

Economy & Market Valuation

The first quarter of 2021 has produced a lot of anomalies as far as the stock market and the US economy are concerned. The US economy in 2021 will witness the strongest growth in many years, but NASDAQ as measured by the Composite Index saw a correction in the first quarter. Increasing interest rates and expectations of rising inflation have introduced volatility in the stock market. The NASDAQ dropped more than 10% from Feb 12 to March 8. Our alpha portfolio returned **-2.53%** in Q1 of 2021. We understand that, for the clients who joined us during the first quarter, the decline has been very painful. For our older clients in the Alpha model, after seeing a 79% return in 2020, the anemic Q1 2021 return may feel like a blip in a long journey. Our Alpha Plus portfolio returned **5.99%** in Q1 2021. At one point during the quarter, it was up ~40%. So, it was a wild ride.

As you know, our Alpha model has been weighted towards technology stocks to capture growth. US stock investors had a major case of FOMO (Fear Of Missing Out) after seeing breathtaking 2020 returns. They bid up technology stocks further in 2021. With the success of vaccines, reopening of the US economy and \$1.9T stimulus package, the yield on the 10-year Treasury started going up (yields move inversely to prices). The reflation trade (movement of money to banks and energy stocks that can handle the inflation better) coupled with higher tech valuations proved to be a double whammy.

Our Alpha model comprises of three buckets of stocks:

- a) Nontechnology long-term compounders - This bucket includes stocks like Moodys, S&P Global, Berkshire Hathaway, Dollar General and so on. These companies have, among other things, proven revenue growth, high Return On Invested Capital (ROIC), stock buyback programs and an acquisition strategy.
- b) Established technology stocks- This bucket includes companies like Microsoft, Amazon and Facebook.
- c) High growth technology stocks- This bucket includes companies like Bill.com, Lemonade and Carvana.

Many high-quality stocks in the third bucket dropped by 30% or more from the peak of Feb. These stocks offer high return with high risk and high volatility. Higher return come at the cost of high volatility. We saw it panning out in the first quarter. We have been exiting/reducing many of our positions in the third bucket due to high valuations (Fastly, Magnite, Datadog etc.). We have initiated positions in companies like Thermo Fisher and Dollar General, which mostly fall in the first bucket. In hindsight, recognizing the insane tech valuations of 3rd bucket, we should have acted aggressively in reducing exposure to the 3rd bucket.

A question has come up, how do we hedge the portfolio for increased volatility. We use cash percentage in the portfolio as a way to hedge against increased volatility. For example, we will

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increase the cash in the portfolio as a way to counter increased volatility.

We strongly believe that the bull market is not yet over. The multiple reasons behind our thesis are

- Federal Reserve is committed to keep interest rate lower till full employment is reached. They are even willing to let inflation go higher than 2%.
- Economy is going to see very strong GDP growth rate in 2021 and 2022 as it reopens.
- The employment number is close to 9 million less than pre covid employment. It will take some time to get to full employment.

We plan to stay close to fully invested. You may see some shift between the different buckets - more from 3rd bucket to first bucket and higher cash percentage as we deem fit.