INVESTOR NEWSLETTER Armbruster Capital Management, Inc. 4TH QUARTER 2020

The ACM Journal

Take to the Sea

Maybe it is because we have our first child going off to college before too long. Maybe it is because we've been cooped up for the past year. Whatever the reason, Nipa and I decided we need to inject a little new adventure into our lives.

For Nipa, adventure means travel to new places. For me, it means outdoor activities. Unfortunately, travel isn't practical these days, so at least for now, Nipa agreed to go along with my plan. That included buying kayaks.

Buying anything outdoor-related is not an easy task in today's COVID world. Stores are sold out of just about everything. However, after much research, I found a small company in Tacoma, Washington that makes sea kayaks and had capacity to build a couple more for us.

Now, these are not your typical plastic, floating bathtub-style kayaks. These are high-performance fiberglass boats that could be taken out on the ocean or for multi-day excursions. Nipa seemed perplexed that we would need that level of equipment but chalked it up to a typically over-zealous husband.

The kayaks arrived just before Christmas. I bought a couple

continued on page 6

IN THIS ISSUE

Portfolio Review 1
Take to the Sea 1
Blue Light Special........... 3
Chris's Corner 5

Portfolio Review

Many are happy to see 2020 come to an end, but it was actually a pretty good year for investors. Just like every other aspect of life, the capital markets were a bit weird, but headline gains for both stocks and bonds were impressive.

The S&P 500 Index gained 18.4% in 2020. Mid-cap and small-cap stocks earned more modest, but still solid returns of 13.7% and 11.3% respectively. International stocks continued to lag U.S. stocks, but rose a still respectable 7.8%. Very few would have predicted these types of returns back in March when the global economy was virtually shut down for COVID.

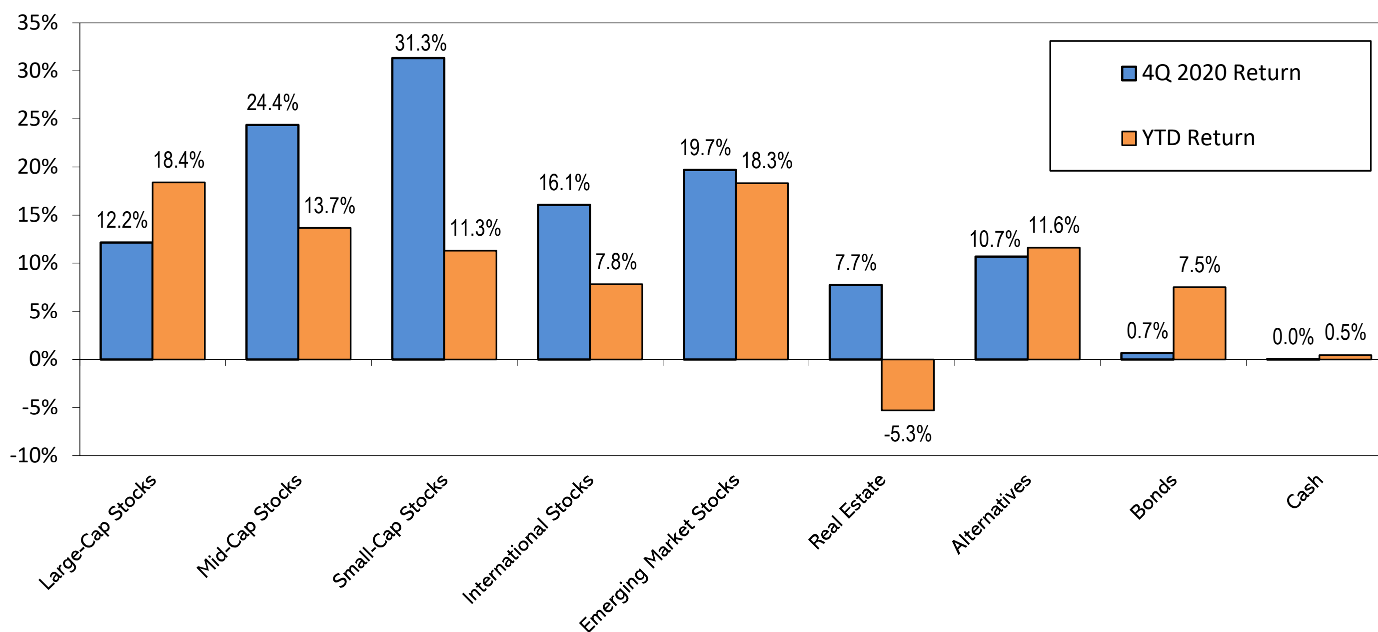
A Tale of Two Markets

The weirdness factor comes into play when you look beneath the returns of the headline indices. Growth stocks rose over 30% in 2020 while deep value stocks posted a loss of around 10%. It clearly was a tale of two markets. Value stocks have historically generated stronger returns than growth stocks over very long periods. However, there are fairly long periods when that has not been true. The current period and the decade of the 1990s are prime examples. Value stocks were already relatively cheap compared with growth stocks at the beginning of 2020, but the COVID shut down hit them much harder than the rest of the market. Value stocks experienced a deep decline that they are still recovering from. They rebounded sharply in the fourth quarter, earning 25.8%. Small-cap value stocks performed even better with a 31.7% return. The fact that they were both still down year-to-date shows the depths of their declines early in the year.

The value rout was largely because of weakness in banks and energy companies. Banks expected enormous loan defaults because of COVID. They proactively booked large losses as reserves against these defaults, hurting earnings and stock prices. But, so far, the drubbing hasn't arrived, and it is likely banks will see a boost in their earnings as they reverse these write downs. Energy suffered as oil prices cratered in the face of less demand. Without travel, there is little need for jet fuel or gasoline. However, oil prices have started to recover, and there is optimism that energy companies' earnings will rebound as the COVID vaccine takes effect and life returns to "normal".

At the root of value's woes last year was the fact that the stock market rise was very narrow. It was driven primarily by only a small handful of stocks, the so-called FAANG stocks. That awkward acronym stands for Facebook, Apple, Amazon, Netflix, and Google. Microsoft, Tesla, and a few others were also key drivers of

continued on page 2



Large-cap, mid-cap, and small-cap stocks are represented by the S&P 500, 400, and 600 indices. International and emerging market stocks are represented by MSCI indices. Real estate is the Dow Jones Real Estate index. Alternatives are represented by the HFRI Fund Weighted Composite index. Bonds are the Barclays Aggregate Bond Index. Cash is the yield on the 30-day T-Bill.

Portfolio Review

continued from page 1

the stock market's gains, but the rise was certainly not broad based. This is reminiscent of the Tech Boom in the 1990s.

Lower Returns Ahead

The Tech Boom didn't end well for investors. While it is not certain that we will see a similar fate this market cycle, valuations for much of the stock market are quite high. Economic stimulus from the government may continue to push stocks higher, but the long-term impact is more concerning. Too much stimulus could lead to inflation and higher interest rates, which would be bad for stocks. A little inflation can help boost earnings, but too much can cause uncertainty, and stock market volatility. Rising interest rates, which often accompany rising inflation, make it harder to justify high valuation levels for stocks, and could be a catalyst for a market decline.

While none of that can be forecasted with any accuracy, there are some things we know for sure. The big one is that high valuations on assets today lead to lower returns tomorrow. So even if stocks don't decline significantly, their returns are unlikely to be as strong as they have been in the past. When valuations have been at today's levels, future ten-year returns have generally been in the low single digits.

The same is true for the bond market. The starting yield on bonds is a strong predictor of future ten-year returns. The current yield is just north of 1% but was as low as 0.5% earlier this year. That likely means bond returns will be below inflation in the years to come, despite the bond market's strong gain of 7.5% in 2020.

A Rotation Ahead

A stock market rotation may already be under way. As mentioned above, value stocks staged a strong rally late in 2020. It is not certain if that will continue, but a change in market leadership seems imminent, and those betting heavily on future gains in the largest technology stocks will likely be disappointed. Turning to

market segments that have been out of favor, like value and international stocks, will probably be the best bet to generate market-beating returns in the future.

Alternative Recovery

Another approach to reaching for better returns would be to use alternative investments. While no one likes these funds after their poor performance the past few years, there were some bright spots in 2020. Both the private lending and reinsurance funds we use posted solid gains in an unlikely environment.

The private lending fund (LENDX) is expected to generate steady gains over time but should lose money when unemployment rises, causing people to default on their loans. Unemployment spiked quickly and sharply in 2020, and the fund declined in value. However, as the year wore on, it became clear that not many people were defaulting. The fund focuses on borrowers with higher credit quality, and many professionals kept their jobs despite rising unemployment. They merely shifted to working from home, while most of the negative impact from unemployment was borne by those in the service sector. So, despite high unemployment, the fund rose 7.6% in 2020.

Similarly, the reinsurance fund (SRRIX) had a decent year, earning 6.8%. This fund should earn money when there are few big storms or natural disasters but should lose money when big storms strike populated areas. 2020 experienced a record number of hurricanes and tropical storms. However, most of them were category three or smaller, and the fund only pays out for damage caused by category four or higher storms. There also were not a lot of storms that made landfall, and those relatively few that did hit areas with lower population density. So, even in an environment where logic would suggest negative returns, the fund was able to perform quite well.

That is not to say alternative investments had a terrific year. There were other funds that lost money. However, LENDX and SRRIX illustrate that markets can work in mysterious ways, and a long-term, diversified portfolio is your best bet for building long-term wealth.

Despite the pandemic, civil unrest, and a highly erratic political environment, 2020 turned out to be a good year for investors. Most forecasts we've seen for 2021 call for a strong economy, but the year is still young, and weirdness seems to be the order of the day. We still have a highly divided nation, lofty stock market valuations, and have not definitively cured COVID. So even though we may need to buckle up in the near future and ride through some turbulence, a thoughtful and diversified approach should still keep the long-term destination in view.

Blue Light Special

Stocks are trading at all-time highs and stocks of unprofitable companies seem to earn the largest gains. Technology, momentum, and growth are the order of the day. Is bargain hunting in such an environment a fool's errand?

Even with all the froth in the market today, there are still some segments of the stock market trading at rock bottom valuations. It is likely some of them will be big winners in the years to come.

Around the office we have been referring to these market segments as Blue Light Specials. As in "attention K-Mart shoppers…"

I don't like to admit it, but back in high school I worked at K-Mart one summer. The pay was $6 per hour and all the pride I could swallow. It wasn't the best job, but I vividly remember the Blue Light Specials. The store actually had a flashing blue light that one of the store associates would haul over to signal the monumental bargain being offered. There was also an announcement over the store's PA system in case anyone missed the big flashing blue light.

Unfortunately, in the stock market there is no announcement and no flashing blue light to point out the cheapest stocks, but among the hot IPOs and soaring tech stocks, there is an opportunity that could help protect capital and also generate significant returns in the decade to come.

These strategies still involve risk and concentrating in them is unconventional. The order of the day is to buy the biggest technology stocks, such as Apple, Microsoft, Google, etc. That is the easy trade. They are solid companies with strong

continued on page 4

Blue Light Special

continued from page 3

growth profiles. Their historical returns have been stellar, and these stocks earn glowing headlines in the media on almost a daily basis. The problem is, they likely cannot continue to provide this same level of returns going forward.

The alternative though is to buy Blue Light Specials, such as value stocks, that have struggled to keep pace with the overall stock market the past several years. They are also in non-flashy industries, or industries that may face future regulatory headwinds, like energy or financials. However, many of these stocks now trade at such attractive levels, that regardless of future headwinds, it seems the stocks almost can't help but outperform in the coming decade.

But note, there's that pesky issue of timing. While it seems obvious that a shift from growth to value will occur, no one knows precisely when. It could be starting now, or it could take several more years. If it takes longer than anticipated, that perceived unconventional failing can result in a lot of pressure to make changes at precisely the wrong moment. This can result in permanent damage to a portfolio.

And, even if we're right, there could be some bumps along the way. Market rotations historically have been accompanied by severe downturns. Today's cyclically-adjusted price/earnings or CAPE ratio for the S&P 500 is the second highest ever recorded, behind only the Dot Com Boom of the 1990s. Prior CAPE peaks have been followed by significant market declines, such as in 1929 and 2000. These have also marked changes in market leadership away from growth and toward more value-oriented stocks.

Of course, we can't say for sure that this market rally will end with a bust. Though, even without a big stock market decline, the data is quite clear that high valuations today lead to low future returns. Forward ten-year returns for the S&P 500 have been at most 6% annualized, and at worst negative when starting valuations have been as high as they are currently. Many forecasters expect anemic or even zero returns for stocks for the coming decade.

This "lost decade" scenario is not without precedent. It happened in the 2000s when the point-to-point return for the S&P 500 was less than 1%. Often during these periods, poor performance for stocks has been somewhat offset by stronger returns for bonds. However, we recently read a paper published by investment firm GMO that shows six periods ranging from seven years to 19 years in length where a 60% stock and 40% bond portfolio generated flat or losing returns. Their data goes back to 1900, but four of these dead money periods occurred during the post-war era.

GMO points out that each of these periods was preceded by either stocks or bonds being overvalued. Today we have the dubious distinction of an era with both stocks and bonds in historical valuation territory. Not only is the CAPE ratio the second highest on record, but interest rates are as low as they have ever been. This will likely result in long-run bond returns of around 1% annualized.

If these forecasts are correct, the high returns we have enjoyed from both stocks and bonds in the past are unlikely to persist. However, institutional and individual investors' needs won't change as a result of the coming shift in returns. So, something needs to be done within portfolios.

Our solution has been to focus on Blue Light Specials. Value stocks globally are trading at valuations as low as they have ever been relative to growth stocks. Emerging market stocks and small-cap international stocks also sport very low valuations. While these market segments are not without risk, we expect they will hold up better than the overall stock market in a downturn and should rebound more quickly.

Value stocks were already cheap compared with growth stocks prior to the COVID downturn. However, the gap widened even further as the economy shut down, which punished cyclical stocks and rewarded growth stocks in the technology sector. This valuation gap cannot be justified by differences in fundamentals, as the least profitable companies have been the best performing stocks lately. Thus, value stocks now offer a rare chance to buy good assets at great prices. In fact, famous value investor Warren Buffet has earned his best returns during periods when value stocks were cheap, and today's environment is the cheapest ever.

Similarly, international stocks have underperformed the U.S. market

continued on page 6

Chris's Corner: Roth IRA Conversion

To convert, or not to convert, that is the question. While Hamlet dithered over trivial questions about life and death, the consideration of how to optimize the tax efficiency of your IRA is far more interesting and important, but it can also be just as tricky.

One way to minimize taxes is to consider converting some or all of your IRA to a Roth IRA. Reasons to do so include:

Tax free withdrawals after 59½

When you take withdrawals from your traditional IRA you are required to pay ordinary income taxes on the total amount distributed (sans any portion that you contributed with post-tax dollars). Conversely, all distributions from Roth IRAs, as long as you meet certain requirements, are tax free.

No required minimum distributions (RMD)

Unlike with traditional IRAs, there are no RMD requirements with Roth IRAs. This allows for your money to grow tax free for a longer period.

Tax free inheritance

Your beneficiaries who inherit your Roth IRA will have to take RMDs, but they won't pay taxes on the distributions, as long as the account has been opened for at least five years. Even if the account has been opened less than five years, only the growth or earnings portion is taxable; your principal may be withdrawn without taxes.

The inheritance issue has become even more important after of the passage of the SECURE Act in late 2019 that discontinued the stretch option for inherited IRAs. The new rules require beneficiaries to withdraw the inherited assets within 10 years. If you're in the "classic" retirement situation where you're living off Social Security, portfolio income, and maybe a pension, your RMDs and other IRA distributions are likely being taxed at a reasonable rate. Now fast forward to the date that your beneficiary inherits your IRA. Again, in the classic situation your child/children are now in their peak earning years and the money you just left them must be distributed over the course of 10 years. Both your savings and the money they are earning could now be subject to taxes at a higher rate.

The unfortunate fix to this is to start thinking again about death and taxes, and to determine if it makes sense to start distributing more money now at a lower rate or leave a larger balance that could be taxed at a higher rate. If you are in a low bracket and have successful beneficiaries, then the determination is easier.

Even if you're not concerned about your beneficiary's tax issues, there may be an opportunity to improve your own tax situation, particularly if you're already retired and aren't collecting social security yet. At age 72 you are required to take RMDs from your IRAs. The rates, and likely amounts, based on the IRS' Uniform Life Table, will continue to increase as you get older and can end up pushing you into higher tax brackets down the road. It can therefore make sense to distribute assets out of retirement accounts before RMD time at a lower rate in order to minimize future taxes.

Generally, the biggest downside when thinking about Roth conversions relates to how to fund paying the taxes now and suppressing the mental accounting around having a smaller post-tax portfolio. We recognize everyone's situation is unique and are happy to talk through if it makes sense for you.

What is ACM?

Armbruster Capital Management, Inc. (ACM) is a boutique wealth management firm serving high-net-worth individual and institutional clients. The firm's innovative "Passive Quant" investment approach incorporates cutting edge financial research to help control risk and pursue superior returns. ACM uses index funds, exchange-traded funds (ETFs), and other investment vehicles to build portfolios designed to reduce investment-related costs and taxes in order to maximize net returns.

Located in Pittsford, New York, ACM is employee owned, independent, and minimizes conflicts of interest. Acting as a fiduciary, the firm creates truly customized investment portfolios tailored to each client's unique objectives.

Take to the Sea

continued from page 1

paddles and set out to get life jackets and other gear we would need. At this point, Nipa asked why I was in such a rush, given that it was winter.

I should explain that Nipa's vision of kayaking is gently paddling around a small lake on a calm, sunny day. She would enjoy taking in the wildlife and relaxing to the sounds of water lapping against the side of the boat. This vision was upended when I explained how I wanted to use the kayaks.

My vision included paddling year-round and taking longer trips with camping gear stowed in the fore and aft hatches. Maybe we would sleep on an island in the Adirondacks or the Thousand Islands. We could cook on our camp stove and sleep in a tent. Days would be filled with paddles of ten or twenty miles as we move on to the next campsite.

It was when I told Nipa that I was going to get out kayaking as soon as possible that the reality of our divergent views kicked in. She informed me, quite definitively, that I would be doing so alone at least until the weather hit sixty degrees.

So, I have been taking solo excursions. I bought a dry suit, which effectively is a set of Gore-Tex footie pajamas. This keeps me safe in case I capsize in almost-freezing water. I'm happy to report I haven't needed it yet, but it does make me, and Nipa, feel better to know I could survive a surprise dip if I needed to.

I have been sneaking out early in the morning on weekends. I don my protective gear, load up the kayak, and head to a local lake. There are a couple that have no cottages on them, so it is just me and the loons most days. I have encountered rain and snow, but the weather really doesn't matter with my dry suit. There are some areas that are icing up, and I've even hit a couple small icebergs, but given the fairly warm winter so far, I expect to be able to get out for at least several more weeks.

Once winter gives way to spring, I'm sure I'll have more company. I'm thinking any long-haul camping trips will have to be with my kids rather than my wife. But I know Nipa and I will spend plenty of hours together, gently paddling along on nice days. That is enough adventure for her.

Blue Light Special

continued from page 4

for a long time now. International economies have largely lagged behind the GDP growth rate in the U.S., so much of this underperformance has been justified. But there are international market segments that are super-cheap currently, such as emerging market stocks, small-cap international stocks, or for those with an even larger risk tolerance, emerging market value stocks. These all trade at rock-bottom price/earnings ratios and below their book value. As a comparison, the S&P 500 is over two times more expensive on a P/E basis and trades at more than three times its book value.

While these market segments can be volatile, it is also risky to pile into overvalued growth stocks today, even though that might be a well-accepted approach based on recent historical returns. But for those with a higher risk tolerance and an appetite to deviate from the norm in search of higher returns, the Blue Light Specials seem particularly attractive.

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