Third Quarter 2021 Investment Perspectives

"An investor relies on internal sources of return: earnings, income, growth in the value of assets. A speculator counts on external sources of return: primarily whether somebody else will pay more, regardless of fundamental value." **Jason Zweig, The Wall Street Journal**

Markets continued their uninterrupted post pandemic rise in the second quarter; the complexion of the market, however, has once again changed as the market enters, with props to Michael Wilson at Morgan Stanley, a "classic mid cycle transition". After a first quarter characterized by accelerating economic momentum, rising interest rate and stock markets led by economically sensitive businesses, the last three months witnessed a decline in interest rates coupled with a shift in leadership back towards traditional growth stocks on the slightest hint that the Federal Reserve might eventually slow asset purchases or someday raise interest rates. While major indices have moved higher, leadership has rotated seemingly daily between growth and value stocks as the market looks for evidence to confirm the direction of the economy as it moves through this transition from stimulus driven to self-sustaining growth. There are reasons to be optimistic with regards to the path forward:

- While potentially diminishing, monetary policy is likely to remain highly accommodative for the foreseeable future. Fiscal policy, likewise, will remain a tailwind for growth moving forward, although the order of magnitude remains in question.

- Consumer net worth at record levels, personal income growth in the high single digits and a favorable employment environment for workers coupled with pent up demand in certain sectors of the economy (travel and leisure, e.g.) will likely support consumer spending, ~70% of the economy.

- Globally, China's recent lowering of reserve requirements suggests a potential shift in their credit impulse, a positive for global growth.

- Finally, businesses have aggressively cut costs through the pandemic with companies exhibiting significant earnings leverage on even modest revenue growth.

On the other hand, taking a balanced assessment of the potential risks inherent in the current environment suggests cause for concern and caution:

- Coordinated central bank manipulation of interest rates impacts the value of every asset determined through a discounted cash flow analysis. Additionally, the level of liquidity flooding into capital markets has successfully created asset price inflation, if not yet traditional inflation.

- Valuation measures for the broad index are at or approaching all time highs across a spectrum of valuation measures as equity prices have meaningfully outpaced earnings growth. To paraphrase Howard Marks, everything with a cusip is overpriced.

- Home prices have outstripped income growth and rent growth in similar proportion to the mid 2000's.

- Sentiment measures are less favorable as corporate insiders are more bearish than at any point over the last decade.

- Variants of the coronavirus remain a threat to the reopening of the global economy.

As we take inventory of the current environment, we continue to focus on areas of the market where expectations appear achievable, valuations reasonable with a strong bias towards quality. Our base case expectation remains that the economy is poised for continued growth – as our partners at Empirical Research emphasize, current valuation extremes (historic valuation premiums for high growth sectors, historic valuation discounts for economically sensitive sectors) suggest the cost of betting on continued economic expansion is low. We have positioned portfolios accordingly with a mix of economically sensitive companies, businesses with higher secular growth rates and more defensive businesses.

A quick comment on some of the more speculative areas of the market, including meme stocks and cryptocurrencies. While they have experienced meaningful corrections, they continue to appear highly speculative. As the quote from Jason Zweig notes, we are not qualified to judge what prices someone might pay where fundamental value is not a part of the investment decision. We continue to observe and educate but remain on the sidelines.

The biggest challenge facing investors, institutional and individuals alike, remains the lack of income in traditional fixed income. The recent decline of real high yield bond rates into negative territory for the first time on record exacerbates this challenge. While interest rates may move modestly higher from current levels, the level of debt resident in our economy increases the likelihood that a low interest rate environment persists well into the future calling into question the efficacy of a traditional balanced portfolio. To state the obvious, allocating a meaningful portion of portfolios to bonds with interest rates below the level of inflation will challenge investors' ability to meet long term goals of preserving purchasing power and growing their portfolios. The case for allocating a portion of portfolios to private investments has never been stronger. As Bruce Flatt, the CEO of one of our portfolio companies Brookfield Asset Management articulated, private markets allow for the opportunity to buy into "imperfect" markets. In building strategic allocations for clients, the introduction of an allocation to private investments may allow for improved returns on a risk-adjusted basis while maintaining appropriate levels of liquidity. As we move forward, we will be working closely with our clients to assess and access opportunities in private markets to take advantage of these "imperfect" markets.

On behalf of the entire Heritage team, we thank you for the confidence you have placed in our firm.

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