2020 and Its Aftermath

Ballast Your Portfolio to Thrive in a Rapidly Changing World

January 14, 2021

How quickly the world can change

We all recall how January 2020 started. We greeted the new year with markets thriving in placid conditions. For several weeks, fully priced markets continued their rally unabated. Only later in the month would they slow when news emerged of portending signs of supply chain disruptions attributable to a new seasonal virus outbreak in central China. Little did the world know what lay ahead, or how unprepared it was for the challenge.

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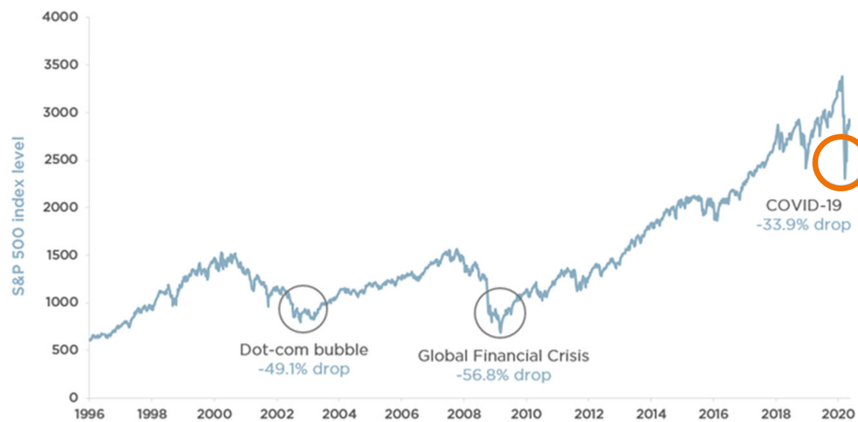
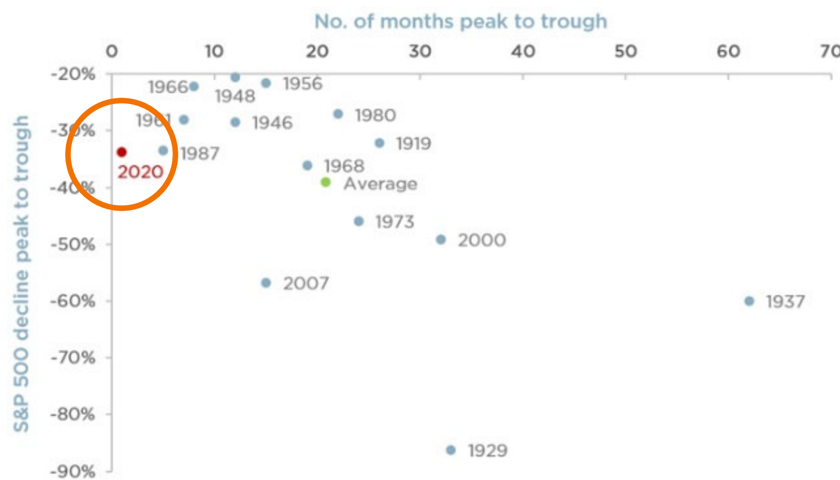
We are now all too aware of the devastating consequences the COVID-19 pandemic has wrought. The impact is pervasive – striking our families, communities, social fabric, well-being, and economy. Hard to detect (not enough testing), hard to trace (symptoms weren't always present) and without a cure, COVID-19 initially overwhelmed the hospitals in Europe and the east coast of the US. Policy makers and a frightened populace triggered shutdowns of major segments of the global economy. This roiled risk assets over the span of four weeks, setting off a series of corrections not seen since the Great Financial Crisis and moving at a pace never before witnessed.

COVID-19 represented the third largest market correction in 25 years [1]



The speed of the sell-off was unprecedented in 100 years [2]



[1] Roy Davidson, "How Does COVID-19 Compare to the GFC?," Craigs Investment Partners, June 2020.
[2] Ibid.

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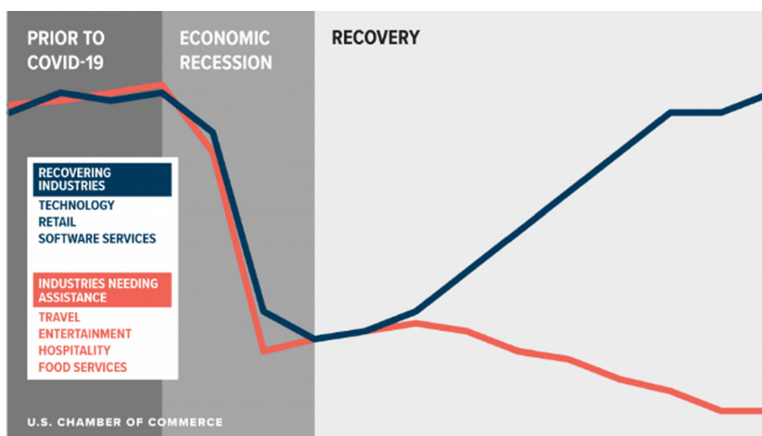
As shutdowns reigned during Q2, regions of the world selectively emerged from the crisis. Economic growth picked up after falling at record rates. Societies tentatively "opened up" again. In our changed world, however, social distancing and facial masks became standard operating behaviors for many. And while vaccines are now approved and their distribution begun, for the near to medium term the virus will continue to challenge our lives and the global economy.

What strikes and ricochets in the economy, ultimately recoils through the capital markets. The rapid shedding of risk during Q1 and the re-establishment of risk positions during the balance of the year challenged many investors. Many cut back exposure during the depths of the crisis. Many remained reticent to fully deploy capital as markets not only corrected but ascended to new highs. Such ill-timed portfolio risk decisions serve to underscore why portfolios need "ballast." Compound benefits accrue to portfolio architectures that help them weather unpredictable periods of economic volatility. Below we will explore how key events impacted the global macro-investing backdrop and then describe how one can think about building more value through resiliency.

The pandemic reveals economic weaknesses

It is too soon to conclude how 2020 has changed us. But what is clear is that the pandemic catalyzed changes with far-reaching consequences. Virtual learning, video meetings and delivery services became the new norms across our lives. Social interactions were deeply challenged. We all continue to question when we will return to normal and how that process will evolve.

A bifurcated recovery picture in COVID-19's wake [3]



The economic fallout of 2020 was harshly focused. The pandemic-induced changes impacted portions of the economy and population differently. Initial central bank and governmental responses were rapid and predictable. Massive monetary easing and fiscal spending on economic support packages around the globe provided much-needed though uneven support. Understanding the breadth of population effects and differential impact of the

[3] Suzanne Clark, President, US Chamber of Commerce, "What is the K-Shaped Recovery?," U.S. Chamber of Commerce, Sept 3, 2020.

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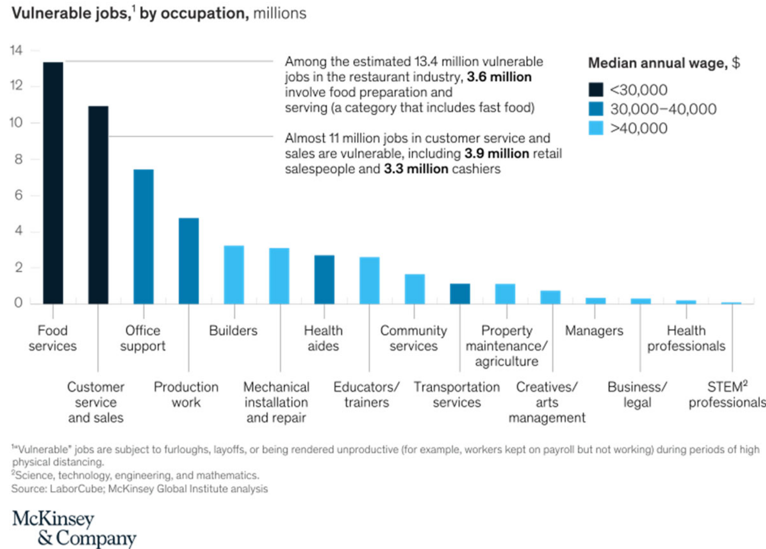
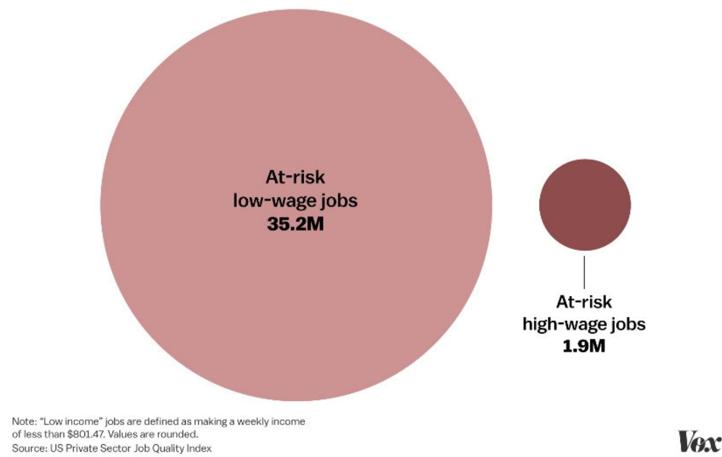
pandemic can help investors understand the likely second wave of fiscal and macroeconomic responses yet to unfold.

46% of vulnerable jobs are in food service, customer service, and sales [4]



37+ million US jobs may be at risk, and highly concentrated among low-wage earners [5]



[4] Susan Lund et al, "Lives and Livelihoods: Assessing the Near-Term Impact of COVID-19 on US Workers," McKinsey & Co., Apr 2, 2020.
[5] Emily Stewart and Christina Animashaun, "How the Coronavirus Crisis Will Hit American Workers, in One Chart," Vox, Mar 24, 2020.

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Waves of macroeconomic responses yet to unfold

Just as the virus poses vastly different mortality and morbidity risks to different segments of the population, the virus's economic effects pose vastly different economic risks to industries, employees, businesses, and more. These many dichotomies of outcome will continue to drive the agenda in Washington. Political will is mustered by the velocity and mass of effects on constituents, and there is no greater policy momentum created than pervasive effects on the population.

A new Biden administration will almost certainly look to address these economic hardships with a shift toward significant fiscal initiatives. These will likely play out in the coming years with a focus on job support, student debt relief, and other forms of direct economic assistance. In addition, long term structural public spending appears more likely. This will eventually be paid for with larger deficit spending, much of which may be initially sterilized by Fed support. The fragile détente of market confidence in central bank monetization is likely to hold steady, but one of the most cogent macroeconomic questions that stands before investors is when does this confidence weaken? The critical follow up question for investors to plan for is how does this eventual weakening manifest itself in global capital markets? Is it gradual, or does it inflect in a disruptive repricing of risk? Is it more of the same or, amplified by understatement, does it get interesting?

A post-COVID economy will accelerate the inevitable

The pandemic has spotlighted change. COVID-19's differential economic impacts will likely lead to policy momentum accelerating changes already afoot. As bright as the spotlight has shone, no more glaringly did it illuminate opportunities to address our biggest environmental and social challenges from climate change to healthcare. The specific responses may well be further propelled by our time when social justice awareness and inclusion are on the rise.

The scale opportunities for governmental job creation will likely come in the form of infrastructure and energy transformation spending. Separate from political and communications efforts, it is the legislative drives thereafter that may move hundreds of billions, if not more, in fiscal spending that will impact investor opportunity.

ESG opportunities rise

Until now, the optical focus of many ESG strategies reflected a slow recognition of inequities and imperatives for change by Wall Street as well as Main Street. Typical of change, there is mixture of vision and temerity. Consider two recent events. At nearly the same time, there were proposals by the NASDAQ to make diversity a requirement of the listing requirements for the exchange, demonstrating one exchange's attempt at redress. Meanwhile, the US Department of Labor issued guidelines restricting ESG investments and throttling true fiduciary responsibility by confusing the past with the future.

We believe the pandemic's aftermath accelerates tempo and deepens commitment. ESG investing is more than optical. A full spectrum view of ESG impact is the largest thematic investment opportunity in a generation. Sophisticated identification of ESG factors reveals their critical underpinning of economic and enterprise growth in the decades ahead. Creating an environment well-suited to investment themes that successfully incorporate these risks is essential to the long-term health of our global communities, and therefore, aligns with the most powerful global macroeconomic growth themes of the 2020's and beyond. Flows are at an early stage. ESG investment

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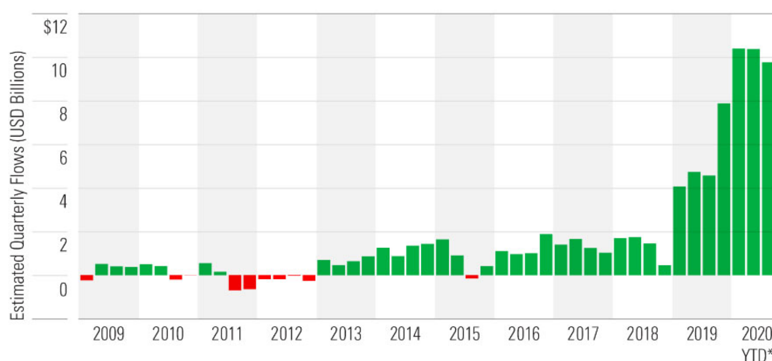
returns will benefit from inexorable growth trends fueled by strongly accelerating environmental, societal, and demographic preference changes in the decade ahead.

Only the Beginning

U.S. sustainable fund flows continue to reach new highs [6]



Source: Morningstar Direct. Data as of 9/30/2020. *YTD 2020 as of 9/30/2020.
Includes ESG Integration, Impact, and Sustainable Sector funds as defined in Sustainable Funds U.S. Landscape Report, 2018. Includes funds that have been liquidated; does not include funds of funds.

A variety of market effects complicate the investment outlook

Central bank policy options are at a crossroads. While interest rate policy has reached effective limits in the majority of large economies, quantitative easing options remain. With the latter's principal effects driving asset prices, fiscal policies will dominate in 2021 to affect any large-scale economic stimulus. Such policies will be deficit-funded and thus interplay with QE policies. These deficits will either have to be monetized or funded. Either approach should put pressure on long- term rates as economies emerge from the COVID-19 crisis. Each approach raises the specter of policy response questions with economic growth, deficit payment financing, and inflation mixing in a cauldron of yield curve control.

The pent-up demand for those consumer activities restricted by the pandemic will be great and fueled by increased consumer savings. Varying increases in demand spread across different sectors of the economy may produce complex inflationary effects. Overall, we would expect consumer demand to have a powerful healing effect on the economy as pandemic control rises.

[6] Jon Hale, PhD, CFA, "U.S. Investors Continue to Endorse Sustainable Investing," Morningstar, Oct 29, 2020.

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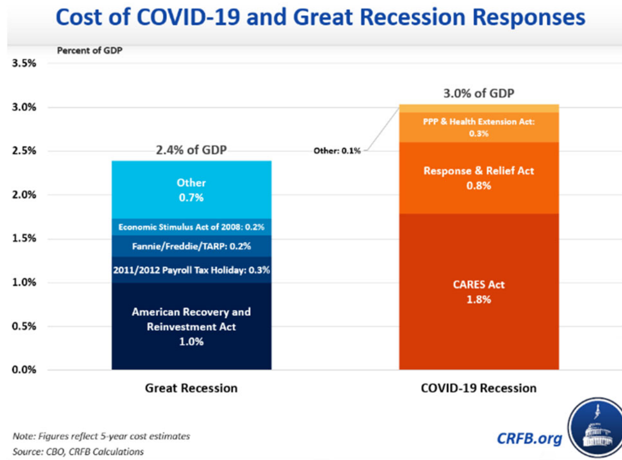
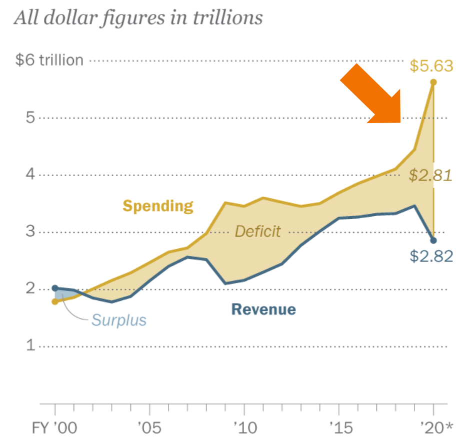
U.S. COVID-19 relief bills total almost $5 Trillion, exceeding the sum of those passed during the GFC [7]



The U.S. budget deficit ballooned during the pandemic as government spending spiked while revenues dropped [8]



*First 10 months of fiscal 2020.
Sources: Office of Management and Budget (historical budget data), Bureau of the Fiscal Service (FY2020 data).
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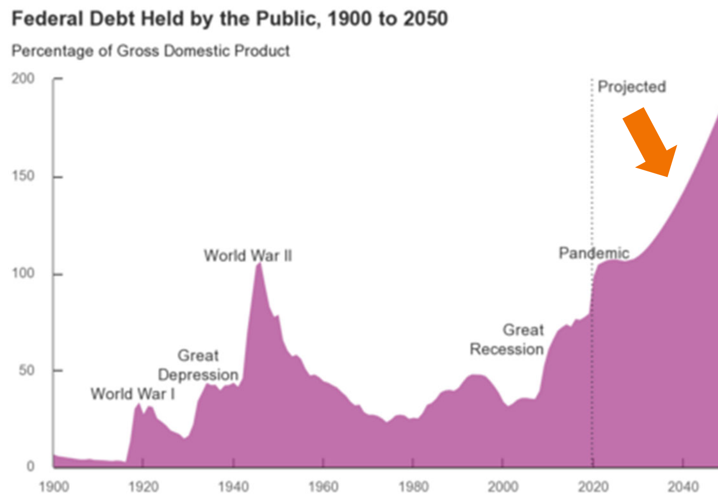
Larger deficits lead the CBO to revise US federal debt projections upward, now forecasted to reach 195% of GDP by 2050 [9]



[7] "The Fiscal Response to COVID-19 Will Be Larger Than the Great Recession Response," Committee for a Responsible Federal Budget," Dec 22, 2020.
[8] Drew Desilver, "The U.S. Budget Deficit Is Rising Amid COVID-19, But Public Concern About It Is Falling," FACTANK News in the Numbers, Pew Research Center, Aug 13, 2020.
[9] Congressional Budget Office, "The 2020 Long-Term Budget Outlook," Sep 2020.

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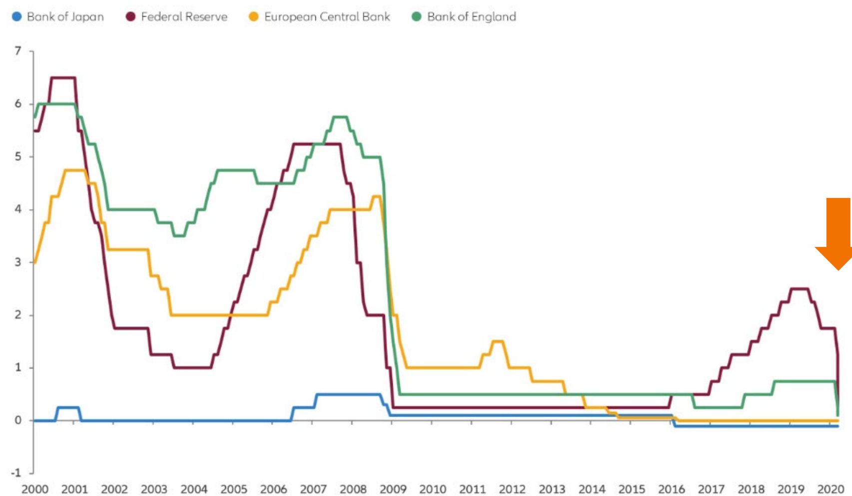
These same market effects open macro trading opportunity

We believe these extreme responses are a backdrop for market trading opportunity. Continued capital market movements will abound, but we do not expect them to be unidirectional nor necessarily stable. Markets have already priced in a return of demand so the rate and magnitude that unfolds remains important to outlook. Persistent Central Bank policy toward low rates will require exchange rates to be a release valve for economic imbalances. The general depreciation of the USD this fall against major trading partner's currencies reflected a first wave of these effects. Former opportunities for directional trading in short dated fixed income may move to currencies with near zero-bound interest rates globally. A post COVID-19 recovery should also boost commodity prices. We are already seeing anticipatory moves in energy and agriculture prices, and these may well continue into 2021 adding to macro trading opportunities.

Policy rates set by major central banks are at low or negative levels [10]



[10] Stefan Hofrichter, "Bond Investors Should Expect Continued Low Yields and Low Returns," Allianz Global Investors, Jan 4, 2020.

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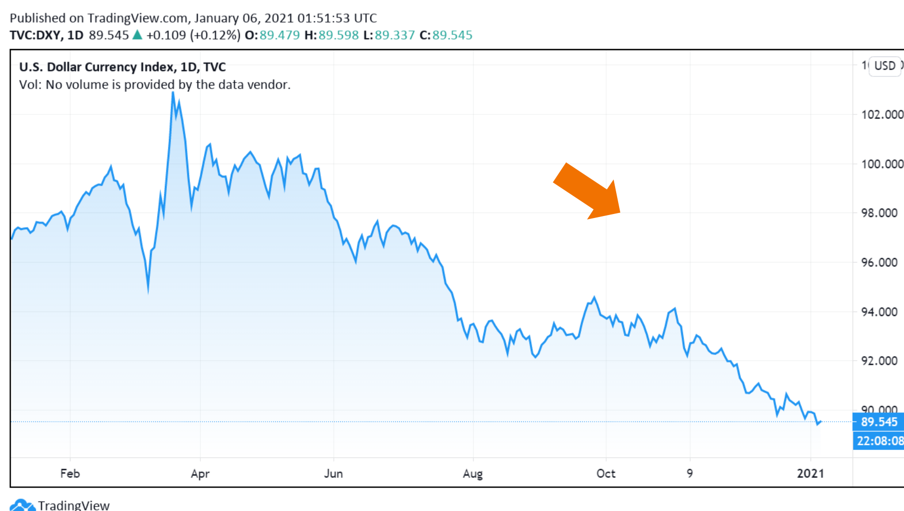
Steady USD devaluation over the last 12-months [11]



Given the breadth and magnitude of capital flows in 2020, the rebound and equilibrium effects in 2021 could be profound. Capital flow differentials will impact markets across sectors, geographies, currencies, credits, and asset classes including real estate and commodities.

The active capital flow conditions seen in 2020 brought both opportunity and risk, and unfolding macroeconomic conditions may stimulate meaningful capital flow conditions again in 2021 and 2022. The amounts of monetary, fiscal, and private capital are simply too enormous to shift without notice. Asset prices will reflect these flows moving with tidal strength.

Building ballast is a structural advantage

In a market environment buffeted by so many different countervailing factors, how should investors think about investing?

Picking one or another trend to react to is a wager on concentration. A clear lesson of 2020 is forecast humility. Another year reminding us that of the near impossibility to predict what will cause risk appetite to change. As a teacher, another lesson of 2020's is timing humility. The year exhibited the damaging rapidity with which markets can decline.

In a connected world of capital markets, designing resilient portfolios requires more than a diversity of assets. The simultaneity and force of capital shifts can easily overwhelm basic diversification. Designing portfolios that can endure unanticipated market environments requires a diversity of strategic investment approaches. One where each approach can perform, based upon first principles, not only during conditions as they occurred in the past but in similarly principled conditions as they may occur in the future.

[11] Tradingview.com

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At a strategic level, introducing strategies into one's portfolio that likely generate positive returns during periods of economic contraction augment those that thrive in procyclical periods. The compelling fiduciary result is that mitigating drawdowns through portfolio construction elevates the compounded return on capital through time. This outcome is fostered by talent. It is impossible without a steady hand.

Advisors have always encouraged investors to have staying power. Too often dismissed as anodyne, too few make choices to put the power in their hands. The challenge of 2020 is having the ability to discern noise from the longer-term generation of value. Markets and intermediaries are designed to challenge investors' strategic holding power. The emotional challenge amplifies overreaction and preys upon poor portfolio design especially when the charts are flashing bright red, the commentators are telling everyone how awful the climate is, and most likely the bad news has already been priced into the market. This is why a portfolio must have ballast. Investors need the confidence to know that the portfolio is well built to sustain such periods. Preparation fortifies resolve.

Ideally, a portfolio with staying power will relentlessly capture the longer-term trends AND harness resiliency by profiting from shorter-term capital-driven market shifts. It is not enough to simply own multiple assets when capital can move rapidly among them or devastatingly shift from them all wreaking havoc in value. Capturing return from the capital movements themselves converts motion to return. It is the most enduring form of ballast.

When a narrowly perceived risk in modern portfolio theory is, in fact, an ever-recurring capital market behavior, it is not a risk. It is an uncaptured opportunity. When the uncaptured opportunity yields enduring diversification, it is a structural advantage. The strengthened design allows the portfolio alpha of capturing performance over cycles and from the cyclicality. Investors are empowered to build less fragile portfolios psychologically and arithmetically fortified to thrive.

Designing for uncertainty and behavior

Overreaction is an investor's adversary. And overreaction to events like Q1 or even Q4 of 2020 is simply to be unprepared to follow an investment through severe uncertainty when the reaction to severe uncertainty itself was never sufficiently planned. Behavioral economics is the important yet academically sanitized taxonomy of human cognitive bias. We cannot design around the human centricity of reaction bias. It is, however, fully within our power to design for the range of uncertainties that most commonly lead to poor investment outcomes. This can be made easier when ballasting a portfolio. Market panics and severe long-lasting contractions happen as recurrently as other capital markets behavior. Design for them.

A discerning question investors ask is whether their portfolio is built to sustain the range of recurring market risks. And then ask its corollary… is their investment decision process built to resist the market's attempt to withdraw returns from them and hand them to another?

There are critically helpful solutions. There are portfolio strengthening building blocks. Constructing portfolios that integrate orthogonal risk factors is supportive to creating better outcomes. They must, of course, earn adequate returns on capital over time lest they lower long term growth.

More powerful components are strategies that harness returns directly from the principal risks of the portfolio core. Most portfolios are long procyclical risks. Integrating investment strategies that derive returns from dramatic shifts in asset pricing and risk premium create powerful ballast. These strategies effect a rare up-and-to-the-left movement of an efficient frontier proving that most allocation designs are neither efficient nor operating near the most desirable frontier.

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The most powerful action of all for ballasting a portfolio is to access strategies that reduce portfolio fragility through their capture of capital movements and do so in a capital efficient manner. With higher returns on deployed capital, the investor has full flexibility. The investor can both strengthen holding power resiliency through uncertainty and increase their target return profile. The problem of access is scarcity. There are billions of dollars in experience-driven capacity in a world with trillions of dollars of portfolio need. The opportunity for active investment officers is to find them. The benefits accrue with the conviction to use them.

As friends of Welton you know our refined and singular focus is to deliver investment solutions that make portfolios better. All of our solutions focus on delivering ballast to help investors capture both the market opportunities as well as provide downside protection. Our flagship Welton Global strategy was built 17 years ago to do just that. Our newest strategy, Welton ESG Advantage, was successfully launched in June 2020. As the first of our Advantage series, it incorporates the same philosophic underpinnings of Welton Global and applies them in the construction of a responsible, ESG-aware, multi-asset class portfolio. Both have navigated the challenges of 2020 successfully.

Challenging times remind us what is truly important. We certainly have much to be grateful for and this includes our relationship with you. Everyone at Welton wishes you, your colleagues and loved ones a happy, healthy and prosperous 2021.

Basil Williams
Chief Executive Officer

Dr. Patrick Welton
Founder & Chief Investment Officer

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