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Equity Outlook

2020 - A Year We Won't Soon Forget

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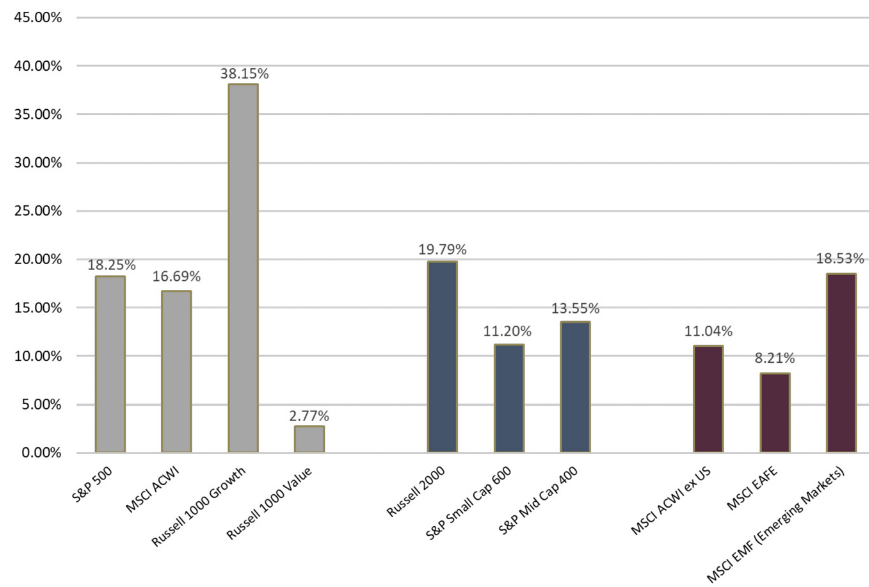
Following an outstanding 2019 for U.S. equity markets, 2020 began in a similarly encouraging fashion with cooling U.S./China trade tensions and a stabilization of global economic growth. The benchmark S&P 500 gained +5.1% through February 19 and appeared poised for additional returns. Unfortunately, the entire tenor of 2020 changed in late February and early March, as the Covid-19 pandemic spread from a largely regional concern and began to wreak havoc on all aspects of global life. As a result, equity markets entered one of the most volatile periods in history, dropping precipitously through late March, then roaring back in the second quarter and advancing much of the remainder of the year. Market-shaping events occurred regularly – from historic levels of stimulus from both central banks and fiscal authorities to support global economic recovery, to a U.S. presidential election season that provided countless surprises, to the astonishing accomplishment of Covid-19 vaccine development in such a short period. "Unprecedented" is a term employed far too often, but given the economic and market experiences of this year, it appears to be an accurate descriptor of 2020.

As 2021 dawns, the ongoing Covid-19 pandemic remains the overwhelming dynamic driving both macroeconomic conditions and equity market performance. Even as much of the world remains in some level of lockdown, optimism for a sustained global recovery continues to drive equity markets higher to begin the year. Overall, we believe the successful distribution and application of Covid-19 vaccines will be the key factor to a return to global synchronized economic growth as the year progresses, along with added stimulus from fiscal authorities and additional policy support from global central banks. While we do not expect the ongoing recovery to occur in a coordinated, linear fashion, we believe the potent combination of successful vaccine implementation and continued fiscal and monetary support will lead to accelerating corporate earnings growth in both 2021 and 2022, with most aspects of the real economy participating. In terms of market leadership, traditional cyclical themes have outperformed early in 2021, buoyed by hopes of sustained economic expansion and momentum trading; however, we anticipate growth stocks will participate in any market upside as well.

2020 EQUITY MARKET RECAP

For 2020, the benchmark S&P 500 delivered a total return of +18.3%, well ahead of its +10.8% average annual return since expanding to 500 companies in March 1957. The path of 2020's return was remarkable in itself; the S&P 500 entered a bear market from peak levels faster than at any point in history, dropping more than -35% from its February 19 peak to its intraday trough on March 23. Volatility exploded

Global Equity Returns FY2020



Source: FactSet 12.31.20

higher, as the CBOE Volatility Index (VIX) reached an all-time closing record of 82.69 on March 16. The average daily move in the S&P 500 was 5.0% in March, a truly stunning figure. Equity markets were characterized by indiscriminate selling with overnight futures hitting "limit up" and "limit down" levels on multiple occasions. For the first quarter, the S&P 500 posted a loss of -20.0%, the index's worst quarter of performance since the fourth quarter of 2008 and the worst first quarter in history. Smaller U.S. stocks struggled even more, as the as the S&P 400 Mid Cap and small cap Russell 2000 lost -30.0% and -30.9%, respectively.

However, global equities roared back beginning in late March, fueled by a needed snapback from oversold conditions, optimism over reopening the U.S. economy and a potential Covid-19 vaccine, and the simple idea of "don't fight the Fed" when both monetary and fiscal policy were committed to supporting the domestic economy through the pandemic and on the path to recovery. The S&P 500 gained +20.5% in the second quarter, the fourth best calendar quarter since World War II. With an additional +8.9% return in the third quarter, the benchmark had its best two quarter performance since 2009. Better-than-expected corporate earnings reports and the announcement of two promising Covid-19 vaccine candidates in November provided additional fuel for stocks in the fourth quarter. As of December 31, the S&P 500 had gained an astonishing +70.2% from its March 23 low in fewer than 200 trading days.

On a full-year basis, growth stocks continued their long-running outperformance relative to value counterparts, as the Russell 1000 Growth provided a +38.2% gain versus +2.8% for the Russell 1000 Value Index. The discussion over "growth versus value" was a popular topic, as the gap in performance had been significant for some time. Since growth stocks began their relative outperformance at end of the second quarter of 2013, the Russell 1000 Growth Index has recorded a cumulative total return of +265.2% versus +96.0% for the Russell 1000 Value Index and +172.2% for the S&P 500. Speculation over the reasoning for this outperformance has been wide and includes anything and everything from interest rate policy to the rise of systematic and quantitative trading strategies. Regardless, a familiar pattern emerged in 2020 whereby investors periodically began to anticipate a rotation from growth to value. Year-to-date growth leaders would periodically trail more cyclically-oriented laggards often more commonly found in value indices. This pattern occurred on multiple occasions over the course of the year, and, in each instance, market watchers debated the likelihood of a more lasting rotation from growth to value. This debate will continue in 2021.

How do we treat growth versus value at Franklin Street Partners? Specifically, we manage concentrated large-cap equity strategies, all benchmarked to the S&P 500, with a variety of style tilts as well as risk, return, and income profiles. We continue to favor growth-levered companies overall, particularly technology and consumer-related companies in industries such as digital graphics and video gaming, financial technology, and differentiated retailing. However, our positioning is not overwhelmingly levered to growth in any of our concentrated strategies at the current time, and we have carefully been adding some cyclically-oriented positions in recent times. Our investment process does not focus on a simple growth versus value framework; rather, we try to identify businesses in all sectors with sustainable structural, competitive, and/or economic advantages with attractive valuations.

International markets followed similar patterns to U.S. stocks – weakness in the first quarter gave way to better performance for the remainder of 2020. For the year, the MSCI ACWI ex-U.S. index gained +10.4% while the MSCI Emerging Market Index was up +17.0%. The Chinese Shenzhen 100, South Korean KOSPI, and Japanese Nikkei 225 led major international markets while indices in the U.K., France, and Germany lagged.

THE WINNERS AND LOSERS OF 2020

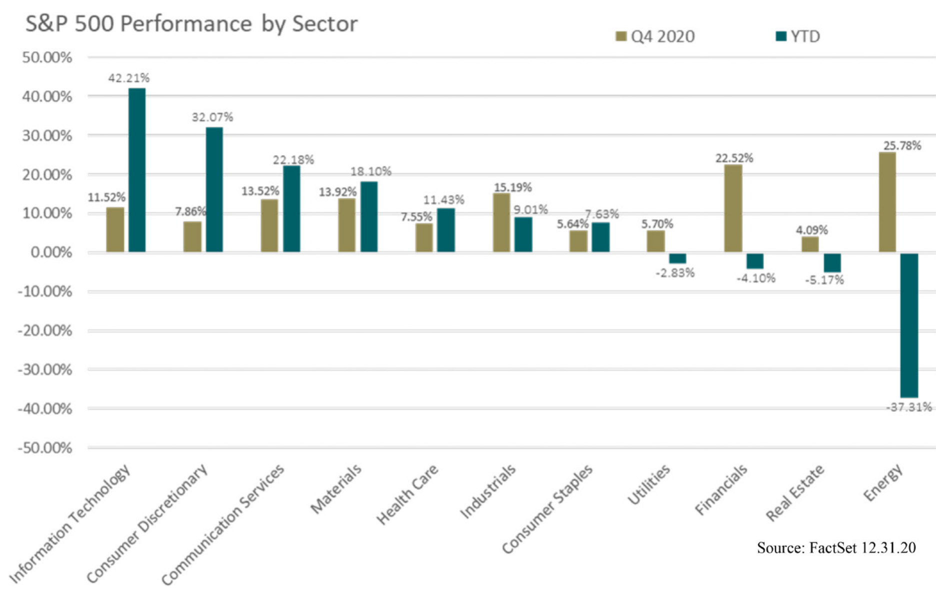
Throughout the year, much was written about the concentration of performance in a relatively small number of stocks, and terms like "FAANG" and the "Big 5" became well known parts of the investment lexicon. As of the end of 2020, the five largest names in the S&P 500 Index were Apple, Microsoft, Amazon, Alphabet (Google), and Facebook. Collectively, these five companies comprised nearly 24% of the index's total market value; this compares with 11.6% at the end of 2013 and represents the highest level of concentration in five companies since 1977 (IBM, General Electric, General Motors, AT&T, Exxon). Impressively, the five companies contributed nearly all of the S&P 500's return for 2020. While we are mindful of the dangers of excessively consensus thinking, we are not concerned by the idea of large positions, as by our own design, we actively manage high conviction and/or concentrated equity strategies. Although there are notable differences between the five companies, each shares a number of similarities: namely, asset-light business models with a large installed customer and/or user base that has a significant component of sticky, service-oriented revenues, strong balance sheets, and high switching costs.

Despite the overhang of Covid-19, the "Big 5" were not the only stocks to enjoy a truly successful 2020. A number of ongoing secular growth themes – financial technology and digitalization, public and private cloud storage and optimization, software as a service, among others – accelerated in the pandemic environment. In most instances, these trends were already prevalent, but the pandemic accelerated the adoption. We believe companies such as PayPal (PYPL) and Nvidia (NVDA) are longer-term, advantaged businesses that are uniquely positioned to emerge as stronger competitors as well as navigate severe economic challenges.

In addition to the aforementioned themes, several new themes entered the lexicon, none more so than "Work/Play from Home." The pandemic introduced an entirely new way of life from the workplace to recreation, and newer companies such as Zoom Video Communications (ZM) and Peleton Interactive (PTON) became universally known in short order. More established standbys like Lululemon Athletica (LULU), Lowe's (LOW), and Activision Blizzard (ATVI) also thrived during 2020, as consumers adjusted behaviors to invest in fitness, home improvement, and gaming entertainment.

On a year-to-date basis, several sectors underperformed the broader market, none more so than Energy. The sector's overall importance has waned in recent years for a variety of reasons, and comprised a mere 2.4% of the S&P 500 as of mid-December versus 12.0% at the end of 2010. Energy's path during the second quarter was particularly interesting; on April 20, the front month West Texas Intermediate (WTI, the benchmark U.S. grade of crude oil) oil futures contract settled at -$37.63 per barrel, a previously unthinkable situation driven by a short-term imbalance of supply and demand. By the end of the second quarter, benchmark WTI had traded back to over $39 per barrel and stood at $48.52 as of the end of the year.

In summary, 2020 provided yet another example of the fallacy of "market timing." According to J.P. Morgan, an investor who missed only the ten best days in S&P 500 performance from the beginning of 2000 to the end of 2019 resulted in an annualized return of +2.4% over that period, compared with an annualized return of +6.1% for someone fully invested over the entire period. Over that same 2000-2019 period, six of the best ten days in the S&P 500 occurred within two weeks of the ten worst days. Not surprisingly, a similar pattern emerged in 2020. The S&P 500 experienced its third worst day in history on March 16 (-11.9%) but followed that up with its eighth best day ever on March 24 (+9.4%). ***We strongly believe in the effectiveness of longer-term thinking and investing. Once again, past experience provides a valuable lesson – market timing is simply not a strategy worth pursuing.***



Source: FactSet 12.31.20

WHAT TO EXPECT GOING FORWARD IN 2021

Since the U.S. and a majority of the developed world began voluntarily shutting down much of its economic output and overall activity in March 2020, investors have speculated about the shape of the recovery and the path of the "reopening" process. Domestically, reopening has not been a coordinated, linear progression – the virus affected various regions at different times and individual states and localities have pursued vastly differing reopening policies based on any number of factors. As expected, there have been ebbs and flows during the process, with both pullbacks and accelerations requiring close attention as to the potential impacts on economic activity. Not surprisingly, economic data has been extraordinarily volatile, and we expect this to remain the case in the current year. Current FactSet consensus estimates suggest solid year-over-year GDP growth for nearly every major economy in the world in 2021, a return to the global synchronized growth last experienced in 2019. The median GDP estimate for the U.S. currently stands at 4.1% with the unemployment rate expected to fall from a current 6.7% to 5.9% by the end of 2021.

Even with the turn of the calendar, the resolution timeline for the Covid-19 pandemic clearly remains the largest determinant of equity performance due to its impacts on both global economic growth and corporate profitability. In the U.S., December was the deadliest month of the pandemic thus far, and both case numbers and hospitalizations continue to rise; this pattern has been repeated in many other parts of the world. Unfortunately, the consensus viewpoint of global health experts suggests worsening data early in calendar 2021. Several global authorities have responded by extending or intensifying lockdown conditions back to levels last experienced in the earliest days of the pandemic.

Despite those difficulties, optimism continues to grow for an eventual end to the pandemic and the return of sustained economic expansion. Fueling this optimism has been the successful development of multiple Covid-19 vaccines late in 2020 followed by the initial distribution and implementation of vaccines during the upcoming year. Early returns suggest the execution of vaccine distribution will challenge even the most developed nations and eventually require much more coordinated, organized cooperation amongst federal, state, and local governments, as well as health care officials and workers at all levels.

Current consensus expectations for a true "all clear" date following the vaccination process remain fuzzy with most observers forecasting a late 2021 target. The potential requirement of a "proof of vaccination" to participate in travel, in-person education, and

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- Expect volatility to remain as market weighs path and speed of recovery.
- Successful implementation of Covid-19 vaccines, additional fiscal/monetary support should help normalize patterns of economic expansion.
- Both 2021 and 2022 earnings estimates suggest strong YoY growth
- A "lower for longer" interest rate environment supports current equity valuations and enhances relative attractiveness of equities versus other asset classes.
- Traditional cyclical themes have outperformed early in 2021, buoyed by hopes of sustained economic expansion and momentum trading; however, we anticipate growth stocks will participate in any market upside as well.
- International developed stocks starting to appear more attractive.

attendance at many larger-scale events may accelerate the process. ***As we've discussed since very early in the pandemic process, the importance of effectively, widely distributed AND administered vaccines should not be underestimated given its importance to renewed economic growth and will continue to influence the broader direction of stocks.***

While the pandemic remains the primary factor affecting economic conditions and equity performance, there are once again other topics worth monitoring entering 2021. In our opinion, two stand out from the pack in terms of true importance – the new presidential administration and Congress' ability to deliver additional Covid-19 related fiscal support and stimulus, and additional accommodation in monetary policy from global central banks. These two factors, combined with the effect distribution and implementation of Covid-19 vaccines, will have vast effects on the drive toward coordinated global economic growth.

The range of estimates on corporate earnings was wide and volatile in 2020; S&P 500 estimates moved from $176 to begin the year, to $125 at the end of the second quarter, to $136 on December 31. 2021 S&P 500 estimates of $166 represent a +22% increase on a year-over-year basis. Importantly for market sentiment, the 2021 estimate is above the $161 earned in 2019. Given the potential for FY22 to represent the first full year of "normalized" economic activity, investors are already turning to FY22 earnings estimates to anchor equity valuations. Current 2022 estimated earnings for the S&P 500 stand at $194, a growth rate of +16.3% over 2021's estimate. *The S&P 500 benchmark is trading at a 19.6x forward P/E multiple of FY22 earnings estimates.*

In addition to various earnings outcomes, we must contemplate a wider range of valuation considerations. Over the last twenty-five years, the average P/E multiple on next-twelve-month S&P 500 EPS has been 16.6x. While the current P/E multiple of 2021 estimated earnings currently stands well above average, it is important to consider that stock prices are ultimately a function of future earnings and interest rates, and the absolute low levels of U.S. Treasury rates suggest a higher P/E multiple is justified. Ten-year yields should remain around 1% until investors have more confidence in the outlook for immunity; however, additional positive developments, such as the success of the JNJ trial, could provide a clearer path to an increase in 10-year yields. If yields breakout, Value will continue to move higher relative Growth, as has been the case over the past 3 months, but stock picking and broader themes would then replace factor trends.

FSP ASSET ALLOCATION AND INTERNAL EQUITY STRATEGIES

Over the course of 2020, we often emphasized the importance of investing versus market timing. As the year progressed, many client portfolios deviated from longer-term strategic weightings due to the extreme volatility in investment markets and performance deviations in various asset classes. In those instances, we continued to prudently rebalance, which involved selling asset classes that have outperformed and buying those that have underperformed. We added to equities in the downturn and also prudently recognized profits when appropriate following large upwards moves in equity markets.

Within FSP, we actively manage five primary large cap equity strategies with a range of return and risk objectives that represent style tilts to the S&P 500 benchmark – Strategic Growth, Partners Advantaged, Equity Income, Growth & Income, and Sustainable, Responsible Equity. Growth & Income uses a barbell approach, combining stocks from our core growth-oriented strategy (Strategic Growth) with our core value conservative strategy (Equity Income); and the Sustainable, Responsible strategy is a thematic ESG approach to our Partners strategy.

In the actively managed, internal equity strategies, we continue to focus on companies with distinct advantaged business models and longer-term secular opportunities, making changes in accordance with the style, risk, and reward objectives for each individual strategy. We continue to favor advantaged companies with secular growth opportunities, strong balance sheets, high free cash flow generation, and capital flexibility. Advantaged businesses are uniquely positioned to emerge as stronger competitors over the longer term as well as weather severe economic challenges. We believe 2021 will be another year where active management and stock selection become an important differentiator.

As we discussed, 2020 was truly an unprecedented year of historic economic and investment volatility, and 2021 may provide additional periods of unease at times. We understand the impact that such activity can place on investor anxiety and are always available for questions and concerns, welcoming the opportunity to discuss individual holdings. We thank you for your continued confidence.

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