5956 Sherry Ln # 1600
Dallas, TX 75225
(214) 361-5383
www.ackermancapital.com

ACM QUARTERLY MARKET COMMENTARY – FOURTH QUARTER 2020

Capital Markets

Global stock markets finished 2020 impressively with a fourth quarter return of 14.4%, which accounted for most of the 16.6% yearly gain. Bonds limped into year-end with modest gains, but otherwise had a solid year with U.S. Aggregate and Municipal bonds up 7.5% and 5.1%, respectively. Generally speaking, our portfolios participated nicely in the strong fourth quarter for stocks, largely because we allowed our equity allocation to remain elevated relative to target weights through year-end. This decision was driven, in part, by the market strength in early November when the up volume for the S&P 500 exceeded 80% in three out of four days. Surges of buying power like this are often a sign of pent up demand for stocks and this was actually the second such occurrence in 2020. Prior to last year, this type of “breadth thrust” had occurred only 8 times over the previous six decades. These historical signals were followed by additional gains (in all but one case) over the next three months averaging more than 5% and in every case over the next twelve months with an average gain of more than 22%.

Perhaps more importantly, this surge in stock purchases was echoed across all economic sectors and regions. Leading up to the fourth quarter, the market gains in recent years (and especially in 2020) have been almost singularly driven by the outsized performance of large U.S. growth stocks. Such narrow leadership is not typically indicative of a healthy bull market and has also resulted in sky high relative valuations for this corner of the global markets. The fourth quarter, though, had a different feel to it with broad participation that we have not seen in a while. In fact, U.S. value and small-cap stocks, international stocks, and emerging markets all outpaced large U.S. growth stocks during the quarter. Could this leadership rotation be the beginning of a more permanent shift? It is too early to say, in our opinion, but another quarter of relatively strong performance could provide important confirmation.

As you know, our asset allocation and fund sizing are driven by two things – valuation and price trends. So, within equities, for example, we try to emphasize the cheaper parts of the global equity markets, but not until the market has recognized that value as demonstrated by an improving relative price trend. The fourth quarter action moved the needle slightly, leading us to moderate our large U.S. growth exposure a bit. However, with a little more follow through, you will likely see us meaningfully reduce this exposure in favor of value, small, international, and emerging markets funds. Inevitably, the dominant performance of large U.S. growth stocks will fade, and as this happens, we expect many investors will not adjust their portfolios accordingly. This type of behavior is a result of various cognitive biases that are, in part, the focus of the interesting field of behavioral finance. Summing up these scientific findings in simple terms, many investors simply fall in love with their winners. Who can blame them? It is easy to do. Recall all the investors (and maybe you were one of them) who profited during the dot.com bubble of the late 1990s, but ended up giving it all back and then some as they rode their former favorites all the way down to the bottom. We suspect it will be déjà vu all over again, sooner or later.

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Portfolio Update

Since the beginning of the new year, we have reduced equity exposures back down to target weights in tax-advantaged portfolios. In tax-managed portfolios, we also cut back on equities, but somewhat less so in an effort to avoid the creation of large realized gains. The impetus for this defensive move was the increasingly euphoric levels of investor optimism and speculation that have historically preceded market corrections. Call option (bullish bets) volume, particularly, among smaller traders has skyrocketed since the beginning of the year, while the ratio of put volume (bearish bets) to call volume is at the lowest levels in almost 20 years. Margin debt is also at an all-time high. All of our favorite aggregated indicators of investor sentiment are near historical bullish extremes. Meanwhile, interest rates have risen about 0.5% since their August lows and, as a result, sentiment toward bonds has turned negative. By our analysis, we show the contrast in bullish stock sentiment to bearish bond sentiment to be in the top 2% of readings going back more than 20 years. From a contrarian standpoint, we cannot imagine a more logical time to reduce equity exposure in favor of bonds. Should the stock market euphoria rise to even higher levels in the coming weeks or months, we would likely reduce equity exposures again to levels that are below equity allocation targets.

Looking Forward

While we have short-term concerns about an imminent pullback in stock prices, we think that any correction would be temporary and that the longer-term outlook for stocks is quite positive. We see long-term expected global stock returns around 6.5%, which is historically attractive compared to current low interest rates. We expect that interest rates will remain low for some time to support an economy recovery that will need all the help it can get. Assuming this is the case, there remains plenty of money in cash and bonds that can continue to flow into stocks. Additional fiscal stimulus measures from Washington will also be a driver of improving economic growth. Finally, from a technical analysis standpoint, the global bull market in stocks is very healthy, with the type of impressive breadth that historically has been a harbinger of higher prices over the next year. In addition, the underlying buying power and pent up demand in the stock market continues to be demonstrated by a number of indicators including the previously mentioned November breadth thrust.

Looking Back

Last year was no fun (how is that for an understatement?). Personally and professionally, we all suffered to varying degrees. The market collapse during the first quarter was brutal. There was no easier time to “hit the chicken button” and abort long-term investment plans. We hope our disciplined approach and reassurances helped you stay the course and sleep easier at night. For our part, we are grateful to have wonderful clients, many that go back decades and generations. A number of you have expressed your appreciation for our work lately, and that means so much to us. Your continuous trust, through good times and bad, is a great source of professional pride.

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Farewell

Over the years, Ackerman Capital Management has also been fortunate to have many dedicated and loyal employees, but none more so than Sari Wilson and Sophie Bowers. Sari started working for my father in 1973 and Sophie joined them in 1985. They played key roles in the success of the company and my father's professional longevity. Over the past twenty years, they have done the same for me. Sari and Sophie, though, are more than just long-tenured ACM employees. Over the years, they became much loved and appreciated members of the Ackerman Family. Unfortunately, it appears that the circumstances around the pandemic have likely forced the hand of retirement for both of them. Their presence in the office will be missed. We wish them all the very best and hope that there will be opportunities for cameo appearances in the future when it is safer to venture out.

David B Ackerman
Managing Partner / Chief Investment Officer