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D.F. Dent All Cap Growth Strategy

January 2021 Commentary

After three quarters of extreme market gyrations, the fourth quarter of 2020 proved to be equally as eventful. The S&P 500 started the year off strong, continuing the rally of 2019. However, the emergence of COVID-19 in late February led to a fast and furious decline in the market. The S&P 500 dropped -35% from peak to trough in February and March before staging one of its sharpest rebounds on record during the ensuing months. The markets were led by the ongoing strength of mega-cap technology stocks, which were perceived as beneficiaries of the pandemic. During September and October, markets took a pause; however, November's election and positive COVID-19 vaccine news sparked a strong rally through year-end. After a handful of mega-cap technology stocks accounted for much of the index gains during the first nine months of 2020, the rally widened in November as 467 of the S&P 500's stocks rose. The month marked a rotation out of the year's most popular stocks. Capital flowed into companies that had been hurt the most during the pandemic, including cyclical sectors such as financials, energy, and hard-hit travel and hospitality companies.

Portfolio Thoughts

Growth stocks generally performed quite well during 2020. Several strategic sectors and themes within D.F. Dent's portfolios were key drivers for 2020 performance. Technology stocks were large beneficiaries of the changes brought on by the pandemic as many people turned to online solutions for work and home needs. Within technology, we focus on finding well-managed companies, oftentimes in "winner-take-most" niche markets. One area that we find particularly attractive is cloud-based software-as-a-service (SaaS) companies with their "build it once, sell it many times" business models. Companies in this space were generally strong performers during 2020. Many life sciences companies have also performed well this year. Beneficiaries include companies that develop instruments and consumables for life science research and clinical diagnostics, some of which were used to develop COVID-19 testing, therapeutics, and vaccines. We have focused on trimming our portfolio winners where high valuations have lowered our return expectations. We have then redeployed that capital into stocks where we see more upside potential.

In the fourth quarter, some of the D.F. Dent holdings lagged the market amidst a rotation into more cyclical stocks that had underperformed for much of the year. During this rotation, "high-quality" stocks based on the S&P quality rating (B+ rating or better by earnings and dividend stability) significantly underperformed "low-quality" stocks (B rating or worse). Low-quality stocks have been the better performers recently as vaccine news and another round of stimulus led investors to seek out stocks that had previously underperformed and, as such, may have had lower valuations and more snap-back potential. It is not surprising that D.F. Dent portfolios would underperform in this kind of market. While the recent rotation towards lower-quality stocks may be impacting our portfolios in the short-term, we believe that our high-quality bias has driven our long-term outperformance and will continue to do so in the future.

Market Thoughts

While few, if any, of us could have foreseen the emergence of COVID-19 around the globe, predicting the impact on the economy, the market, various industries, and on civilization broadly has proven equally challenging. The scale and scope of the pandemic is unprecedented in our lifetime. One could try to look to prior pandemics as a guide. In fact, some of the public health interventions that have been embraced – social distancing, lock downs, and face masks – aren't quite so unheard of when studying pandemics of the past. However, it is a different world today than it was 100 years ago when the likes of Polio, Smallpox, or the influenza of 1918 ravaged nations. Smallpox, the only disease to be completely eradicated around the world through vaccines, saw a vaccination effort that spanned centuries. The complexities of influenza have baffled researchers for decades. It took over 20 years to develop a polio vaccine. And yet, scientists have been able to develop a COVID-19 vaccine in less than 12 months amidst global collaboration and government support.

During the 1918 influenza pandemic, it has been noted that President Woodrow Wilson, occupied with World War I, never publically addressed the influenza. During 2020, COVID-19 dominated the agendas of politicians and lawmakers around the world. The response of the U.S. Federal Government and Central Bank to buoy the economy and flood markets with liquidity was swift and strong. The $2.2T CARES Act was the largest stimulus by Congress in its history, and another package is forthcoming. Even during the Global Financial Crisis, it took three times longer to get a stimulus package that was only half the size. These reactions to the pandemic have been more unprecedented than perhaps even the pandemic itself and have had a tremendous impact on how the market has responded to and recovered from the crisis. They will continue to impact markets into 2021 and beyond, in our view.

As we look ahead, we are somewhat cautious given that the market has had a tremendous run over the last decade, with the most recent two years returning more than 50% for the S&P 500. We anticipate that news should be incrementally more positive than negative for the first part of 2021, so the market may have a slight upside bias. The improvement in overall market breadth since the election and positive vaccine announcements would seem consistent with such an outlook. With bond yields so low, investors are likely to continue to look to other asset classes for returns, which should benefit equities. The dividend yield on the S&P 500 remains well above the yield on the 10-year Treasury. Even with the likelihood of more muted returns in the equity markets, stocks continue to provide an attractive alternative to fixed income.

While the trend may continue upward in 2021, any substantial gains may be borrowing from future returns. Risks remain. The issues of higher interest rates, inflation, the durability and effectiveness of the vaccine, and elevated unemployment may weigh on the market. While earnings growth is expected to be strong in 2021, many companies are still only getting back to 2019 levels. Valuations appear elevated by historic measures, even taking into account low interest rates. As such, we suspect earnings growth will be the more important factor to move stocks higher. Additionally, a handful of mega-cap technology stocks account for a disproportionate percentage of major market indices, and the performance of the indices will depend heavily on the performance of those stocks. Having done very well for the past several years, those stocks may be poised for a pause. These factors lead us to believe that stock selection will be much more important going forward than in the past few years when investing in indices broadly has led to solid gains. We believe that our process of in-depth company research and stock picking are well suited to such a market.

While predicting market movements in the near term or anticipating tail risk events is difficult, at best, and a fool's errand, at worst, one of the many benefits of having an experienced investment team is the perspective that it provides us in times of uncertainty. While we fortunately have not lived through a global pandemic prior to 2020, members of our investment team have lived through many crises and their aftermath, including the Savings & Loan crisis of the 1980's, the dot-com boom and bust of the late '90's and early 2000's, the September 11th terrorist attacks, and the Global Financial Crisis, amongst others. This provides perspective and it teaches patience, persistence, and perseverance. It helps remind us that exogenous factors will continue to shock markets over time. Rather than attempt to predict them, we have learned to maintain composure in the face of crises, and most importantly to stick to our investment process. We have learned to assess risk and reward and the probability of future events in order to frame our investment approach. As we have in the past, we will aim to use the many lessons learned throughout 2020 to make us better investors going forward.

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Despite the challenges of 2020, the year provided an opportunity for reflection and prioritization from an investment perspective and a business perspective, as well as for many of us personally. We are proud of our team and our culture, which has endured even with the many changes brought by 2020. Our team rose to the challenges of the year with diligence, grace and empathy. We've learned how to work remotely, how to connect when we're forced to be apart, and how to hold meetings, calls, and attend conferences over Zoom and Microsoft Teams. We even enjoyed a virtual White Elephant holiday celebration together over Zoom. We have added several new colleagues over the course of 2020, including two this past quarter. Melissa Heathcote joined us in October as a Portfolio Administrator, and Ray Stochel joined us in December as a Research Analyst. We are thrilled to have them on board!

We are incredibly grateful for all of our clients who have continue to entrust us with managing their money. We look forward to the times when we can be together face-to-face for meetings once again. As always, please feel free to reach out to us with any questions or concerns. We welcome the chance to discuss your portfolios or just to say hello. We appreciate the confidence you have placed in D.F. Dent and Co and will continue to work diligently on your behalf.

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As we move into 2021, we wanted to highlight a few topics that might be relevant to our private clients.

Required Minimum Distributions: In 2020, clients with defined-contribution retirement plans (which includes IRAs) were entitled to waive required minimum distributions (RMDs) under the CARES Act. However, that exclusion has not been extended into 2021. Your custodian should likely be able to assist with the details of your RMD requirements. Please keep us posted on your desired timing for your distributions.

Gifting Stock: We wanted to remind our clients that as you consider charitable gifting priorities for 2021, gifting appreciated stock may be advantageous from a tax perspective. As always, you should consult your tax advisors, but we would be happy to help from an investment standpoint should this be a part of your charitable giving plan going forward.