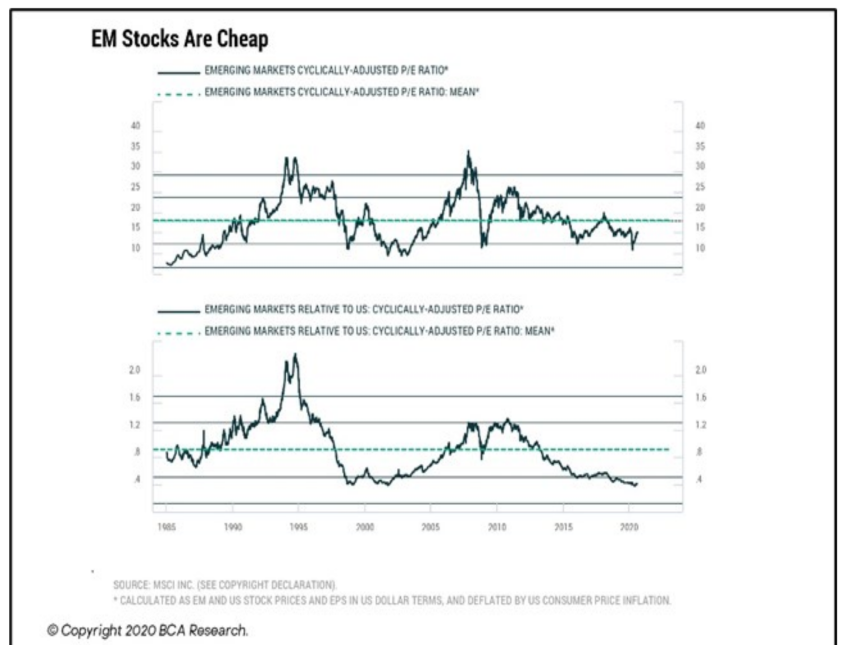
while still maintaining resilience should a more challenging scenario play out.

A reasonable base case economic scenario involves one in which the global and U.S. economies continue to recover and the pandemic risk recedes without major economic disruption beyond scattered localized flare-ups. With central banks keeping interest rates exceptionally low, this would be supportive for global equity markets and credit markets.

On the equity side of balanced portfolios, as a reminder, we were underweight to U.S. stocks and stocks in general going into the pandemic. In March after an initial large decline, we added to U.S. stocks at more attractive prices. Since that time, U.S. stocks have appreciated strongly, outperforming most other investments.

We have maintained a moderate tactical underweight to U.S. stocks because the market is overvalued on an absolute basis and currently offers below-average expected returns in our medium-term (five-year) base case. However, the relative valuation of U.S. stocks versus core bonds (the equity risk premium) and the likelihood that the Fed will keep interest rates "lower for longer" provides support for high valuations, at least until rates meaningfully rise. And there are plausible more optimistic scenarios where U.S. stocks generate mid to upper single-digit medium-term annualized returns. So, respecting the wide range of potential outcomes, we don't want to be too underweight to U.S. stocks despite their absolute valuation headwind.

Related to this, within our U.S. equity exposure we want to remain broadly balanced to growth versus value stocks, whether via broad market index exposure or active managers. Growth has crushed value in recent years and now looks extremely overvalued relative to value. And we do expect this cycle to turn at some point, as it always has. But the tailwinds to the recent growth/tech stock outperformance—superior earnings growth and ze-



example, when vaccines are available), that may be the catalyst for a market rotation out of expensive “defensive” mega-cap growth stocks into undervalued out-of-favor value sectors, such as financials and industrials. As the Bank Credit Analyst recently put it, “The ‘pandemic trade’ will give way to the ‘reopening trade.’”

It’s also worth noting that in a scenario of sustained global economic recovery with Fed-repressed U.S. interest rates, odds are the U.S. dollar will depreciate as capital flows to other markets. When the U.S. dollar depreciates against foreign currencies, U.S. investors receive an additional positive currency return from holding international assets. Given the potential higher returns and currency tailwind, we don’t want to reduce our global diversification right now.

## **Closing Thoughts**

History shows markets are consistently unpredictable. Adding to the uncertainty are the unprecedented circumstances, challenges, and structural changes the global economy is currently facing.

Having a high degree of conviction in any single outcome strikes us as imprudent. Instead of trying to continuously predict the future, we are focused on building resilient portfolios across multiple plausible scenarios, accounting for a range of shorter-term risks but keeping our primary focus on the medium- to longer-term fundamentals that ultimately drive investment returns.

Investing this way requires discipline, patience, and a willingness to stand away from the herd at times. It can feel uncomfortable to stay the course, put capital at risk when markets are plunging, or refrain from chasing overvalued markets higher when they are soaring. But in the end, this is the best approach we’ve found to achieve long-term investment goals.

## **Partnering with You**

While we are constantly making decisions about what actions may be needed in portfolios, we are also working behind the scenes to grow your wealth and bolster your financial position in ways that don’t necessarily show in performance reports.

Some steps we’ve taken with clients this year include tax-loss harvesting in taxable accounts, especially earlier in the year. This can offset realized gains this year and possibly into the future. We have also been moving assets that generate higher income into tax-deferred accounts where possible

In addition to focusing on portfolio tax optimization, our advisors can help strategize broader planning areas, such as education and retirement planning or arranging a plan for philanthropic goals. Financial planning has taken on additional complexities this year, as we work through the rules and opportunities presented by the SECURE and CARES Acts. These Acts created opportunities for waiving required minimum distributions, planning for IRA beneficiary changes, rolling over traditional IRA accounts to Roth accounts, and reviewing existing estate plans.

As always, we appreciate the trust you place in us and encourage you to contact us with any questions about your specific situation.

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