FA Financial Alternatives
integrated wealth management

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2020 Review

If you had somehow known in January last year that we were going to have the world's worst global pandemic since the global flu pandemic of 1918, you might have been tempted to sell your stocks and wait until the pandemic was over before buying them back. And if you had done that, you would have missed out on a very good year of investment returns. See our Market Review Newsletter which shows 2020 returns for stock and bond markets around the world.

The past year illustrates just how difficult it is to predict stock returns in the short term, even if you correctly predict economic growth or contraction and rising or falling unemployment levels. We had a dramatic contraction in the economy coupled with an increase in unemployment in 2020 due to COVID 19, and yet stock market returns around the globe were strong.

Bonds also produced outsized returns due to falling interest rates. Remember, when interest rates fall bond prices increase - which is precisely what happened in 2020.

We are proud of all our clients for not panicking during the March COVID 19 correction, which was one of the swiftest drops in stock market history. We are also

Executive Summary

- In the face of a global pandemic, stock and bond markets performed surprisingly well in 2020.
- Last year investors experienced one of the swiftest drops and subsequent full recoveries in stock market history.
- We took advantage of the correction and rebalanced portfolios in March when the market was low. We also took advantage of market lows by executing tax-saving tax swap trades.
- Over the next 10 years, Vanguard expects stock and bond returns to be lower than historical norms.
- GMO's 7-year return forecast is significantly lower than Vanguard's.
- Both Vanguard and GMO expect equity markets outside of the U.S. to outperform.
- The possibility of lower future returns should be taken into consideration in your future financial planning.
- Staying diversified and disciplined and maintaining a long-term investment perspective is the best course of action going forward, as always.

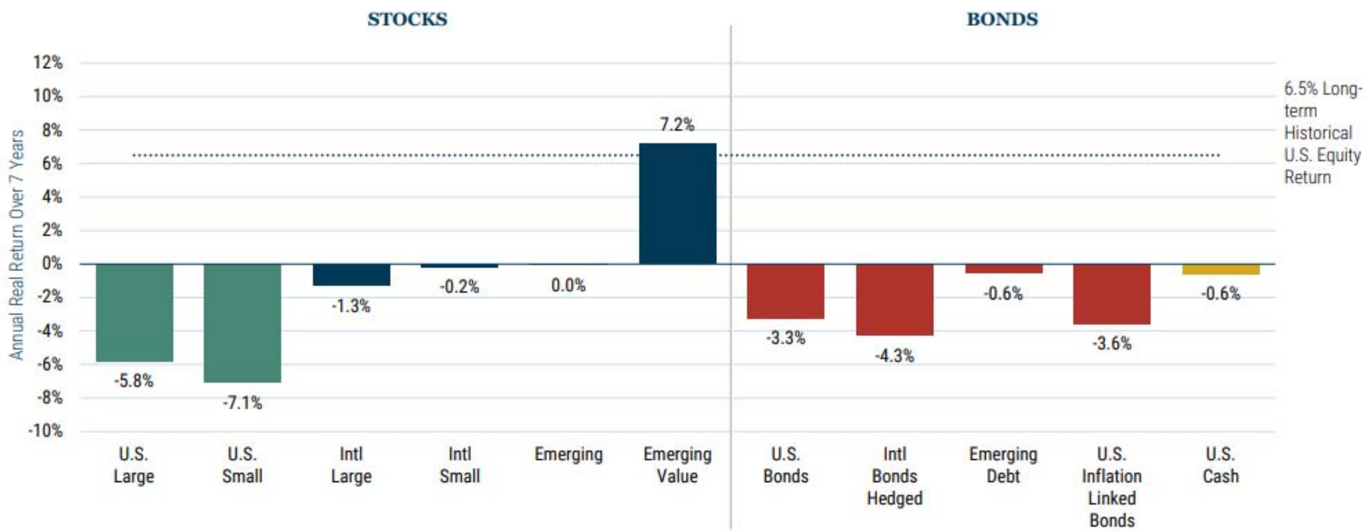
Vanguard Asset-Cass Return Outlooks

Equities	Return projection	Median volatility
U.S. equities	3.7%–5.7%	16.9%
U.S. value	4.8%–6.8%	18.7%
U.S. growth	1.1%–3.1%	18.1%
U.S. large-cap	3.6%–5.6%	16.5%
U.S. small-cap	3.7%–5.7%	21.6%
U.S. real estate investment trusts	3.3%–5.3%	19.5%
Global equities ex-U.S. (unhedged)	7.0%–9.0%	18.6%
U.S. inflation	0.9%–1.9%	2.4%

Fixed income	Return projection	Median volatility
U.S. aggregate bonds	0.7%–1.7%	4.0%
U.S. Treasury bonds	0.3%–1.3%	4.1%
U.S. credit bonds	1.3%–2.3%	5.6%
U.S. high-yield corporate bonds	2.7%–3.7%	10.3%
U.S. Treasury inflation-protected securities	0.4%–1.4%	6.3%
U.S. cash	0.6%–1.6%	0.9%
Global bonds ex-U.S. (hedged)	0.5%–1.5%	2.4%
Emerging market sovereign	2.3%–3.3%	10.5%

Source: Vanguard (Important disclosures at original source: advisors.vanguard.com/iwe/pdf/FAVEMOBF.pdf)

GMO 7-Year Asset Class Forecast: November 2020



Source: GMO (Important disclosures at original source: ww.gmo.com/americas/research-library/gmo-7-year-asset-class-forecast-november-2020)

proud for having the courage to recommend that we rebalance client portfolios in March in the midst of this correction. We also took advantage of tax loss harvesting opportunities for clients in 2020 when markets were down.

So, what can we expect going forward? In this year-end newsletter we will take a quick look at Vanguard's 10-year return forecast for various asset classes as well as GMO's more bearish 7-year return forecast. If the forecasts above end up being accurate, we should expect more modest returns going forward.

Vanguard's 10-Year Forecast

The 10-year projected returns listed on page 1 for various asset classes come from Vanguard's December Market Perspectives newsletter. As you can see, Vanguard's expected returns for various equity/stock asset classes are relatively low. And the expected returns from various bond asset classes are also low.

Vanguard also states the following, "Given the strong recovery in global equity prices, the risk of a sharp downturn over the next three years remains elevated."

Even though Vanguard's forecasted returns are on the low side, the higher end of the forecasted equity returns can still provide meaningful growth if inflation remains low.

GMO's 7-Year Forecast

Over the years, we have discussed GMO's 7-year forecasts at length. GMO is a firm located in Boston and the name GMO comes from the founder's names Grantham, Mayo & Van Otterloo. GMO has typically been more bearish than many investment firms and they have written a lot about investment bubbles and bear markets.

As you can see from the chart above, GMO's 7-year forecast is pessimistic. In fact, they are very pessimistic. They believe the market is overvalued. The forecasted returns shown are after an assumed 2.2% inflation rate, so be sure to add 2.2% back to each of the returns on their chart before comparing them to Vanguard's forecasted numbers. Even after accounting for this, GMO is forecasting markedly lower returns than Vanguard.

We show you GMO's dramatically lower return forecasts not to worry you, but to illustrate how very different forecasts can be from two respected sources. This wide difference is part of what makes investing so difficult. Too often people go all in on one investment forecast rather than looking at other forecasts.

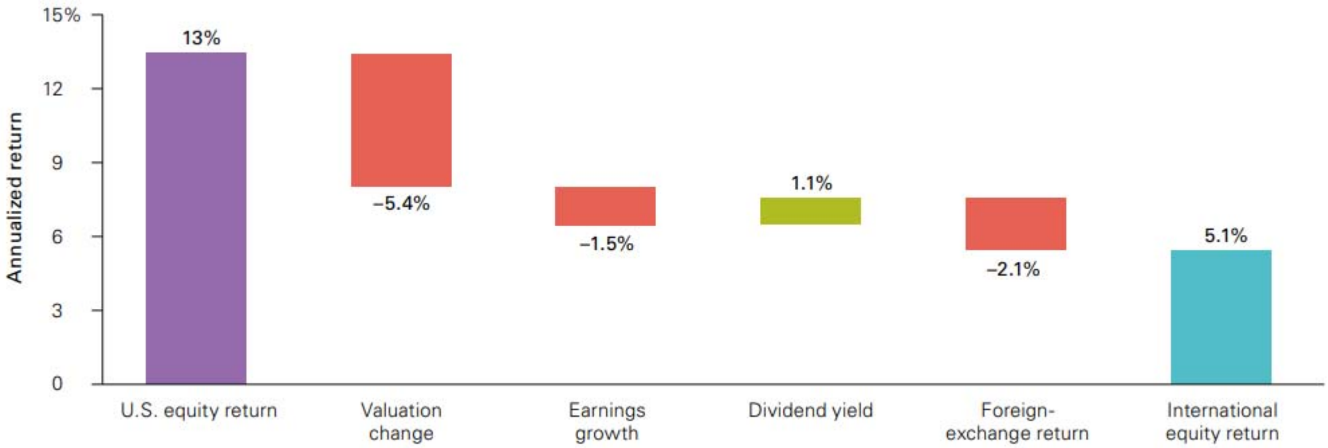
When you look closer at their forecasts and infer what they are recommending, they are advising clients to reduce their weighting in growth stocks which have performed so well recently and to overweight value stocks and emerging markets stocks.

Since both Vanguard and GMO are forecasting lower equity returns, our takeaway is to factor this into our clients' financial planning. During times like these, it is important to run retirement projections with lower rates of return and then devise a plan for how to deal with this should lower returns materialize. If lower returns materialize, one's spending plan or objectives may need to be adjusted.

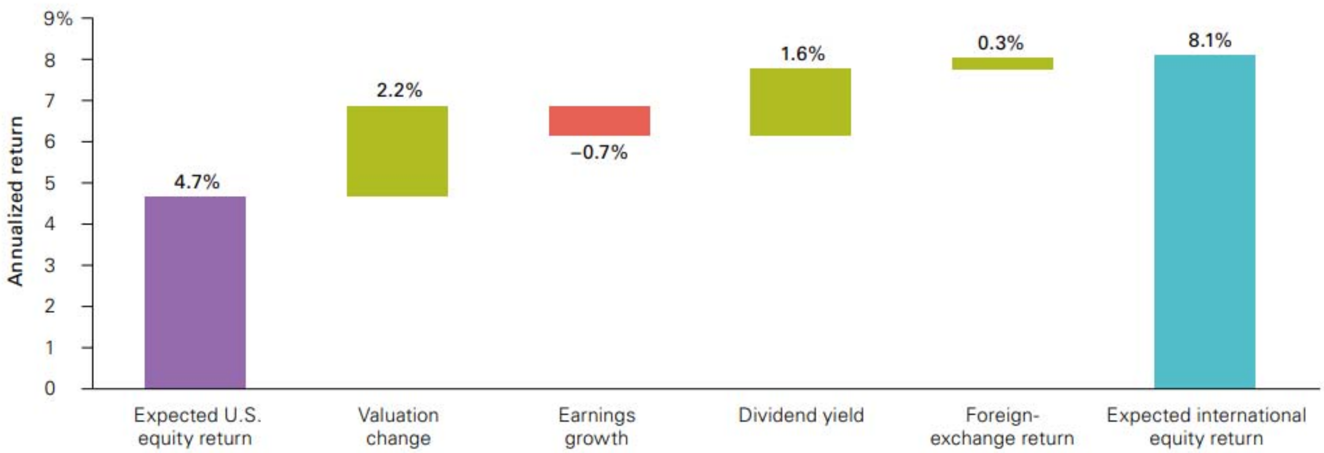
Both Vanguard and GMO Expect Non-US Markets to Outperform

Vanguard uses two charts to break down how U.S. stock markets have done relative to international markets over the past decade, and how they are expected to fare in the next 10

US Valuation Expansion (in the Last 10 Years)



US Valuation Contraction Estimated (in the Next 10 Years)



	Valuation expansion	Earnings growth	Dividend yield	Foreign-exchange return	Total return
U.S.	–2.1%	5.0%	1.8%		4.7%
International	0.1	4.3	3.4	0.3%	8.1

Source: Vanguard (Important disclosures at original source: advisors.vanguard.com/iwe/pdf/ISGUSIE.pdf)

years. As you can see from the US Valuation Expansion chart above, U.S. equity returns outperformed international equity returns over the past 10 years. It also shows that much of this outperformance was due to an increase in valuations (second bar from the left).

In the next chart, US Valuation Contraction Estimated, you can see how Vanguard is predicting a valuation contraction in U.S. equities that will result in higher returns for international equities over the next 10 years. There is no way to know whether this will happen or not – time will tell. When you look back to GMO's forecasts, they are essentially forecasting the same thing.

We believe it is prudent to maintain our client's international allocations at current levels.

First Trust Deed Investing Looks Particularly Good in this Environment

With returns on cash at almost zero and investment grade bonds yielding less than 2%, a First Trust Deed investment fund yielding roughly 6% or more looks extremely competitive. There are many Trust Deed funds available to accredited investors, and some are structured and managed better than others. Essentially, these types of funds provide higher yield loans backed by real estate – and factors such as the loan-to-value, maturity, and real estate market activity have more significant impact on the returns to investors.

First Trust Deed investments with short maturities will not be as adversely affected by rising interest rates like intermediate-term bonds will be, if and when interest rates rise. If First Trust Deed investing continues to provide a total annual return of 6%, it could outperform Vanguard's forecasted equity returns.

If you are not familiar with this type of investment, please see our blog post entitled Private Trust Deed Investments - Finding the Diamond in the Rough.

Remain Diversified and Disciplined

As always, it is important to remain diversified, disciplined and maintain a long-term perspective in the management of your portfolio. Discipline and fortitude are required to rebalance a portfolio after bear market losses. If you are currently uncomfortable with the amount of your portfolio allocated to stocks, now is the time to discuss it with us – while the market is hitting all-time highs – not after we have entered a bear market. Please let us know if you would like to have this discussion.

Summary

Despite the COVID 19 pandemic investment returns were surprisingly strong in 2020. Due to the rapid market recovery, current stock market valuations, and the low interest rates on bonds, it is prudent to expect lower returns going forward and to plan accordingly.

Discipline and diversification will remain critical to your investment success. We are here to help you with both. If you would like to discuss your investments or any other aspect of your financial life in greater detail, please give us a call. We are wishing you all the best in 2021.

Past performance is no guarantee of future results. All content in this newsletter is intended as general information, not specific advice. Performance data listed is for illustrative purposes only. Portfolios are personalized and often consider many variables, including investment objectives, age, time horizon, risk tolerance, and tax variables. Information contained herein has been obtained from sources believed reliable, but not guaranteed.

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