CHANGE CAN BE UNCOMFORTABLE, BUT IT DOESN'T HAVE TO BE

The global economy changed significantly in 2020 and seems set for more uncertainty during 2021. How well are your clients positioned, and how can we help?

SEI New ways. New answers.®

The 2020s began with a roller-coaster ride

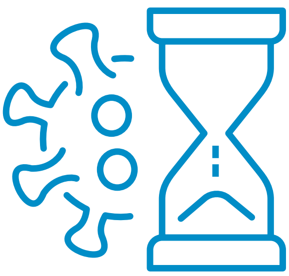
The global equity market set record highs in February as economic growth gained steam before the COVID-19 crisis provided an exogenous shock to global capital markets. The forced recession resulted in a typical overreaction, causing stocks to plunge.

Overall, the year was characterised by a polarised equity market. High-flying technology companies shared the spotlight with businesses that benefitted from the pandemic. In both cases, a narrow band of extraordinarily high-priced stocks led the market higher as reasonably priced, fundamentally sound businesses languished. Investors tended to favour "stay-at-home" stocks that would benefit from people working from home, while "going-out" names—mostly travel and leisure—were punished.

An aggressive response by governments and central banks helped markets recover quickly as investors saw hope that a more severe financial crisis could be averted. The US Federal Reserve and European Central Bank both took early and consuming action to stabilise and provide liquidity to financial markets.

Financial markets adjusted to the pandemic, helped by the fast action of central banks and a big assist from government appropriators. Equities climbed rapidly, and fixed-income spread sectors recovered almost without interruption from late March through the end of the year, spurred on by reopening economies and positive developments in therapeutics and vaccines.

While COVID-19 dominated most headlines, it wasn't the only issue investors and markets had to digest. A tumultuous US presidential election and last-minute "skinny" Brexit deal created further considerations. In addition, yield curves typically steepened on the back of lower short-term rates as central banks eased their respective monetary policies and governments provided fiscal stimulus.



The pandemic persists

Unfortunately, when it comes to the havoc wreaked by COVID-19, the pandemic is very much with us. New cases, hospitalisations and deaths are up. The US is among the nations reporting the most new cases of COVID-19, recording nearly 20,000 confirmed cases per 1 million people during December 2020.

Some western European countries are recording downturns in new cases after lockdowns and other mitigation actions forced social distancing and reduced mobility. This has helped lower the infection rate but likely caused overall economic activity to contract during the fourth quarter.

The UK experienced a particularly sharp surge in new infections in December associated with a mutation of the virus that enhanced its transmissibility. The possibility of extended lockdowns leading to continued reductions in social mobility and economic activity poses concern for struggling sectors, such as hospitality, leisure and travel, especially if we were to see a double-dip recession.

Looking beyond the valley

Although there is a danger that business activity could be throttled by additional lockdown orders, investors are looking beyond the valley. The promise of vaccines being widely available in the US and other developed countries has been enough to encourage a "risk-on", pro-cyclical posture.

The US has already contracted for more than 1 billion doses, enough to give more than 3.4 jabs to each person. (Several vaccines will need two shots spaced three or four weeks apart to be fully effective.) The European Union (EU) is in about the same position in terms of per capita doses purchased. More importantly, the vaccine rollout is well underway, with the UK among the front-runners on a regional basis.

Further, the increased effectiveness of therapeutics to treat patients with COVID-19 adds hope that most global economies will return to some form of normality in the near future.

The skinny on the skinny deal

Six months ago, investors faced uncertain outcomes from both Brexit and the US elections. Today, there is much greater clarity.

The UK's departure from the European Union promised to be messy and full of uncertainties from the start. Negotiations went on for as long as they possibly could before 1 January when the Brexit withdrawal agreement was implemented.

The result is a "skinny" deal that allows the UK to gain preferential access to the EU market for its goods, providing that it follows many EU rules and regulations involving governance, labour and the environment. If those standards change in the future, the UK will be permitted to deviate from them and will be able to challenge future disputes in an independent court.

The zero-tariff/zero-quota trade arrangement comes at a cost since businesses that trade with the EU will now be burdened with additional expenses and red tape. Although politicians and the media will likely point to tariff-free trade, the UK's significant—and higher value-add—services sector, which accounts for about 80% of the UK's economy, will face challenges in continued access to the single market.

In short, the deal avoids the prospect of an economic rupture but comes at the cost of increased trade friction and ongoing uncertainty in several important areas.

The market's response to the deal has been relatively muted, although is not easy to disentangle from the ever-changing news on COVID-19. Investors have had four years to digest the economic damage from Brexit; it is well understood by now, and we believe it is reflected in the prices of UK equities and currency. Still, the newfound clarity should be a positive for markets (and investors) going forward. The agreement provides some certainty on tariffs, and the government's trade negotiators have already fanned out across the world to make sure that the UK retains the same trade agreements that it has enjoyed as a member of the EU.

What will the Biden administration bring?

How will US President Joe Biden use the next four years? Looking ahead, the Biden campaign's plan offers a glimpse into how the administration may take shape.

With Democrats gaining effective control in the Senate and retaining control in the House, the legislative branch of the US federal government will now be aligned with the executive branch under the Biden administration. This dynamic should support Biden's agenda for at least the first two years of his presidency, although the narrow majorities could limit some of the more ambitious plans.

The likelihood of passing sizable fiscal stimulus will be fairly high given the united Democratic government and the party's traditionally greater willingness to spend (relative to Republicans). If such a plan come to pass, we expect it will provide the US economy with a limited but much needed economic boost.

One of Biden's most important nominations was that of former Fed Chair Janet Yellen as treasury secretary. The Senate's confirmation of Yellen means that the Treasury and the Fed will likely work together in a fashion not seen since the days of World War II when the central bank held interest rates at fixed levels in order to smoothly fund the war effort. This close working relationship will probably be reassuring for investors in the near term since there is little doubt that the central bank will continue its extraordinary efforts to support the economic recovery in 2021. That's good news for the economic outlook.

The 'Great Rotation'

The rollout of surprisingly effective vaccines has energised the rotation into cyclical stocks. It should surprise no one that growth and momentum stocks were the big winners of 2020. Although they represent separate investing styles, growth and momentum portfolios are currently dominated by information technology (about 40% of both), with the communication services, consumer discretionary and healthcare sectors also well represented in both.

The big laggard has been the value style. Again, this is not a surprise. This index has relatively low exposure to the sectors where strong performance has been concentrated. It also suffered from having high exposure to financials, amounting to nearly 20% of its market cap. Value has been trailing other investing styles for a long time. In fact, its relative performance actually peaked in March 2007 when the global financial crisis began to hit the financial sector with its full fury. The pandemic of 2020 has had a similar impact.

In terms of relative total-return performance, the value style has underperformed growth by an even greater degree over the past 13 years than during the 1990s when the tech boom was revving up.

Changes in stock market leadership in favour of cyclical and traditional value sectors often occur around recession periods; the long period of mega-company, tech-stock outperformance since the global financial crisis led to extremes in both valuations and market-cap concentration that, in the past half-century, were exceeded only during the peak of the Nifty Fifty craze in the early 1970s and the tech bubble of the late 1990s.

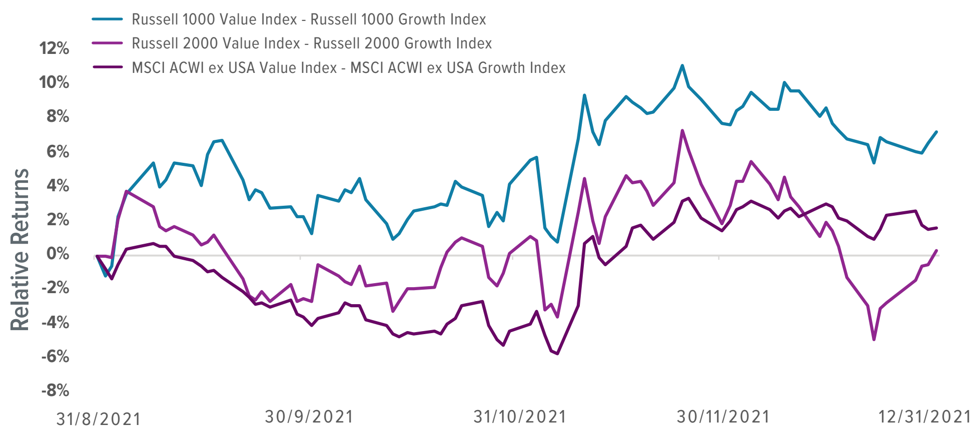
While conceding that tech and other stay-at-home stocks were big winners as a result of the pandemic, we note that even the best companies do not stay the best stock market performers forever.

Looking ahead, we believe there are several reasons there could be a major change in investment regimes. These include a deceleration in the earnings growth of the favoured few from super fast to merely fast, an acceleration in the revenue and earnings growth of the laggards in response to a vaccine and the ramping up of a return-to-work trend, a shift in the political winds that could lead to higher taxes and more aggressive antitrust enforcement against the big social media and other leading tech companies, and a rise in bond yields that would harm high-multiple growth stocks more than low-multiple value stocks.

This change in investing regimes played out in a big way in November and the first half of December, and we expect the nascent trend to reassert itself during 2021. The big moves in relative performance came on 9 November, the day Pfizer and BioNTech announced surprisingly strong efficacy results of their COVID-19 vaccine. No one knows if this is the turn in the relative fortunes of these investment styles, but we think investors will prove willing to shrug off the likely prospect of more bad news during the difficult days and months ahead in the world's battle against the virus. The focus will turn instead to the rising odds that the world will be in a better place economically as we enter the second half of 2021.

Since September, value-style equity indexes have outpaced their growth counterparts to varying degrees across geographies and market capitalisations, most notably in US large caps.

Exhibit 1: Value Stocks Go for a Run



Source: Bloomberg. Data spans 8/31/2020-12/31/2020.

We are already observing several signs of potential normalisation. Announcements of highly effective vaccines have shaken the worries that the pandemic would last forever, while regulatory developments on both sides of the Atlantic have hinted that the run of large technology companies might no longer be as simple, forever or profitable as some investors have grown accustomed.

There are still risks related to the virus and its impact on the global economy, but we believe the groundwork is being laid for economic activity to return to pre-pandemic levels. Vaccine distribution has begun, and additional fiscal support is on the way. Additionally, central bank rhetoric continues to indicate that policy rates are on hold for the foreseeable future, that all policy tools remain on the table, and that higher inflation would be welcomed.

At SEI, we have suggested that recessions have a way of shaking up leadership trends in financial markets, and we are optimistic on several fronts that investors could continue to shift from stay-at-home-oriented assets toward underappreciated, economically sensitive assets that should stand to benefit most from strengthening global economic growth in 2021—this continuation would give us more confidence that a secular-style change is underway.

We believe the current performance gap between growth and value still represents what may be the most attractive investment environment for value stocks that we have seen in nearly 20 years. Over the next several years, signs of a continued value recovery should be overwhelmingly clear. Economic activity will likely normalise with COVID-19 vaccines or natural immunity while fiscal spending and accommodative central bank policy will likely lead to higher inflation.

A changing economic environment

We believe there is likely to be stronger global growth and higher inflation (accompanied by a weaker US dollar) once the world economy is able to move beyond the pandemic, driving the market environment toward a reflationary regime with both rising growth and inflation.

We understand that the outlook is still challenging in the near term with worsening infection rates, vaccine distribution challenges, new variants of the virus, political uncertainties and below-trend economic activity. Despite the near-term challenges, we believe the markets will mostly continue to look ahead to better times in the latter part of 2021.

Exhibit 2 provides a model framework that highlights asset performance during various environments, with a reflationary environment shown in the top-right quadrant.

Exhibit 2: Economic Regimes Tend to Favour Certain Assets

For illustrative purposes only.

Risks to the reflation view

The main risks to our broad reflationary view and active allocation positioning include negative surprises on the vaccine front, an unexpectedly severe worsening (or lengthening) of the pandemic, tighter-than-expected fiscal or monetary policies, and a significantly stronger US dollar. The uncertainty created by unanticipated events is one reason we believe so strongly in the principles of diversification. The COVID-19 pandemic, which would have been almost impossible to expect just over a year ago, is a powerful reminder of the uncertainties that can sometimes wreak havoc on economies, financial markets and investment portfolios.

Most importantly, we do not believe investors should try to broadly tailor a long-term (strategic) portfolio to any specific growth/inflation environment. Rather, we use this framework to help design all-weather strategic portfolios that incorporate a variety of diverse asset class exposures in order to help investors manage through whatever the economic and market environments might throw at them.

How we can help

A well-designed portfolio is the foundation for investment success. In addition, the cornerstone of that foundation is diversification. Effective diversification requires a thorough appraisal of a portfolio's sources of risk. This goes beyond simply estimating overall expected risk; it involves decomposing that expected risk into its subcomponents. This is important because risk allocation (the percentage of portfolio volatility driven by its holdings of stocks, bonds and cash, for example) can be very different from capital allocation (the percentage allocations to stocks, bonds and cash). This appraisal can be carried out by asking, for example, how much of a portfolio's expected risk is attributable to changes in interest rates, unexpected changes in inflation or other economic surprises, stock market movements or other factors.

SEI has played a leading role in identifying and developing solutions that help better balance the sources of risk within portfolios, and will continue to do so. This includes the use of additional asset classes and non-traditional investments, such as multi-asset and objective-based funds. We continue to investigate ways of more fully incorporating the insights of Modern Portfolio Theory into strategic asset allocation in order to improve the risk balance (and risk-adjusted returns) of many portfolios.

The bottom line is that uncertainty is always present in financial markets and demands more—not less—diversification. The compounding of risk and uncertainty means that potential outcomes vary increasingly over time, and striking a better balance among the sources of risk in a portfolio can help to deal with these realities.

The result: not flashy, but reliable

It's virtually guaranteed that a diversified portfolio will never outperform every individual asset class. Comparing the overall performance of your portfolio to the best-performing asset class (or classes) in a given year is simply the wrong way to look at it, yet far too many investors do just that. In addition, the temptation (thanks to overconfidence and hindsight bias) to counter subsequent disappointment by trying to pick next year's winner rather than investing in a safe-but-boring, middle-of-the-road portfolio is understandable.

Let's assume an investor can follow one of three naïve investment strategies: a momentum approach that invests in just the best-performing asset class from the prior year, a contrarian approach that invests in only the worst-performer from the previous year, and a naïve diversification strategy that allocates equally to all of the asset classes shown in Exhibit 3. From 2010 through 2019, the momentum approach would have won 40% of the time versus the other two approaches. Over the same period, the contrarian approach would have won 50% of the time versus the other two approaches. A naïve portfolio with equal weights in all 12-asset classes would only have beaten these two approaches once during this period.

So why in the world would you choose to diversify?

Because your cumulative return over the full 10 years would have been 64% for the naïve diversified approach versus 24% for the naïve return chaser and a 6% loss for the naïve contrarian.

Even better, the volatility of those annual returns (as measured by standard deviation, a formula used to predict potential future volatility of performance) would have been 7.0%, 9.8% and 14.2%, respectively. In risk-adjusted terms (return per unit of volatility), a diversified approach would have won, hands down.

Exhibit 3: Select Asset Class Returns, 2010-2019

BEST

2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Long Duration 22.50%	Emerging Equity 18.20%	US Small Cap 38.80%	Long Duration 19.30%	Short Duration 1.00%	US Small Cap 21.30%	Emerging Equity 37.30%	Cash 2.10%	US Large Cap 30.70%	US Small Cap 20.00%
Core Fixed 7.80%	International Equity 17.30%	US Large Cap 31.50%	US Large Cap 13.00%	US Large Cap 0.70%	High Yield 17.50%	International Equity 25.00%	Short Duration 1.50%	US Small Cap 25.50%	Emerging Equity 18.30%
TIPS 4.90%	Emerging Debt 17.10%	International Equity 22.80%	Core Fixed 6.00%	Core Fixed 0.50%	Commodities 11.80%	US Large Cap 21.10%	TIPS 0.40%	International Equity 22.00%	US Large Cap 17.80%
High Yield 4.40%	US Small Cap 16.30%	High Yield 7.40%	US Small Cap 4.90%	Cash 0.20%	US Large Cap 11.20%	US Small Cap 14.60%	Core Fixed 0.00%	Long Duration 19.60%	Long Duration 16.10%
Short Duration 3.40%	High Yield 15.50%	Cash 0.20%	High Yield 2.50%	TIPS -0.10%	Emerging Equity 11.20%	Emerging Debt 12.70%	High Yield -2.30%	Emerging Equity 18.40%	International Equity 7.80%
Emerging Debt 2.80%	US Large Cap 15.20%	Short Duration -0.20%	Short Duration 1.20%	International Equity -0.80%	Emerging Debt 10.00%	Long Duration 10.70%	Long Duration -4.70%	High Yield 14.40%	Core Fixed 7.50%
US Large Cap 1.50%	Long Duration 8.80%	TIPS -2.00%	Emerging Debt 0.90%	Long Duration -3.30%	Long Duration 6.70%	High Yield 7.50%	US Large Cap -4.90%	Emerging Debt 14.3%	High Yield 6.10%
Cash 0.30%	Core Fixed 4.20%	Core Fixed -2.00%	Cash 0.20%	US Small Cap -4.40%	TIPS 3.10%	Core Fixed 3.50%	Emerging Debt -5.20%	Core Fixed 8.70%	TIPS 5.70%
US Small Cap -4.20%	TIPS 2.70%	Emerging Equity -2.60%	TIPS -1.10%	High Yield -4.60%	Core Fixed 2.60%	Commodities 1.70%	US Small Cap -11.00%	Commodities 7.70%	Short Duration 4.30%
International Equity -12.10%	Short Duration 0.90%	Emerging Debt -7.10%	Emerging Equity -2.20%	Emerging Debt -6.90%	Short Duration 1.10%	Cash 1.10%	Commodities -11.20%	TIPS 5.10%	Emerging Debt 4.00%
Commodities -13.30%	Cash 0.50%	Long Duration -8.80%	International Equity -4.90%	Emerging Equity -14.90%	International Equity 1.00%	TIPS 0.80%	International Equity -13.80%	Short Duration 4.20%	Cash 1.10%
Emerging Equity -18.40%	Commodities -1.10%	Commodities -9.50%	Commodities -17.00%	Commodities -24.70%	Cash 0.70%	Short Duration 0.70%	Emerging Equity -14.60%	Cash 2.60%	Commodities -3.10%

WORST

Annual performance from 1/1/2011 through 12/31/2020. Asset-class proxies: US Large = Russell 1000 Index, US Small = Russell 2000 Index, Int'l Equity = MSCI EAFE Index, EM Equity = MSCI Emerging Markets Index, Core Fixed = Bloomberg Barclays US Aggregate Bond Index, High Yield = Bloomberg Barclays US Corporate High Yield Total Return Index, EM Debt = 50% JP Morgan EMBI Global Diversified Index/50% JP Morgan GBI EM Global Diversified Index, TIPS = Bloomberg Barclays 1-5 Year US TIPS Index, Commodities = Bloomberg Commodity Total Return Index, Long Duration = Bloomberg Barclays US Long Government/Credit Index, Short-Duration = ICE BofA 1-3 Year US Treasury Index, Cash = ICE BofA USD 3-Month Deposit Offered Rate Constant Maturity Index. Sources: Bloomberg, SEI. Past performance is not a guarantee of future results.

Of course, despite the impressive weight of historical evidence, holding a diversified portfolio still requires discipline, patience and the right focus. An investor who pays too much attention to the hot, outperforming asset class in any period may abandon what is clearly the better approach. This is especially true in periods when asset class performance is concentrated within one or two significant outperformers as we saw, for example, with US large-cap stocks from 2013 through 2015 and again in 2019.

Alpha source approach

Our actively managed strategies are designed to capitalise on long-term drivers of market performance through exposure to persistent sources of returns such as value, momentum and stability. The long-term viability of these alpha sources has been proven by years of academic research.

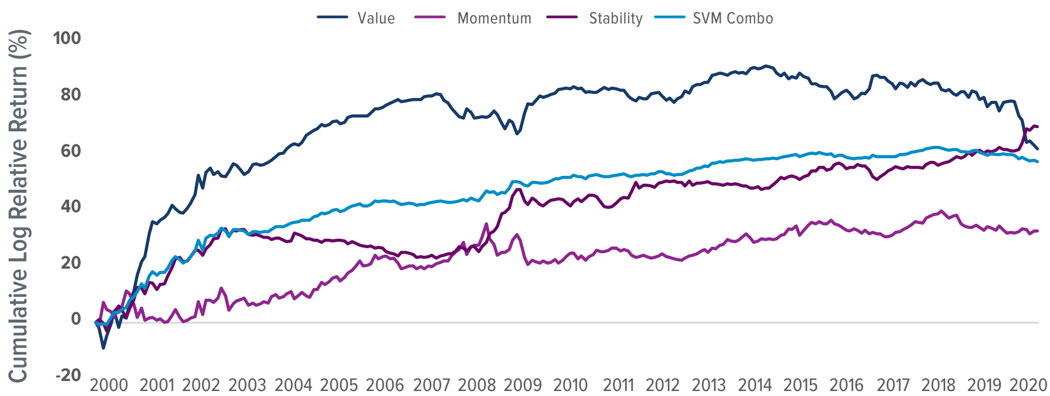
SEI categorises these alpha sources into three primary families that have been empirically identified, along with the behavioural anomalies that drive their persistence:

- **Value:** Designed to exploit mean reversion. Investors tend to overreact to the low chance of a high-loss event (loss aversion). Longer-term investors can exploit this risk premium. Value factors help identify company stocks that are priced cheaply due to investors being overly cautious about recent market conditions.

- **Momentum:** Designed to exploit investor anchoring and adjustment bias—two behaviours that typically result in medium-horizon trends. We seek to capitalise on this anomaly by measuring a variety of trends such as earnings growth and share price performance.

- **Stability:** Designed to exploit investors' tendency to underestimate the compound-return benefits of investments that provide stable earnings over the long term. These stocks are also often unloved and considered boring as short-term investors seek more immediate stock market outperformance. We identify higher-quality business models, income statements and balance sheets, with strong interest rate coverage and generally high solvency.

Exhibit 4: SEI Alpha Sources



Source: SEI, using data from Russell, Axioma and FactSet. Data spans 1/1/2000-30/6/2020, using SEI's most recent composite methodology. Data is for US equities, based from the Russell 1000 Index. Factor portfolios are constructed using the top one-third of the liquidity-weighted index, grouped by the respective factor style and rebalanced quarterly. The metrics are composites of underlying ratios that SEI has determined to be the appropriate measure of each factor. SVM Combo refers to the average return of the individual factors in any given year. Factor performance is shown relative to capitalisation-weighted market. Factor and index performance do not reflect any management fees, transaction costs or expenses. Indexes are unmanaged and one cannot invest directly in an index. Data refers to cumulative past performance; cumulative past performance is not a reliable indicator of future results.

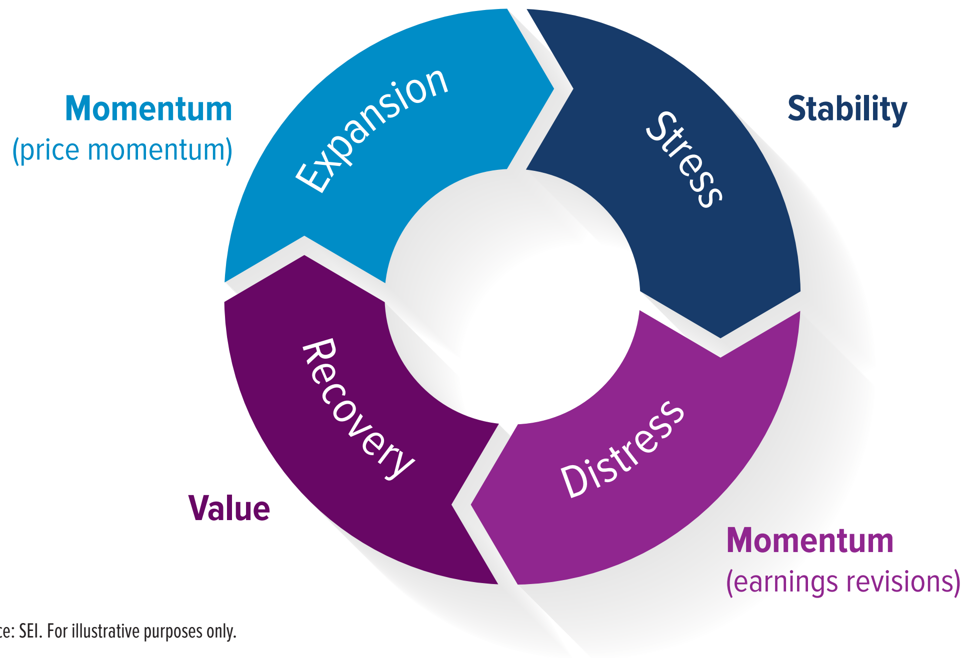
We remain committed to our alpha source framework and believe it should generate outperformance over a full market cycle. Additionally, these alpha sources should add value in a way that does not add uncompensated market beta or risk. The benefit is that they are also lowly correlated with each other. So combining them in a portfolio can provide an investor with a much smoother investment experience. These factors have demonstrated an ability to generate historical returns above a cap-weighted index and should provide tailwinds over the long term.

The value of our active managers coming at these alpha sources from different perspectives is that there is not a generic factor. Different managers with the same alpha sources will have different outcomes but still be aligned. While none of the factors suggests they might not underperform over a short time horizon, our alpha source framework keeps in mind a longer investment holding period.

Exhibit 5 shows how factor favourability can change as the economic cycle progresses through different stages. We believe forward-looking investment strategies that shift portfolio weights dynamically among factors provide the framework necessary to capitalise on the available opportunity set. SEI conducts factor-specific scenario analyses to measure performance across economic cycles, which helps inform the timing and sizing of our factor allocation decisions.

Momentum stocks have historically done better in market expansion environments, while value stocks have typically performed better during economic recoveries. The usually lower exposure to volatility of stability stocks broadly helps mitigate downside performance during stress environments.

Exhibit 5: Shifting Factors Along With the Economic Cycle



Source: SEI. For illustrative purposes only.

The path a long-term investment takes can be just as important as the outcome. An active manager can help manage the investment journey so it is more consistent over time by not chasing the hottest trends or buying into sectors that have already risen substantially. These tenets can help an investor stay organised and confident. Our answer to active management benefits client expectations and behaviours rather than compounding the issues that contribute to irrational decision and suboptimal decisions.

How can we help?

The benefits of active management are not necessarily obvious during a prolonged bull market. However, with the return of volatility and more anaemic and harder-to-find returns, investors once again should be rewarded for paying a small premium for the ability of active managers to deliver additional returns. SEI's strategic portfolios are actively managed at several levels and are designed to help protect or enhance returns in a variety of market conditions and deliver consistency with expectations. Because of the disproportionate impact of a few fundamentally expensive stocks in the broad indexes, we see an opportunity for strategic diversification to prove its potential benefit with active management. SEI closely monitors the financial markets and takes action in volatile times to try to protect its clients while delivering consistent returns.

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