PENDLETON STREET
BUSINESS ADVISORS

Pendleton Street Advisors
4th Quarter 2020 Investment Commentary
January 21, 2021

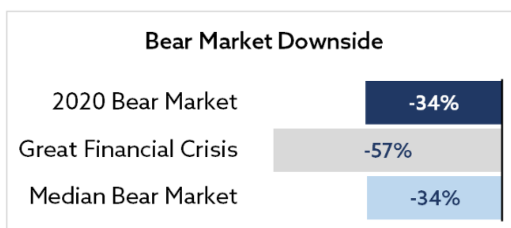
Index Returns	4th Quarter	Calendar Year 2020
S&P 500 US Large Cap Stock Index	12.1%	18.4%
Russell 2000 Small Cap Stock Index	31.4%	20.0%
MSCI All Country World Ex-USA Stock Index	17.0%	10.7%
Barclays Capital US Aggregate Bond Index	0.7%	7.5%
US Core Consumer Price Index - (Inflation)	0.4%	1.7%

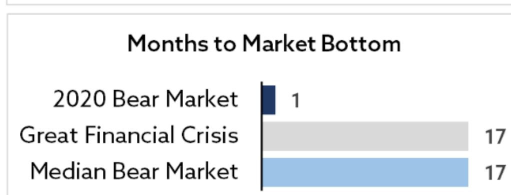
**All figures as of 12/31/20 unless otherwise noted.*

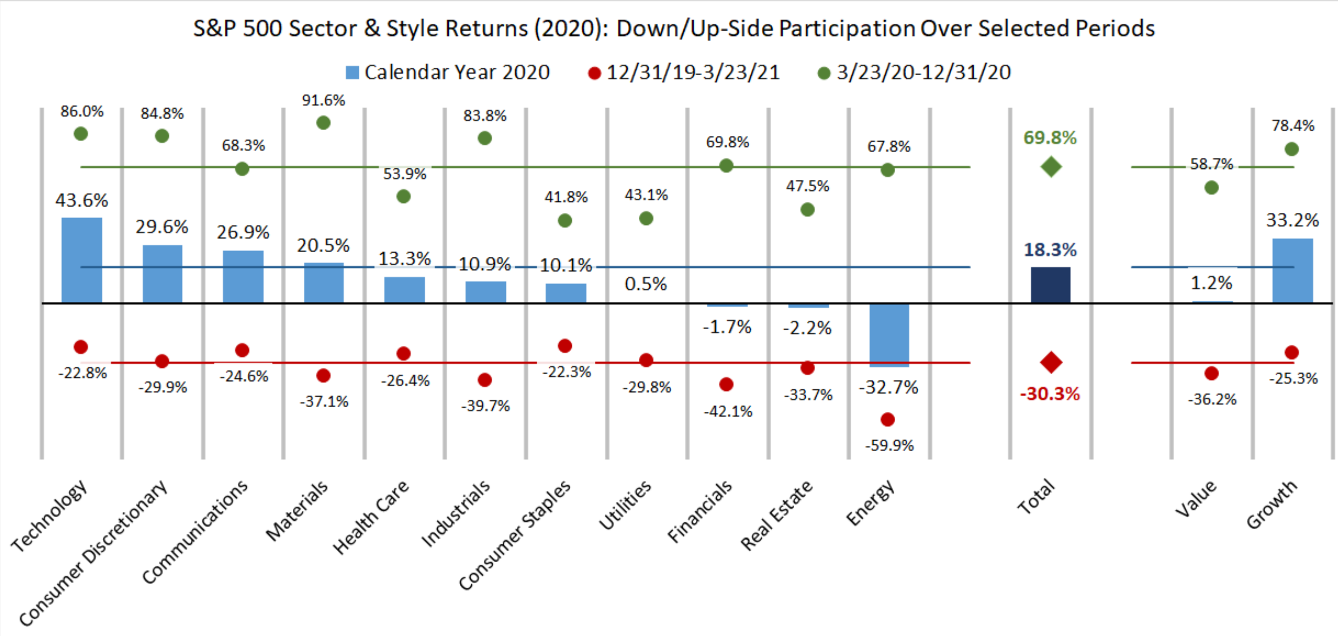
Markets continued to reflect investor optimism throughout most of 2020, despite a crippling pandemic, a heated general election, a turbulent transfer of presidential powers, and frequent civil unrest across the country. The S&P 500 stock index climbed 18.4% (close to double the long-term annual average) after increasing by over 30% in 2019. Bonds in aggregate returned 7.5%; only 1% less than in 2019 and still well above the long-term annual average of around 5%. Asset classes and market segments that gained steam in April as the virus took hold persisted through the end of the year. As the long-awaited new year begins, markets weigh a few key issues and we look ahead to consider the long-term ramifications of current conditions for portfolios.

Smarter Than the Average Bear: In February of 2020, markets began declining precipitously in anticipation of COVID-19's impact. After almost 11 years without a market decline of greater than 20%, the S&P 500 had declined as much as 34% by late March. By mid-July (about 5 months), the index had returned to its mid-February peak-level, adding another 16.5% by year-end. This is by far the quickest bear market "round trip" (the time it takes the index to decline to bear market levels and then return to its previous peak) in the S&P 500 index's history. **<u>At 6 months in total, this market's round-trip from downturn to recovery took 3 years less than the average bear market since 1950.</u>**

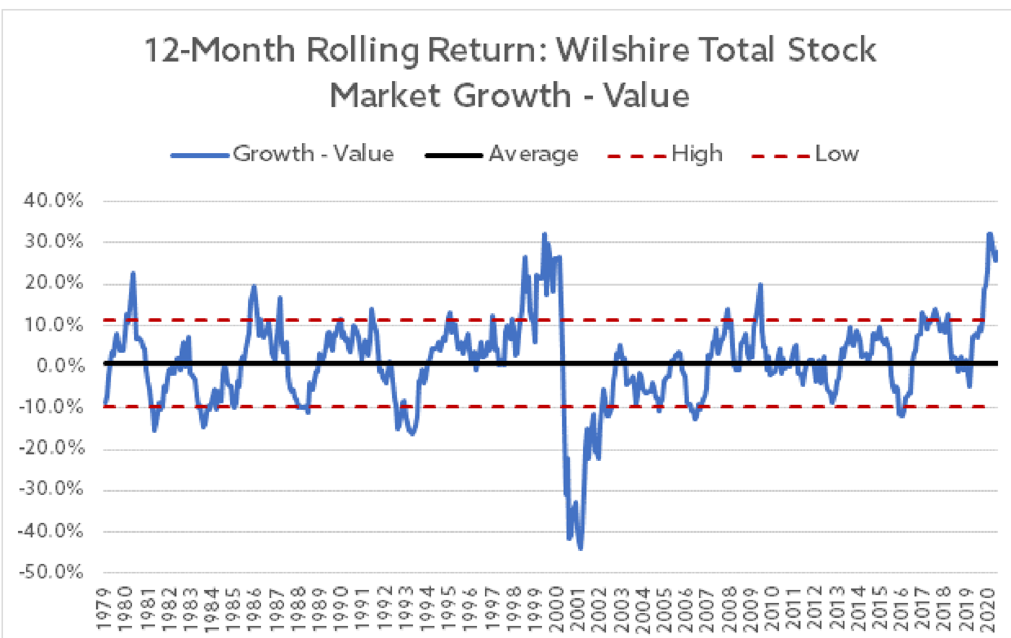
The Data: S&P 500 Bear Markets since 1950				
Year	% Market Went Down	Days to Bottom	Days to Recover	Recession?
1957	21%	99	329	Yes
1962	28%	196	434	No
1966	22%	240	209	No
1970	36%	543	650	Yes
1974	48%	630	2114	Yes
1982	27%	622	83	Yes
1987	34%	101	600	No
2002	49%	929	1694	Yes
2009	57%	517	1480	Yes
Average	36%	431	844	
Median	34%	517	600	
2020	34%	34	145	Yes
Vs. Median	*101%*	*7%*	*24%*	





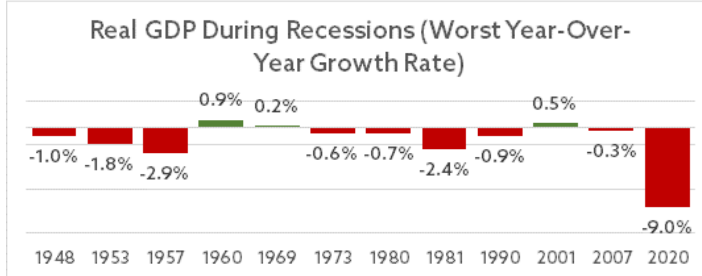


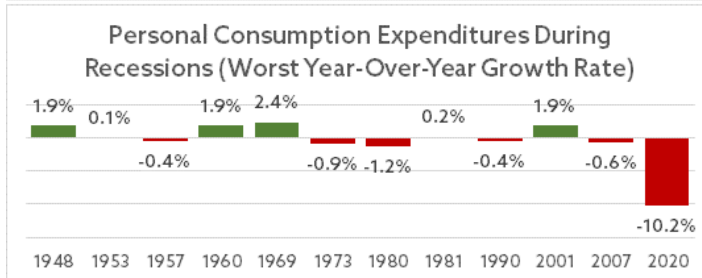
As we illustrate in the chart above, neither the downturn nor the recovery were uniform across stocks. There were definitely winners and losers among sectors (most notably Technology with at 43% return in 2020 vs Energy with -33% return). The most striking difference, however, was the difference in performance between Value and Growth stocks: The S&P 500 Value index increased by 1.2% for the year, while the Growth index increased by 33% resulting in the **highest period of outperformance by Growth stocks since the run-up to the bursting of the internet stock bubble in 1999.**



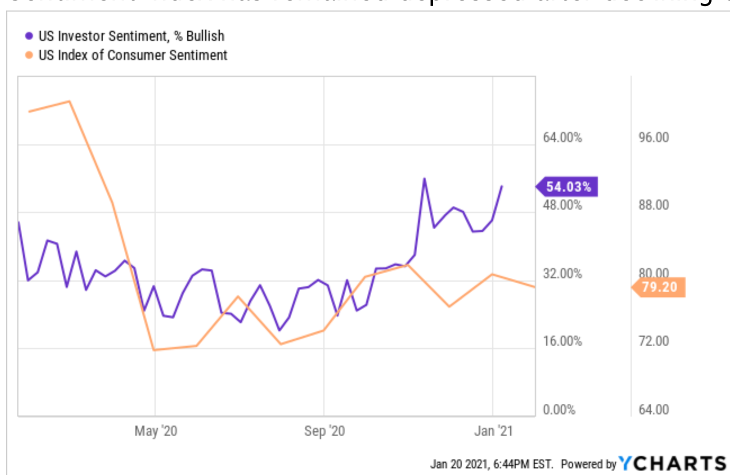
We believe the outperformance of Growth relative to Value is unsustainable at current levels, and history agrees with us: the average outperformance of Growth stocks over rolling 12-month periods since 1979 (including the most-recent periods) of 0.3% indicates relative performance of Growth and Value evens out over time. We cover more about what this means for portfolios, below.

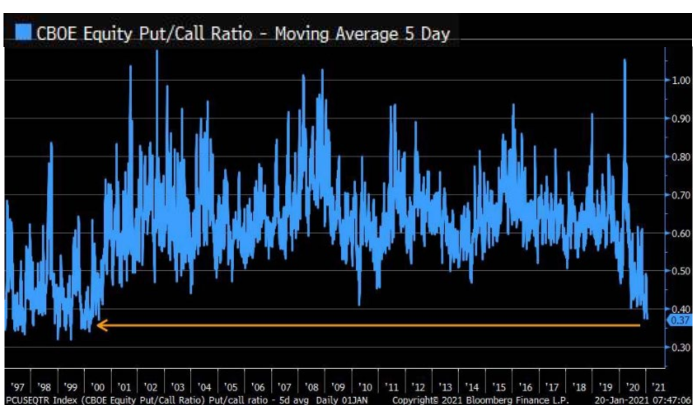
The Economy and Markets: While stocks have – *after a short bear market* - continued to climb to new heights, consumers and businesses have been navigating the worst recession in Post-WWII history (see accompanying charts). So, are stock prices increasing because investors remain increasingly optimistic about economic growth and company fundamentals? We think those were major factors in the 2nd and 3rd quarters, but beginning in the 4th quarter and into the new year, investors began more decisively falling into one of two major buckets:

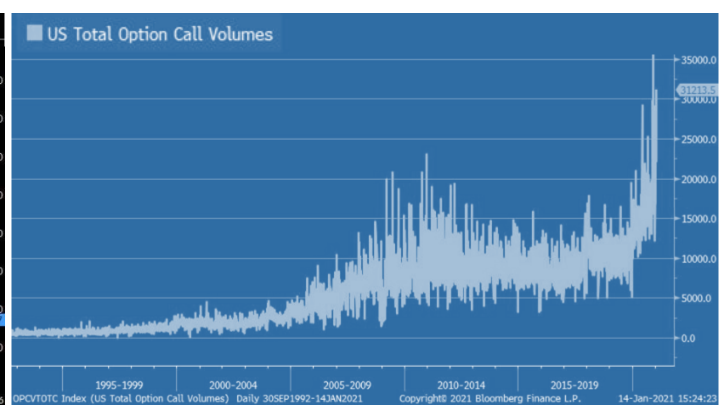




1) **Long-term investors** who continue pricing up stocks as an asset class because the returns amongst traditionally "safe" investments (i.e. bonds) are so low. Essentially, these investors are saying: "The risk that stocks underperform is worth taking since the alternative is buying bonds or staying in cash, both of which have yields below the rate of inflation." Or…
2) **Speculative investors** who continue pricing up stocks because when **[** *INSERT SPORT HERE* **]** season was cancelled, they opened an online trading account as a distraction from everyday life. Stock performance over the next few months provided positive feedback, which has driven speculative investing into the "euphoria" stage. For example, while The UofM Consumer Sentiment Index has remained depressed after declining by over 30% in March, the AAII US Investor Sentiment Survey indicates 54% of investors are currently bullish, up from around 20% during the summer months and around 17%-points higher than the long-term average of 37%. Options-market indicators (call option volumes, put/call ratio) also suggest that investors are increasingly willing to "bet" on stock prices increasing, regardless of the quality or cheapness of the underlying companies.

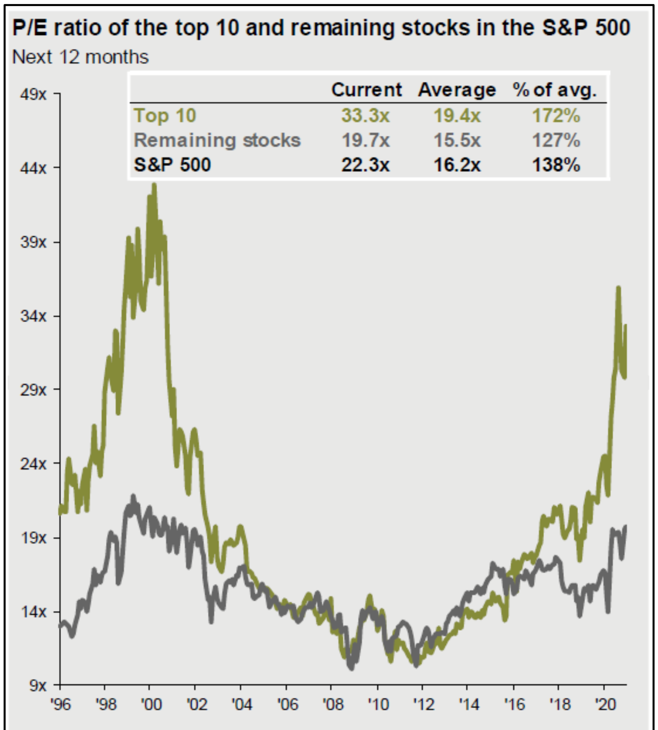






To be clear: We fall into the first bucket… with a few major caveats: We believe the risk-mitigation benefits of bonds and other non-equity assets ***in moderation*** outweigh the cost of missing out on rising stock prices of trendy companies with poor balance sheets and excessive valuations. We believe yield can still be found in fixed-income/bonds that fairly compensates investors for inflation, interest-rate, AND default risk. We won't invest in stocks ***indiscriminately***, and our focus remains on high-quality companies that are undervalued relative to the cash flow they produce and the prospective growth of those cash flows.

Why Valuation Still Matters: In summary, increased risk-taking by long-term investors seeking to outrun inflation, and speculative investing fueled by stay-at-home-induced boredom and historically low market volatility as a result of massive liquidity injections by the Federal Reserve have led to the following situation: **stocks are expensive**. Regardless of the trajectory of the virus or the political uncertainty that accompanies a new Administration, it is difficult to argue by almost any measure that stocks in aggregate are priced favorably for investors. As one seasoned investor put it: "2021 will be the year when boring gets exciting and exciting gets wrecked."



Source: FactSet, Standard & Poor's, J.P. Morgan Asset Management.

S&P 500 Valuation measure	Description	Latest	25-year avg.*	Std. dev. Over-/under-Valued
P/E	Forward P/E	22.33x	16.56x	1.79
CAPE	Shiller's P/E	34.24	27.47	1.10
Div. Yield	Dividend yield	1.59%	2.05%	1.37
P/B	Price to book	3.84	2.99	1.16
P/CF	Price to cash flow	15.93	10.79	2.54
EY Spread	EY minus Baa yield	1.35%	0.06%	-0.65

The silver lining: as we dive successively deeper into the data, we find that valuations vary widely based on factors like size, quality, sector, and geography. **Our conclusion: opportunity exists in overlooked companies with strong balance sheets, proven resilience in the face of catastrophe, and strong prospects for growth coming out of the recession.** Those are the types of companies we currently own and consistently seek to add to client portfolios.

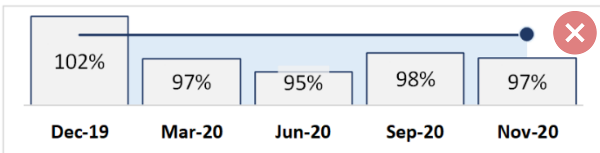
As we navigate the current environment for stocks, we also remain aware of bigger picture issues that we expect to influence markets:

- Coronavirus and its impact on the health of the economy and more importantly the people that make up the economy remains front of mind. Congress recently passed more legislation providing direct stimulus payments to individuals, as well as reopening the Paycheck Protection Program to a more limited set of small businesses more directly impacted by the virus.
- As Joe Biden takes the reins as President of the US, he has indicated he will press for even more fiscal stimulus to counteract the virus's economic damage. So far, markets have responded favorably to the ever-growing mountain of fiscal and monetary stimulus being pumped into the economy.

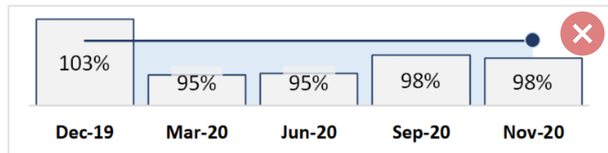
Assuming the government is able to agree on subsequent stimulus packages, the risk to investors is that the stimulus begins acting more like water than fuel in the economic engine. We have concerns about the long-term viability of running multi-trillion dollar budget deficits funded by issuing US Treasury debt, but we believe one of the best ways for investors to personally mitigate the risk that the chickens come home to roost in the near term will be maintaining an unwavering focus on quality and value, regardless of asset class.

The Economic Recovery: Selected Indicators

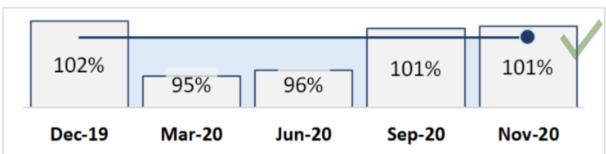
US Monthly Real GDP
%-of Same Period Last Year



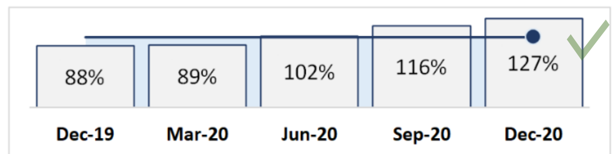
Personal Consumption Expenditures (PCE)
%-of Same Period Last Year



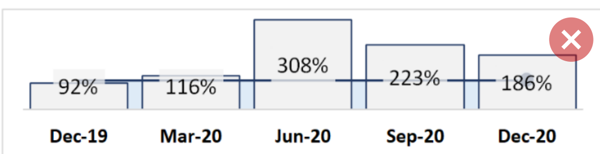
Total Business Sales
%-of Same Period Last Year



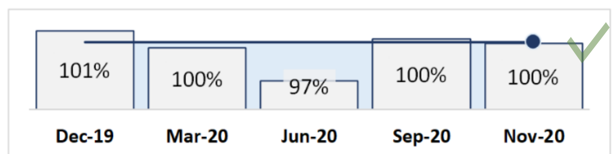
US ISM Manufacturing PMI
%-of Same Period Last Year



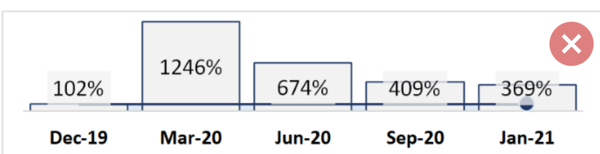
US Unemployment Rate
%-of Same Period Last Year



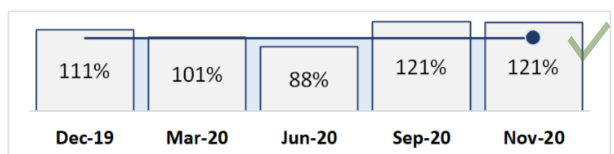
Real Personal Income
%-of Same Period Last Year



Initial Unempolyment Claims - 4 Wk Avg
%-of Same Period Last Year



US Existing Home Sales
%-of Same Period Last Year



Our firm values frequent communication with you to discuss changing conditions and to ensure that we understand and stay updated on your objectives. Our client-service staff will be reaching out to you as usual to schedule a meeting. If you would like to set up a meeting sooner, please contact us at your convenience. We look forward to hearing from you.

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