Weekly 3

WHAT YOU NEED TO KNOW ABOUT THE MARKETS

July 6, 2020

ORION

More Gains Ahead? | Election Season | Balanced Portfolio Expectations

By Rusty Vanneman, CFA, CMT
July 2020

- The market outlook, despite some dark clouds, is still mostly sunny.
  - After one of the best three-month periods in market history, we believe the odds suggest more gains ahead.
- The upcoming presidential election is pivotal.
  - The market will likely provide clues to who will win.
- Return expectations for balanced portfolios should be adjusted lower.
  - Investors should be taking steps to prepare for market uncertainties.

1 *More Gains Ahead?*

2 *Election Season*

3 *Balanced Portfolio Expectations*

Market Performance

as of 07/04/2020

FIXED INCOME	10-YEAR	5-YEAR	3-YEAR	1-YEAR	YTD	QTD	LAST WEEK
Cash Equivalent[1]	0.58	1.12	1.65	1.39	0.43	0.02	0.00
U.S. Investment Grade Bonds[2]	3.82	4.30	5.32	8.74	6.14	2.90	0.21
EQUITIES	**10-YEAR**	**5-YEAR**	**3-YEAR**	**1-YEAR**	**YTD**	**QTD**	**LAST WEEK**
Global Equity Market[3]	9.26	6.43	6.05	1.90	-6.47	19.36	-2.01
Total U.S. Market[4]	13.88	10.27	10.34	6.96	-3.11	21.98	-2.86
Domestic Large-Cap Equity[5]	14.44	11.62	12.16	10.82	-0.69	20.91	-2.65
Domestic Small-Cap Equity[6]	10.50	3.83	1.38	-8.42	-14.17	25.49	-3.78
International Equity[7]	5.27	2.52	1.37	-4.38	-10.94	16.69	-1.06
Developed International Equity[8]	5.69	2.30	1.06	-4.79	-11.29	15.79	-1.44
Emerging Market Equity[9]	3.79	3.21	2.39	-3.27	-10.00	19.25	-0.07
DIVERSIFIERS	**10-YEAR**	**5-YEAR**	**3-YEAR**	**1-YEAR**	**YTD**	**QTD**	**LAST WEEK**
Diversified Alternatives[10]	2.24	-0.50	-1.13	-5.05	-8.23	6.48	-0.53
Commodity[11]	-5.82	-7.69	-6.14	-17.38	-19.40	5.08	-2.09
Global Real Estate[12]	6.88	2.59	-0.27	-11.14	-17.16	11.96	-3.25

Source: Morningstar

[1]Morningstar Cash Index [2]Bloomberg Barclay's Capital U.S. Aggregate Bond Index [3]Morningstar Global Market Large-Mid Index [4]Morningstar U.S. Market Index [5]Morningstar U.S. Large Cap Index [6]Morningstar U.S. Small Cap Index [7]Morningstar Gbl ex U.S. Large-Mid Index [8]Morningstar DM ex U.S. Large-Mid Index [9]Morningstar EM Large-Mid Index [10]Morningstar Diversified Alternatives Index [11]Bloomberg Commodity Index [12]Morningstar Global Real Estate.

The Weighing Machine podcast is on Google Play and iTunes.

On Orion Portfolio Solutions' The Weighing Machine podcast, Rusty Vanneman and Robyn Murray cut through the market clamor and focus on time-tested, proven principles that help financial advisors and investors reach their long-term financial goals.

Market Update Video

June Market Review

June was another good month for the markets. It capped one of the best-ever quarters for the U.S. stock market and saw the best returns for the overall U.S. market (as defined by the S&P 500) since the late 1990s. The U.S. market had its best 100-day stretch in more than 80 years.

Despite an epic sell-off earlier this year, plus continued stress from COVID-19, social unrest, and the worst economy since the Great Depression, the overall U.S. market ended June up by 7% over the last year, and an average of more than 10% per year for the last three- and five-year periods.

So, where to next? Between now and the end of the year, investors should prepare for more volatility and the idea that anything could happen. However, they should also, all things considered, expect more gains.

We'll review the outlook factors, but first let's take a closer look at the June and second quarter numbers.

The U.S. stock market, as measured by the S&P 500 index, was up 2% in June and finished the quarter with a 22% gain. These gains were propelled by another great month (+4%) and quarter (+30%) for growth stocks, as measured by the Russell 1000 Growth index. Small-caps, as measured by the Russel 2000 index, also did well in June (+2%) and for the quarter (+25%).

Against a backdrop of U.S. dollar weakness, international stocks, as measured by the MSCI EAFE, outperformed last month. Emerging market stocks, for instance, were up 7% in June (19% for quarter), as measured by the FTSE Emerging Markets Index.

Among diversifying asset classes, bonds were up 1% for the month and 3% for the last three months, as measured by the Bloomberg Barclays U.S. Aggregate Bond Index. The 10-year U.S. Treasury closed the month at 0.69%.[1] The three-month Treasury bill finished June at 0.14%.[2] Commodities, as measured by the Bloomberg Commodities Index gained 4% in June and were up 9% for the quarter.

RUSTY VANNEMAN, CFA, CMT
Chief Investment Officer

Rusty Vanneman serves as Chief Investment Officer (CIO) for Orion Advisor Solutions, where he is responsible for overseeing the investment processes across Orion and its subsidiaries, including CLS Investments.

*Mr. Vanneman joined CLS in September 2012 as CIO. Previously, he served as CIO and Portfolio Manager at Kobren Insight Management (KIM) in the greater Boston area. His 11-year tenure at KIM included a 5-year span during which the firm was owned by E*TRADE Financial and he served as the Senior Market Strategist for E*TRADE Capital. Prior to working at KIM, he was a Senior Analyst at Fidelity Management and Research (FMR Co) in Boston. He was also a Managing Analyst at Thomson Financial. In 2018, Mr. Vanneman took on the role of President of CLS, in addition to his position as CIO. He became CIO of Orion in 2019.*

*Mr. Vanneman received a Bachelor of Science degree in Management from Babson College where he graduated with high distinction. He has held the Chartered Financial Analyst® designation since 1994, and is a member of the CFA Institute. He has also been a Chartered Market Technician® since 1999, and is a member of the Market Technician's Association (MTA). In addition, Mr. Vanneman authored the book "Higher Calling: A Guide to Helping Investors Achieve Their Goals." He was named one of the Top 10 Portfolio Managers to Watch by Money Management Executive in 2017.**

**Rusty Vanneman, CFA, CMT, was selected as a "Top 10 Fund Managers to Watch" in 2017 by Money Management Executive. Money Management Executive is an unbiased, third-party publication covering the asset management industry. Money Management Executive chose the list of managers to watch by screening Morningstar data from funds with a single manager, ranked as having the best three-year annualized returns in their respective categories. The list of managers was published March 27, 2017. Money Management Executive is not affiliated with CLS. Ratings and awards may not be representative of any one client's experience and are not indicative of CLS's future performance.*

1 Source: https://www.treasury.gov/resource-center/data-chart-center/interest-rates/pages/TextView.aspx?data=yieldYear&year=2020

2 Source: https://www.treasury.gov/resource-center/data-chart-center/interest-rates/pages/TextView.aspx?data=yieldYear&year=2020

Market Outlook: Expect More Gains

1

While it is possible, and even probable, that we could see large short-term gains and/or losses before year-end, I believe the bulk of the evidence points to more gains.

In the current environment, it's very easy to get negative. First and foremost, COVID-19 is not going away. As of this writing, while the growth rate for deaths continues to drop, the growth rate for infections has not dropped.

The economy is also producing Great Depression-like numbers[1] and will take time to fully recover. And this is all playing out against the backdrop of social unrest and a highly contentious political environment. Meanwhile, valuations, in an absolute sense, are clearly well above long-term averages. Some analysts have noted the economy is in the bottom 1% of its history but the top 1% of its valuation history. Not a good mix.

Yet, I believe it's more likely than not that we will see new highs and the market will finish with a gain, potentially a large one, by year-end.

Let's review some of the positives.

A strong quarter doesn't mean losses must follow.

Just because we had a big quarter doesn't mean the market has to falter. Many investors are hesitant to buy after such strong gains and are waiting to buy on weakness. While buying investments on sale is a good practice, waiting too long often doesn't pay. According to the Bespoke Investment Group, the strongest quarters in recent decades were followed by above-average gains over the next one-, two- and four-quarter periods.[2]

Quarter	Quarterly Gain > 15%	Next Quarter	S&P 500 Return Next Two Quarters	S&P 500 Return Next Four Quarters
3Q 1970	15.8%	9.3%	19.1%	16.8%
1Q 1975	21.6%	14.2%	0.6%	23.3%
4Q 1982	16.8%	8.8%	19.5%	17.3%
4Q 1985	16.0%	13.1%	18.7%	14.6%
1Q 1987	20.5%	4.2%	10.3%	-11.2%
Q2 1997	16.9%	7.0%	9.6%	28.1%
4Q 1998	20.9%	4.6%	11.7%	19.5%
Q2 2009	15.2%	15.0%	21.3%	12.1%
Q2 2020	16.4%	?	?	?
	Average	9.5%	13.9%	15.1%
	Median	9.0%	15.2%	17.0%
	% Positive	100.0%	100.0%	-11.14

1 Source: https://www.wsj.com/articles/coronavirus-slump-is-worst-since-great-depression-will-it-be-as-painful-11589115601

2 Source: https://www.bespokepremium.com/

1

Fiscal and monetary policies continue to boost the economy.

Recent monetary and fiscal policy efforts have been massive and unprecedented by historical measures. The federal deficit is now the largest it has been since WWII[3], and it's unlikely those spigots will close during an election year. This stimulus has had an impact. Aggregate net worth is currently holding up, the housing market has been resilient, credit markets are well behaved, and, needless to say, growth assets are significantly higher.

A strong market in a negative environment is typically a positive indicator.

In the early days of my career, I often heard traders say a market that doesn't go down on bad news is a market we want to buy. Well, we have had plenty of bad news lately. Never mind the notion that the market needed a breather after the ferocious rally, and that a step back would have been natural and normal (especially since many institutional investors needed to rebalance and sell equities into quarter-end). Instead of taking that step back, the market simply consolidated, and some indices even broke to new highs. Impressive.

Economic data has nowhere to go but up.

While it may take years for the economy to fully recover, economic data should trend toward consistent, above-average growth. Since the economy is coming out of a deep hole, the math suggests we should expect above-average growth for most quarters in the years ahead.

This summer should be better than most.

While the summer months are typically the weakest of the year, as is the third quarter, there are a couple of important exceptions to consider.[4] One is that July is typically a decent month. It has typically delivered above-average returns for the last 20- and 50-year periods and has actually been the best performing month of the year, on average, over the last 100 years. Interestingly, even though the third quarter is typically the weakest of the year, it's often the best quarter during election years. This is often due to monetary and fiscal policy stimulus in the economic system, which creates above-average economic activity. Sounds like our current market backdrop.

Sentiment is still negative.

The Wall of Worry is still in place. One would think bricks from this wall would have been removed given recent price gains, but it's actually getting taller (as of this writing, the American Association of Individual Investors Sentiment Survey, remains extraordinarily negative). All else being equal, when sentiment is this negative, investors should expect above-average gains moving forward. Again, another recent study from Bespoke Investments' July 2020 Bespoke Report showed that when sentiment has been this negative historically, the market generated above-average returns over the next one-, three-, six- and 12-month periods.

Low interest rates are countering high valuations.

High valuations remain a concern, but they don't look quite as bad when interest rates are this low. This might change when rates start to move materially higher. Besides, where else would investment money go now? Bonds? Commercial real estate? Small business? With the Fed basically pushing investors toward risk assets ("Don't fight the Fed"), stocks still seem to be the best option.

Add it all up:

Being invested and staying invested appears to be the best course of action.

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3 Source: https://www.bloomberg.com/news/articles/2020-04-13/u-s-debt-deficit-forecast-to-hit-levels-not-seen-since-wwii

4 Source: https://www.advisorperspectives.com/commentaries/2020/05/29/the-summertime-blues-a-look-at-how-markets-perform-from-may-through-august

Election Year Expectations

2

This year has obviously been historic for many reasons. The upcoming election will be, too.

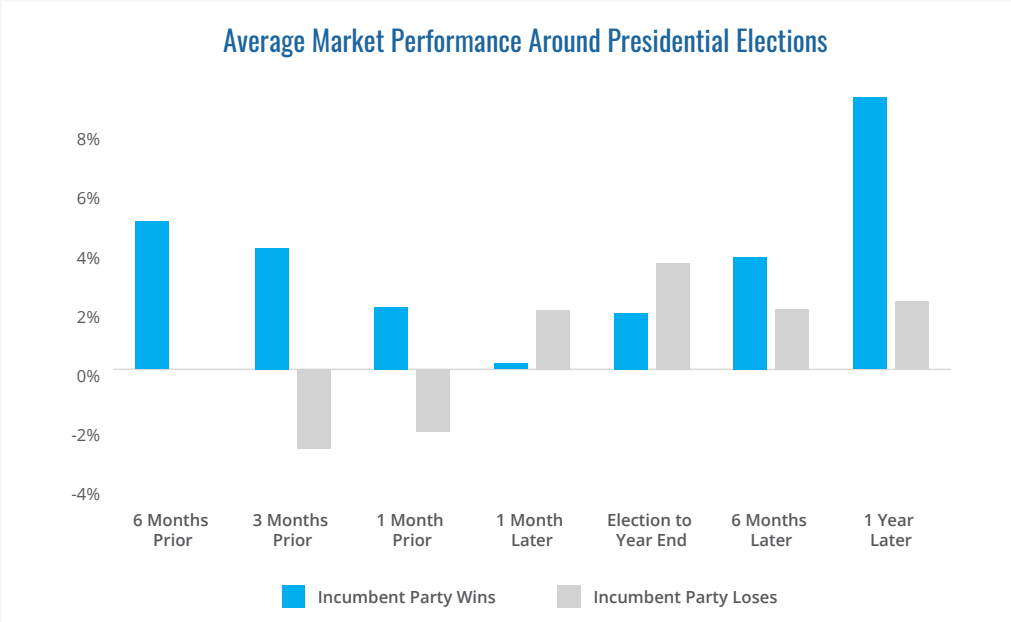
At this point, it almost looks like a lock for the incumbent to lose[1], but I wouldn't count the president out yet (please note this is not a political discussion; simply the view of an investor).

The president's chances probably hinge on the economy. Since the economy will be coming out of a deep hole and likely showing impressive numbers as a result, consumer, investor, and, most importantly, voter moods are likely to improve. If the market rallies as a result and gains ground, it's more likely that the president will get reelected. At least this is how historical market precedents have worked in the past. However, I do fully recognize that many historical precedents have been shattered this year!

Watching the stock market will likely provide the best clues on who will be elected and, in turn, a good clue for market direction in the quarters that follow. A recent study[2] showed that since 1928 the stock market predicted with 87% accuracy who the president would be, based on how the stock market (as defined by the S&P 500) performed the three months prior to the election. It has worked every time since 1984. In short, when the S&P 500 Index has been up for the three months leading to the election, the incumbent party usually wins. However, when stocks have been down, the incumbent party usually loses.

Fortifying the study above, Orion Portfolio Solutions' Research Analyst Nick Codola crunched some numbers going back to 1928 to determine the average stock market performance around presidential elections. I think there are two big takeaways:

Watch the market before the election to help predict who will win, and regardless of who eventually wins, expect the market to gain ground after the election. While returns typically fall when the incumbent loses, the market usually recovers quickly and climbs higher in the following six- and 12-month periods.



Source: Morningstar, IA SBBI Large Stock TR Inflation Adjusted.

1 Source: https://www.predictit.org/
2 Source: https://www.pagnatokarp.com/since-1928-sp-500-correctly-predicted-19-22-presidential-elections/

Balanced Portfolios: Investors Need to Adjust Expectations

3

The typical U.S.-based balanced portfolio has had a great 10-year stretch of performance, but don't expect that to continue moving forward. Investors in balanced portfolios will need to adjust, both in terms of portfolio construction and return expectations.

Let's examine the classic balanced portfolio, which is typically the "60/40" portfolio, in which 60% is invested in the stock market and 40% is in bonds and cash. There are reasons it's a classic, as it has worked for many investors. It is typically less volatile than the overall stock market, allowing investors to participate in market gains, but generally doesn't lose as much when the stock market drops.

Orions' in-house investment firm, CLS Investments, prefers targeting a level of risk[1] as opposed to a level of equity exposure. However, whether an investor is using an asset allocation target or a portfolio risk target, both approaches may provide a balanced, diversified investment portfolio. This may include a balance of growth, stable, and diversifying asset classes in an appropriate mix to meet an investor's objectives and risk tolerance, which may help to keep investors invested over time. As it has been said, "Wealth cannot be created unless capital is invested — and remains invested." Balanced portfolios help to do that.

U.S.-based investors utilizing the 60/40 approach have done quite well over the last 10 years. The U.S. stock market, as measured by the S&P 500 has returned an average of nearly 14% (as of June 30, 2020) per year over this time frame, while the U.S. bond market, as measured by the Bloomberg Barclays U.S. Aggregate Bond Index, has had an average annualized return of 4%. Thus, a 60/40 mix during this time would have returned (gross of any fees), approximately 10%. That is an outstanding result, and is in line with the long-term experience of returns since 1900 (according to this fantastic resource).

However, we do not believe investors should expect similar results moving forward. Based on current absolute valuations, the U.S. stock market is a lot more expensive than it typically is. That alone likely indicates lower expected returns. Based upon the current higher valuations, combined with lower dividend yields, we believe that a better estimate for the U.S. stock market's annualized return over the next 10 years will likely be closer to 4-5% — nearly 10% per year less than what we have witnessed during the last 10 years.[2] The probability for a loss is also higher.

Arguably even worse for balanced portfolios, however, is that interest rates are a lot lower than they have been. For example, the average interest rate for the 10-year Treasury bond has been approximately 5% over the last 50 years and just under 3% over the last 10 years. Compare that to the current yield, which is now 0.7%.[3]

1 Source: https://www.clsinvest.com/expertise/risk-budgeting/
2 Source: https://www.clsinvest.com/wp-content/uploads/dlm_uploads/2016/05/CLS_Monthly-Perspectives_05-2020.pdf
3 Source: https://ycharts.com/indicators/10_year_treasury_rate

Not only did bonds generate higher yields in recent decades, they also benefited from declining interest rates, which pushed prices higher and contributed to higher total returns. Now, however, the Bloomberg Barclays U.S. Aggregate Bond Index — a proxy for the overall investment grade domestic bond market — has a current yield of approximately 1.25%. So, assuming interest rates don't go negative (and they could), bonds may return 0-1% per year in the years ahead at best. Given these expectations, the U.S.-based 60/40 portfolio will likely return about 3% per year — before taxes, inflation (both which are likely to increase), and fees. In fact, it could be argued that these assumptions might even be too rosy, especially if longer-term rates start to move much higher (inflation anyone?).

3

What should investors do to prepare, especially as they consider longer life expectancies and increasingly expensive long-term care costs?

In a lower-return environment, there are a variety of actions investors can consider. But, again, the key to building wealth is to invest and stay invested.

Consider fees and taxes.

Investment management fees, of course, need to be reasonable (thankfully for investors the cost of investing has come down considerably in recent decades), and taxable portfolios need to be properly tax-managed.

Tax management is a key consideration as tax costs are often higher than investment costs. Tax management doesn't have to be an expense; sometimes it can be a value-added activity. This year, for instance, has been incredible for taxable portfolios that are actively and aggressively tax-managed. The bear market in March provided ample opportunities to "harvest tax credits" (realizing investment losses to offset future realized gains). A technical term to describe this activity is "tax alpha.[4]" If 2020 ends up being a positive year for the stock market (which it most likely will), taxable investors who aggressively generated tax alpha may have a doubly good year.

Creatively diversify portfolios.

With interest rates so low, investors should consider additional ways to creatively diversify portfolios. This may include the consideration of diversifying strategies, such as real assets (commodities) and alternatives (i.e. merger arbitrage, market neutral, and other hedge fund strategies). Fixed income will still have a role, of course, providing some stability to portfolios, but investors will likely need to be more thoughtful and progressive in diversifying equity risk to enhance risk-adjusted performance.

Find "on-sale" opportunities.

While the overall U.S. market is expensively priced, not all parts of the equity markets are expensive. Value-based sectors, for instance, such as the financial sector, are not expensive based on historical measures. CLS Investments calculates its own in-house capital market assumptions (i.e., long-term return expectations) and also collects capital market assumptions issued by other groups from around the industry. CLS's review suggests that value is expected to significantly outperform. Smaller, U.S.-based companies are also not as expensive by historical measures, and in turn also have significantly higher return expectations than the over-all market.

International markets are also relatively more attractive by historical measures. Current expectations suggest international stock returns may also significantly outperform. Emerging market stocks may produce even higher returns, based off valuations.

4 Source: https://www.forbes.com/sites/brianmenickella/2019/03/28/how-to-maximize-tax-efficiency-using-tax-alpha/#5f71beec1eef
5 Source:
6 Source:

Consider shifting the equity balance.

Since we're living longer and return expectations are lower, it might also be worth considering owning more equities. Shifting the 60/40 to 70/30, for instance? Quite frankly, I understand this argument and can get behind it. But I would stress that the risks of doing so need to be properly understood and managed to make sure it is indeed appropriate and enhances the investor's chance for success.

3

Thank You

We often hear these days that the world will never be the same and we will never return to normal, but isn't that always the case? We are always dealing with change. It might be my glass-half-full attitude, but despite temporary setbacks, aren't we as a civilization ultimately trending toward being safer, healthier, and wealthier? Change is constant, but we are resilient and creative, and we learn our lessons, eventually at least.

In the same philosophical vein, we have been receiving good information from our strategic partners. For instance, Michael Arone, a two-time guest on the Weighing Machine, has a regular monthly commentary called "Uncommon Sense." I want to give a belated hat tip to his June article called the "The Struggle is Real." It was well-written, balanced, honest, and provided a nice overview that was rational, yet compassionate.

Lastly, as you may have heard, late last month it was announced that Orion is merging with Brinker Capital. These are exciting times. More details will be provided in the weeks and months ahead, but for now, I can say that I'm truly pumped, as should be advisors, to tap into those additional resources, including more in behavioral finance and high-net-worth investing.

Thank you for your time and trust in these historic times. If you have any questions or feedback, please let me know. Stay balanced, stay the course, and please be well.

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The Morningstar Global Market Large-Mid Index is an index that measures the performance of the global market's equity markets targeting the top 90% of stocks by market capitalization. The Morningstar U.S. Market Index is an index that measures the performance of U.S. securities and targets 97% market capitalization coverage of the investable universe. It is a diversified broad market index. The Morningstar U.S. Large Cap Index is an index that measures the performance of U.S. large-cap stocks. These stocks represent the largest 70% capitalization of the investable universe. The Morningstar U.S. Small Cap Index is an index that measures the performance of U.S. small-cap stocks. These stocks fall between the 90th and 97th percentile in market capitalization of the investable universe. In aggregate, the Small Cap Index represents 7% of the investable universe. Morningstar Global ex U.S. Large-Mid Index is an index that measures the performance of Global Markets (ex-U.S.) equity markets targeting the top 90% of stocks by market capitalization. The Morningstar DM ex U.S. Large-Mid Index is an index that measures the performance of developed markets ex-U.S. equity markets targeting the top 90% of stocks by market capitalization. The Morningstar EM Large-Mid Index is an index that measures the performance of emerging markets targeting the top 90% of stocks by market capitalization. The Barclay's Capital U.S. Aggregate Bond® Index measures the performance of the total United States investment-grade bond market. The Morningstar Cash Index is an index that measures the performance of a Treasury Bill with six to eight weeks until maturity in the U.S. market. The Morningstar Diversified Alternatives Index allocates among a comprehensive set of alternative underlying ETFs that employ alternative and non-traditional strategies such as long/short, market neutral, managed futures, hedge fund replication, private equity, infrastructure or inflation-related investments. The Bloomberg Commodity Index is made up of exchange-traded futures on physical commodities and represents commodities that are weighted to account for economic significant and market liquidity. This index provides investors with a means of understanding the performance of commodity futures markets and serves as a benchmark for investment performance of commodities as an asset class. The S&P 500 Index is an unmanaged index of 500 large-capitalization companies. This index is widely used by professional investors as a performance benchmark for large-cap stocks. Morningstar Gbl Real Estate NR USA Index: measures the performance of mortgage companies, property management companies and REITs. The Russell 2000 is an index comprised of the 2,000 smallest companies on the Russell 3000 Index and offers investors a benchmark for small-cap stocks. The S&P MidCap 400® provides investors with a benchmark for mid-sized companies. The index, which is distinct from the large-cap S&P 500®, is designed to measure the performance of 400 mid-sized companies, reflecting the distinctive risk and return characteristics of this market segment. The volatility of the indexes may be materially different from the individual performance attained by a specific investor. In addition, portfolio holdings of investors may differ significantly from the securities that comprise the indexes. You cannot invest directly in an index.

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