Heritage Wealth Advisors
First Quarter 2020 Investment Perspectives

Investment success doesn't come from 'buying good things' but rather from 'buying things well.' There's a big difference between probability and outcome. Probable things fail to happen – and improbable things happen – all the time. That's one of the most important things you can know about investment risk." Howard Marks

"…we no longer have a shared sense of reality in this country. We observe the same circumstances with our own interpretation of reality, then wonder why other people don't see it the way we do." Phillippa Dunne, The Liscio Report

Happy New Year! And farewell to an extraordinary decade (technically, the decade has one more year but conventional thinking, sometimes dangerous, starts the decade at year 0). While the idea of reflection and resolutions are a standard part of each new year, the benchmark of a new decade brings even greater emphasis on the human "renewal" process. Personally, as I turn the decade firmly ensconced in middle age, I have resolved to eat healthier (I recognize this is a staple resolution, but just ask my colleagues or family how hard it is for me to pass up sweet tea at lunch or Slurpees…) while reflecting on what is important in my life. It is in this vein that I am truly humbled by the trust and confidence that each of you as clients place in Heritage and by the dedication of my colleagues to deliver on the promise that we make to you.

As you have likely picked up on by now, this is not a conventional year end outlook commentary. We will touch on 2019 and our current outlook, but I am not naïve to reality and feedback. You receive plenty of emails and commentaries all saying essentially the same thing. Some are highly technical, some are quite witty – but the message is ultimately the same. If you will indulge me in this letter, my hope is to have a little fun reflecting on what has transpired over the last decade and why there is reason to remain optimistic about our future. I would be remiss, however, not to be direct about the storm clouds that are building somewhere beyond the horizon that may challenge our current sense of stability and complacency over the course of the next decade.

A Decade in Review

It is hard to reflect on the last decade without focusing on the **economy** (at least, for an investment nerd). The decade began with the economy struggling to resume growth in the aftermath of the Great Recession. Official unemployment stood at 9.8% while a broader measure of unemployment that includes discouraged workers began 2010 at 16.7%. Even the most optimistic forecasters recognized the challenges facing an economy where one in six workforce participants were out of a job, liquidity remained constrained by banks' continued efforts to repair balance sheets and unconventional monetary policy (QE1) was deemed a temporary response to the financial crisis. Fast forward to today and we have enjoyed the first decade since 1850 without an economic recession, official unemployment at 3.5% represents a fifty-year low (the aforementioned broader measure of unemployment is 6.7%) and bank balance sheets are in arguably their strongest position in decades.

Markets have similarly benefitted from a combination of an extended cycle, the largesse of the Federal Reserve and timing – the decade began at the end of the Great Recession following the worst ten-year period for equity markets looking back to 1900. The S&P 500 began the decade at 1,074, still 30% below the pre-recession peak, before enjoying a 13.4% annualized return for the decade, above the long-term average of 10.1%, to close at 3,223. Digging into the market further, there have been meaningful transitions in the hierarchy of the market over the decade. General Electric, an original member of the Dow Industrials in 1896, was dropped from the index in 2018 while Apple, the largest company by market capitalization, began the decade as an outsider to the index. In fact, the exceptional performance of technology over the course of the decade can be seen in the magnitude of growth in market capitalization of the leading companies. At the beginning of the decade, Apple, Amazon, Microsoft and Google had a combined market cap of $716 billion. Today, their combined market cap is over $4.5 *trillion*. The changing composition of the US economy and market can be summarized in the following: Facebook, which came public in 2012, currently holds a larger market cap ($622 billion) than AT&T, GE and Citigroup combined ($577 billion). Investor behavior and preferences have also changed over the course of the decade. Warren Buffet made an ultimately successful $1 million wager in 2007 that the S&P 500 index would outperform a collection of hedge funds selected by the counterparty to his bet. Following suit, the investor shift towards index funds as a means to own stocks in a low cost, efficient manner has been a powerful trend over the course of the decade. Passive fund assets, which stood at $2.3 trillion of assets in 2010, now exceed $10 trillion, representing over 50% of all mutual fund assets up from roughly 20% in 2010, and have doubled as a percent of the total global market capitalization to 14%. One could logically question at what level investor behavior overwhelms the ability for markets to perform their primary function, to provide capital to businesses for future growth, in a world where current capital is indiscriminately allocated according to the relative size of each business in the index.

Major trends in technology and industry have likewise painted their own narrative of the decade. It is honestly surprising to realize that Apple introduced the first iPad in 2010 (I would have guessed earlier). Smartphones, nearly ubiquitous today with penetration over 80% amongst adults, began the decade at 20% spurred on by the increasing capabilities of 4G mobile networks introduced at the beginning of the decade. What now seems like typical, everyday behavior (mobile banking, Instagram, mobile shopping) was anything but in 2010. To pivot to the commodity sector, we entered the decade with belief in the commodity supercycle (a sustained period of rising commodity prices due to rising demand and limited supply) still strong, if temporarily interrupted by the Great Recession. Oil prices began the decade at $80 per barrel, down from the pre-recession peak of $150 but well above historic price levels. Lingering concerns of "Peak Oil" coupled with the increasing dependency on deepwater and international supply supported this permanently higher price level. Fast forward to today, the energy world has changed dramatically. Innovations including fracking technology and meaningful investments over the course of the prior decade have altered the energy landscape. U.S oil production, which declined every year from 1985 through 2008, began the decade at 5.5 million barrels per day. Today, domestic oil production stands at 12.9 million barrels per day bringing the US to the precipice of energy independence. We are in the early days of transition in the ways we access entertainment (streaming), travel (driverless cars, air taxi networks) and treat health issues (genetic mapping, telehealth), to name a few. We could spend pages discussing innovation over the course of the last decade but the singular message is best captured in Bill Gates quote, "We always overestimate the change that will occur in the next two years and underestimate the change that will occur in the next ten." As an equity investor, this belief in human innovation and progress is critical to maintaining a long-term position in equity markets which ultimately discount the future cashflows of their participants.

A few fun facts on the passage of time:

- **If the 'Wonder Years' aired today, it would cover the years between 2000 and 2005**
- **Jurassic Park, The Lion King and Forrest Gump hit theaters in 1994 – closer to the moon landing than today.**
- **The break up of the Soviet Union is now as close to JFK's assassination as today.**

Source: waitbutwhy.com

2020 Outlook

The setup for 2020 remains consistent with our narrative from a quarter ago: easing monetary policy around the world, receding trade tensions and improving sentiment with respect to the global economy pushed markets higher in the fourth quarter (the S&P 500 was up 9% in the fourth quarter alone) while suggesting low odds of recession in 2020. While our crystal ball is no better, or worse, than others, continued economic growth – in fact, the potential for an acceleration in global economic growth – should favor equities over fixed income alternatives. Valuation expansion over the course of 2019 places a greater burden on earnings growth to carry equity returns in domestic markets while international markets appear poised to deliver improved relative returns given accelerating earnings and modest valuations. We have undertaken a modest shift in client portfolios towards international stocks to reflect this view.

Clouds

If you stop reading the letter at this point, you might walk away with the impression that we are exceedingly optimistic on the outlook for the decade of the 2020's. However, as a steward of client assets, one can't help but take an increasingly skeptical view of many trends and dynamics in place in the economy, markets and society that cause one pause with respect to the future. The past decade was borne out of the extreme volatility in capital markets in the wake of the Great Recession which muted risk-taking, arguably to the detriment of economic growth, for a large portion of the decade. It is naïve to believe that the extraordinary stability of markets and the economy is not sowing the seeds of the next recession through increasing complacency (it is palpable). To quote John Mauldin's interpretation of Hyman Minsky's view that stability leads to instability, "Humans have a way of reinterpreting stable periods that seemingly redefines words like reasonable, manageable, and prudent. That's why we continue chasing yield and risk until we go too far." To wit, I have "learned" (or been told by a young market strategist…) that anyone who started their career prior to 2008 is at a disadvantage in this brave new world of investing! I, on the other hand, will respectfully submit that cycles have not been eradicated and prudence will be rewarded over the fullness of time. While consumers have remained disciplined over the course of the decade, governments and corporations have moved in the opposite direction thanks in part to strong capital market returns and low interest rates. Dick Cheney told us back in 2002 that "deficits don't matter". In the same vein, with the Federal Reserve embarking on QE4 (with unemployment at fifty-year lows), former Federal Reserve chairman Ben Bernanke believes that the Federal Reserve has plenty of ammunition to counteract the next recession. We don't pretend to know the day that deficits matter, or that policies of unconventional monetary policy that have characterized this cycle will create deeper challenges within markets and the economy.

To remain consistent with Howard Mark's quote at the beginning of this note, we are clear that if we brought together the ten brightest minds to discern the next decade, they would be no more accurate than the same exercise would have generated a decade ago. "Probable things fail to happen – and improbable things happen – all the time." Major change typically begins as an insignificant, if not imperceptible, event or shift at the margin – this is the primary principle of Chaos Theory ("If a butterfly flaps its wings in New Mexico…) which posits that small changes in initial conditions can lead to drastic changes in results. To look inwardly, this is particularly relevant in the societal challenges that face our country. The reality of the decade narrative above is that it is not an inclusive narrative but confined to the highest levels of our socioeconomic ladder. Anecdotally, the five hundred richest people in the world added $1.2 trillion to their collective net worth in 2019, to quote Bloomberg, "an astronomical amount". To put this in perspective, that represents an increase of 25%. Meanwhile, the median family net worth increased by a compound annual growth rate of 0.4% from 1989 to 2016. The reality is only the top 20% of US households have seen household wealth recover to pre-recession levels over the course of the decade. This concentration of wealth, or said conversely widening inequality of wealth, is and will be a major issue that we will be required to address. Increasingly heated political discourse, polarization within the political system, rising populism and societal angst are being fueled by the lack of shared experiences and resultant increasing inequality. Big picture, the increasing potential for political and social upheaval in the face of rising debt globally suggest darkening storm clouds somewhere over the horizon. And we haven't even gone down the path of discussing an increasingly unstable Middle East, a diverging relationship between China and the U.S., an accelerating demographic shift towards the over 65 year old segment and other geopolitical issues. We will save for future letters…

Heritage Wealth Advisors
First Quarter 2020 Investment Perspectives

As stewards of client assets, we view our role to position portfolios to best achieve long-term goals based on what is probable while appropriately managing risk and liquidity to insulate portfolios from that which seems improbable or unknowable. I have always believed our role as investors is to define the glass as “half-empty” and then build the case for why the glass may be “half-full” but protecting ourselves and clients through biasing our investments towards quality and maintaining appropriate liquidity.

Heritage

In closing, we thought many of you, particularly those of you who have been around since our beginning, would enjoy a quick snapshot of the last ten years at Heritage. It has been an exciting period for our firm as we have grown in terms of the number of clients who have engaged the firm (102 to 290), the number of teammates that have joined our firm (11 to 27) and the assets that we have been entrusted with managing ($226mm to $2 billion plus). Over the course of the decade, our growth has allowed Heritage to add resources to better deliver on our promise to clients. We are truly humbled by the trust that you place in our firm and look forward to building on our relationship in the years to come.