Chief Investment Office
Annual Update

December 2021

Foreword

In the mid-1800s, French writer Jean-Baptiste Alphonse Karr wrote “plus ça change, plus c'est la même chose” which has been translated into a now popular English phrase “The more things change, the more they stay the same.” For investors, change is an ever-present force that challenges us all. Economies, companies, geopolitical structures, technologies, and trends rise and fall, creating the gyrations in the market we come to know as volatility. As we reflect on the year 2021, change was the dominant theme. The world today seems quite different from the one we lived in this time last year. However, despite that change many things remain the same. The S&P 500 is set to post its 8th calendar year of double-digit returns in the last 10, reflecting a now decade long trend of outperformance. While new risks have emerged, the persistent challenges of elevated valuations and low interest rates remain. Change is almost always uncomfortable, but for those that are thoughtful about its impacts and pro-active about addressing the risks, opportunities can be created.

In this letter, Pathstone’s Chief Investment Office will take a look at the developments of 2021 and offer a perspective on emerging investment trends and themes we are focused on as we look ahead to 2022 and beyond.

Steve Braverman
Co-Chief Executive Officer
Chief Investment Office

Alex Hart, CFA, CAIA
Executive Managing Director, Investment Research
Chief Investment Office

John Workman
Managing Director, Investment Strategy
Chief Investment Office

2021 a Year of Change:

The post-pandemic economic recovery continued in 2021. Consumer and business balance sheets enjoyed gains with the aid of ongoing fiscal and monetary policy supporting their recovery. For the average U.S. household, job openings have been plentiful, wages have been rising, and the wealth effect created by rising home values and stock market returns on the back of low interest rates have all contributed to a stronger financial position. Consumer sentiment coupled with a desire to make up for lost time during the pandemic has spurred demand for goods and services and has driven corporate profit margins to all-time high levels. Europe's economy, which is more sensitive to global economic growth including travel related spending, has been slower to recover but has still made solid progress in 2021. Emerging markets with such a diverse collection of countries have seen wide dispersion in their recovery. China has dealt with its share of regulatory and policy related issues in addition to relatively tight restrictions surrounding covid protocols that have hampered its economic growth in 2021. The downside of the recovery in global demand for goods and services is that the supply side hasn't been able to keep up, which has spurred inflation rates to jump globally. A political stalemate in the U.S. has so far pre-empted the expectation that income and corporate taxes would rise, providing more runway for spending and exuberance to drive asset prices higher. The next challenge for the economy, however, will be the inflection point that has been reached with central bank policy. Most of the major central banks have followed the same path of aiming to wind down their bond purchases by early- to mid-2022, with interest rate hikes soon to follow.

U.S. equities have set the pace for returns in 2021 with gains in excess of 20% as we sit with just a handful of trading days left in the year. Robust earnings growth rates have outpaced prices, meaning that price-to-earnings metrics have come down despite significant price increases. European equity markets have also been nice contributors to portfolio returns with low double-digit gains even with the headwind of a 7% decline in the value of the Euro vs. the USD. The laggards in terms of equity returns come from Japan +2.5%, while China was the weakest of the larger markets with losses now exceeding 20% year-to-date. The Chinese equity markets have been roiled by a series of regulatory measures that have cut into corporate earnings potential and scared many investors away. Municipal bonds have held up much better than treasuries and investment grade corporates, both hurt by climbing interest rates. Credit risk alternatives including high-yield bonds, closed-end bond funds, and hedge funds, particularly those focused on distressed debt have had outstanding years relative to the Bloomberg US Aggregate Index. In the less liquid markets, Venture Capital has been on a tear this year as fundraising for technology and technology-enabled businesses has been plentiful. All in all, with so many unknowns at the start of the year, current geopolitical uncertainty and the ongoing battle with the coronavirus investors have much to celebrate.

As we close out 2021, investors will be challenged to consider how much recovery is still ahead and how the path from here will impact portfolio returns. Will inflation remain elevated or begin to subside? How quickly and how far will central banks go in raising interest rates? How will corporate earnings growth evolve, and which segments of the market offer the best opportunities for returns in 2022? Our research team will continue to address these topics and others with our periodic investment commentaries and our suite of tools, including our Market Cycle Dashboards, Capital Market Assumptions, and Stress Test Scenario Analysis Tool which supports our investment decision making and ongoing dialogue with our clients.

Donna Szeto, CFA
Director, Long-Only Research
Chief Investment Office

Global Equities - An Uneven Bull Market

With less than two weeks to go, most broad equity markets are looking to finish 2021 in positive territory. The path the markets followed to arrive here has been less than even, creating opportunities for active managers to adjust portfolios. The rally that began in the 4th quarter of 2020, with positive news of a COVID vaccine, continued to carry steam into early 2021. Cyclical stocks most impacted in the depths of the COVID lockdown measures rebounded significantly as economies and industries reopened. However, by the middle of the year, the rally started to fade as supply chain issues worsened and COVID variants emerged – first delta in the summer, then omicron in November. The exception has been in emerging markets, weighed down by China, whose equities came under pressure when the government issued a number of regulations and then were further stressed by looming debt problems at the second largest private property developer.

In addition to picking the right stocks, having the right style exposures was an important factor in driving returns in 2021. While Value vs. Growth styles have had mixed results in the different market segments, in US small cap, our tilt to Value rewarded clients as the Russell 2000 Value beat the Russell 2000 Growth by over 20% through mid-December. The smaller capitalization stocks were also particularly exposed to the meme stock market craze that took hold in early 2021 as retail investors heavily influenced prices on small companies with little regard to business fundamentals. We recognize that exogenous events and factors can continue to drive the markets for periods of time. While their adverse effects on relative performance can be disappointing in the short-term, we believe that they are typically temporary. As the headwind abated in certain segments of the markets, we have seen our managers, who generally have a high-quality bias, particularly in US Small Cap, overtake their respective benchmarks and deliver attractive risk-adjusted returns for the full year.

Lost in the focus on the reopening trade and meme stock rally was the equally powerful rise and fall of SPACs. We wrote about this topic in the Spring of 2020 and advised caution for the enthusiasm by which the market was embracing this capital raising method (SPACs Impressive Comeback: Opportunities and Risks). The rally in these stocks peaked in mid-February 2021, followed by significant drawdowns through the spring. While we watch these trends closely, our focus on utilizing managers with a disciplined approach to fundamentals helped to insulate portfolios from these gyrations.

Despite the rise and fall of these trends, we believe there is an underlying growing trend in the investment industry which seeks to abandon conventional geographic and sector-based approaches to portfolio construction in favor of thematic-based investment approaches and products. Demand from the public for these strategies appears to be robust, and the industry is responding. As we look forward to 2022, we continue to follow the developments of our managers and the markets they invest in closely. As this space evolves, we will evaluate these strategies to determine their viability for our platform and, ultimately client portfolios.

Christopher Martin, CFA, CAIA
Director, Alternatives Research
Chief Investment Office

Alternatives - A Reversal in Trend?

Although 2021 began with the rise of the “Reddit Army,” which wreaked havoc on the performance of some long/short equity funds, overall, hedge funds finished the third quarter managing the most money they ever have (reported by HFR: $3.97T as of 9/30/21) and with some of their best annual returns of the last decade. This rise in assets includes $24B of inflows from investors. The rise in volatility throughout the year provided plenty of opportunities, as well as caution, depending on a strategy’s primary focus. Distressed credit and relative value strategies shined while technology and biotechnology faced headwinds. Outside of hedge funds, other alternative investment strategies also delivered robust returns. Listed closed-end fund discounts narrowed as vaccine rollouts buoyed risk appetite and alternative credit strategies were able to outperform more vanilla bond investments given the anemic rate environment. It was a great year for alternatives, and the opportunity set only appears to be improving into 2022[1].

While large cap equity indices posted attractive gains in 2021, a significant portion of these gains was driven by only a few companies. Underneath the surface, technology and biotechnology stocks experienced quite difficult years. On the technology side, software and eCommerce struggled as vaccines were rolled out, and the re-opening trade drove index returns. These companies have primarily strengthened their business models and competitive moats throughout 2021, and poor stock price performance has provided significant opportunities for active managers. Biotech is a slightly different story. Many biotech companies are relying on the future success of various drugs and products. As interest rates rise and more heavily discount the value of those future cash flows, the sector tends to perform very negatively. However, we believe there are companies in the sector that have proven products and strong balance sheets where the sell off with the rest of the sector presents opportunity. We are excited about the forward-looking opportunity sets for specific strategies with focuses on technology, sustainable solutions, and biotech in 2022.

[1] Trepp CMBS Research December 2020

Within alternative credit, we entered 2021 with what we felt was a ripe opportunity set in both liquid and illiquid markets. Accordingly, we shifted capital into stressed and distressed credit managers within our hedge fund portfolios. Contrary to popular belief at the time, we recognized the distressed opportunity did not dry up as the Fed injected liquidity into the market in 2020, and many companies would need continued capital and restructuring well into 2021. This shift helped drive strong absolute and relative performance in these strategies through the remainder of the year. On the liquid side, we preferred multi-sector credit mutual fund managers who were able to trade across bond segments to extract relative value and delivered positive returns for the period against a negative return for the Bloomberg US Aggregate Bond Index. Finally, listed closed-end fund discounts remained attractive at the end of last year, and our strategies were able to drive significant positive performance as those narrowed.

Our expectations for alternatives remain strong heading into 2022, given the continued backdrop of low interest rates, high equity valuations, and increased volatility. We are favoring strategies with less directional exposure to credit as spreads have narrowed and looking for opportunistic and thematic approaches to investing in other markets. Our alternatives platform is well-positioned to take advantage of this environment, and we continue to seek out ways to make our alternative investment offerings even stronger.

Dave Freudenberg, CAIA
Director, Private Markets Research
Chief Investment Office

Katie Robinette, CFA
Director, Private Markets Research
Chief Investment Office

Private Markets - Demand Meets Opportunity

In 2021 U.S. private equity experienced its fastest pace of deal and exit activity in at least two decades and posted its best returns on record. Cheap and abundant debt drove dealmaking while private equity backed exits surged amid one of the most active IPO markets since the early 2000s.

The opportunity set in private equity today is robust. An accelerated shift in technological transformation is touching almost every industry across the world. It has caused a massive shift in how consumers choose to spend and pay, how employees work, how we provide access to education, how businesses across industries think about delivering goods and services and how consumers and businesses protect themselves in an increasingly digital world. These trends have only accelerated amidst COVID. Growth themes include cybersecurity, financial services (payments for example), education technology, content, artificial intelligence, wireless, healthcare and more emerging areas like quantum computing, decentralized finance (blockchain), NFTs, and space infrastructure. In addition, there continues to be a healthy opportunity set in turnaround and carve-out opportunities as companies seek to rationalize business models and balance sheets.

Sustainability principles have become increasingly important to many investors. Investment strategies that actively integrate ESG analysis into decision making processes and/or proactively seek to generate positive social or environmental impact alongside market-rate financial returns have experienced significant asset growth. Themes of focus include environmental sustainability (accelerating the transition to a low carbon economy), enhanced social equity/social justice (improving access to goods & services, increasing representation among historically underrepresented people), human health (sustainable food & agriculture, access to healthcare services), modern mobility, and many others.

Valuations do remain high across the board amidst a competitive deal environment which could suppress future returns, highlighting the importance of having specialized expertise, advantaged sourcing, and value-add capabilities, as well as the prudent use of leverage. For managers with a competitive edge in these areas, we continue to think the return potential from private equity investments will significantly exceed public equities.

All real estate sectors improved in 2021 compared to levels from 2020. Apartment and industrial properties never stopped being resilient through the pandemic, maintaining stable occupancies and investor cash flow. This performance is expected to continue in 2022 as new leases capitalize on higher rents driven by strong fundamentals. This trend is most notable in apartments as rents are growing 10% or more in many markets. Hotel and retail properties have experienced a dramatic turnaround from the depths of 2020. Loan defaults across this group have fallen for 17 consecutive months since the peak of June 2020. The 30-day delinquency rate for CMBS loans improved to 9.4% for hotels (from 24.3%) and 8.09% for retail (from 18.1%). These Covid hit sectors are still challenged to return to pre-pandemic levels; however, they invite optimism for 2022.

The office sector remains the clear wildcard. Despite a steep decrease in daily office use and the success of work from home, tenant credit quality persists, and longer-term leases uphold the sector. Although broad market stress is not evident, it is reasonable to question future corporate space planning needs. Surveys indicate there will be modest reductions in demand yet leasing interest in high-quality space is surprisingly active in certain markets. The early stages of a recovery provide experienced operators a good baseline to underwrite with confidence in select locations and build a quality pipeline.

Within private assets, we are also seeing a growing set of opportunities in income strategies that can provide significantly higher yields than what is currently available in the public markets. These include direct lending, real estate debt, and other specialty finance strategies (royalties and consumer finance, for example). Given the outlook for continued low interest rates and high valuations across traditional fixed income, we think the private income space will offer an attractive alternative income source for the foreseeable future.

Executive Managing Director, Investment Research
Chief Investment Office

Conclusion

At Pathstone, we are optimistic about the future and how we have positioned client portfolios to address the risks and opportunities in the market. However, we know we cannot rest on last years' work. To stay ahead, we have re-invested in our team, our technology, and re-imagined best practices to deal with a changing world. This process always starts with our people. Pathstone's Chief Investment Office is part of a growing group of 15 dedicated professionals located across the country focused on investment research. During 2021 we further refined how we work together in a virtual setting and utilized technology to expand our scope of coverage beyond what was possible pre-pandemic. We have invested in new data vendors and software providers to enhance our analytical tools and strengthened our focus on operational due diligence (Alternative Investments: 8 Due Diligence Red Flags and Risk Areas). We believe investment success requires an unwavering focus on the details but also an ability to think long-term. To ensure we stay a step ahead, we have established a new Thematic Research Committee that will investigate and publish research on emerging trends that have the potential to become long-term secular themes ("Quantum Impact" – The Potential for Quantum Computing to Transform Everything). Many challenges lie ahead, but we remain as confident as ever we are well-positioned to navigate them with you.

On behalf of the Chief Investment Office and all of the Pathstone family, we are thankful for your continued trust and partnership. We wish you and your families happy holidays and a prosperous New Year.

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