MIDWEST CAPITAL
ADVISORS™

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To Our Clients and Friends:

We are pleased to bring you our report for the fourth quarter of 2020.

Who would have thought on the day of the market-bottom (March 23) that 2020 would turn out to be a record year for stocks? Not many, we'd venture. The drop in March was not a normal market correction. It was triggered by a huge unknown never before faced by anyone, making the economy and the markets' ability to recover from the specter of that challenge that much more uncertain. That the rally occurred amid (and despite) a catastrophic pandemic, which has killed more than a million people, halted business, recreation and travel to a great extent and wreaked havoc on the economy and employment, makes it that much more stunning. Although much of the recovery can be attributed to the Federal Reserve's unprecedented monetary policy intervention (the tab for which will eventually come due — more on this below), it was nothing short of amazing.

Markets built on gains from the third quarter and ended the year at their highs for the year. The S&P 500 index was up 12.15% for the quarter and 18.40% for the year to post an all-time high. The MSCI World ex-USA Index (gross dividends), despite having been down 6.75% through 3 quarters of 2020, outpaced the U.S. markets, returning 15.91% for the quarter and 8.09% for the year. Bonds continued their winning ways, with the Bloomberg Barclays U.S. Aggregate Bond Index returning 0.67% for the quarter and 7.51% for the year.[1]

Rarely do we get to look back a year and remind ourselves of literally life-changing events that, directly or indirectly, impacted everyone in the world to some degree. There were seismic shifts in the way we work, live, socialize, school our children, shop and recreate; a precipitous drop in employment, and an employment landscape that may be forever changed. Some have learned (and many more of us have been reminded of) many of the investing lessons that were so vividly illustrated in 2020. Here are a few that come to mind.

First, we were reminded that markets are not necessarily reflective of the current economy. While this has been known for a long time, it was never more evident than in 2020, which saw a rising stock market despite massive layoffs (from which we are not expected to recover for years — more on this below too) and drops in business, particularly in the travel, recreation, hospitality and entertainment industries. We know that the stock market is forward-looking (typically six to twelve months), and consistent with this, it recovered far faster than the economy is going to.

Second, it pays to not try and time the markets. We have beat this drum for years, most recently in our Q1 2020 letter that was issued on April 1, just before the markets started recovering.[2] In it we reminded our clients that for the vast majority of

[1] All returns data is from Dimensional Fund Advisors.

[2] Between March 4 and March 11, 2020, the S&P 500 index dropped by twelve percent, descending into a bear market. On March 12, the S&P 500 plunged 9.5 percent, its steepest one-day fall since 1987. The index began to recover at the end of March.

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investors, staying invested (despite it being emotionally harrowing at times) pursuant to a good financial and investment plan is far better than trying to hop in to or out of the market.[3] Based on what we have seen, our clients have heard and understood.

Third, history tells us that following market downturns, returns have been significantly positive. This too was a topic of our Q1 2020 letter. Excluding 2020, in the 13 bear markets since 1929, market recoveries have been strong, and often dramatic.[4]

Fourth, it (still) does not seem to matter much to the markets what party is in the White House (or, apparently, in control of Congress). We discussed this in general (and the possibility of unified government in particular) in our Q3 2020 letter. While we have a long way to go before seeing how the new administration's policies will affect the markets in the longer term,[5] preliminary indications are that the markets cheer the prospect of the positive economic impact of the various stimulus packages that will be rolled out.

Fifth, as more and more technology companies become an ever-increasing part of day-to-day lives (and many becoming very profitable), the tech trade is only getting bigger. Technology stocks benefited most from the pandemic.[6] This has only heightened what is referred to as concentration risk, which is the consequence of a small group of companies in the S&P 500 Index accounting for more and more of the Index's returns. The S&P 500 Index is made up of the largest 500 U.S. companies, but, because it is market-cap (as opposed to equal or some other measure) weighted, the best performing stocks in the index tend to make up a disproportionately large (and, at least lately, increasing) percentage of the index. This concentration is further increased because as an S&P 500 Index open-end mutual fund (vs. an ETF) receives new money, it must buy more of the stocks with the highest market cap, regardless of their valuation. While concentration risk has always been present in market-cap weighted indexes, the S&P 500 Index is approaching record concentration. To illustrate, the five largest index components, all of which are tech stocks,[7] account for just over 22% of the total index capitalization. Contrast this with the fact that the 250 smallest components collectively account for just over 10% of market capitalization. The upshot is that more and more of the S&P 500's performance is being driven by a smaller and smaller number of companies. This means that owning the S&P 500 index by itself does not, as many presume, give one broad exposure to the U.S. economy. The best defense against concentration risk is diversifying one's investments, which is one reason why all our core portfolios provide exposure to asset classes far broader than the S&P 500, including the large cap value asset class, whose holdings are currently made up primarily of

[3] "Someone who reacts to a crisis by exiting the market is just practicing a form of market timing, meaning that they are predicting when the markets will have a positive or negative return. Ill-advised selling is unfortunate because you have then locked in your losses. Additionally, if one flees the market after a crisis, he or she must decide when to return to the market."

[4] Post downturn cumulative returns for the 1-, 5- and 10-year periods following the end of a bear market averaged 46.7%, 109.1% and 104.6%, respectively. Source: Standard & Poors; American Century Investments 2019.

[5] The fear of course is that down the road higher taxes, inflation and interest rates will depress equities, and bonds will suffer due to the record deficits that will result from the expected stimulus measures. It is at least some comfort to know, however, that according to Fortune (January 7, 2021), on average, the S&P 500 returned ~9% per year in all unified government scenarios since the 1950s.

[6] There are numerous examples, but one that illustrates this point well is Zoom Video Communications, which gained almost 400% in 2020. This was roughly 24 times the gain of the S&P 500. Source: *Wall Street Journal*, January 4, 2021. As businesses see the cost and other benefits of and individuals become more comfortable with remote communications, this industry has a good chance of continuing to grow, potentially at the expense of traditional office and other real estate companies.

[7] Apple is ~6.93%, Microsoft is ~5.4%, Amazon is ~4.45%, Alphabet (A & C shares) is ~3.33% and Facebook is ~2.11%.

U.S. companies in the financial, healthcare, consumer, and industrials asset classes.[8]

Despite consensus estimates of a decline, the manufacturing sector had a great finish to 2020, with the ISM Manufacturing Index rising to 60.7 in December,[9] the best reading since late 2018. Only two of eighteen reporting industries reported a contraction, which means the improvement is broad based[10]. The ISM Non-Manufacturing Index rose to 57.2 in December, topping consensus estimates of a decline to 54.5. Fourteen of the eighteen service industry sectors reported expansion.[11] Yes, much of these improvements are coming off a low base but nevertheless, they are a good sign.

Employment remains a trouble spot and unfortunately it looks like the road back is going to be long and slow. After seven consecutive months of gains, COVID-19 restrictions are again depressing jobs data. Nonfarm payrolls fell 140,000 in December, quite a downside surprise given the consensus estimate for a 50,000 gain.[12] Not only that, but the pandemic may have accelerated a great number of changes in the employment landscape, some of which may involve pre-pandemic jobs not returning. There are now nearly 10 million fewer jobs than there were in February.[13]

How will all of this shake out? No one knows for sure of course, but we found interesting the well-reasoned views of Nobel laureate Paul Krugman in a December 31, 2020, New York Times op-ed. In that letter Mr. Krugman spoke of a "clear case for optimism" for the economy and made critical distinctions between what happened in 2008 and what we faced in 2020, including how those distinctions might indicate a much faster recovery now.

The MCA team wishes you wish you a safe, healthy and prosperous 2021.

[8] For example, the Vanguard Value ETF (VTV) current holdings are only ~11.5% technology companies, and the Putnam Equity Income Fund (PEIYX) holdings are only ~10% technology companies.

[9] Anything above 50 signals an expansion; anything under 50 is a contraction.

[10] Source: First Trust Advisors, January 5, 2021.

[11] Source: First Trust Advisors, January 8, 2021.

[12] Source: U.S. Department of Labor. Note that DOL numbers are often revised the following month.

[13] Source: Wells Fargo economist Jay Bryson.

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