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ON OUR MINDS

20/20 Vision and Walking Around Blind

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Investors are constantly making decisions based on imperfect information; none of us can predict how the future will unfold, nor can we predict how other investors will respond to whatever may happen in the future. Yet we don't get mulligans for events we don't (or can't) foresee – we're still responsible for managing our clients' money prudently and wisely, even when events overwhelm us or upend everything we had anticipated. So perhaps it's not surprising that some of us had the late folksinger Kate Wolf on frequent Spotify rotation last year:

> *I've been to the doctor and he says I'm alright*
> *I know that he's lying 'cause day looks like night*
> *We're stumbling in darkness with our eyes opened wide*
> *20/20 vision and walking 'round blind.*[1]

More than at any time in living memory, investors were truly stumbling in darkness in 2020, unable to know with confidence how the pandemic would evolve or how governments and societies would react to it. Careful attention to emerging data – *eyes opened wide!* – certainly helped us understand our immediate situation but did little to help us assess the future. The Covid-19 pandemic was unlike anything we had seen before; both the disease and our response to it dominated the economy and the markets throughout the year. Now, with 2020 behind us and the new year dawning, we can look backward to assess how we handled the past year – and forward to discuss our positioning for 2021 markets.

2020 Markets Review

Last year's markets passed through three distinct phases: the six-week culmination of an eleven-year bull run, then the steepest bear market in history, and finally a nine-month rally to new highs. By year-end, nearly every asset class had recovered; only oil and the dollar remained in the red (Chart 1). Volatility was extraordinary, as stocks posted more days with 3% price swings than in any year since 2008. The range from high to low and back to high was dizzying: several asset classes lost more than a third of their value through March, only to end 2020 at new highs.

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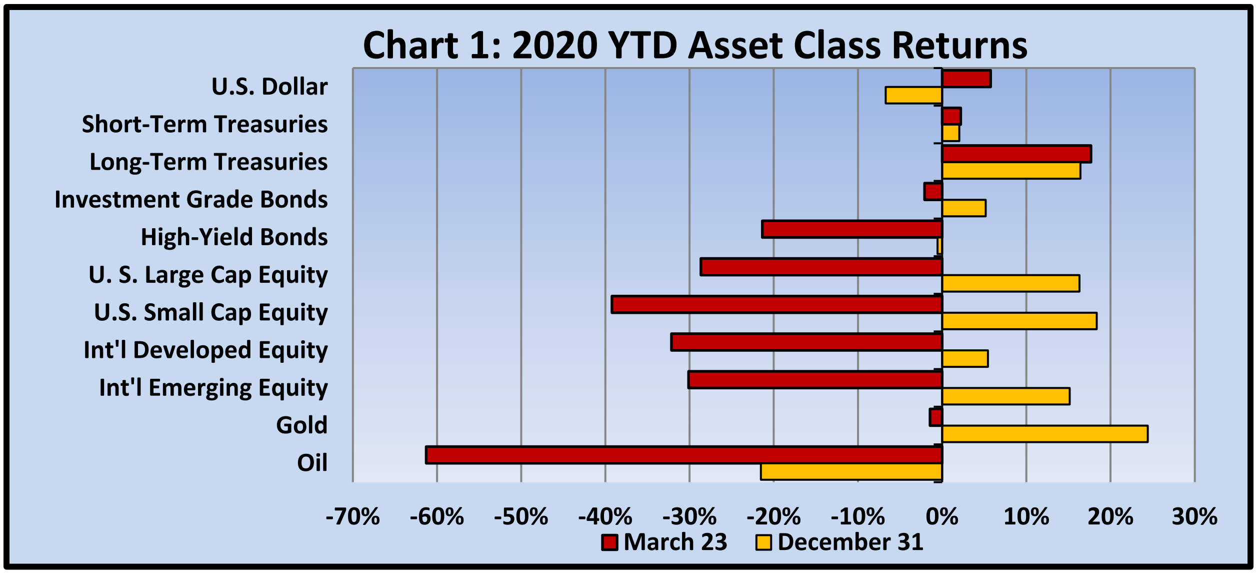
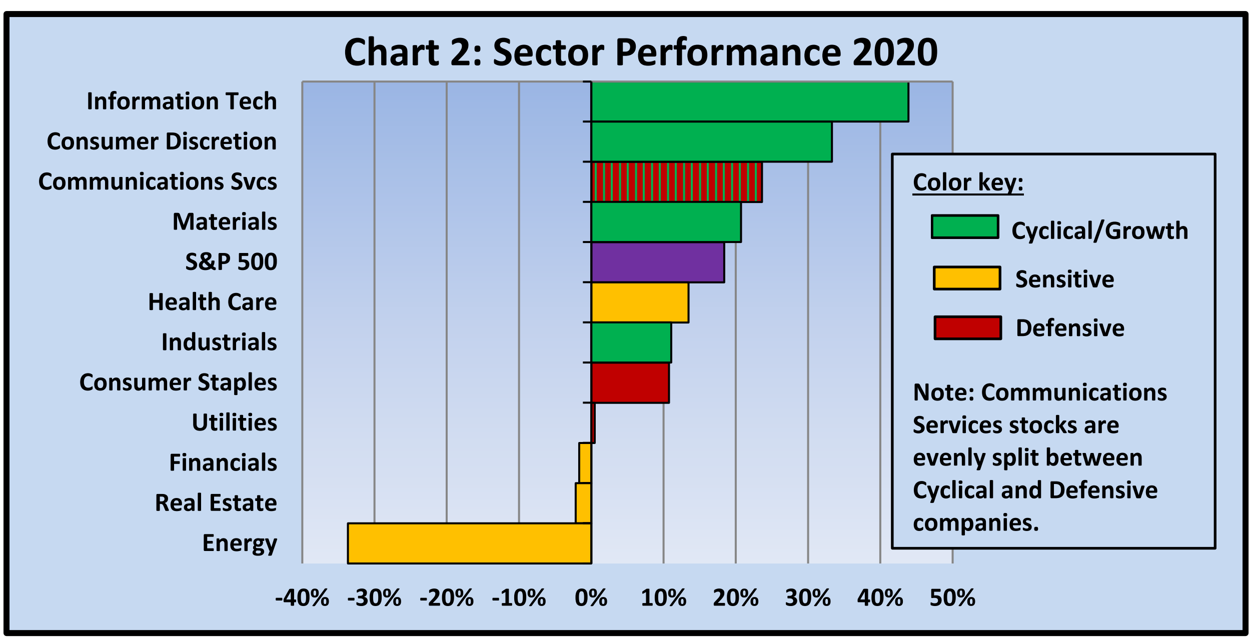
[1] The song was originally recorded in 1954 by Gene Autry and focused on a soured romance. Ms. Wolf's late 1970s update (posthumously released a couple of years ago on the *Live from Mendocino* album) broadened the lament to include an entire world falling apart; somehow her version seems more relevant to the current moment.



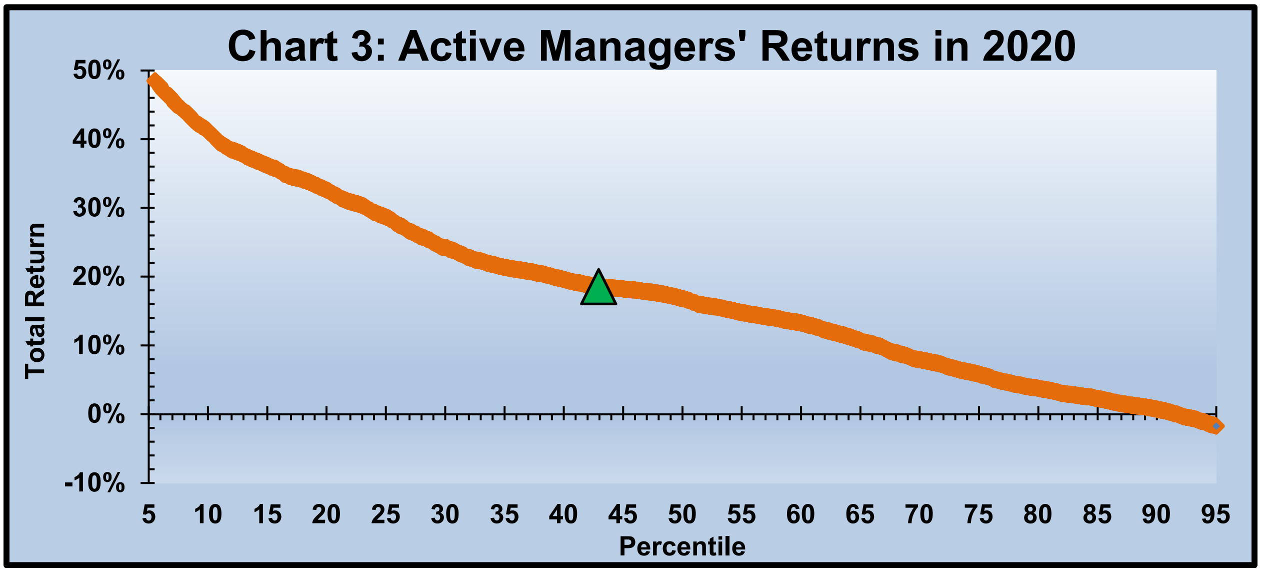
Source: FactSet

Domestic equities. From beginning to end, large-cap U.S. equities returned 18.4% last year, including dividends. Smaller stocks did even better, roaring to a 20% total return. Unlike the broad-based 2019 markets, the gains in 2020 were concentrated in a small number of companies and industries, as shown in Chart 2. The FANMAG group led the way as investors came to recognize that the pandemic wouldn't end quickly and that these stocks would hugely benefit from the emerging work-from-home environment. The market's laggards were in industries that were devastated by shelter-in-place rules. Although these laggards constitute about 20% of all American jobs, they contribute only about 7% to stock market profits; part of the remarkable S&P 500 performance can be attributed simply to the mix of companies that constitute the index.



Source: FactSet

It was a year in which individual stock selection mattered greatly: The range of returns among active U.S. large-cap managers was substantial, as shown in Chart 3. In this chart, the orange line represents the individual returns of about 3,600 mutual fund managers surveyed by Morningstar, arrayed from best to worst. Managers in the tenth percentile saw a 41% return, while those in the 90th picked up less than 1% last year. The S&P 500 return is highlighted with a green triangle; that the passive index finished in the 44th percentile indicates that active managers mostly missed out on a strong year. (The chart leaves off the top 5% and bottom 5% of managers to exclude outliers that could otherwise skew the data.)



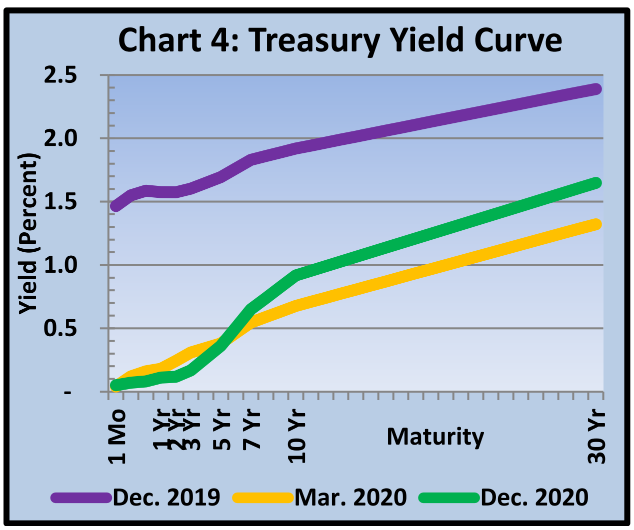
Source: Morningstar, Eastern Bank Wealth Management

Global equities. For the ninth time in the last ten years, international stocks badly lagged domestic equity markets last year – despite generally better responses to the Covid-19 pandemic. Foreign economies remained hamstrung by negative interest rates and political upheaval. That was especially true in the United Kingdom, which finally reached a trade agreement with the European Union just days before a potentially disastrous "no-deal" Brexit would have taken effect. The FTSE 100 index of large British stocks lagged all peer countries, falling almost 15% last year. Across the globe, China's markets soared 35% on optimism for an end to the pandemic; other Asian markets also performed well. These countries enforced Covid-19 shutdowns and contact tracing regimes early and rigorously, and were able to avoid the widespread contagion seen in the U.S. and Europe. Those economies (and New Zealand) are now operating at close to normal levels, and their stock markets reflect the recovery. For U.S. investors, foreign market returns were enhanced by the weaker U.S. dollar.

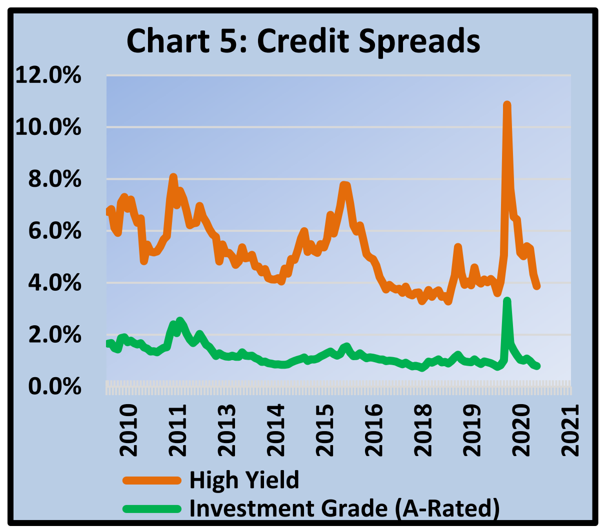
Fixed income. Early into the pandemic, the Federal Reserve demonstrated that it had learned its lessons from the 2008 financial crisis. The central bank cut the benchmark fed funds rate by 175 basis points to zero; perhaps more importantly, it also implemented programs to ensure liquidity in money markets, municipal bonds, Treasury and corporate debt markets, and more. The swift and massive action reassured investors that the nation's financial markets would continue functioning normally, but they also drove investors into riskier investments in search of vanishing yields.

Chart 4 shows that yields fell across the maturity spectrum in 2020; at the short end of yield curve, the Fed cut overnight rates to zero, while at the long end investors initially bid up prices in response to recessionary conditions and the disappearing threat of inflation. Later in the year, as the economy recovered and some investors began to think about inflation again, longer-term rates did creep up a bit, but the 10-year Treasury yield still posted its lowest year-end level in history at 0.92%. As Americans began to shy away from the Treasury markets in favor of higher yields in credit markets, foreign investors still flocked to buy bonds because comparable rates abroad were even lower. Indeed, about $17 trillion of debt (the vast majority sovereign) traded at negative yields at year-end.

When bond markets initially panicked because of Covid-19 restrictions on economic activity, credit yields initially spiked (Chart 5), with investment-grade corporate credit hitting about 4% and speculative bonds topping 11%. As the Fed implemented its ultra-accommodative policy and reassured investors that markets would function smoothly, these yields fell just as quickly as they had risen. By year-end, investment-grade corporate bonds traded at barely 1% above Treasury debt, while high-yield spreads were under 4%. Whether intended or not, the Fed's actions clearly pushed investors into riskier assets.



Source: FactSet

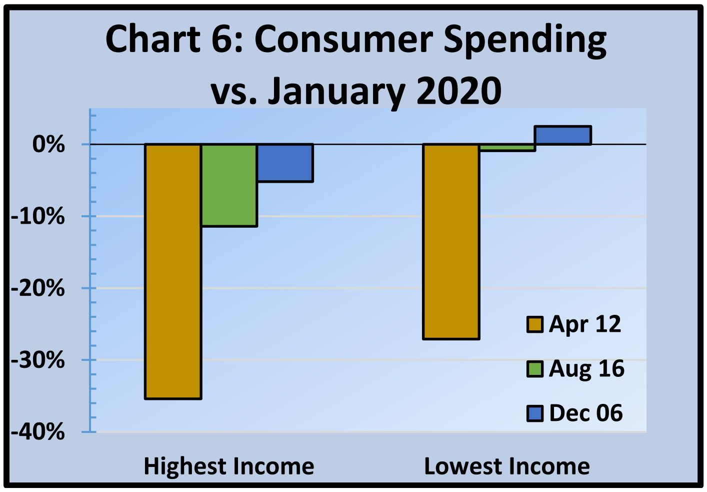


Source: Federal Reserve, Merrill Lynch

2021 Economic Outlook

After a precipitous drop last spring, the U.S. economy has made substantial progress in its recovery – but there is still a long way to go. The pain last spring was broadly felt across nearly every sector of the economy, but the recovery has been much narrower. The CARES Act and the Federal Reserve's panoply of programs provided a lifeline for many consumers and kept the financial system functioning, but these programs were limited in their effectiveness. With the benefit of hindsight, it is easy to see that government can put money in a consumer's wallet but it can't force the consumer to spend it. Savings rates skyrocketed as people – especially those who retained their jobs – held onto their stimulus payments rather than spending them. When they did spend, it was mostly on staples and goods for their homes, a large shift from prior spending patterns.

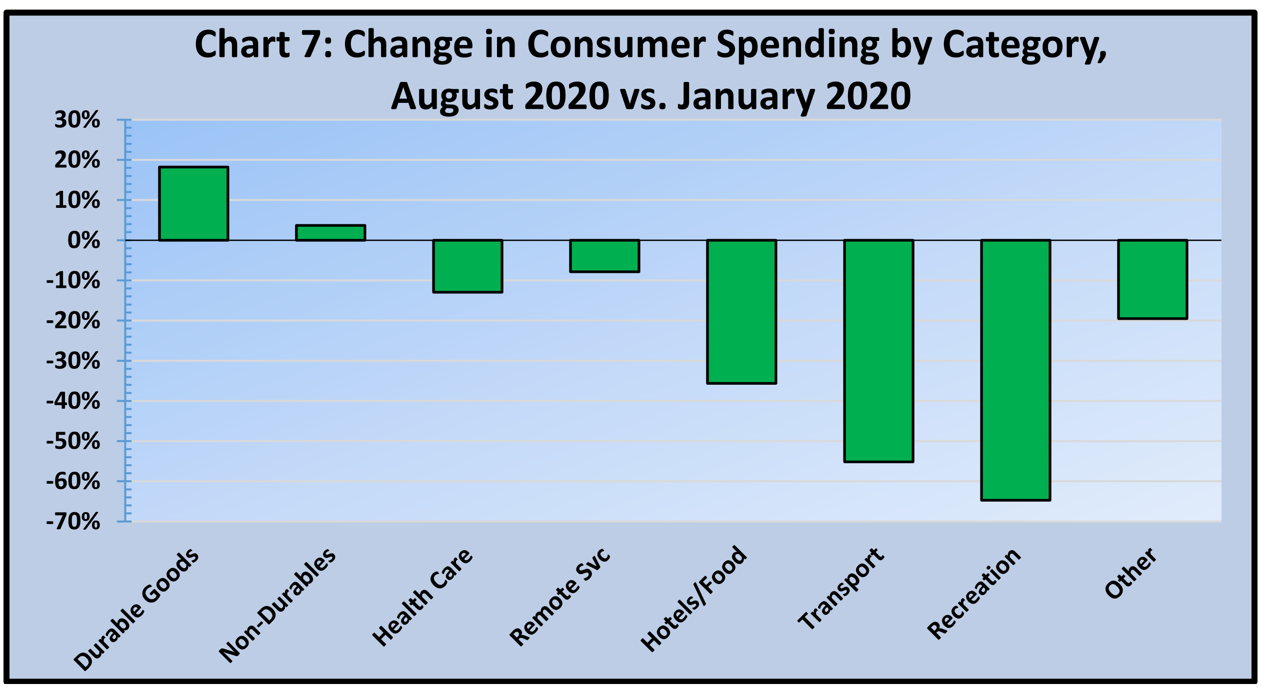
Chart 6 shows that spending behavior last year varied significantly across different income levels. For the lowest-earning individuals and families, the CARES Act proved to be a lifeline, enabling them to maintain their spending on basics: As seen in the right half of Chart 6, their spending dipped sharply at the onset of the pandemic (when many lost their jobs), but then returned to historical levels by mid-summer, thanks to programs included in the CARES Act. By year-end, spending had even begun to exceed January's level.



Source: Chetty et al., www.tracktherecovery.org

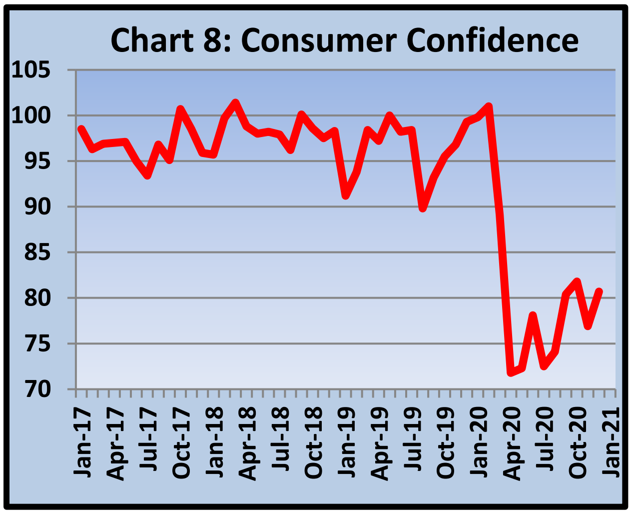
At the highest end of the income scale, the picture looks very different. These consumers also dramatically cut back on discretionary expenses in April, at an even greater rate than the lower-income demographic. Here, however, spending remains below pre-pandemic levels.

Chart 7 breaks out several categories of spending. This chart demonstrates the limitations of government support during the pandemic-induced recession. Wealthy consumers invested heavily in their home offices (shown here as durable goods), and all income groups maintained their spending on basic staples (non-durable goods and health care). The sustained decline in high-income spending has been concentrated in high-touch services like hospitality, dining, leisure travel, and recreation. While the late December stimulus bill provided necessary support for low-income families, it did nothing to boost spending in these high-touch services.

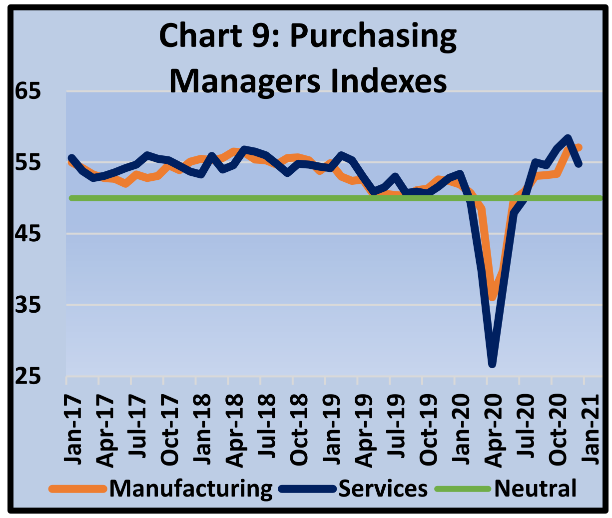


Source: Chetty et al., www.tracktherecovery.org

Indeed, only the combination of widespread Covid-19 vaccinations and rising consumer confidence can revive these industries. Yet even after the early rollout of the Pfizer and Moderna vaccines in the past few weeks, consumer confidence remains subdued (Chart 8). Business confidence recovered much more quickly and is still looking considerably better, as shown by the surveys of purchasing managers in Chart 9.

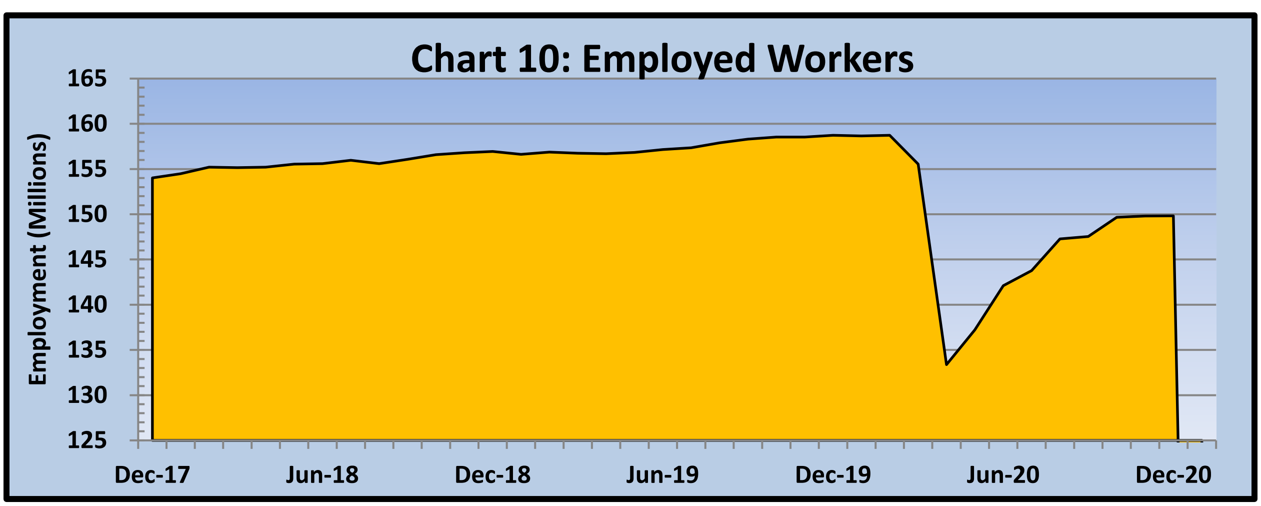


Source: University of Michigan



Source: IHS Markit

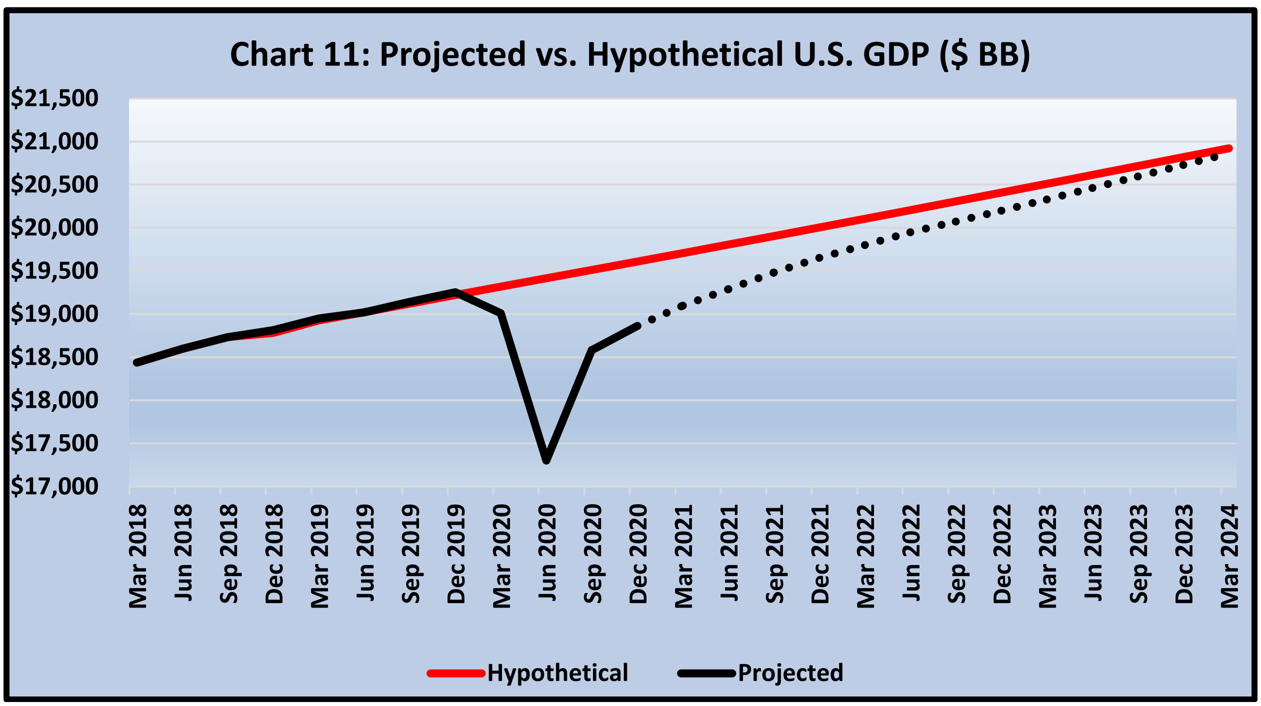
The slow recovery in consumer confidence is hardly surprising; confidence follows pocketbooks, and consumers are still reeling from high unemployment nine months after recovery began. (Hourly wages are up, but that is only because the mix of high vs. low wage jobs has changed as low-wage workers were disproportionately laid off in the pandemic.) Chart 10 shows that the U.S. economy has regained only about half of the jobs lost in the early stages of the pandemic shutdown. The pace of recovery has slowed sharply, and even regressed in December. Thus a Catch-22 has emerged: Spending – especially on labor-intensive high-touch services – won't increase until confidence improves, and confidence won't improve until jobs recover, but jobs won't recover until spending in high-touch services resumes.



Source: Bureau of Labor Statistics

In recent weeks, many Wall Street strategists have published their forecasts for the U.S. economy in 2021; their estimates range from 3% to 7% growth. In our view, this is a fool's errand: Even with 20/20 vision of the world around us today, we are all still stumbling in the darkness and walking into the future blind. No one can predict the path of the virus or its possible mutations; no one can know with certainty how quickly the vaccines will be distributed or how widely they will be used; no one can reasonably guess how rapidly consumer spending on high-touch services will return to pre-pandemic levels; and no one can know when another ten million jobs will be created.

Even so, we do need to come to grips with the broad path of the U.S. economy, even if we must acknowledge that specific forecasts could easily lead us astray. For this reason, Chart 11 may provide some insight. Here, the red line shows the pre-pandemic path of the total U.S. economy, measured in inflation-adjusted dollars; the slope of this line, i.e. the rate of economic growth, has averaged about 2.5% in the years preceding the pandemic. We think of this as the likely productive capacity of the economy – the so-called Goldilocks scenario in which everything is working at close to optimal levels. The black line shows the actual GDP through September 2020, and the dotted portion suggests a reasonable guess as to the path of the economy in the next few years.

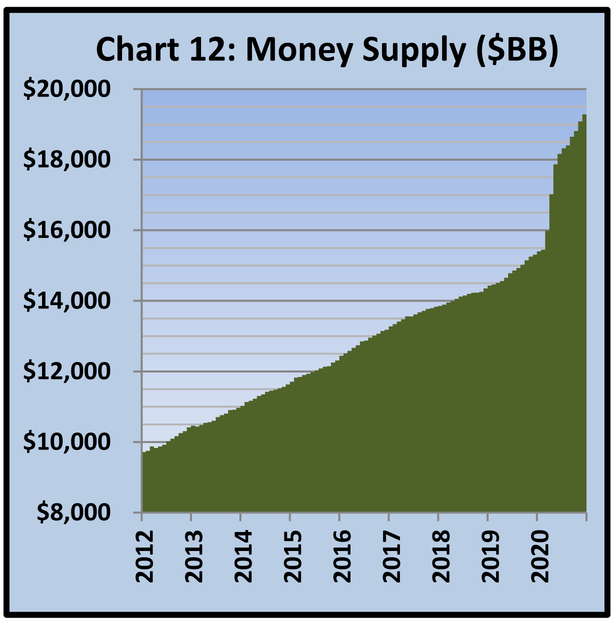


Source: Commerce Department, Eastern Bank Wealth Management

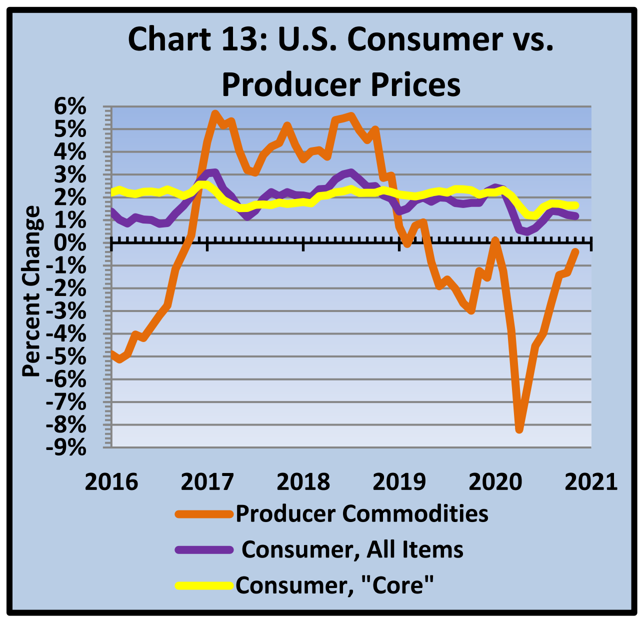
The key to Chart 11, in our view, is that the economy will take a long time to get back to where it was at year-end 2019. Those ten million jobs won't return overnight; if we have learned anything in the past six months, it is that while the "easy" jobs returned quickly because of high demand for the products and services they provide and because those jobs can be done relatively safely in a Covid-19 environment, the "hard" jobs won't return until there is rising demand for travel and other high-touch services. Thus, we see a deceleration of economic growth in the coming year.

At the same time, however, we think that the locus of growth is indeed shifting toward the high-touch services that have lagged so badly thus far. The rapid recovery in manufacturing, housing, and some service sectors means that they can't continue their pace into the future; they are back to pre-pandemic levels already. But the high-touch industries can begin to accelerate, even if haltingly, and we think this is where the leverage to economic recovery lies this year.

Inflation. Many economists think that the U.S. is headed for an inflationary spiral. They base their conclusions on the irrefutable increase in the money supply (Chart 12) as the Federal Reserve flooded the economy with cash and credit last year. We have also lately seen some increases in commodity prices (Chart 13), mainly in response to the boom in housing construction. But an inflationary fire requires three things: fuel, oxygen, and spark. The fuel is the money supply; there's plenty of that, to be sure. The oxygen is consumer demand, which remains soft. Perhaps most important, the spark is scarcity, which is utterly absent. The country currently has plenty of untapped labor and manufacturing capacity, which means that an increase in demand (oxygen) can be met by putting slack supply capacity to use again. In our view, it will be several years before the economy has fully absorbed its slack productive capacity, so we are not concerned about any meaningful inflation this year.



Source: Federal Reserve



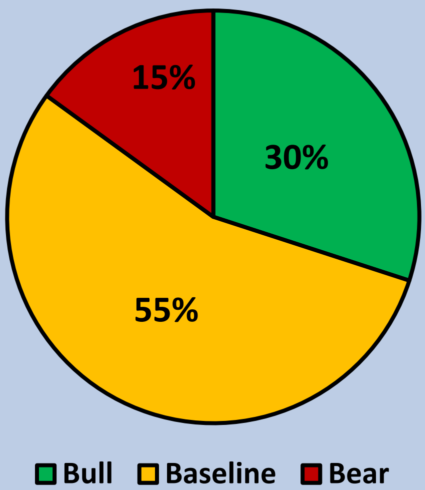
Source: Commerce Department

2021 Tactical Asset Allocation

Every year in January, we rebalance our client portfolios to correct for market drift and to reflect our views of market conditions in each major asset class. We also rebalance at other times of the year, whenever market conditions push portfolios too far away from their targeted allocations. We rebalanced twice last year, in January (taking money out of equities after a spectacular 2019 made the asset class look too expensive) and again in April (putting money back into equities after the bear market bottom). By year-end 2020, the stock market rally had once again pushed equity allocations above their long-term targets.

For 2021, we have opted to retain equity positions about 6% larger than their long-term targets, reflecting our perception of value and outlook for each major asset class. We don't have 20/20 *foresight*, so our asset allocation decisions consider a wide range of possible economic trajectories for the nation's economy over the coming year. Chart 14 outlines our view of the Covid-19 pandemic, which still drives the country's economy this year.

Chart 14: Covid-19 & Economic Outlook



Bull:
- More vaccines are rapidly approved, distribution logistics are worked out, widespread inoculation is complete by midyear
- Rising optimism fuels upside surprises to economic growth

Baseline:
- Vaccine distribution ramps up to reach widespread usage by summer 2021, with few unexpected logistical problems
- Economic restrictions are lifted by midyear; consumer confidence rises, and even the most seriously ravaged industries show meaningful recovery by year-end

Bear:
- Adverse Covid-19 surprises crop up: distribution snags or harmful side effects; new mutations resistant to vaccine
- States reimpose economic lockdowns

Source: Eastern Bank Wealth Management

Our base case, denoted in yellow in Chart 14, already has a bias toward optimism. The evidence so far is pointing us in this direction: Two vaccines have already been approved for use in the U.S., with more almost certainly on the way. Distribution of these vaccines has hit a few early snags, but we believe these stumbles will be corrected in reasonably short order.

The vaccine is critical. For all the talk of stimulus legislation in Washington, by far the biggest possible economic stimulus for this country would be widespread inoculation leading to a resumption of normal economic activity, across all income demographics and all spending categories. We think that outcome is within reach, though by no means a certainty.

The fundamentals of the U.S. economy are therefore pushing us to a somewhat bullish stance. Equally important, the valuation and market dynamics of each asset class reinforce this view. Equities may be somewhat expensive, as we discuss below, but bonds are near all-time historically high prices and offer little potential upside.

While we judge our base case scenario to have a high likelihood of occurring, we nonetheless recognize that many factors could cause a significant downturn in the stock market – not least of them an inflation scare that could drive up long-term interest rates, a new strain of Covid-19 resistant to vaccine, a renewal of trade tensions with China, a sudden escalation of hostilities with Iran, domestic terrorism, Fed policy missteps, and more. Much can still go wrong.

Taking these varied outcomes and weighting them by our judgment of their probability of occurring, we think the burden this year remains on the bears; that is, the natural tendency of markets is to rise, unless compelling contrary evidence emerges. We won't ever put too many eggs in one basket; our 6% overweight to stocks should be viewed within a policy framework that allows tactical weightings to be as much as 20% over or under the long-term target.

2021 Portfolio Construction

Bonds. American bonds are undoubtedly expensive to our eyes. The Federal Reserve has anchored overnight interest rates at close to zero, and indicated that this policy will remain in effect for at least the next year or two. The yield curve has been steepening slightly in the past few weeks as some investors begin to worry about long-term inflation, but even so the 10-year Treasury yield remains at about 1.0%; historically, it has approximated the sum of the inflation and GDP growth rates, which would suggest a current yield closer to 5% or more. Yet short of an unexpected inflationary spiral, there is nothing in our view that would cause interest rates suddenly to jump up. Bonds are expensive and likely to stay that way.

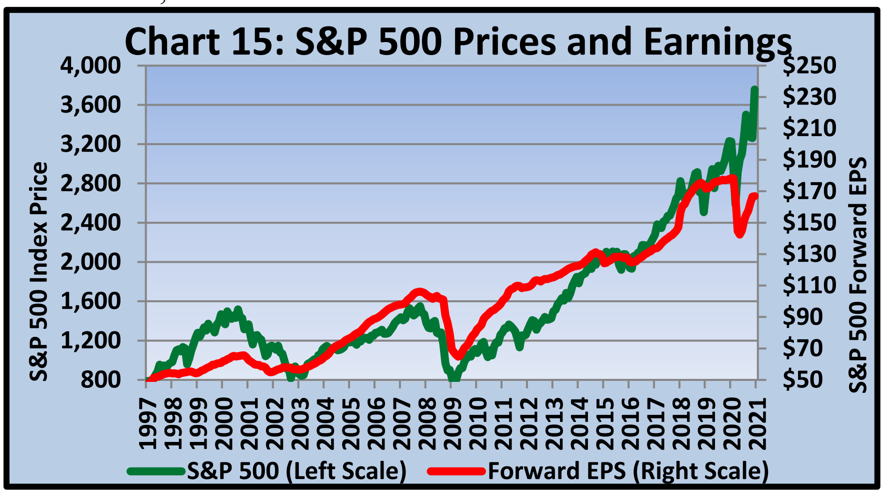
If the downside is limited, so too is the upside. The Fed has reiterated many times that it will not permit overnight rates to go below zero, which sets an upper bound on the price of short-term debt. Across the Atlantic Ocean, the European Central Bank has pursued a negative rate policy for several years, which has done nothing to improve Europe's economy but has damaged the Continent's financial system. We think it's possible the ECB may finally begin to let rates rise, which would put a ceiling on prices there – and here, too.

In the credit markets, corporate debt spreads (the interest rate premium that investors demand for riskier corporate debt in comparison with Treasury debt of comparable maturity) have been shrinking, as investors appear to be chasing yields wherever they can be found. Chart 5 (page 4) shows that these spreads spiked up at the onset of the pandemic; in the case of high-yield spreads, much of the move was related to Saudi Arabia's initiation of an oil price war with Russia, which threatened highly leveraged U.S. drillers as well – and energy companies represent a large swath of the high-yield market.

We think there is still some value in corporate debt in comparison with Treasury debt, so we have structured our fixed income portfolios with a tilt toward credit risk; this includes mutual funds and ETFs focused on bank loans, high-yield bonds, and preferred securities. While we tip toward credit risk, we are concurrently tipping away from interest rate risk; although we expect bonds to trade in a tight price range this year, we recognize that the range of possible outcomes is asymmetric: There is more risk of longer-term interest rates rising than falling.

Equities. Chart 15 shows S&P 500 prices contrasted with expected year-ahead earnings. In the past two years, the S&P 500 index (in green) soared 50% while earnings per share (in red) slipped 4%; P/E ratios expanded more in this two-year period than at any time in this century. The stock market is now trading at close to 23 times year-ahead earnings, well above the historical average of 16x. (When the two lines in Chart 15 intersect, the market's P/E multiple is exactly 16; when the green price line is above the red earnings line, the P/E ratio is above 16 and stocks could be considered expensive.)

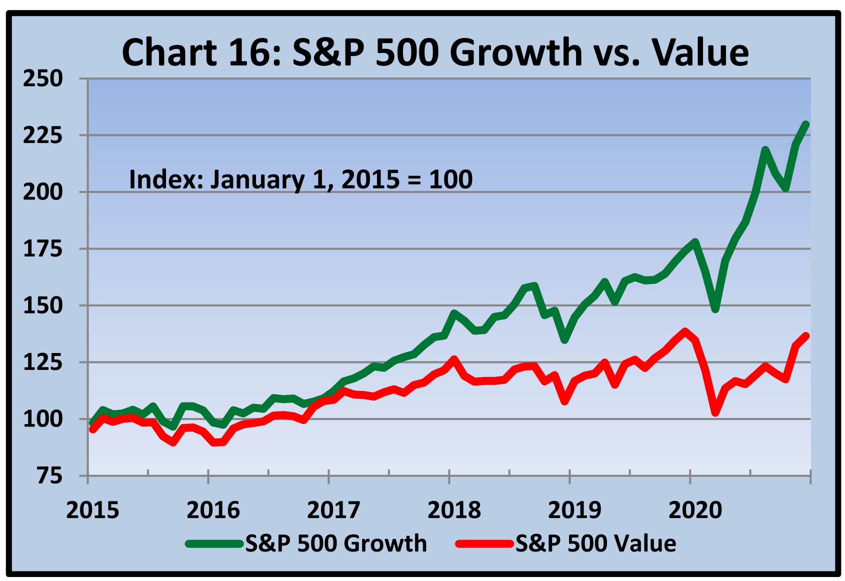
There are reasons aplenty for stock prices to appear so expensive: The Fed has turned on the money spigot and is clearly driving investors to seek risk; the economy *will* revive at some point in the future, as vaccinations continue to roll out and as scarred industries begin the long road to recovery; the newly Democratic Congress is likely to enact some form of stimulus legislation, which could include additional $1,400 direct payments, extended unemployment benefits, and perhaps infrastructure investment; and the low current level of interest rates means that future earnings can be more richly valued today.



Source: FactSet

The "stock market" is hardly a monolithic beast; even when the market as a whole appears expensive, we still find several corners where bargains can be found. In particular, we note the extreme divergence in performance over the past several years between "growth" and "value" stocks. Chart 16 roughly bisects the S&P 500 into these two categories and shows that growth has left value in the dust: From a hypothetical standing start at the beginning of 2015, growth stocks have returned 130%, while value stocks are up only 32%. According to Morningstar, in 2020 the average "growth" mutual fund jumped 34% while the average "value" mutual fund gained 2.6%. It was a wipeout, as growth stocks were ten times better than value stocks last year.

We have added a value bias to our equity portfolios this year, most notably by increasing our investments in the financials, manufacturing, retail, dining, and hospitality industries. As the American economy pulls out of its pandemic-induced recession, we think these sectors are poised to recover some of their lost ground in relation to the technology, social media, and similar growth stocks that have dominated the market in the past few years.



Source: FactSet

For clients with global portfolios, we are also increasing our participation in foreign markets. The U.S. stock markets have outperformed global markets in nine of the past ten years, mainly because the U.S. economy has been more dynamic (especially in technology) and because the U.S. stock markets are less oriented to energy and financial companies. But as Europe begins to emerge from the paralytic shocks of Brexit and Covid-19, we think developed (mature) foreign markets have potential to improve. We have also retained our substantial investments in emerging markets, which have thrived in the past year as they quickly put Covid-19 behind them and expanded their exports to the U.S. rapidly. We think the U.S. dollar may lose a little more ground in 2021, boosting returns for foreign markets.

Chart 17 provides a summary of our current positioning in comparison to this time last year. We do not attempt to portray here our April 2020 rebalancing toward equities, nor the effects of market drift during the year. (Market drift simply refers to the way an asset class's allocation will rise or fall just because of price changes in comparison to those of other asset classes.) To put Chart 17 in context, we started 2020 with a neutral balance between stocks and bonds; each asset class was set exactly to its long-term target. By late March, the bear market had pushed the stock allocation down, and we purchased more equities to get back to neutral. As stocks rallied through the balance of the year, the equity allocation drifted substantially higher, in most cases to more than a 6% tilt in favor of stocks by year-end.

Consequently, our tactical asset allocation shift and our trading activity appear to be paradoxically at odds with each other. Although Chart 17 shows that we have *increased* our tactical asset allocation target from neutral at January 2020 to a 6% bias in favor of stocks today, in most cases we actually *decreased* equities when we rebalanced our client accounts this month. In other words, we're still overweight stocks, but to a slightly smaller degree than we were at year-end 2020.

Chart 17: Asset Allocation	**2021**	**2020**	**Change**
Tactical Equity Weighting	**+6.0%**	**0.0%**	+6.0%; tilt toward equity
U.S. Equities:			
U.S. Large-Cap Stocks	72.0%	77.0%	-5.0%; shift to value funds
U.S. Mid/Small-Cap	5.5%	4.0%	+1.5%; vaccine beneficiaries
Sector Funds	6.0%	5.0%	+1.0%; add industrial sector
Total U.S.	**83.5%**	**88.0%**	-4.5%; shift to international
Benchmark	~83.0%	~82.0%	+1.0%; U.S. outperformed in 2020
International Equities:			
Developed ETFs/Funds	9.0%	6.0%	+3.0%; valuations & sector mix
Emerging ETFs/Funds	7.5%	6.0%	+1.5%; weaker dollar helps
Total International	**16.5%**	**12.0%**	+4.5%; shift from U.S.
Benchmark	~17.0%	~18.0%	-1.0%; int'l lagged U.S. in 2020

Chart 17 (Continued)	2021	2020	Change
Fixed Income:			
U.S. Investment Grade			
Individual Bonds	75.0%	75.0%	0.0%; nine-year ladder
Short-Term Corp. ETF	0.0%	5.0%	-5.0%; replaced by ladder
Intermed. Corp. Fund	15.0%	5.0%	+10.0%; accept credit risk
Other U.S. Funds			
Senior Loan Fund	2.0%	0.0%	+2.0%; enhanced yield
High-Yield Bond ETF	4.0%	0.0%	+4.0%; enhanced yield
Preferred Stock Fund	4.0%	0.0%	+4.0%; enhanced yield
Government Funds			
Intermed. Gov't ETF	0.0%	10.0%	-10.0%; shift to credit risk
Mortgage-Backed ETF	0.0%	5.0%	-5.0%; shift to credit risk

Chart 17 shows targeted allocations for our Multi-Asset model using actively selected individual stocks and corporate bonds. We have developed comparable models for client portfolios that use only mutual funds and ETFs instead of individual securities, and for variants of the Multi-Asset style including Core, ESG Sustainability, and Catholic styles. All model portfolios are derived from the same economic analysis and market interpretation, and therefore have analogous asset allocation targets. Individual client portfolios often differ from these models because of factors unique to each client, so Chart 17 should be read as only as a guideline for client portfolios.

2020 Report Card

Finally, we think it is appropriate to evaluate our investment decisions in the year just ended. This evaluation necessarily must cover only hypothetical guideline models: Since each client's portfolio is unique, it would be impossible to judge any individual client accounts here. Instead, we look back to our *On Our Minds* 2020 preview, "2020 Foresight: Keeping the Faith," published January 21, 2020, to review our predictions and judge our work. On the whole, we think the results were quite good:

- U.S. economy. We didn't foresee the Covid-19 pandemic, so in retrospect our economic outlook was far too bullish. Nonetheless, we correctly anticipated both low inflation and a housing boom, but the job losses stemming from pandemic-driven lockdowns were clearly much worse than anything we could have expected. The Fed's ultra-accommodative policy was consistent with our understanding of their approach.

- Asset allocation – by asset classes. Last January, we pared our equity positions from overweight to neutral. The key to our thinking was one critical insight: "We see a high probability of small positive returns and a low probability of big negative returns." In other words, we recognized that prices of risk assets were anticipating a nearly perfect economy, limiting upside potential while exposing investors to potentially catastrophic outcomes. We didn't foresee Covid-19 *per se*, but we nonetheless were well prepared for a bear market when one finally came to pass.

Further, we stuck to our discipline by rebalancing accounts back into stocks in early April, recognizing that the bear market had pushed equity allocations to their lower-bound "guardrails." By repurchasing equities at that point, our clients benefited from the stock markets' 50%-plus rallies through year-end. We also shifted some money into small-cap stocks, which languished for most of the year before racing to a spectacular finish; they ultimately topped the large-cap index for the full year. Our tactical asset allocation, in other words, was a substantial creator of value for our clients' portfolios – not just once, but twice last year.

- Asset allocation – by geography. We had positioned our international equity allocations well below the benchmark's 18% weighting; this was a very smart decision. The U.S. outperformed just about all foreign markets yet again last year. Developed markets, as measured by MSCI's EAFE index, rose 5.4% last year, more than ten percentage points behind the 18.4% total return of the S&P 500.

  Emerging markets gained 15.2%, but with wide variation; just about the only major international market to keep pace with the U.S. was China's domestic shares, which soared 35% on that nation's rapid reopening from Covid-19. Our geographic allocations were correct in two crucial ways: We were sharply underweight foreign markets as a whole, but we focused most of our international investments in emerging markets.

- Equity stock selection – Core / Multi-Asset. Our Core equity model outperformed both the S&P 500 and our competitive peer group for the fourth straight year. In 2020, the Core model returned 19.65% including dividends, compared with 18.40% for the S&P 500 and 16.83% for the median manager in the peer group. Our client portfolios benefited from good sector allocations – underweighting financials and energy while overweighting communications services, consumer discretionary, and technology. Stock selection also played a large part in our success last year: We found a bountiful mix of both defensive and "post-pandemic recovery" stocks, including winners such as BlackRock, Adobe, Broadcom, NextEra, the FANMAGs, and others.

- Equity stock selection – other models. Our ESG Sustainability portfolios outstripped their conventional counterparts, mainly because they mostly avoided the fossil fuel companies that were among the worst American stocks last year. On the other hand, our Dividend Plus models underperformed the Morningstar Dividend Composite Index. We focused Dividend Plus on companies with steady growth and defensive characteristics, and our strategy paid off handsomely through the early stages of the pandemic. However, as the markets began to embrace early-cycle value stocks late in the year, our Dividend Plus model lagged the index.

- Fixed income. In client fixed income portfolios, we aim to produce stable and predictable cash flows with limited reinvestment risk; most accounts use a multi-year individual bond ladder. This results in portfolios with shorter duration than most bond benchmarks. Since our objective (cash flow and capital preservation) differs from that of the benchmark (total return), performance assessment is of only limited utility. We do use ETFs and some mutual funds to sculpt overall credit and duration risk.

> When 2020 began, we believed that credit spreads were very thin, meaning that investors weren't getting compensated for taking the extra risk associated with corporate debt; so we de-risked the bond portfolios, fortunately just before the pandemic sent corporate bond prices plunging. When the pandemic and the Saudi-Russian oil spat sent credit spreads soaring in March, we quickly reversed course, selling our low-risk Treasury and mortgage bond funds in exchange for high-yield corporate bond and preferred securities funds. Both the January de-risk and March re-risk moves were exceptionally well timed.

All in all, 2020 was another outstanding year for investors who had the intestinal fortitude to stay fully engaged even when the bottom fell out in March; taking the year from beginning to end, every risk asset class except oil produced good returns. Our asset allocation navigated the pandemic exceptionally well. Our equity stock selection and our focus on cash flows in fixed income portfolios helped our clients enjoy returns that in most cases were ahead of other active managers and of the market indexes.

We approach 2021 with hope for what can go right, but also with keen awareness that prices are high and much can go wrong. We begin anew each January at zero. We thank all of our clients for placing their trust in our stewardship of their financial assets, and we hope to see you all in the new year.