LIGHTHOUSE CANTON

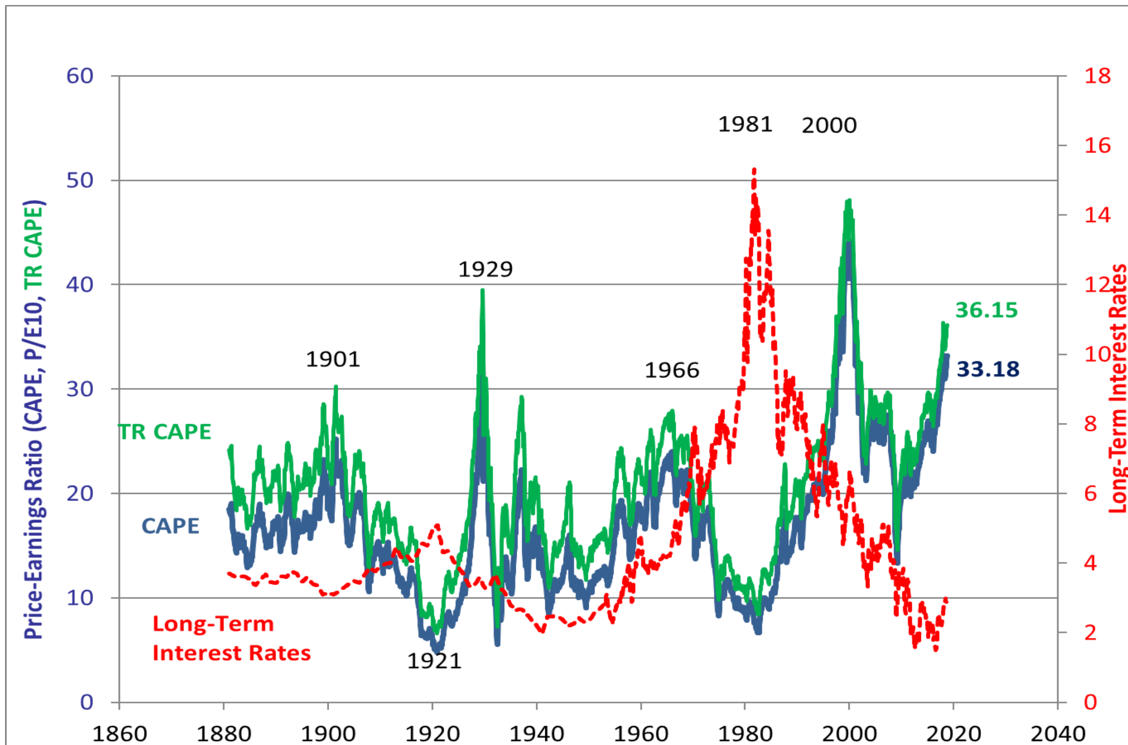
Creating Value through Innovative Financial Solutions

LC Monthly Investment Memo: November 2020

November was a good month for risky assets. Reasonably "smooth" transition from Trump administration to incoming Biden's, combined with the fact that the democrat government will be composed of seasoned professionals (J. Yellen, A. Blinken) has seemed to provide a sense of stability and reassurance to the financial markets. On top of that, investors were relieved on the progress made on the Covid-19 front with both Pfizer and Moderna announcing promising results, with efficiency rate for their respective vaccine above 90%.

In such a supportive context, US equities have broken new record high and pushed valuations even higher. As an illustration, the Shiller Cyclically-Adjusted Price-to-Earnings ("CAPE") ratio currently sits above 33 times, higher than 97% of its historical values dating back to 1881. In fact, the Shiller CAPE indicator has never been so expensive, except during the dot.com bubble (1999-2001) as shown on the chart below. The CAPE, which is pioneered by Robert Shiller, is a yardstick that investors often cite to illustrate that US equity valuations have climbed decisively in recent years. To put things in context, a PE ratio of 33x for the S&P 500, implies that equity investors are comfortable holding the benchmark for a 3.0% expected yield (1/33).

Chart 1: Shiller cyclically-adjusted PE ratio since 1880



Source: Yale University, Robert Shiller

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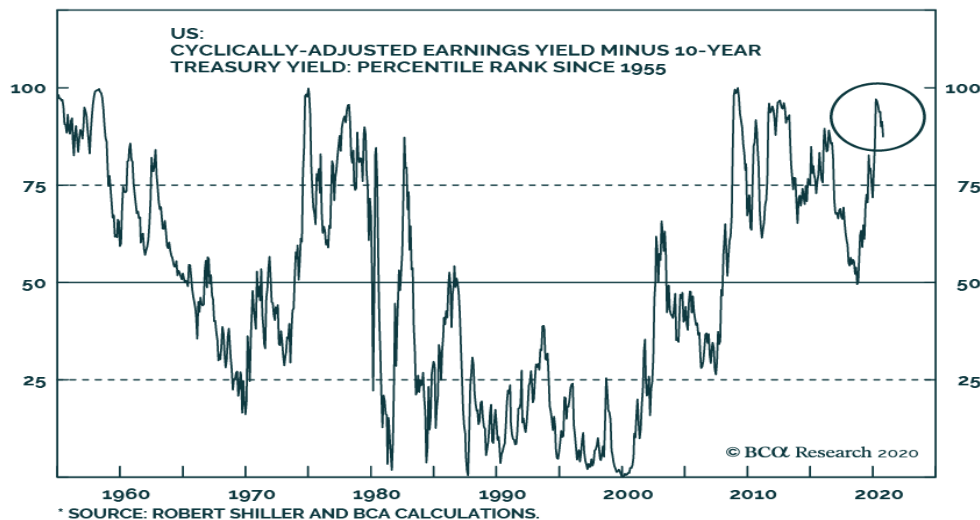
As pointed by BCA research, while valuation of assets drives long-term return prospects, relative valuation is what matters when allocating assets. Chart 2 below illustrates the difference between the inverse of the Shiller CAPE and the US 10-year Treasury yield, in percentile terms from 1955. The chart highlights two interesting points: First, while US stocks have commanded a decisive valuation advantage versus bonds following the 2008-2009 global financial crisis, the rise in bond yields that occurred in the two years following the 2016 US election meaningfully eroded this advantage. Second, the decline in bond yields that has occurred since late-2018 completely reversed this trend, such that stocks are now decisively cheap versus bonds despite having recently risen to a new high. Thus, for investors, the message from the Shiller PE is clear: *stocks are likely to earn below-average absolute total returns in the future but are likely to significantly outperform bonds over the long-term.*

Chart 2: The Shiller CAPE still argues for an overweight equity stance



Source: Robert Shiller, BCA Research

While we agree with BCA research that equities look relatively more attractive than bonds, the question we would like to pose to investors is "how likely are equities to be trading higher (on average) in 12 months' time?". If history is any guide, the probability of US equities performing well is rather thin when looking at Price-to-Sales ratio on S&P 500 index (Chart 3 below). For that specific reason, we think that stock pickers, and especially those with a long/short approach, have a good chance of outperforming benchmarks and consequently ETFs in the coming years, as they have the ability to cherry pick stocks opportunistically. On the opposite, since ETFs return the weighted average performance of their components, we do believe that dispersion within equities may drive ETFs to return disappointing performances when compared with the last 5 years.

Chart 3: S&P 500 index - Price / Sales ratio since 1990

Source: Lighthouse Canton, Bloomberg

For Fixed Income, early November was relatively quiet as companies and investors were waiting for the results of the US election. Anticipations of a large democratic stimulus package and, subsequently higher yields (to compensate for potentially higher inflation), have resulted in corporate resuming their bond issuances in prevision of higher rates in 2021. This translated to the 10-year US Treasury rate rebounding to 90 bps, from an historical low of 50 bps in August, as well as a steepening of the US yield curve as measured by the 10Y-2Y spread now at 72 bps (from 10 bps in March).

On the other hand, the Chinese bond market recently suffered a small sell-off and spread widening due to the departing sanction of the Trump office on “military-related” state owned enterprises (“SOEs”) and defaults of a few onshore bonds issued by some high-profile SOEs. However, some of the sanctioned SOEs actually have very little US market exposures and may now offer good investment opportunities.

Our View Going Forward

Considering the historical high valuations on equities and bonds, we believe investors will have to be increasingly selective to keep attractive returns going forward. In that context we see value in active managers who should benefit from dispersion within each asset class, as opposed to ETFs that will return the average performance of their members. Long/Short managers (bonds and equity alike) are, in our view, better positioned to deliver positive performance in a context of inflated valuations.

Keeping in mind that 90% of a portfolio performance comes from its asset allocation (i.e. proportion of bonds, equities, others), we keep recommending investors to diversify away from the traditional approach of combining equities with bonds. A well-diversified portfolio of low beta managers (0.2 or lower), should be favored in our opinion. Not only are they likely to keep performing well should 2021 be a positive year for risky assets, but they are also likely to largely outperform benchmarks otherwise. As usual, track records and discipline in risk management are paramount when calibrating the long-term allocation to these managers.

Yours Faithfully,

The Lighthouse Canton Team

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