APTUS CAPITAL ADVISORS

Investment Policy Committee Q&A April 15, 2021

Derek: Hello. Derek at Aptus here. I've got a few of the team members from the investment committee and we were just going to go run through some of the topics that have been driving markets. Some of the things that we're thinking about when we think about portfolios and also some of the questions that we're hearing from advisors that maybe their clients are asking, and just make it a free flowing discussion about things that might impact the markets from here and through the rest of 2021. It's obviously been a pretty wild 52 weeks looking in the rear view mirror. We just want to look ahead and see what other topics are going to be important going forward. So, we're going to talk a little bit about some of the rotations, because there's been a lot of rotations, basically every other month, between some of the more growthy aspects and some of the more cyclical stuff.

Derek: We'll talk a little bit about how hard it's been to generate income with rates being so low. Talk a little bit about what's coming up here in the next couple of weeks with earnings and throughout 2021 with inflation now being something that to think through, and we're going to take a little bit of a detour to some of the speculative type stuff that we don't necessarily include in portfolios, crypto and SPACs and marijuana and clean energy, just because clients are asking, we're hearing from advisors that, "Hey, my client's asking, "How do I invest in this?" There's not a ton of great ways to do it right now, but we still want to arm you with as many good answers as we possibly can.

Derek: And then maybe just bring it back to what matters. How do we help clients stay on track? How do we help them meet their goals? Maximize upside versus downside? That'll just be a place we can close it out. So, I'll do quick introductions. JD's here, the founder and chief investment officer, we've got Dave Wagner who's equity analyst. Beckham's also focused on the equity side and John Luke's are our internal fixed income guru. So, we have a lot of different perspectives to tackle some of this. And I guess we'll just start with some of that rotational stuff, some of the allocation changes, which, to anyone that's been with us a while, we don't make a lot of changes at the portfolio level cause we can do it inside of the ETFs, but we did make some specific moves at the very beginning of the year. And maybe the team can talk through some of that and what we're seeing and thinking about that now.

Dave: Hey, thanks Derek. This is Dave Wagner here, guys. I focus on the equity side here at Aptus. So let's just talk a little bit about the quarter. We saw the one year anniversary of the market bottom. Coming off this market bottom the S&P 500 is up 75% since that March 23rd date. And there's not many historical comps right there, even in the ballpark for the first 12 months really coming off of a recessionary market bottom. But if we were to look at some, 1982 which show that the market bounced 58% in the first 12 months, and in 2009, we saw a 69% boost from the S&P 500 off really the market bottom. And if you guys have really heard me talk, especially over the last three months from a thematic standpoint.

Dave: I always say that the first year of recovery is financially rewarding. Obviously the market was up 75% off the bottom, though very difficult to intellectually understand. And that's really what we've seen here over the first 12 months since the market bottom. But moving forward, year two tends to be more rational, though obviously less rewarding. You tend to see more average, normalized types of returns in the market.

So, let's delve into the lot of the things that we've really prognosticated, especially coming off of our year end call and some of the moves that we did within our asset allocation, but what was our theme for 2021? Our theme was, it was the same. The path of least resistance is up, but we are likely going to see some type of volatility. So let's break this sentence down from what we've seen in this quarter.

Dave: All right, so the first part, the path of least resistance seems up. The S&P 500 was up 6.2% during this quarter. And right now, 96% of the stocks in the S&P 500 are in an uptrend. And most people think, "Hey, that's a bear sign," but when you actually get these types of moves in the market with this many names trading above their 200 day moving average, we take it as a bullish signal. So the path of least resistance we believe is up here because when you get these types of reads, one, like I said, it's not a bearish indicator, but you tend to not see market tops here. And if we continue to believe that we're going to be some type of absent fed, especially from tapering talk, we think that stocks will tend to grind higher.

Dave: So if you look at the second part of this comment, the path of least resistance is up, yada, yada, yada, but with some type of volatility, the year two of recoveries tend to never be a straight line up, okay? Yes, the markets tend to go up in the second year, but it has tended to come with some type of chop. And if you look at examples, especially types of environments that we're seeing right now with relatively high GDP, this tends to be the case. If you go back to most recently to 1984, you saw a 14% correction in year two, you had GDP about 7%. And that's what we're looking actually here at Aptus, we're looking to get about GDP growth in 2021 of about 7%. If you go back to 1955, you also saw GDP, real GDP, grow about 7%. You saw an 11% pullback.

Dave: So we're not really trying to, here at Aptus, to ever make some type of call on the market because it's impossible. But two, we've actually might've already seen this correction to here during the first quarter. From peak to trough, small caps were down, 12% at one point. The NASDAQ from peak to trough during the quarters of down at one point 11%. We even saw more of the thematics here, trade into bear market correction, as you saw the SPAC and IPO index down almost, right now, 25% since February 11th. So the moral here is, you wouldn't have expected this type of chop in a quarter in this first quarter where you saw the S&P 500 up 6.2% and a VIX below 20.

Dave: But knowing this, we as advisors taking care of clients' capital, we need to be prepared for anything. And even if the market feels like it can only go up, which it does feel here personally to me, market corrections are healthy in the long run. So why not be prepared to take advantage of them when they occur? And we believe that our portfolios are very well positioned from an asset allocation standpoint to take advantage of those. So, let's quickly touch base on some of the moves that we made over the last quarter from an asset allocation. All right, so we increased our exposure to RSP, which has an equal weighted S&P 500 index, increased our exposure internationally. And we also increased our exposure down the small cap market cap spectrum with domestic small caps.

Dave: The laggard here is actually international, surprisingly, has underperformed domestic international stocks are up about 2% or the quarter. And as I mentioned, the S&P 500 was up about 6.2%. So I'm going to pass it off to Beckham and then he can maybe talk to us about where we think from a thesis standpoint what happened this quarter and especially moving forward, why we're still very bullish on this area.

Beckham: Sure. Dave, thank you. Yeah, and like you said, although we haven't seen the out-performance so far this year, we still do think the setup is there for strong performance in the international space. This is typically something that we've seen in the past where international does outperform domestic markets coming out of global economic attractions like this. So I guess looking at the space, you have it in developed markets and emerging markets. I just want to touch on the components that we think make both markets still attractive currently. So if you think about in the developed market space, how we look at stocks and our framework provided on that, we have a yield plus growth plus valuation framework and looking at it through that lens, we think it still looks really attractive. Yields are very easy to calculate, typically, higher yielding than American companies abroad.

Beckham: And then from a growth perspective, believe it or not, there's actually stronger projected growth potential internationally then than there is domestically. So there's 35% expected growth on the MSCI Europe, Asian far East index versus 25 at home. So growth prospects are still something that we're excited about. And then from a valuation perspective, we're really seeing some good value overseas. There's a typical valuation discount in overseas stocks of around 8% compared to us stocks and right now they're trading at a 25% discount. So, looking at the developed market space, broad strokes, we think that the setup is there for continued strong performance. And we think that it was a smart decision to increase the waiting there in the portfolios.

Beckham: And then, if you look at emerging markets, there's really two main themes that are driving our thoughts on EM, and that's the commodity driven nature of those markets. And secondly, the impact of the dollar, whether it's strengthening or weakening. So just to touch on commodities really quickly, many of these economies have a commodity or commodities as a major export and driver of their economic growth. So if you think about that from the environment we find ourselves in coming out of the economic contraction, these economies are beginning to reopen, manufacturing is picking back up. So we expect that the demand for commodities is going to pick back up. That's something that we've seen, which should translate into higher output from these countries and better performance.

Beckham: And secondly, and which has been surprising for us so far is that the dollar has remained strong and the returns of emerging market economies are reliant on the strength of the dollar. So, we think that the setup is there for a weaker dollar, if you just think about the amount of the money in the system, the monetary and fiscal stimulus that's been enacted over the past year. It's just been historic if you think about the money supply, the M2 money supplies, basically the amount of money in the system, has increased by 26% since the COVID pandemic. So, if you take all those things into consideration, we do think that there's potential there for a weakened dollar, which should further boost emerging market returns.

Beckham: So, that's our thoughts on the emerging market space. As Dave mentioned, we have increased waiting in the allocations to both of those spaces and we're optimistic that we'll see a good return from that side of the portfolio going forward. [crosstalk 00:11:10].

Dave: We continue to be pretty bullish also on RSP, the equal weighted index, as I mentioned before, and also small caps, relative performance over large cap. We still think that there's a long runway here coming off the market bottom where we think these other two asset classes cannot continue to outperform. So we're really happy with our asset allocation stands from an equity standpoint.

Derek: Thanks, guys. We're going to kick over a little bit into this fixed income. As you know, we've gone from disliking bonds to really hating the asset class. It's just, it's a drag, it's an anchor on portfolios and a lot of people just feel as though it's a... We think it's a forced asset class. People are just traditionally used to go on 60/40 means they got to find the best 40 to put in here. And we think about it a little bit differently and we've got a crew in here that can talk as deeply as needed on credit spreads and yield curves and all that. But I figured they can just discuss a little bit of the backdrop and maybe some of the things that we think are better ways to tackle that side of things.

John Luke: Good, Derek, thanks. That's a perfect intro. And I think one of the more powerful things we've done in our allocations is the avoidance of traditional fixed income. And if you look at returns through the first quarter, the AG had its worst quarter in 40 years. It's the first time that clients will see losses on their statements since the 2013 taper tantrum. And so, as you see clients that look at portfolios and their allocations and see losses in their safe bond portfolios, we think it could definitely cause some concerns. So I think one of the more powerful things in our allocations that we've been able to accomplish is just simply avoiding them. And so, I think as we look moving forward, are we likely to continue to see those losses occur? And that's really what's important. And we've seen that the 10 year treasury, which is probably the most quoted and thought about yield out there and importance for drivers of GDP and growth moving forward, and what expectations look like.

John Luke: And in August of last year, the 10 year treasury was at 50 basis points. And it ended the quarter of over 1.7%. So obviously you had a huge move in long-term rates, which more than anything is just in a normalization of the economy reopening and things more or less getting back to normal. And then on the other side of that, you've had the Fed, which has basically been okay with rates on the long end going up and going up pretty quickly. And I think what we can continue to expect is the Fed to pin those front end rates at zero, or pretty close to zero for the next maybe even year to two years out. And so I think that leaves room for the yield curve to continue to trend up and be painful for fixed income investors.

John Luke: So, as we look across the opportunities in fixed income, we know that the 40 year tailwinds and decline in interest rates is likely over and we could very likely see rates continue to trend up. And if you look across the risk spectrum, we continue to see spread, like Derek, mentioned across credit products, trading very tight. Actually most products are trading tighter than they were pre COVID. And so, looking forward, we consider fixed income to be a very difficult space. And so I think how we target our asset allocation of owning VOL and owning more stocks with risk management to replace some of that fixed income drag is going to be huge moving forward. So with that, I'll throw it over to JD.

JD: Yeah. Thanks, John Luke. And I don't have a ton to add other than, I guess like Derek mentioned, that bonds are an asset class that served, they have an anchor in portfolios right now, just because it's the way things have always been done. And we have the perspective that because it's always been done in the past doesn't mean you have to do it moving forward. And when you look at potential for return, obviously we're not excited about fixed income in any way. So we've chosen, I think this is the most valuable ad that we've injected, is the ability to avoid an asset class that we feel like is a ball and chain on returns moving forward. And we're starting to see that play out.

JD: And so, we're offering advisors and portfolios the freedom to think outside the box, which is, "Hey, I actually don't have to own bonds. As long as we can do something for the portfolio that we think doesn't inject a whole bunch of risk with that decision, we've actually... We think there's a ton of value that's brought to clients that have traditionally been handcuffed to owning a lot of bonds because they're more conservative in nature. So, I think that is one of the biggest things where if you're dealing with a household or a client that is the risk tolerance may not be all that conducive to accepting volatility and things like that, well, you have to have a way to... You can't put 60% in fixed income right now because there's no return you're going to inject longevity risk.

JD: And so what we've been able to do is help advisors really hit on and express the view that we don't like bonds. How can we not own bonds and still not take up risks? You don't want to have tough conversations around volatility and draw down and things like that. So, I think all that John Luke said, and Derek, you laid it out nicely. The biggest thing that we're doing from a portfolio standpoint from a really high level is just, we don't have that ball and chain of bond. And we’ve seen it help returns and we expect it to be moving forward.

Derek: Cool, thanks guys. And we've covered portfolio level allocation type stuff. I guess now that we're getting into earning season, I see a couple of banks are starting to trickle out. Maybe we can touch on some of the catalysts that might be ahead in the coming weeks and even throughout the rest of 2021, if you guys have thoughts there.

Dave: Yeah, so going into 2021 on our year-end call, we said, "Hey, in the first half of the year, the market tends to focus on just a few things." And in the first of this year, we thought it was going to be the earnings recovery and inflation. I think the inflation portion has driven more market sentiment here more recently than earnings, but let's touch on earnings real quick. Stocks recently have more traded in line with more of the recovery. What are the vaccine developments? What are the COVID cases? Are the numbers coming on down? And more importantly, is there some type of reopening occurring?

Dave: Given that we had a shutdown basically one year ago, we think that going into this earning season, that earnings seem ready to blow estimates out of the water. Usually in the second year of the earnings recovery, the S&P 500 tends to see earnings growth of about 25 to 30%. We're expecting year over year earnings growth culture to be actually closer to 40%. Obviously, too, a lot of the reasons that Beckham explained earlier, "Hey, there's a lot of stimulus in everything out in the market right now." There's a lot of pent up demand. A lot of consumers are sitting on a ton of capital and they are very much have the high propensity to spend that capital right now.

Dave: So in thinking that earnings are going to be unbelievable still, just moving forward, but for earnings right now, I think that the companies and how the stocks react to these earnings reports is going to be very much based on profitability. All Right? There's a lot of talk of inflation, higher input costs really coming into play right now. And commentary really coming from management teams, not just for this quarter, but moving forward on profitability is really what we think the market is going to start focusing on within earnings right now. And that dovetails us this profitability talk, dovetails us into our next conversation. That second theme we were talking about is going to be the hot topic the first half of this year. And that's inflation.

John Luke: Yes. Thanks, Dave. And this is a fun topic to talk about, and it hasn't been one that's been relevant for years, really, since maybe the seventies or eighties where we've actually had inflation run really hot. So, the market is right in having concerns over inflation and we've seen the Fed give us a little bit of a change in their mandate moving forward, where they're going to, instead of looking to price, stability, and employment, they're going to really just focus more on a single mandate to focus on employment and wage growth. And so, as my comments alluded to earlier, really the Fed has pretty explicitly communicated that they plan to look past the next few months of inflation as it's priced into the market off of the comps from 2020, during the depths of COVID.

John Luke: So, we expect inflation numbers from a economic data perspective to run hot the next few months. And I think what happens beyond really, June and July moving forward, is where the market could see things get a little dicey. And so what we've seen to start really, since the bottom, last March, is commodity prices have been on a tear. And so, as David alluded to with profit margins and inputs is some sort of cost push inflation that we've seen across these companies from a profitabilities perspective where their input costs have gone up significantly. Cost of shipping, cost of raw materials. And so I think, more importantly of what this means now, is that the markets have really priced in the next few months of inflation running hot. And as we've seen the bond market response, there hasn't been a whole lot of fear and worry.

John Luke: So, I think, more importantly looking forward is the market has soaked up the inflation talks and really stuck to believe what the Fed has said, that they're going to look through inflation over the next couple of months. And importantly, we'll look past these next few months comps and see what happens towards the end of the year. And if we really do have these price inflation wage inflation types of deals moving forward, that could considerably throw a wrench in the Fed engine of keeping the market satisfied and happy with the communication and very open communication line that they've given us here so far.

Dave: Yeah. We all know that inflation is coming, all right? It's in the data. We've seen it anecdotally. But it might not matter if we're going to have inflation or not have inflation, it's all going to depend on how the market reacts to the expectation of the types of inflation. And more importantly, how long we're going to see this inflation, like John Luke has said and the Fed has said, it's transitory, all right? We're going to see it in 2021. The big question the market is starting to focus on right now is, "Hey, is that going to persist into 2022?" And then more importantly, I'll end with this, it's really just this, how's the Fed going to address this inflation, all right? They have a lot of different levers that they can pull to try to cap inflation in a way, but lo and behold guys, we're going to see inflation. It's just, it's likely dependent on how is the market going to react to the expectation of this inflation?

Derek: All right, little bit of a detour and an area that we're not necessarily allocating funds, but if you're an advisor and hearing questions from clients, it's our responsibility to help you answer those questions as best we can. So, there's been a lot of crazy stuff going on with, SPACs, and some of the thematic stuff like clean energy and marijuana, and you've got crypto and defy, and there's a lot going on an clients... You're always going to have those clients who want to know how can I play this? And it's not really a perfect area to play. And I think it would be good for us to both give you some answers, give you some good talking points, but also help you with the perspective of what is investment versus speculation? And so, I figured, this is probably a good time to just talk through a little bit of that since it's been a hot topic of late.

JD: Yeah. And I'll jump in on that. I would say, first we have our primary, the way that we view portfolios is through a yield plus growth framework. And everybody that's listening on this call have probably heard us talk through that. Obviously we like companies that have both components, yield and growth and they have a history of doing so and we can really understand what we own and get an expectation. Anything that doesn't have yield associated with it or growth that we can really feel like we can wrap our heads around, it opens up the purely speculation. And there's a lot of things that they're Derek's just rattled off, like clean energy, defy, really block chain's impact on the financial services in general, cannabis, a lot of these thematic plays where they're newer technologies, they're newer industries that we've been aware of for years now.

JD: But you are starting to see industries rise up that they could have a long growth potential for them, a runway for growth. And so, while we're not actively deploying capital in any of these areas right now, because we think there are a lot of issues from valuations and speculation standpoint, but there is a ton of internal work going on here at Aptus to understand what we need to understand, and that not only the industries in general, but also the potential allocation opportunities for us, what vehicles make the most sense, who's doing things that are interesting, that are efficiently getting access to these things that we think could make sense? So while we're not actively deploying capital into these spaces yet, there are a few that have piqued our interest and we're just looking for prudent ways to gain exposure.

JD: So, hopefully that's helpful, and if any of these questions come up with clients, feel free, we've got plenty of info that we can send your way on any of the thematic stuff that we've rattled off.

Derek: Thanks, JD. Yeah, and we really do want you to ask us if you do get those questions, because we have assisted with materials for advisors, not stuff that we're publishing and like JD said, not stuff that we're doing, but I'm happy to share some of our research. A good place to wrap it up would just be, let's bring it back to what really matters. And that's you helping clients, keeping them confident, keeping them on track to hit their goals. And part of that is just maximizing upside versus the risk that you're taking. And so, I figured this would be a good place to bring things back home and just talk through knowing what you own and why we put together portfolios the way we do. And if you guys want to jump in on that, this is a pretty key topic.

Beckham: Sure, sure. And JD hit the nail on the head there. I think especially now with what we're seeing with a lot of new technologies, different thematic factors that really have a lot of momentum and story behind them, critically important to know what you own from a investment perspective, but also then at the asset allocation level, very important to know what you own, how they work together, and how that impacts your portfolio. So, if you think about it, each specific holding in your asset allocation, in our opinion, should be there for a reason and have a specific job and a purpose. And that's something that we spend a ton of time on both in our internal models and also with the partners that we work with and our perspective partners, we'd really like to get in there, dissect the holdings and make sure the sum of the individual parts gets us to an allocation that everybody's comfortable with from a risk and return perspective.

Beckham: So, we think that's really important. Two big reasons and obvious advantages to do that are to help get the traditional diversification benefits of a well-constructed portfolio. And you think about that, that's our first line of defense when volatility hits, is just having different asset classes and investment vehicles in there that act differently, and we think that helps you that reduces hidden correlations, which is basically, want to make sure that the different ticker symbols that you have in your asset allocation are giving you exposure to different areas of the market and to different strategies. So that when volatility in turmoil hits and correlations converged somewhat, you have benefits of just different return drivers and different performance stream. So, what we always say at the asset allocation level is we want our equity exposure to be equity, and we want our bonds to be bonds.

Beckham: So if you think about our stock exposure, we want to drill down and make sure that our market cap and our factor exposure, our geographical exposures are in line with what we feel makes sense when we look at the broad spectrum of the investment universe and same with on the bond side, want to make sure that we understand our credit exposures and our issuer quality. We want to make sure that we understand our interest rate risks and what sort of duration exposure we have. And again, the geographic regions and different areas of the fixed income market, we're more excited about some over others. So again, just crucial to know what you own, what the drivers are in those areas, and be sure that the things that we're relying on, to make our investment decisions look like they're going to be consistent going forward.

Beckham: So, and to set JD up to finish this up here, I think anyone who's listened to us or read our stuff understands our thoughts and our attitudes towards fixed income and especially how we think things that have been beneficial in the past will not be super beneficial going forward. And we think sometimes it makes sense to own a more non traditional asset classes as a solution towards the, some of the headwinds that we're facing in that space specifically. So, with that, I'll kick it over to JD and let him talk a little bit about volatility as an asset class.

JD: Yeah, and I'll be very brief there close this up, but I think that that is one of the biggest things that we haven't mentioned yet, but in all of our portfolios and all of our allocations, everything that we do has some component of, we want to own volatility. We view it as an asset class. And what that allows us to do, obviously from an allocation standpoint, is get away from bonds and own more of the asset class that we think actually has returned. And we do think that while, like Dave mentioned the path of least resistance, we do think it's higher because of all the things we've rattled off, but that doesn't take away from the fact that volatility is back near lows. There's still uncertainty all over the place in a lot of areas of the economy and the markets.

JD: And so, we think volatility is a really compelling asset class, if you can own it efficiently within the overall portfolio. And that is exactly, that's what we specialize in. That's what we try to do. And I think that our approach to portfolio construction is compelling. And I think the environment that we're in now makes it about as compelling as it ever has been just because, again, not the beat the same drum over and over, but we don't have the ball and chain of traditional fixed income exposure to deal with. So Derek that's all I had, but obviously anybody listening, I'll let Derek wrap it up, but if you've got questions or want to dive into anything specific, obviously we're here. So, please reach out, but we do appreciate you listening in on this today.

Derek: Thanks, guys. Appreciate the time. We've got a whole team of CFAs and they're talking about this stuff every day. So it's fun for me to be able to pick their brains a little bit and then share it with the advisors that we have relationships with. So, thanks again. We'll try to do these at least quarterly. We'll get a little summary together and share it as broadly as we can. So thanks again, guys. Have a good day.

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