Greetings!

"Those were the days -- no global warming, terrorism or giant tsunamis. And best of all, you could pick stocks by throwing a dart on the wall."

If you are the type of investor that has been investing in ETFs, mutual funds, and target date funds, the COVID-19 environment should make you reconsider your investments and be more strategic – it could have a powerfully positive impact on your portfolio. As of this writing, many of my clients' equity positions are up for the year. As an economist, I've always rejected the idea that it is impossible to predict, or at least form an educated opinion, about the profitability of different sectors. If profitability prediction is impossible, we have been wasting time studying economics and applying business strategy like Michael Porter's Five Forces. When I transitioned from being a macroeconomist at a global mining firm to a financial advisor, I warned the attendees at my Harvard Club lecture in 2015 to stay out of energy stocks.[1] Had you followed this advice, your equity portfolio would be 7% higher than if you had stayed invested in energy, even before this week's monumental energy collapse.[2] It was clear to anyone who understood the oil markets that demand had eroded as China's infrastructure build receded and oil supply blossomed particularly with the US shale industry.

Stocks not Sectors

Now, it should be clear to everyone that entire industries across the economy – airlines, hotels, brick and mortar retailers, and more - are facing monumental negative demand issues and some are facing bailout, bankruptcy, and permanent closure. So, why would anyone want to be invested in a broad ETF or mutual fund which includes all these companies facing the precipice? Per my analysis below, even if you had streamlined and just bought sector ETFs of the top two performing sectors of Health Care and Consumer Defensives, you still would have lost -9% this year, compared to -14% for the S&P. That's better, but no cigar.

Alternatively, you could have invested strategically in stocks across every industry – and thus had been very diversified – and been significantly up for the year. An easy case in point is had you been invested in Amazon, you would be up 25% for the year but had you invested in its sector ETF of Consumer Cyclicals, you would be down -34% as off-line retailers shut. This is true across every sector as can be seen below.

S&P Sectors	**YTD Returns**			**Stock Performance**	
Sector	**Average**	**Best**	**Worst**	**Best**	**Worst**
Healthcare	-8%	36%	-34%	Regeneron	Align
Consumer Defensive	-9%	27%	-49%	Clorox	Coty
Utilities	-11%	5%	-42%	American Water Works	CenterPoint Energy
Technology	-13%	31%	-62%	Citrix	DXC Technology
Communication Services	-19%	32%	-64%	Netflix	Viacom CBS
Real Estate	-21%	25%	-59%	SBA Comm	Simon Property
Industrials	-25%	11%	-64%	Carrier	United Airlines
Basic Materials	-25%	34%	-47%	Newmont	Mosaic
Financial Services	-30%	20%	-69%	MSCI	Alliance
Consumer Cyclical	-34%	25%	-79%	Amazon	Norwegian Cruise
Energy	-53%	15%	-72%	Cabot	Noble
Equally-weighted Average	**-22%**	**24%**	**-58%**		
Benchmark					
S&P 500	-14%				
S&P 500 Growth Spyder ETF	**-7%**			Data as of 4/16/2020.	
S&P 500 Value Spyder ETF	-21%				

Source: ycharts.com, Maya Joelson.

It doesn't take a rocket scientist to anticipate that Amazon and Netflix would outperform given a countrywide lockdown -- though given their lofty valuations, it wasn't a clear call to buy the stocks. In my opinion, this year's stock winners should single-handedly debunk the notion that stock-picking is just a "Random Walk Down Wall Street."[3] Of course it is nearly impossible to pick all the top stocks, but there were 72 stocks in the S&P 500 (or 15% of total) that were either flat or positive for the year. There were 201 stocks (34%) that performed better than the S&P Index. It was even easier these past few months to eliminate the losers, further increasing the probability to pick a portfolio of stocks that would beat the market indices. Moreover, if it is in a taxable account, you can offset the winners with the losers to reduce your capital gains taxes as I explained in my article "Are you Missing Out on Tax-Loss Harvesting and other Single Stock Benefits?". [4]

Not Value vs. Growth

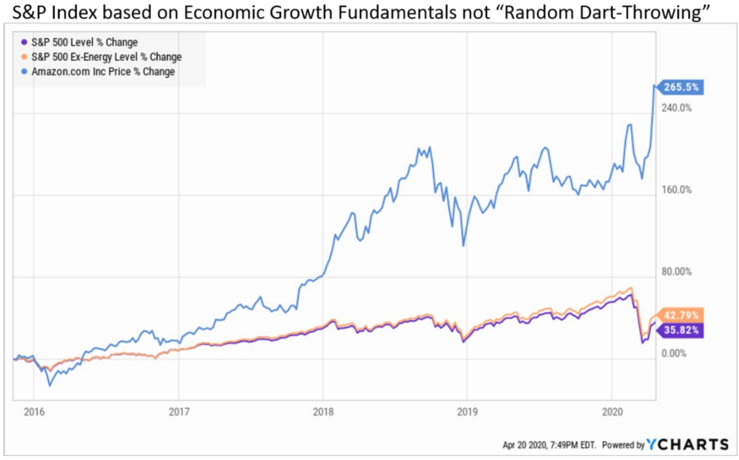
Morningstar and many financial advisors like to separate stocks into value and growth. As an economist, I don't espouse this approach because it obscures the underlying dynamics driving the industries in these broad-based indices. For instance, both energy and financials tend to be in value indices. Yet, energy stock prices are driven by oil prices but financial stocks' profitability is more dependent on interest rates. For cruise ships, airlines, casinos, and hotels which have dropped into value territory, you need to separately analyze when or if demand will return and whether the companies have the cash or bailout/loan prospects to them through the downturn. Analyzing the sectors themselves would provide better information on the future profitability of the stocks in these sectors. Without teasing out the core drivers, it is easy to fall into a "value trap" in which you buy stocks because they are "cheap" but they are cheap for a reason. You may be able to more than double your money if the company succeeds, but if not, you could lose all of your investment.

Financial pundits often like to say there will be a rotation from growth stocks, which have dominated the last decade, to value stocks. They use mean reversion as a rationale that are ostensibly grounded in statistics. I think the concept of mean reversion is often overused as an intellectual crutch in the context of the stock market – perhaps more on that in a later post.

Not Mutual Funds

So if broad-based ETFs aren't working, what about mutual funds whose *raison d'etre* is to actively pick stocks? Well, the vast majority of mutual fund managers have underperformed ETFs for the past decade which is why ETFs became so popular. But the reason mutual funds might underperform is not because active management can't work but because mutual fund structures and cultures impede savvy active managers.

Active Management Can Work: Amazon and non-Energy Indices Outperform Broad S&P Index based on Economic Growth Fundamentals not "Random Dart-Throwing"



Here are a few issues:

1. **High fees** – Mutual funds can add an extra ~1% annually to your fees.

2. **Benchmark hugging** – *Question:* What's the #1 goal of a mutual fund manager? *Answer:* Not to lose his job. So, how does this play out in the marketplace? The mutual fund manager chooses stock allocations which are very close to the index benchmark. Notice that the MSCI is the top performing stock in the financials space this year. This is perhaps the result of fund managers who still have to pay MSCI for index data. The end result of benchmark hugging is that too often mutual funds often closely mirror their indices so have a similar performance to an ETF but are weighed down by higher costs (see point #1).

3. **Not nimble** – Drastically switching stocks in the portfolio had to be done in a few days to have the best effect. Mutual fund companies are simply too slow to make these drastic changes in a timely manner.

a. **Bureaucratic, slow decision-making** – Analysts do in-depth work on companies, creating financial models. Analysts need to convince fund managers to implement their new buy and sell recommendations. These discussions often occur on a set time table which may be too slow to implement in a timely manner in a fast moving market.

b. **Inefficient trades that move the market –** Even if portfolio managers agree to implement changes in their stock positions, the sheer size of the trades will move the market price in the wrong direction for the fund (buying stocks at increasingly expensive prices while selling at increasingly lower prices). This also drags down performance.

4. **Higher capital gains you pay are often unwarranted**– Let's say you invest in a mutual fund because it has outperformed its peers. However, the fund manager may have invested 5% in Tesla which has more than doubled since last year. Fund guidelines may say he can't have more than 10% of the portfolio value in a single stock. So he has to sell Tesla. What happens? He sells Tesla and you, the new mutual fund owner, have to pay taxes on the Tesla capital gains sale even though you never benefitted from the appreciation of the stock. Investing in stocks avoids this problem as investors only have to pay taxes on gains they actually benefitted from. As redemptions to mutual funds increase with the flow to ETFs and out of the market, remaining mutual fund holders are primed to suffer from even more passed on capital gains which they can't control. In contrast, when I buy a portfolio of strategic stocks for you, all your capital gains and losses will be directly related to your own portfolio and based on your needs.

5. **Limited tax-loss harvesting.** Mutual funds tend to pass along more capital gains than losses. As well, they send along capital gains and losses based on their needs, not yours. In contrast, I can work you based on your expected annual income, risk tolerance, and ESG preferences to generate tax gains and losses that best fit your needs.

6. **Mandate limitations.** Many mutual and hedge funds must conform to a pre-determined mandate even if the world changes and they think that they could preserve or make money better with another strategy. For instance, many have cash limits or maintaining exposure even though in recent months, cash has proven to be superior to most investments. It is better to work with a financial advisor who can adapt your portfolio based on your requirements, preferences, and goals.

We are in a regime shift that we have never seen before. As the situation changes, it makes sense to have a wealth advisor who can shift your portfolio to best position you for the new reality.

Please contact me if you want to discuss more and how this applies to you.

Best regards,
Maya

maya@metapointadvisors.com
(415) 691-1062

Sources:

1. Joelson, Maya. "The New Reality of Investment and Retirement." Speech at Harvard Club of DC. November 9, 2015. **http://hcdc.clubs.harvard.edu/article.html?aid=1101**.
2. SP-ex Energy returned 43% vs. S&P 500 return of 36% since November 9. 2015 per ycharts as shown in the third image.
3. Malkiel, Burton. "A Random Walk Down Wall Street: The Time-Tested Strategy for Successful Investing." W. Norton & Company, Twelfth Edition. January 14, 2020.
4. Joelson, Maya. "Are you Missing Out on Tax-Loss Harvesting and other Single Stock Benefits?". December 28, 2018. https://www.metapointadvisors.com/

Marisa (Maya) Joelson **maya@metapointadvisors**
Founder of Meta Point Advisors *415-691-1062*

Maya is a Harvard-trained economist who leverages her two decades of top-level experience across Wall Street, the City of London, emerging markets, and advanced technology to devise investment strategies for her clients. She founded Meta Point Advisors after several years as a Financial Advisor at Merrill Lynch. Maya's clients benefit from her ability to provide savvy active management without the cumbersome costs and structure of mutual funds. She has been quoted in ***The Wall***

Street Journal and ***Barron's***.

Marisa Joelson holds a MPA from Harvard Kennedy School, a MBA from Kellogg at Northwestern University, and a BA from Wesleyan University.