THE GORTON
WEALTH MANAGEMENT GROUP
of Wells Fargo Advisors

2020 Annual Review

January 2021

An update of performance, trends, research, and topics for the long-term investor

Relevant rates of return a/o 12/31:	**2020**	**vs.**	**2019**
Russell 1000® Growth Index: Stocks within this index include: Amazon, Facebook, Google (Alphabet) Home Depot, Visa	+38.49		+36.39
Russell 1000® Value Index: Stocks within this index include: Berkshire Hathaway B, Exxon Johnson & Johnson, JP Morgan	+2.80		+26.54
Barclays US Agg Total Return Index:	+7.51		+8.72
S&P 500 Index:	+16.26		+28.88
Russell 2000® Value Index:	+4.63		+22.39
MSCI EAFE® Index:	+5.43		+18.44
CBOE S&P 500 BuyWrite Index (BXM):	-2.75		+15.68
DJ Real Estate Price Index:	-8.62		+24.13

Long Term Historic Returns, compounded annually (1970-2019)[1]

- Small Value +13.9%
- Large Value +10.6%
- Small Growth +9.3%
- Large Growth +8.9%

Growth and value stocks in this example are represented by the Ibbotson Associates Growth and Value Indexes for 1970–1997 and the Morningstar Style Indexes thereafter. Ibbotson Associates Growth and Value Indexes calculated based on data from CRSP US Stock Database and CRSP US Indices Database, Center for Research in Security Prices (CRSP®). The data assumes reinvestment of income and does not account for transaction costs or taxes.

Description of Indexes

An index is unmanaged and not available for direct investment.

S&P 500 Index - consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market value weighted index with each stock's weight in the Index proportionate to its market value.

Russell 1000 Growth Index - offers investors access to the large-cap growth segment of the US equity universe. The index is constructed to provide a comprehensive and unbiased barometer of the large-cap growth market. Based on ongoing empirical research of investment manager behavior, the methodology used to determine growth probability approximates the aggregate large-cap growth manager's opportunity set.

Russell 1000 Value Index - measures the performance of those Russell 1000 companies with lower price-to-book ratios and lower forecasted growth values. These stocks are selected from the 1000 largest companies in the Russell 3000 Index.

DJ Real Estate Price Index - a capitalization-weighted, real-time index that provides a broad measure of the US real estate securities market.

CBOE S&P 500 BuyWrite Index (BXM) - a benchmark index designed to track the performance of a hypothetical buy-write strategy on the S&P 500 Index.

MSCI EAFE Index - a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of the developed markets, excluding the U.S. and Canada.

Russell 2000 Value Index - measures the performance of those Russell 2000 companies with lower price-to-book ratios and lower forecasted growth values.

Barclays US Agg Total Return Index - covers the USD-denominated, investment-grade, fixed rate, taxable bond market of SEC-registered securities. The index is composed of government and corporate securities, mortgage pass-through securities, and asset-backed securities.

"Don't let yesterday take up too much of today." —Will Rogers[2]

This Crazy Year

Michael Gorton
Managing Director - Investment Officer

As the year began, which seems like eons ago, the U.S. economy was humming along, unemployment was at a 50 year low and investors continued to benefit from the long term bull market. Then the lights went out!

A barely understood virus instantly closed economies around the world, markets plummeted and unemployment skyrocketed. The amazing thing is how quickly the U.S. stock market recovered, led by a small group of popular stocks, e.g. Amazon, Apple, Facebook, Google, Netflix and Tesla in addition to 480 IPO's[3] and cryptocurrencies. Six companies accounted for 23% of the value of the S&P 500 Index and 77% of the gains for the year ending 9/30/2020.[4] Value stocks lagged as you can see from the box on the left. This is eerily reminiscent of two periods in the recent past: the mid-1970s, driven by the "Nifty Fifty"[5] companies (the top 50 growth companies, one decision stocks) which traded at nosebleed multiples, right before they collapsed in 1973/74 and the "Dot-Com Bubble" of the late 1990s, driven by Tech and IPO's, where fundamentals were completely disconnected from valuation. During that same period (late 1990s) value stocks also waned, but value investors were well rewarded when the bubble eventually collapsed.

This is why it is so important to stick with an investment philosophy and not buy into extreme valuations. But, it is difficult to be patient. Remember this is a marathon, not a sprint. Focus on good quality companies at fair prices and you should finish that marathon.....

Another Lesson in History:

Hegemon, the leadership role of the U.S. in the world, and why it is so important. My inspiration for writing this was a series of podcasts by Confluence Investment Management on the topic, so here are my thoughts:

What is a Hegemon you ask?

- "A political state, having dominant influence or authority over others." —Merriam-Webster[6]
- "The American self-image of a mighty power that is also a benign hegemon, the global custodian of democratic values and human rights, is deeply rooted." —Allister Sparks[7]
- Hegemonic Stability Theory says, "The world is more stable when a single nation-state is the dominant world power." —Assoc. Prof. Dr. Mohd Noor Mat Yazid[8]
- A Hegemon must have a large economy and military, top 1 - 3 in the world, so only a few can fulfill the role.

What is the role of the Hegemon?

- Provide a reserve currency for world trade.
  - Be able to run large deficits so that other countries can acquire the reserve currency.
  - Global importer of last resort.
- Provide global security.
  - Commit large resources to the military and become the policeman of the world.
  - Keep trade routes open.
  - The Hegemon does not eliminate war/conflict, but keeps small wars from turning into big ones.
  - Enforcer of contracts.
- Benefits the small developing countries to become developed ones.

Recent history of former Hegemons.[9]

- Hegemons have typically lasted 70-120 years.
- Former Hegemons:
  - Portugal (1494-1580), ousted by the Dutch (1580-1688).
  - Britain had two swings at it, 1688-1792 and 1815-1914.
    - First time, when the British were fading, the French were on the rise and allowed the French revolution, American revolution and rise of Napoleon.
    - The second time when the British stepped back, the vacuum created allowed WWI, the great depression and WWII.
- As England's role waned the U.S. had a policy of Laissez-faire: Leave well enough alone; and the vacuum left by the British allowed WWI, the depression and WWII before the U.S. took on the role of Hegemon, begrudgingly, as we feared for our own security as the oceans were no longer a protectorate of our

country (aircraft carriers and planes bridged the gap, only bridged by ship before).

How does it affect the U.S.?

- A Hegemon can become unpopular with many adversaries.
- The world is growing weary and so are we.
  - World War II was a long time ago. Truman was the salesman of Hegemony and we were told it was to protect us from being attacked again, and protect us from the spread of Communism. With the fall of the Berlin Wall and the spread of Communism on the decline, many Americans no longer remembering WWII or buying into this dialogue.
- Running large deficits to allow other countries to acquire the reserve currency to build their economies can have negative consequences for the Hegemon.
- We face unfair competition from foreign companies who are supported by their governments and are low cost producers.
  - Bottom 90% of households — general feeling is they get cheap imports, but difficult to get jobs, kids go into military then they are harmed by wars. Don't see elites sharing the burden in equality and efficiency, in fact they benefit from it (**thus playing into the disparate income gap of my last newsletter creating the economic shift we are now seeing**). Evident in Europe too — Brexit. —Confluence Investment Management Hegemony Podcast Series[10]

Where are we in this process and do we really want to give up this role? What happens when we do? Who would be the next Hegemon and is that what we want?

- Much of the world manufacturing after WWII was destroyed and as we became the Hegemon, we also became the world's manufacturer of goods, dominating the economic output.
- The U.S. is 75 years into a role that typically lasts 70-120 years.[9]
  - The world has taken over much of the manufacturing as a lower cost producer.
  - There is no public leadership behind us being in this role and I am not sure our leaders understand the dynamics. You are seeing discussions of reducing our troops overseas, tariffs to fend off the foreign competition and alternate world currencies.
  - Even so, 88% of world trade is still settled in U.S. dollars.[11]

What happens to the world if there is no Hegemon?

- What has happened historically is that global trade declines, globalization falls apart. Regionalism takes hold. Trade becomes more difficult- pirates, trade barriers, wars become more frequent and inflation rises as the world economy becomes less efficient.
- It is difficult being the parent (someone has to wear the black hat) and not backing down from your duties to your country and to the world. But it may be better than the alternative. In this next cycle we may end up with two regional blocks, the east and the west.

Who could be the next Hegemon?

- Since a Hegemon needs to have a large economy, military and provide the reserve currency, so few qualify. The EU? China? Would we prefer they take over the role?

We will need to see the policies outlined and put forth by the new Administration before we know if there are any specific investment themes to pay attention to. As you know I don't forecast markets, but attempt to create a sensible long term portfolio without too much risk. There are a lot of new investors and their results in investing in the popular stocks have made them feel knowledgeable based on their short term success. Be wary of the fool's errand....

I look forward to returning back to the new normal in 2021, especially seeing people, breaking bread, traveling and spending time with extended family. And I wish the same for all!

We are headed into annual review time and look forward to our discussions over the coming months.

Happy New Year! May it be a good one!

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My inspiration for writing this newsletter was a series of podcasts put out by Confluence Investment Management. Other sources were Charles Kindleberger, Duncan Snidal, Robert Keohane, John Agnew, and Assoc. Prof Dr. Mohd Noor Mat Yazid who all wrote about Hegemony and the Hegemonic Stability Theory.