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The Federal Reserve fuels an historic stock market rally

A perspective on an unprecedented 2020

Q. The stock market has had an amazing run since the lows in March. Can you talk about the impact of the massive monetary and fiscal stimulus on the market, and the disconnect with the economy and COVID-19 pandemic around us?

With the Federal Reserve ("Fed") promising to do whatever is needed to support the markets, many investors feel the Fed has provided a backstop for the markets. The Fed has said that it will keep interest rates low for a long time, and it has added significant liquidity (cash) into the economy and made unprecedented asset purchases to keep credit markets stable, while indirectly boosting the stock market. Stocks have risen sharply despite declining earnings because the cost of borrowing money dropped to almost zero, and lower interest rates and bond yields made stocks appear more attractive.

The U.S. government was also aggressive in its response to the pandemic, quickly passing bills that offered trillions of dollars in relief to businesses and individual Americans. Now it looks like another coronavirus relief deal will be passed soon.

The stock market is looking ahead, and seems to not focus on valuations, but on the prospects of improving corporate earnings, and the light at the end of the tunnel. At the same time, Main Street continues to struggle as the economic recovery has been very uneven and unemployment remains high. It has been a V-shaped recovery in the stock market, but not for the economy.

> "Stocks are seldom popular and cheap at the same time."

Q. What role has the increased participation by retail investors and the fear-of-missing-out played in the stock market rebound this year?

Retail investors, trading on popular apps like Robinhood, have played a large part in supporting the stock market rally this year. During the pandemic, retail investors have spent a lot of time at home because of the lockdowns and have had the time to trade. With the ability to buy fractional shares and no trading commission, they traded in and out of stocks that had fallen sharply, and piled into a narrow group of large-cap technology stocks. These investors bought the dip with the belief that the Fed is acting as a backstop to the market. New IPOs, such as Airbnb and DoorDash, had huge swings on day one, more than doubling the offering price as retail investors traded in and out of the stocks.

However, it is important to remember that stocks are seldom popular and cheap at the same time. While it is good that more people own stocks, these new investors have not had the experiences, sometimes bad experiences, that more seasoned investors like us have had that lead us to invest selectively and carefully.

Q. Small-cap stocks have surged past large caps in 2020 after November's sharp rally carried into December. Why this turnaround?

"You can't go broke taking a profit."

As noted in September, we thought a sector rotation would likely occur in the market. Growth stocks had a strong run and value stocks appeared to offer better opportunities and valuations. The disparity was at an historically extreme level with growth stocks up 24% year-to-date, while value stocks were down 12%.

At the end of September, the FAAMG stocks - Facebook, Amazon, Apple, Microsoft, and Alphabet (Google) were up 42.0% year-to-date, while the S&P 500 minus the FAAMG stocks were down 1.8% year-to-date.[1] At their early September peak, these five stocks represented nearly 25% of the S&P 500.

We also believed smaller stocks would start to outperform larger stocks as they had substantially lagged large caps. With no viable alternative to stocks, investors turned to areas of the market that had not done as well during the market rally. Since the news of the vaccines came out in November, small caps have had a remarkable run as investors believe that the vaccine will help the broader economy recover. It is also worth noting that small-cap stocks historically perform better during an economic recovery.

Q. With interest rates at 0% and the 10-year U.S. Treasury yield around 0.9%, cash and bonds don't look very attractive. What are your thoughts on the fixed income market?

We don't believe the bond market is attractive with yields artificially depressed. As COVID-19 vaccines become more widely available by mid-year, the economy should improve and as a result interest rates will rise. In this environment, any return is likely to come from the interest income generated. Given the current valuations, we believe that you should stay with a duration of less than 5 years to reduce risk and not reach for lower credit ratings in search of yield.

Q. What should investors who are looking for yield and income do?

Low interest rates may be good for borrowers, but not for investors seeking income from bonds. The current yield on the 10-year U.S. Treasury Note is only 0.9%, while the yield on the S&P 500 is close to 1.7%. We believe dividend stocks are a better option for income-oriented investors. While stocks come with more volatility, dividends have historically increased over time. We look for companies that have a good history of paying and growing dividends based on increasing earnings. On the other hand, the yield on a fixed income holding is just that; "fixed" and can get eaten up by inflation.

Q. Investors shifted from optimism to near-euphoria in November after the election and positive news on the COVID-19 vaccine. Is this bullishness warranted now when there seems to be a light at the end of the tunnel and investors believe that "there is no alternative" to stocks?

The stock market is expensive, and we have seen that with the volatility of new IPOs recently. So, we may see a short-term pullback. I can understand the bullish sentiment as we now have clarity on some of the big unknowns. For example, while the Georgia Senate battle in January could upset the market due to potential tax increases, the Presidential election is over. We now also have a COVID-19 vaccine. As mentioned earlier, stocks look more attractive than bonds, and the Fed again reiterated its commitment of keeping interest rates low and continuing the $120 billion per month bond-buying program to support he economy. Two sayings remain a constant however: "You can't go broke taking a profit" and "Don't fall in love with a stock, it won't love you back".

Q. Few times have the saying "Don't fight the Fed" been more relevant than in 2020. Investors have largely shrugged off bad news and given stocks a "free pass" on the underlying fundamentals of many companies. Do you think that investors will focus more on company fundamentals and earnings in 2021?

It seems apparently not. Valuations are stretched. Companies are trading at huge multiples of 20, 30, 70, and more times earnings, and the valuations of the S&P 500 are two standard deviations above the 30-year average. But cash yields nothing, bonds yield very little, so investors are buying stocks regardless of valuations. The trading by retail investors on the Robinhood app is reminiscent of the day-trading back in 1999, when investors were only buying the stocks that were the most popular.

> "Don't fall in love with a stock, it won't love you back."

Q. What are a couple of examples of stocks you hold in the portfolio that represent your investment approach? Why do you like them?

One of our long-term holdings is **Pool Corp.** It is the dominant distributor of products for swimming pools. During this period of social distancing, we have seen consumers spend heavily on their homes and other forms of recreation that do not necessarily involve significant social contact. We believe Pool will continue to benefit from not only this spike in swimming pool installations, but also the long-term maintenance-spend for these new pools for years to come. 58% of Pool's revenues are non-discretionary items for existing pools, such as buying chemicals, performing maintenance and repairs, and another 24% of its revenue is to replace or refurbish the existing pools. This creates the kind of recurring revenue investors love. We continue to like the growth profile and the competitive position that Pool enjoys.

Another holding is **ON Semiconductor Corp.**, which manufactures and sells semiconductors for various devices worldwide. The stock benefited from the stay-at-home trends during the COVID-19 pandemic and the reliance of working remotely. Semiconductors have also been the most important drivers of the overall growth in technology. 5G is coming and people demand it. We believe that ON is well-positioned to benefit from what we think will be a massive 5G cellular buildout over the next several years as well as the trend to increase technology in automobiles and medical devices.

Q. Some people compare the 2020 stock market and investor behavior to the markets in late 1999 and 1929 before they crashed. At these valuations, is the stock market vulnerable to a potentially large set-back? What do you believe are the biggest risks to the markets in 2021?

Markets are always vulnerable to a set-back as unexpected things can happen any given time, just as we saw this year with the coronavirus, a real Black Swan event. While we now have a vaccine, the coronavirus is spreading at a rapid pace, which could result in more partial shutdowns and months of social distancing and precautionary guidelines. This is a near-term risk to the markets.

The markets seem to look past the short-term turmoil, knowing that there is light at the end of the tunnel, but the disconnect between Wall Street and Main Street has continued much longer than people expected back in the summer.

Stretched stock valuations is what makes me the most nervous for 2021. We should see a broader, improving economic recovery as the vaccine becomes more available, however, corporate earnings and fundamentals need to improve, as expected, and validate the lofty stock prices. The question also remains how much has already been priced into the stock market. The stock market rally has broadened in the last few months, but the concentration in a small number of large-cap stocks also makes the market vulnerable.

Another risk to the market related to COVID-19 is the rollout of the vaccine, how long it will take, and if people are more resistant to taking the vaccine than expected.

Opinions expressed are subject to change, are not intended to be a forecast of future events, a guarantee of future results, nor investment advice.

RISK CONSIDERATIONS

A mutual fund's investment objectives, risks, charges, and expenses must be considered carefully before investing. The statutory and summary prospectuses contain this and other important information about the investment company and may be obtained by calling 866.209.1129 or visiting villere.com. Read carefully before investing.

Mutual fund investing involves risk; loss of principal is possible. Investments in smaller and medium sized companies involve additional risks such as limited liquidity and greater volatility than large-cap companies. The Villere Balanced Fund will invest in debt securities. Investments in debt securities typically decrease in value when interest rates rise. This risk is usually greater for longer-term debt securities. Investments in lower rated and nonrated securities present a great risk of loss to principal and interest than higher rated securities. The Villere Equity Fund may invest in foreign securities. Foreign investments involve additional risks, including currency fluctuation, political and economic instability, lack of liquidity and differing legal and accounting standards. These risks are magnified in emerging markets. The Equity Fund's ability to invest in initial public offerings (IPOs) involves a higher degree of risk than more seasoned companies. Past performance does not guarantee future results.

Yield is the income return on an investment and refers to the interest or dividends received from a security; is usually expressed annually as a percentage based on the investment's cost, its current market value or its face value.

Initial public offering (IPO) refers to the process of offering shares of a private corporation to the public in a new stock issuance. Public share issuance allows a company to raise capital from public investors.

Duration measures a bond price's sensitivity to changes in interest rates. The longer a bond's duration, the higher its sensitivity to changes in interest rates and vice versa.

Black swan is an unpredictable event that is beyond what is normally expected of a situation and has potentially severe consequences. Black swan events are characterized by their extreme rarity, severe impact, and the widespread insistence they were obvious in hindsight.

Price-to-Earnings (P/E) Ratio measures share price compared to earnings per share for a stock or stocks in a portfolio. Earnings growth is a key indicator for measuring a company's success and a driving force behind stock price appreciation. Earnings growth is the percentage gain in net income over time.

Price-to-Earnings (P/E) Multiple is used to compare a company's market value (price) with its earnings. A P/E of 10x means a company is trading at a multiple that is equal to 10 times earnings. A company with a high P/E is considered to be overvalued and a company with a low P/E is considered to be undervalued.

Standard deviation is a statistic that measures the variation or dispersion of a set of values/data. A low standard deviation shows the values tend to be close to the mean while a high standard deviation indicates the values are more spread out. In terms of valuing investments, standard deviation can provide a gauge of the historical volatility of an investment.

S&P 500 Index is an unmanaged index which is widely regarded as the standard for measuring large-cap U.S. stock market performance. The stock index does not incur expenses and is not available for investment.

It is not possible to invest directly in an index.

[1]Sources: FactSet Research Systems, Standard & Poor's, and Thomson Reuters Datastream.

As of December 16, 2020, the Villere Balanced Fund held 28,227 shares of Pool Corp, Inc. and 379,380 shares of ON Semiconductor Corp. The Villere Equity Fund held 7,270 shares of Pool Corp, Inc. and 91,690 shares of ON Semiconductor Corp. Neither fund held any shares of Airbnb, DoorDash, Facebook, Apple, Amazon, Microsoft, or Alphabet (Google).

Fund holdings and/or sector allocations are subject to change at any time and are not recommendations to buy or sell any security.

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