Retrospectives and projections are the norm for year-end commentaries. Our year-end (or beginning) comments are traditionally light on forecasts. We made the point in last January's web-cast video that forecasts can actually be significant detractors to investment outcomes if inherent uncertainties are not considered. Forecasts invite a behavioral bias called "anchoring and adjustment", a tendency of investors to put too much weight on an original expectation, despite new information which should cast doubt on its validity. Subsequent adjustments to portfolios are too small because investors cling to their original (incorrect/disproven) hypotheses. The "cognitive cost" of throwing their hypotheses in the trash and starting from scratch is too great. We saw plenty of this behavior last year as the Coronavirus continued to ravage much of the country but left the stock market pretty much unscathed. "Betting the farm" that interest rates would rise throughout 2020 seemed like a safe move, fully nuzzled in the middle of consensus forecasts—until the pandemic arose. Justifications for large cash positions due to the pandemic quickly gave way to justifications due to the election (an occurrence in this country which happens every two years) …and so on.

The biggest equity trend in 2020 was unambiguously the US large-cap growth category's outperformance (by quite a margin) of the rest of the US equity universe. Narrowing this category, we witnessed firms involved in the development and applications of web-based cloud computing, e-commerce, and artificial intelligence steal the spotlight, with returns ranging from 50% to 100% and more. A close competitor to US large-cap growth stocks was the MSCI China Equity Index, a broad-based snapshot of the Chinese equity universe. MSCI China was up 29.49% in 2020, exceeding the S&P 500's return by over 12%. Narrowing this index to include the same emphasis on cloud, e-commerce and AI, and returns were also well over 50%, and often closer to 100%!

CCR Wealth Management's clients benefitted from both trends, having initiated positions in a China-centric technology fund about a year ago, and having sharply weighted US large-cap growth vs. all other equity categories back in March. The question, of course, is where do we go from here?

Here, we must meld a combination of economic history (the odds), technical analysis (the current realities), and the consensus narrative (taken with a high degree of skepticism). The economics have befuddled investors for much of the last year. We currently remain in a recession, though you would never know it from the performance of equity markets in the US. It pays to understand how most major equity indices are constructed. The S&P 500, and most major indexes are *market-cap weighted*. This means that the actual index level (S&P 500 closed the year at 3,756.07, for example) is derived each day, and throughout the day, using an algorithm. The output of this algorithm is heavily influenced by how large a company is relative to the other 499 stocks in the index. The size of a company is determined by simply multiplying its free-floating share count by the price per share. The larger the company in a market cap-weighted index, the more influence that company's performance has on the overall index performance. Over the last couple of years—several companies have become gigantic on a relative basis, with market-caps surpassing $1 trillion. These names have been exclusively tech-oriented businesses. The higher these stocks climb, the bigger the companies get, the more influence they have on the market-cap weighted indices, so the higher these indices climb. As a matter of fact, as of April 2020, the five largest companies in the S&P 500 accounted for 20% of the S&P 500's market cap! Remove these names (call it the S&P 495), and the return of the S&P is significantly lower than the nominal returns we actually saw.

The nominal S&P 500 total return was up 17.88% in 2020. If we break that down by GICS (GICS=global industry classification standards, meaning we are breaking the S&P 500 down by sector), we can see significant outperformance by Information Technology and Consumer Discretionary sectors. These two sectors alone account for ~37% of the S&P 500 (also note the Consumer Discretionary is dominated by a single stock, which is the largest e-commerce company in the world and a technology/cloud-computing powerhouse. You may have seen their vans around town this year).

Our point in all this is to illustrate the fallacy of continuing to view "the market" as a single entity reflective of all US businesses and sectors. While the S&P 500 was up nearly 18%, *2020 was decidedly a year of the "haves" and the "have-nots"*.

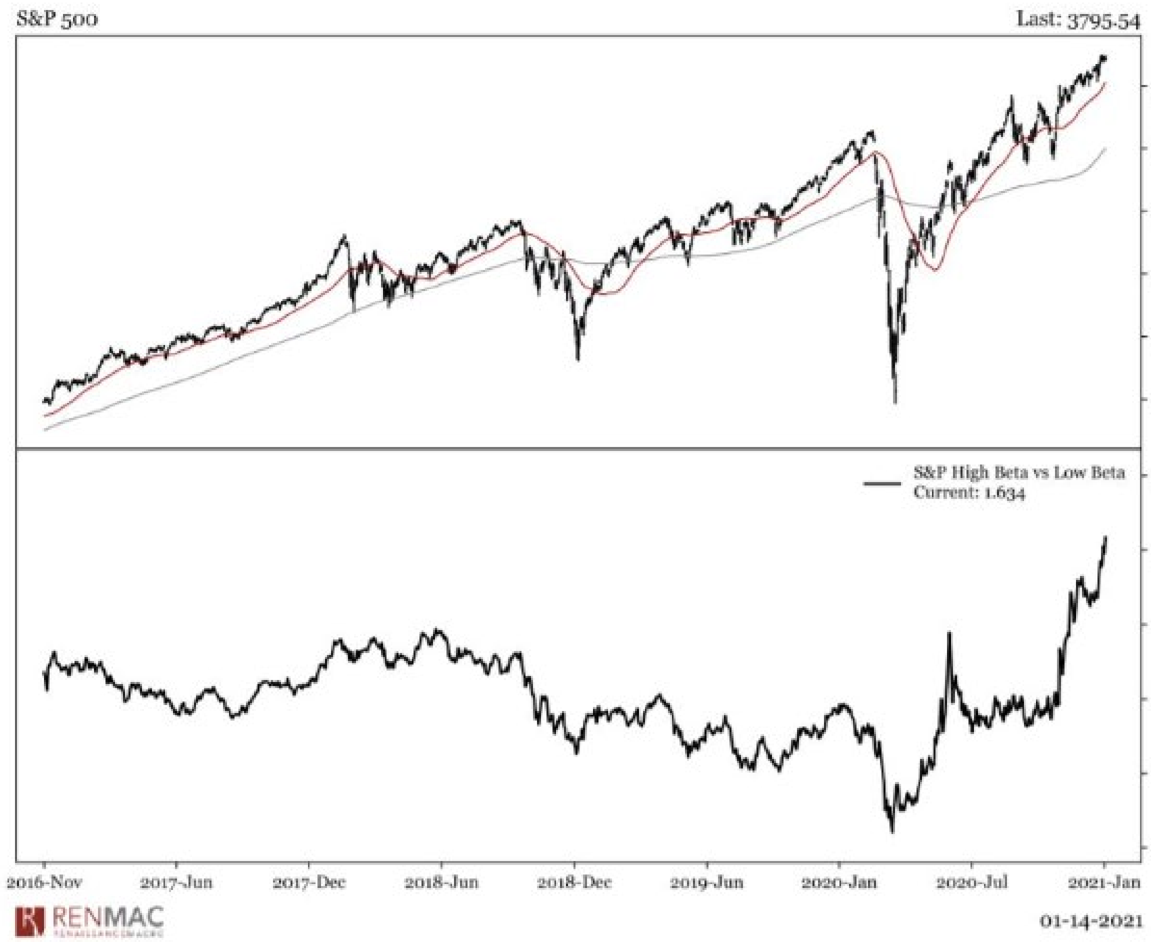
SECTOR INDUSTRY Chart Performance

Sector Expand All Collapse All	Last % Change AS OF 02:08 PM ET 01/05/2021	Market Cap 01/04/2021	1-Year % Change 01/04/2021
Communication Services 5 Industries	+0.44%	$5.83T	+19.44%
Consumer Discretionary 11 Industries	+0.69%	$8.20T	+30.02%
Consumer Staples 6 Industries	+0.06%	$4.27T	+7.52%
Energy 2 Industries	+6.93%	$2.15T	-37.55%
Financials 7 Industries	+0.75%	$6.93T	-5.23%
Health Care 6 Industries	+0.77%	$7.24T	+11.57%
Industrials 14 Industries	+1.34%	$4.87T	+4.46%
Information Technology 6 Industries	+0.69%	$13.20T	+38.76%
Materials 5 Industries	+2.38%	$2.42T	+20.32%
Real Estate 2 Industries	+0.55%	$1.35T	-7.81%
Utilities 5 Industries	+0.19%	$1.55T	-4.14%

The dividing line between December 31 and January 2 is, unfortunately, often considered to be a logical point for investors to conduct major revamps of strategies and portfolios—usually to accommodate the plethora of New Year's market predictions. In fact, as we have pointed out before, turning this calendar page should be an unceremonious process which does not assume, without ample evidence, that the leaders of yesterday must become the laggards of tomorrow. In our view, the leaders of 2020 were always going to be the dominant shapers of our world in the coming decade. The Pandemic, and governments' responses to it, simply accelerated this process. By our estimation, the global adoption of AI and 5g technologies is likely still in the third inning of a nine-inning game.

Much of the conversation in the financial press over the last 6-8 months has been focused on, or rather *anticipating* a large shift ("rotation" is the term often used) from growth stocks to value stocks. This conversation usually centers on an anticipated reversion to the mean between growth and value, based on performance, or valuation. Anticipating reversions to the mean, as we have pointed out before, is also known as "gambler's fallacy", in behavioral finance parlance. It is true that there have been impressive moves off the bottom in both financials and energy sectors over the fourth quarter and into this year. This has led many market commentators to conclude that the rotation is on—justifying their long-touted predictions. But let us look at things a bit more technically. "Beta" is a term we use to define risk, or volatility, relative to a particular standard. Often that standard is the S&P 500. Beta for a stock is derived through a regression calculation. High-beta stocks are generally more volatile than the S&P 500, and low-beta stocks less so. Volatility is defined as standard deviation. A stock with a beta of 2, for example, is about twice as volatile as the S&P 500, while a stock with a beta measurement of 0.5 is about half as volatile. High-beta stocks also tend to share characteristically higher valuations (measured by P/E, P/B, P/S or P/CF), such that the term "beta" itself is often used as a proxy for momentum stocks, and growth stocks in general.

The nearby chart, which comes to us from Jeff DeGraff at Renaissance Macro Research (a macro-research firm we recently adopted into our pantheon of research providers) shows an interesting relationship between high beta, low beta, and the S&P 500, which is comprised of the two groups.



The top chart depicts the S&P 500 over the last four years, along with its high-beta components (red) and low-beta components (blue), high-beta being the clearly dominant outperforming category. But as the breadth of the market has broadened out over the last five months or so (a development we welcome), and laggard value sectors like energy and financials have rallied sharply, we think it pays to take a deeper look before "rotating" along with the talking heads on CNBC (i.e. dumping our tech and growth names in favor of banks and energy companies—or at least reversing our weighting tilt).

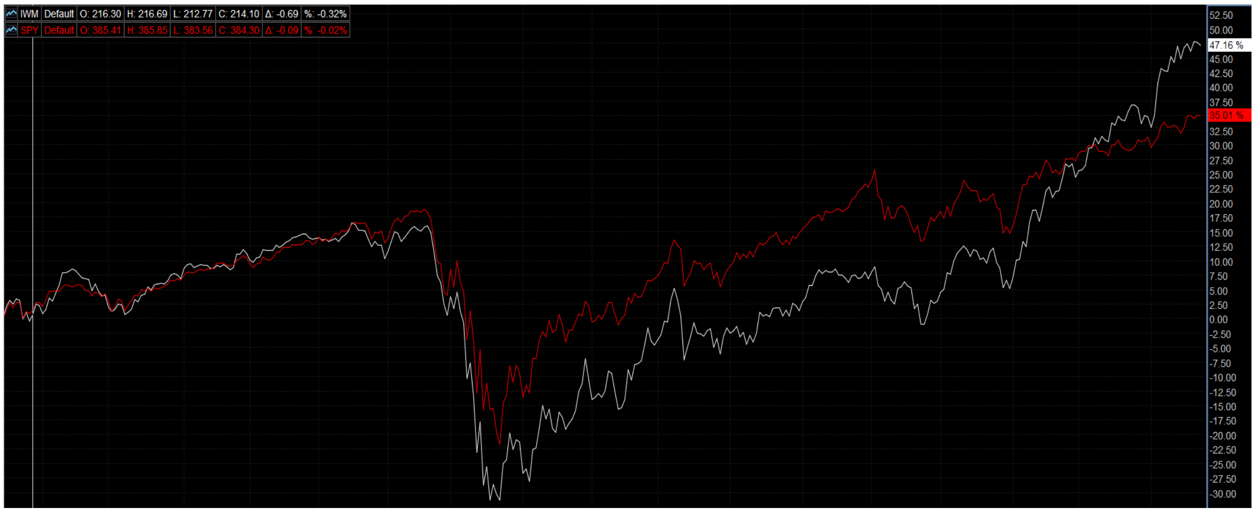
The chart on the bottom is a ratio which divides the performance of high-beta stocks by low-beta stocks. This is necessary, in our view, to get a more accurate picture of leadership between the two categories in a market that has broadened out, and as a result, is a bit "noisier" than it has been recently. This chart may be bad news for investors who have already taken the "value plunge". It is also one major reason CCR Wealth Management has not adjusted our model portfolios in favor of value stocks to any great degree.

To summarize our point in less technical terms, America and the rest of the world are justifiably elated and relieved at the reality of vaccines for COVID-19. This is a momentous development, executed at a historically unprecedented pace. It assures us a return to normalcy—our children will return to the classroom, families will be reunited, and social interaction--a defining characteristic of our species--will again enrich our lives. And who knows? Perhaps a source of political rancor will also die with the virus (we can only hope). Of equal importance, a return to economic normalcy will again bring us broader financial prosperity.

But given the scope of this pandemic, it should also be understood that this return to economic, financial, and social normalcy is still likely nine months to a year out, maybe more. "It is always darkest before the dawn", wrote English theologian Thomas Fuller. 2 million deaths have been directly attributed to the virus thus far, and a recent Wall Street Journal analysis puts the figure at closer to 3 million when we consider early-stage pandemic testing deficiencies and health-care disruptions. Hospitalizations and death-counts have risen (expectedly) again around the world, and prosperity-killing economic restrictions are again the norm. Office buildings remain empty, and work-from-home remains the default policy, where possible. While things certainly seem dark once again, the technologies and services we used last Spring to cope both financially and socially remain very much a part of our "new normal".

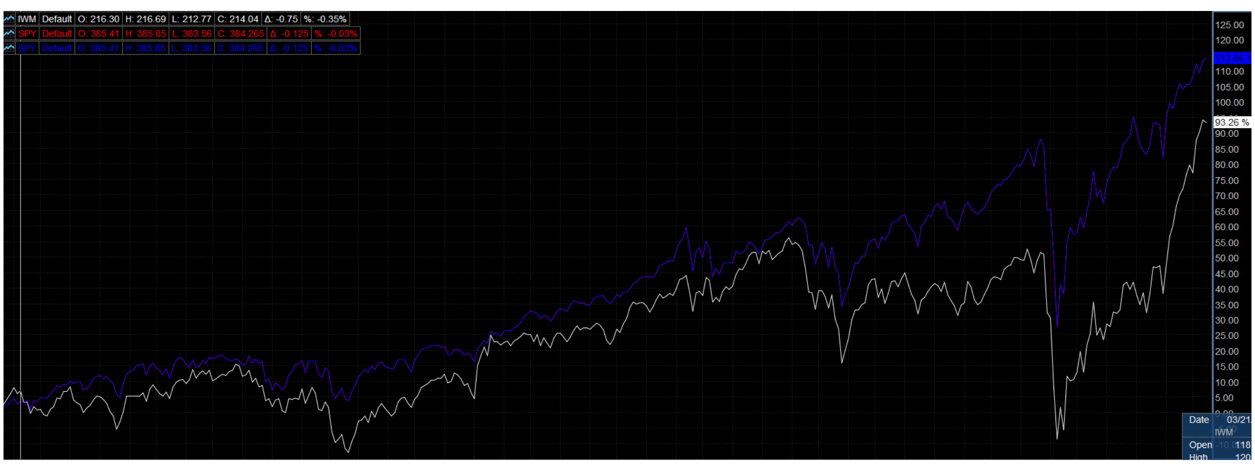
One interesting development that has occurred in recent months is the awakening of small-cap stocks relative to their large-cap counterparts. Here, too, we have considered economic history (odds) and technical analysis (the current reality) and decided to bolster our small cap equity exposure to ~10% of portfolios' total equity allocation.

First, the technicals:



The nearby chart depicts a timeline going back to mid-August 2019 (about 18 months) and shows the relative performance of the S&P 500 (red line) and the Russell 2000 (white line). The Russell 2000 is the most recognized index of US small-cap stocks. Here these indices are represented by tracking ETFs. We can see that after underperforming the S&P 500 for most of this period, small-caps found significant buyers relative to large-cap stocks toward the end of the year.

Look again at the same relationship (below) but extend the period back to mid-February 2014 (about seven years, large caps in blue this time, small caps in white). This view encompasses most of the last market cycle, and we can see that while the cumulative return of small caps still lags, the gap closed significantly in the last few months of 2020.



In fact, the move the small cap index made in Q4 was enough to propel returns for the year to 20.20% for the Russell 2000, beating the S&P 500 for the first time in four years.

CCR Wealth Management's view is that this outperformance could have staying power when we consider things in the framework of historical market-cyclicality. Market cycles are normal patterns the markets go through on their way from one recession/bear market to the next. Granted, the last bull run was significant (and historic) in its length, but the end finally arrived last March. One such pattern is the tendency of small-cap stocks to outperform in the early stages of an economic recovery (actually, beginning in the latter stages of the preceding bear market). The reasoning behind this generally holds that the smaller a company, the more economically sensitive it is. Government stimulus (either fiscal or monetary) which is usually injected into an economy in a recession is thought to have a greater relative impact on smaller companies versus their large-cap brethren.

As we have said before, this recession is unique in that it has lasted far longer than the accompanying bear-market (which ended ten months ago!). However, we stand at a point where it is reasonable to envision the prospects of a fully re-opening economy, given the development and distribution of a COVID vaccine(s). Furthermore, whether *the market* needs it or not, it is likely that congress will finally, after much debate and delay, be shoveling more money into the economy via fiscal stimulus. Good for stocks. Better for small cap stocks.

Many clients have noticed in recent portfolio reviews that the allocation to our Asia-centric fund a year ago is up about 100% over this period. Who knew that an allocation to a fund which holds over 50% of its assets in Chinese stocks, made at a time when the first news of an odd virus was discovered in Wuhan, could yield such results? We certainly did not! No—we will stick to our knitting and revisit our investment thesis. A year ago, we wrote:

> *When we look for growth, certain areas of the world stand out. Much has been written about the slowing Chinese growth rate over the years (notwithstanding the recent increase in China's growth estimates by the IMF). But high growth in China exists when we exclude heavy industries and construction. Indeed, we see the most compelling growth stories outside the US to be found in Asia's rapid development of e-commerce. Names like Alibaba and Tencent have already become well-known to US investors and have fueled e-commerce to account for 20% of retail sales in China as of 2018 (compared with 10% of retail sales in the US)1 . E-commerce was 2-3% of retail sales in Southeast Asia in 2018, but gross merchandise sales are expected to increase fourfold in the next 6 years to $102 billion from $23 billion according to a joint study by Google and Singapore's Temasek Holdings in November of 2018.*

After doubling your money, its usually good form to pause and ask yourself, "what's changed?" Much has changed around the world, obviously. We are dealing with a full-blown pandemic, of course. Interest rates are again at rock-bottom levels. We have a new administration here in the US. But our investment thesis? No changes there. Rather than add to this position throughout the year, we have simply allowed it to grow organically, without rebalancing. So much of the China and Southeast Asian digital explosion of the last few years is driven by demographics (larger young and well-educated populations, coupled with a rapidly growing middle class). And demographics change slowly. After discussions with management, we remain confident in the long-term prospects of this position.

As we pointed out then, our investment choice was devoid of manufacturers and exporters, and thus was likely insulated from the trade tensions which has characterized much of the last four years of US-China relations. While the previous administration's approach to China could be characterized as pugnacious, we see little change in US posture with the new administration—even if the tone is softer. Impatience with China's trade-gaming remains a bi-partisan issue. One thing investors should keep an eye on, however, is the implementation of the recently passed (and signed into law last month) Holding Foreign Companies Accountable Act. This is a law that directly targets certain foreign stocks (mainly Chinese) that trade here in the US. We will likely revisit this issue further in more detail in the future.

We were recently asked if we would be expanding our non-US equity allocation. Our response was that, in a way, we already have. No—we are not talking about the 100% return from the fund discussed above. We instead refer to our recent allocation to emerging markets bonds at the end of September.

Forgive us for dragging out the term "Beta" again--we generally like to keep these Outlooks jargon-free. But this term is descriptive. Bonds outside of the *government*, *government agency*, and *high-grade corporate* categories share two main things in common: first, they tend to have yields well in-excess of yields in those categories. The second similarity is a level of volatility. In fact, from a portfolio management standpoint—we look at the risk (volatility characteristics, or *beta*) of high yield and emerging markets debt as being much more in-line with equities than with the rest of the bond market. We would say emerging markets bonds (and high yield bonds) have their own return characteristics, but they have an *equity-like beta*. CCR Wealth management added emerging markets debt as an asset class to our models in late September 2020 (a modest allocation of ~8% of fixed-income). While this asset class technically is an extension of bonds, the risk profile is an extension of equities.

Our foray into emerging markets debt came as we considered the outlook for traditional fixed income here in the US, as well as all other developed nations. The Fed has committed to supporting bond prices by quashing higher yields across the yield curve. This policy will trickle down from Treasuries to high-grade corporates. The net effect will be a reduction (we dare-say, a near-elimination) of price return, for the foreseeable future. This leaves us with nothing to earn from bonds except the income yield. Currently, the yield on the Bloomberg Barclays Aggregate Bond index is about 2.00%.

Our choice to boost yield in the portfolio came down to either a reduction in credit-quality in exchange for a yield little over 2% higher than the Barcagg index, or a reduction in credit quality to boost the yield by significantly more than 2% *and* have the chance to participate in capital appreciation in foreign assets that are largely accounted for by a declining US dollar. Emerging market balance sheets, on average, have improved greatly over the last 20 years (a blanket statement). In contrast, high-yield US balance sheets have actually deteriorated over this period (cheap credit will do that to you). We see the recent decline in the US dollar as a tailwind (brought about by trillions in fiscal expansion and promises/expectations for trillions more) for emerging market bonds.

There always is much more to be said than we can fit into this e-mail. We hope you will join us on our Zoom-cast in a couple of weeks when we discuss our thoughts on inflation, and answer any questions that you, our clients submit (please look for the e-mail soliciting these topics/questions!). We look forward to a healing-year, and we hope all our clients remain safe and optimistic in the New Year!