The Colony Group

OUR VIEW

JANUARY 2022

Since the start of the global pandemic, there have been 300 million reported Covid cases and 5.5 million deaths[1], worldwide. In the U.S. more than twice as many people have died of Covid than died in World War II. The numbers have become so large they have lost their original shock value. In 2021, headlines expanded their focus from the human health crisis to the economic crisis -- supply chain disruptions, rising inflation and the possibility of tighter monetary policy. Despite a relative absence of positive headlines, and for the second year in a row, most equity markets performed extraordinarily well, proving again that the media is a poor barometer of equity market returns.

Equity Market Returns

Table 1

India	26.4%
U.S.	25.6%
Europe	17.2%
World ex-U.S.	8.3%
China	-21.7%

Note: Indices represented are MSCI India; Russell 3000; MSCI Europe; MSCI All Country World; MSCI China. All returns are in US$. Source Bloomberg.

Time Horizon

The beginning of each calendar year reminds us of the importance of maintaining an appropriate time frame. Breathless prognostications of where the market will be at year end are often too focused on brief time periods equivalent to one revolution around the sun. Instead, investors should focus on multi-year periods, in which there will likely be both positive and negative stretches of performance. Importantly, volatile periods tend to present opportunities to generate even stronger future returns by investing into market weakness. A recent case in point was investing into the downdraft of the pandemic. The U.S. equity market has appreciated 89% since the selloff of March 2020. India, our favorite non-U.S. geography, has appreciated 112% over that same period. Investing in both at that time required accepting risk when others were seeking safety. However, the risk averse investor who sold equities and reinvested the proceeds in a relatively safe, diversified portfolio of investment grade bonds generated only a 2.6%[2] return over the same period.

[1] Source: Johns Hopkins University of Medicine.
[2] Barclays Aggregate Index, Source Bloomberg.

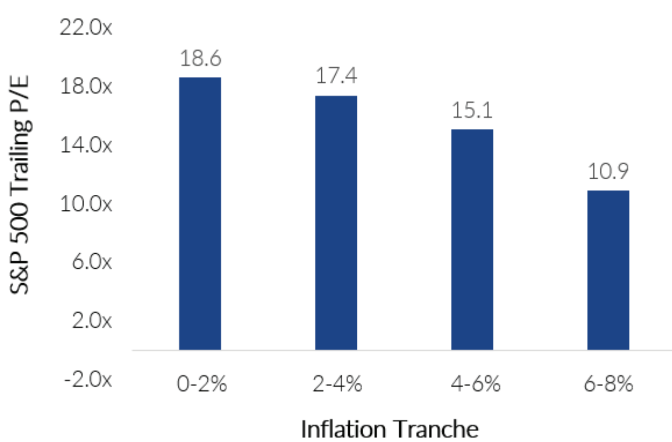
Looking Forward

Today the risk/reward opportunity appears balanced, and we have reduced equity exposure to a neutral stance, which has meant an increase in liquid assets. On the positive side, corporate earnings growth should have more room to grow as we are still in the earlier stages of recovery from the pandemic. In addition, interest rates remain extremely low versus historical levels, and it seems unlikely that there will be a catastrophic increase in the cost of capital for some time. The counterbalance is monetary and fiscal policy is likely to become tighter, if it has not already begun. In our opinion, not only have we passed peak liquidity, but we have also passed peak economic and earnings growth. To be clear, we expect continued growth, but it will likely be a decelerating rate of growth relative to the rapid growth achieved in 2021 off the pandemic nadir of 2020.

Valuation

History has shown that higher inflation typically results in lower equity valuation multiples (Chart 1) which explains why so much attention has centered on resurgent inflation.

Inflation Greater than 4% has Historically Led to Significant Multiple Compression

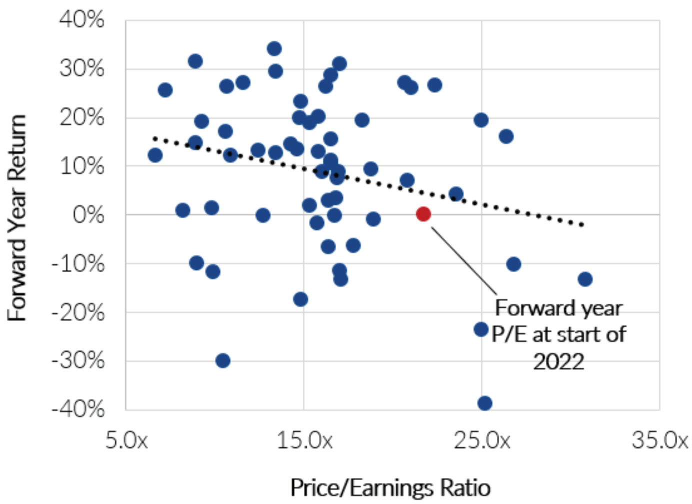


Source: Strategas.

Chart 1

The S&P 500 currently trades at 26x trailing 12-month earnings and 21x forward 12-month earnings, levels that are higher than historic averages. Certainty that inflation will get worse from here is unknowable and it is plausible that we have reached "peak inflation" growth as we lap last year's elevated economic data, and the world has time to alleviate the bottlenecks in labor and goods. Regardless, the previous 50 years of history indicate forward year returns generally have been higher when the starting valuation is lower (Chart 2).

Forward Returns Benefit from Lower Starting Valuations



Source: Bloomberg data.

Chart 2

Portfolio Construction

Throughout 2021, we were constructive on equities and we continue to believe that equities are the best asset class to compound wealth over the long-term. Nearer term, it seems quite possible that we will see an increase in market volatility. In our opinion, 2021 was as close to market nirvana as one could hope for with the largest equity pullback in the U.S. being about 5%. Despite the variants of Covid there does not yet seem to be a variant that will meaningfully reverse the global economic rebound. This should allow for more segments of the economy to recover and create a broader opportunity set within markets.

We continue to believe market leading companies with earnings durability and high-quality franchises are attractive. The U.S. remains our largest equity allocation and we continue to favor Asia outside the U.S. Southeast Asia[3] looks increasingly attractive with earnings expected to double from 2020 to 2022, modest current valuations of 13.7x FTM earnings[4] and minimal analyst coverage, allowing for inefficiencies. Our work in private equity continues to uncover extraordinary examples of innovation occurring in healthcare, technology, materials science, and other industries. Uncorrelated diversifiers continue to be a focus for us, generating strong risk adjusted returns in niche investments that avoid the crowdedness of other asset classes. Within traditional fixed income, we continue to focus on owning shorter duration securities with an emphasis on investment grade quality and maintaining liquidity. If equity markets do exhibit an increase in volatility, we believe it will be beneficial to have "dry powder" available to re-invest into equities at attractive valuations. The pandemic has been humbling but it continues to reveal that new opportunities are ever-present, and investors with a long-term horizon can benefit materially by being proactive, and receptive to disruption.

[3] The Philippines, Indonesia, Malaysia, Thailand.

[4] Source Bloomberg. MSCI EM ASEAN Index in US$.