Insight Newsletter
THIRD QUARTER 2020

Litman Gregory
ASSET MANAGEMENT

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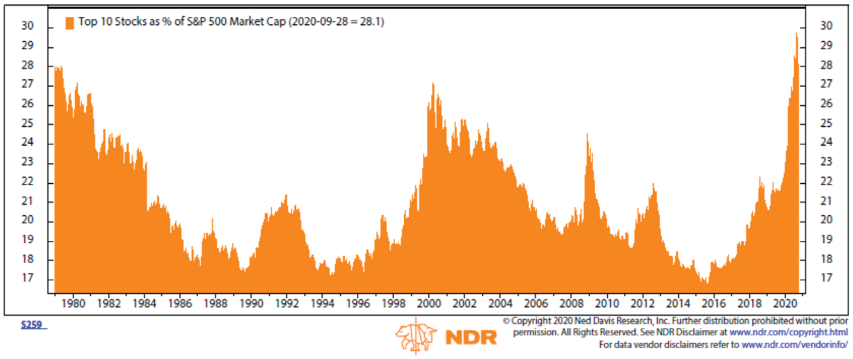
Market Recap

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

Market Concentration Is Not Unusual But Is Currently Extreme

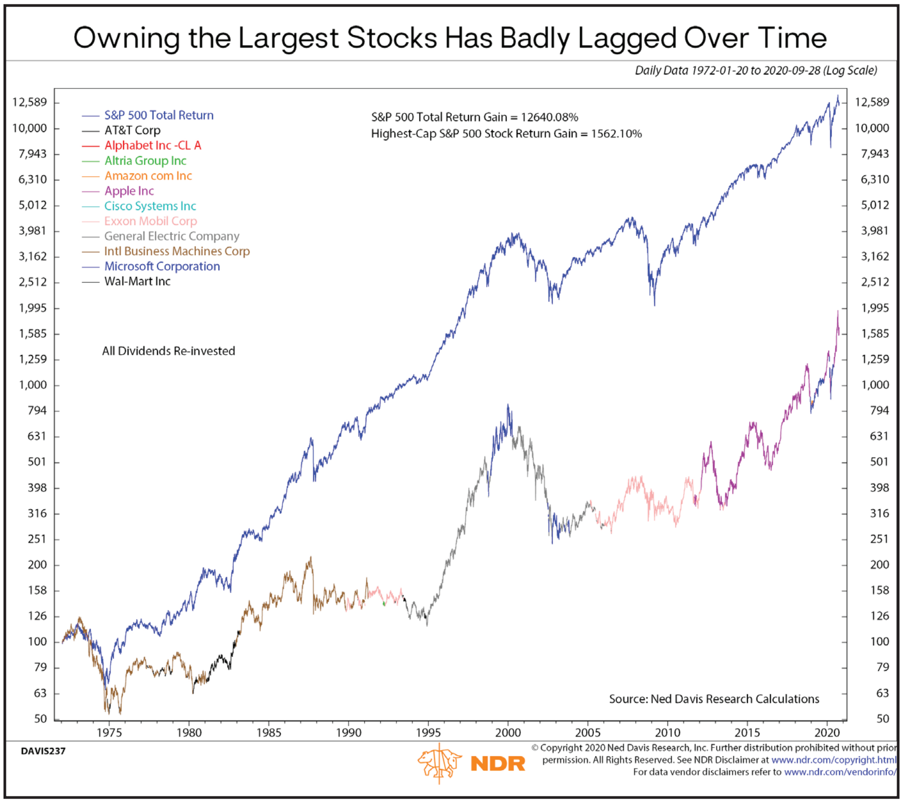


Top 10 S&P 500 Constituents During Other Highly Concentrated Periods

1980	1999	2020
IBM	Microsoft	Apple
AT&T	General Electric	Microsoft
Exxon	Cisco Systems	Amazon.com
Standard Oil of Indiana	Wal-Mart Stores	Facebook
Schlumberger	Exxon Mobil	Alphabet
Shell Oil	Intel	Berkshire Hathaway
Mobil	Lucent Technologies	Johnson & Johnson
Standard Oil of California	IBM	Procter & Gamble
Atlantic Richfield	Citigroup	Visa
General Electric	America Online	NVIDIA

Source: ETFdb.com and Morningstar Direct. Top names in 2020 as of 9/24/2020.

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 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.

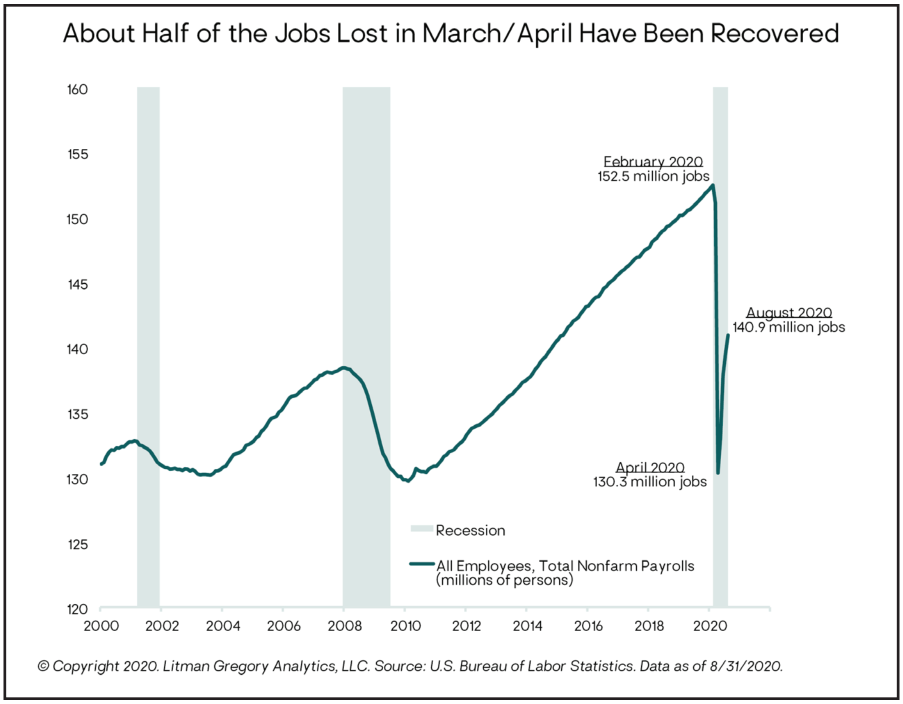
Looking through the election, there are reasons to be cautiously optimistic about the investment prospects for global equities and corporate bonds. And there are reasons for caution.

Reasons for Optimism

An economic recovery *is* underway. Economic data and forecasts are improving. All else equal, rebounding economic growth here and abroad should support equity and corporate bond markets.

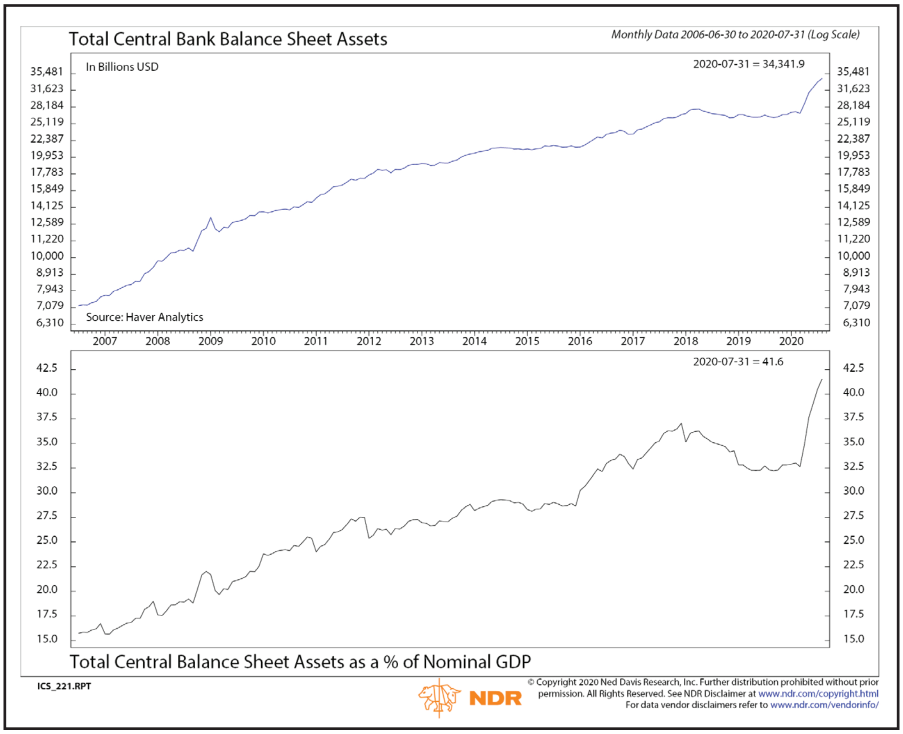
On the virus front, the speed of progress in vaccine development is promising. An effective and widely distributed vaccine would allow economic activity to return to its full pre-pandemic potential.

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 global 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.

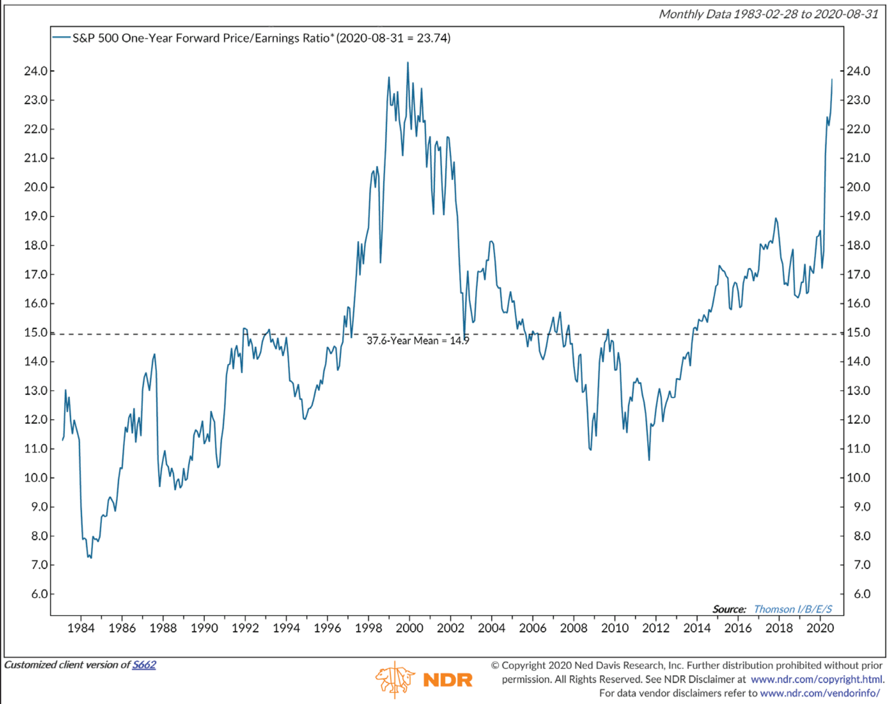
Finally, there is always the potential for a negative geopolitical shock. The U.S.-China conflict and Brexit come to mind, but a new development could emerge that no one is considering (like the pandemic did earlier this year).

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.

S&P 500 Forward Price/Earnings Ratio



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.

The third broad component of our balanced portfolios comprises actively managed alternative strategies. These investments further diversify equity and bond market risk and are intended to generate mid-single-digit-type annualized returns over time. On a risk-adjusted basis, this is much better than what we expect from core bonds and competitive or better than our base-case expectation for U.S. stocks. In a bull market, these alternative strategies will likely trail equity market returns and beat bonds. In a bear market, they will likely trail bonds but do much better than stocks.

Closing Thoughts

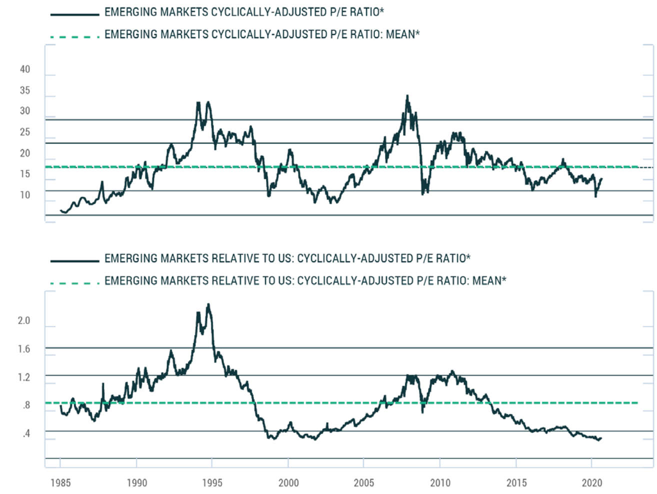
History shows markets are consistently unpredictable. Adding to the uncertainty are the unprecedented circumstances, challenges, and structural changes the global economy is currently facing.

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.

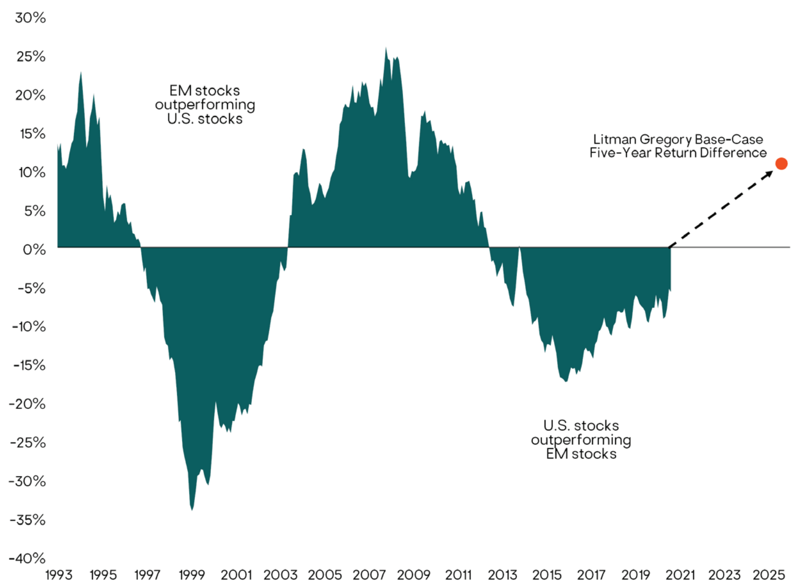
—Litman Gregory Investment Team (10/5/2020)

EM Stocks Are Cheap



SOURCE: MSCI INC. (SEE COPYRIGHT DECLARATION).
* CALCULATED AS EM AND US STOCK PRICES AND EPS IN US DOLLAR TERMS, AND DEFLATED BY US CONSUMER PRICE INFLATION.

Rolling Five-Year Return Differential: Emerging-Market vs. U.S. Stocks



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Tax Planning Opportunities in 2020

Addressing the SECURE & CARES Acts

This year, we've been discussing the recent changes enacted by the SECURE and CARES Acts with clients and helping them identify where it makes sense to take advantage of various provisions of the laws. Here are some of the more common strategies we've been considering with our clients:

- *Waive 2020 IRA Required Minimum Distributions (RMDs):* The CARES Act allows all IRA owners to waive RMDs for tax year 2020, avoiding taxable distributions and keeping more money in your IRA growing tax-deferred. If you already took an RMD this year, contact us. You may still be able to use the 60-day IRA rollover rule to return unneeded distributions back to your IRA.

- *Roth IRA Conversions:* Because the SECURE Act ended the opportunity for a "stretch" in distributions to an inheritor of an IRA, inheriting a tax-free Roth IRA is now even more attractive than a traditional tax-deferred IRA. While a conversion from a regular IRA to a Roth IRA does create current taxable income on the amount converted, all future earnings will be tax-free. If you intend to leave IRA money to the next generation, it may make sense to start converting traditional IRA money into a Roth IRA.

- *Update Charitable Giving Plans:* Our clients who want to revise their giving plans in light of COVID-19 are benefiting from gifting rules this year. The CARES Act now allows each individual to deduct up to $300 in cash contributions, whether or not they itemize.

- *Explore Other Planning Opportunities:* Given that each individual, family, or organization's situation is unique, it is worthwhile to have a conversation so we can uncover other opportunities made possible by recent law changes (such as deferring tax or loan payments, applying for business loans, refinancing, reviewing beneficiaries, contributing to retirement plans, and more).

Tax Planning for All Seasons

As part of our tax sensitivity in managing investment portfolios, we regularly look for opportunities to maximize after-tax portfolio returns beyond investment selection, allocation, and periodic rebalancing. We utilize these techniques in our client portfolios:

- We try to hold investments in taxable accounts for more than one year before selling them so that long-term capital gains rates will apply. The tax difference can be significant. (However, we always assess the potential risk and return tradeoffs that result from any decision to extend an investment holding period.)

- We seek to place the interest-earning portion of portfolios in tax-deferred accounts given interest income is taxed at the top marginal rate, unlike long-term capital gains.

- We consider carefully before selling investments with large built-in gains, unless the sale is justified by a higher expected return from an alternative investment or is necessary to maintain portfolio asset allocation objectives.

- When raising cash in your portfolio, we do so by selecting securities or individual lots of a security that have the lowest taxable gain consequences.

- During market volatility throughout the year, as well as regularly during our year-end review, we look for opportunities to "harvest" capital losses. These realized losses can then be used to offset realized gains elsewhere within or outside the portfolio, and within the same tax year or rolled forward to future tax returns. In either case, proceeds can be placed in a comparable investment so the portfolio allocation remains intact.

- For portfolios without significant tax-deferred assets, we will generally recommend holding tax-exempt bonds in lieu of taxable bonds, depending on the client's marginal tax rate.

There is also a short list of almost timeless tax-wise practices to always stay aware of, which we try to highlight to our clients each year around this time:

- Maximize the use of tax-deductible retirement plan contributions each year to lower your tax liability as much as possible. The SECURE Act now permits savers to continue contributions to IRAs even after age 70½.

- Make annual or one-time gifts to family members to remove taxable income from your portfolio, potentially reduce family-wide tax liability, and reduce your taxable estate during your lifetime.

- Gift appreciated securities held for more than one year directly to charities or to a charitable donor-advised fund (DAF). The tax deduction is for the value of the gift, and taxes on any built-in capital gains are eliminated.

- Concentrate multiple years of charitable deductions into one year to maximize the tax benefits of giving, using the technique of "charitable bunching."

- For those over age 70½, we can help you process qualified charitable distributions (QCDs) from IRAs, especially if you would not otherwise receive as advantageous a tax deduction for gifting taxable assets.

- Consider a Roth IRA or Roth 401(k) conversion or even discretionary distributions of IRA assets, especially if this will be a low-income-tax-rate year for you. If you have not already begun taking RMDs from IRAs, one strategy we often recommend is to reduce or eliminate your traditional IRA assets before they kick in.

What to Revisit For 2021

Many planning techniques, including those necessitated by the SECURE and CARES Acts, may need to be executed over multiple years. It is important to check in with your Wealth Advisor to review the recent law changes in light of your situation. It is also the case that political developments may result in tax-law changes as soon as next year or in years to come. With this backdrop we are attentive to incorporating flexibility where possible into our planning.

Final Thoughts

We welcome the opportunity to discuss these planning topics with our clients and to coordinate with tax advisors to determine the best techniques for each tax profile. Please contact your Litman Gregory Advisor for more information and to review your situation.

Note: As with all tax planning, every person's tax situation is different. We suggest consulting with your tax advisor before implementing any of these tax planning techniques.

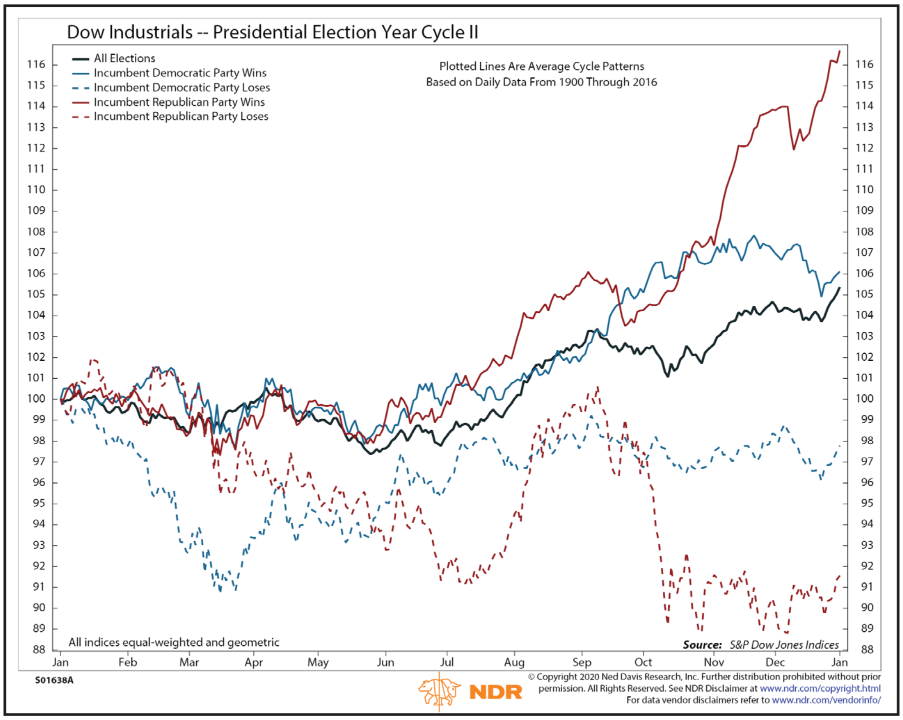
Join our ***Year-End Planning Webinar*** on November 19th. Details to be shared as the event nears.

How We Think About Elections & Investment Decisions

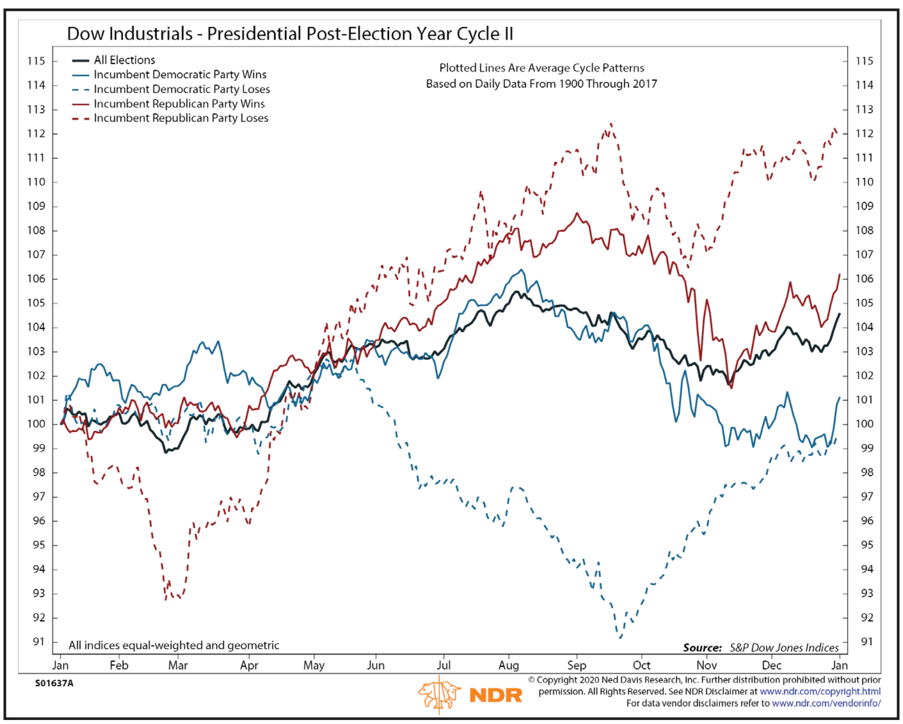
Each time a U.S. presidential election approaches, we revisit with clients our views about the impact on our investment outlook and portfolio positioning. Here is a quick review of how we think about elections in general within the context of our overall investment approach.

Why We Don't Market-Time Elections

While the specific circumstances of any given election are always unique, our approach remains the same. We recognize that to the extent a particular election outcome is widely expected (for example, based on strong, consistent polling data), current financial asset prices should already reflect that market consensus. The public information is discounted in the markets in real-time.



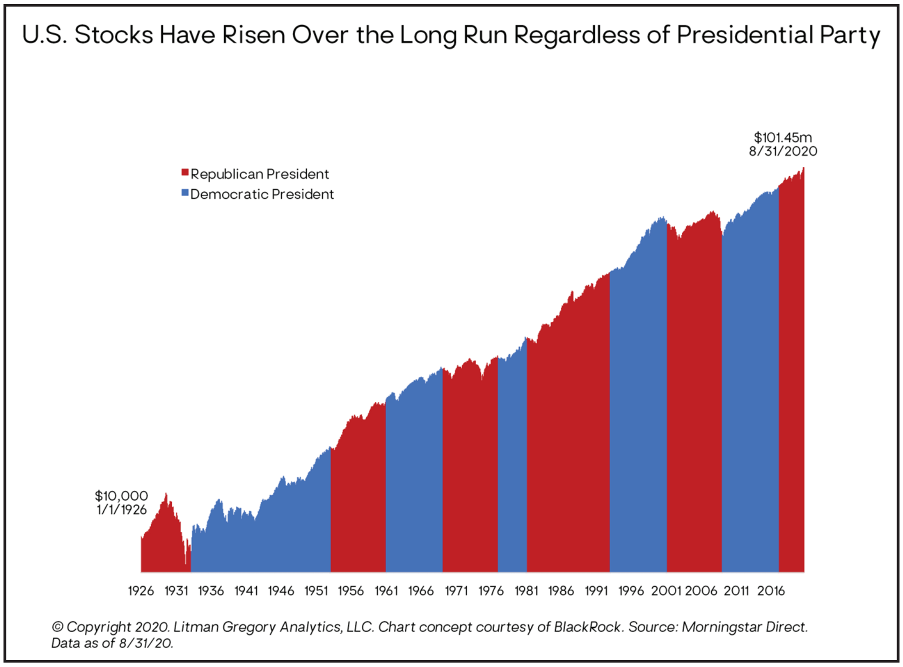
For us to believe there is a reason to change our overall portfolio positioning stemming from a particular election outcome, several things must be true. We'd need to believe we have an edge and high conviction in our ability to assess the likely outcome *better than the market consensus.* Our view would also have to be materially *different* from the consensus view. And we'd need to have conviction that our divergent election view would clearly translate into a specific investment outcome. But history tells us that the linkage between an election result and a market impact is not always clear. The 2016 presidential election was a perfect example of this, with stocks initially plunging on the surprising result and then soaring.



There is too much uncertainty and too many non-election variables that impact investment outcomes over time for us to likely see any value in positioning our portfolios for a particular result. Even if we had a higher degree of certainty as to both the outcome and the policies that would be implemented, the ultimate economic effects and outcomes would still be highly uncertain. Macroeconomics is far from a hard science. There is a multitude of other factors and variables that impact economic and financial market outcomes.

Market Performance Around Elections

Election years have sometimes led to downside volatility for the stock market, especially when incumbents lose. However, markets typically rebound strongly from any declines around elections the following year. (See the two charts on the prior page courtesy of Ned Davis Research.) This supports our point that for any investor with a time horizon longer than a year or two, elections do not have a meaningful or long-lasting effect on investment performance. It will generally pay off to look beyond the election at the other drivers of markets and potentially even to take advantage of election-year declines.



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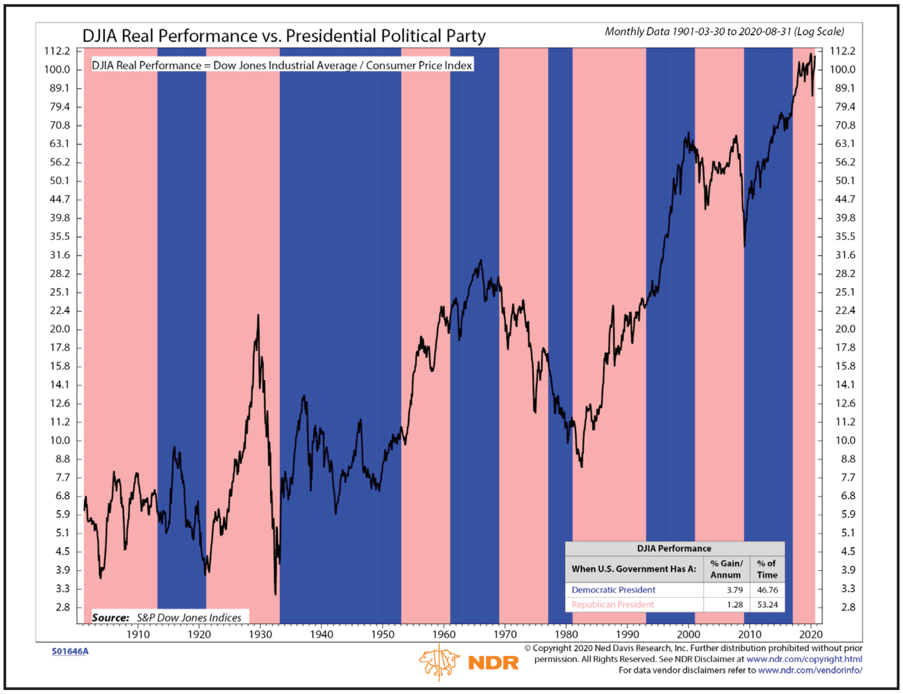
It's important to note that the election and post-election year analyses in these charts represent the *average* result historically, and the sample size is often small. There are many reasons the market could respond differently this year, among them the large amount of economic stimulus, the ongoing pandemic, a quickly rebounding economy, and so on.



Fundamentals Drive Long-Term Investment Outcomes, Regardless of the Party in Power

Instead of betting on election results, 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. As investors, we expect to experience market volatility and shorter-term downside risk at times. Stock market history makes this clear. The degree will depend on the portfolio's risk profile and the corresponding risk exposure. Experiencing volatility is a necessary evil of owning stocks and other higher-returning “risk assets.” They wouldn’t be considered risky otherwise!

Finally, history also shows that the political party in power is not a significant differentiator or driver of investment returns. There are simply too many *other* factors, variables, and events that impact markets and asset prices over time beyond election outcomes.

In summary:

1. We are not willing to bet on a particular election result relative to the odds already embedded in current market prices.

2. There is a wide range of potential macro outcomes around either result.

3. There are many factors unrelated to the election results and out of U.S. politicians’ control that are likely to have at least as meaningful an impact on the course of the global economy and financial markets over the next several years.

The Value of an Experienced, Accountable Fiduciary Partner

During these turbulent times, it has never been more important if you are a nonprofit board or investment committee member to partner with an experienced investment advisor with a long history of working with endowments and foundations through many different environments. Today’s challenges are many, including the uncertainty associated with a global pandemic, historically low interest rates, low expected future returns driven by stretched valuations across most asset classes, increased competition for fundraising, and increased regulations, to name only a few.

Litman Gregory has been working with nonprofits for over 30 years, and we have helped our clients in a wide range of areas from educating boards on investment industry best practices, to investment policy creation/modification, to assisting with fundraising and engaging current and prospective donors. With five offices around the San Francisco Bay Area and clients that span across the United States, our network of relationships is broad and our experience deep.

We are helping our institutional clients successfully navigate the issues facing them by:

- Ensuring strong governance
- Sharing investment committee best practices
- Evaluating or determining appropriate spending rates
- Reaffirming the appropriate risk and return profile for their institutions
- Creating or reaffirming investment policy statements
- Exploring the appropriate balance between active and passive vehicles
- Evaluating the role of alternative investments
- Understanding their organizations’ liquidity profile
- Integrating environmental, social, and governance (ESG) investment principles into portfolios
- And aligning investment portfolios with their institutions’ mission

Our experience, accountability, disciplined process, and client focus distinguish Litman Gregory from our peers:

Investment Experience and Risk Management. With a 30-year track record of strong risk-adjusted performance, our fundamentally driven investment approach seeks to balance our long-term outlook—and our clients' unique goals—within a defined level of risk for each portfolio.

Advice with Accountability. As a fiduciary partner, we take ownership of our clients' goals as we help them navigate complex and volatile markets, balancing capital preservation with long-term growth, to help them meet their institutions' financial objectives.

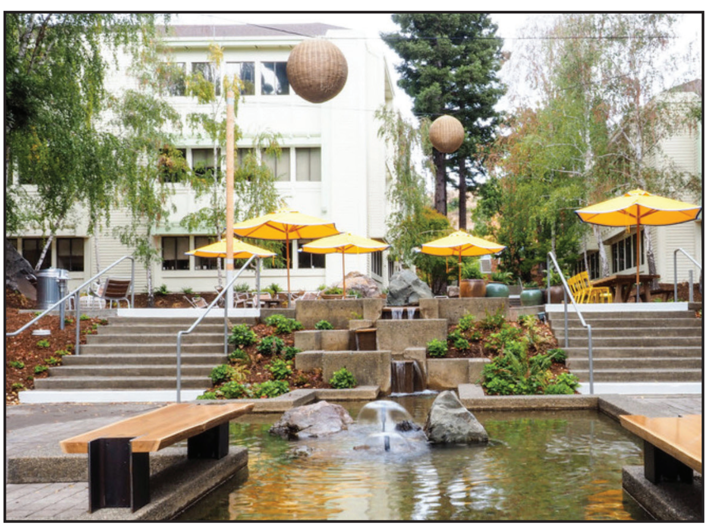
Disciplined Investment Process. We have made a significant commitment to independent research. Our in-house research team includes dedicated asset class and manager-selection research analysts. Further, we continue to integrate sustainable investing criteria into our investment framework, as we believe it makes us better stewards of our clients' assets, improves risk management, and can increase returns.

Client Focus and Service. Our relationship-driven service model ensures proactive attention and clear communication. Litman Gregory provides the objectivity of an independent investment consultant with the agility and accountability of a discretionary Outsourced Chief Investment Officer (OCIO).

Board and investment committee members play an integral role within an organization. Our team supports the work you're doing by offering education and financial guidance beyond our core services with the goal of helping to advance your organization's mission. We look forward to the opportunity to discuss the unique challenges that your institution faces today and how we can help.

Please contact us to learn more about our services for endowments and foundations.

Announcement: Larkspur Office Move



Our Larkspur Office is Moving! (Just Around the Corner)

We look forward to welcoming you into our new space when it is safe to do so.

900 Larkspur Landing Circle

Suite 900-285

Larkspur, CA 94939

Please update your records!

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