Key Takeaways from the Recent Equity Rally

We think a closer look at how certain areas of the equity market performed during the recovery from the March lows may provide insights on the winners and losers of the post-shutdown era.

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For 2020, the Key Word for Equity Returns Has Been "Dispersion"

1 Large Caps Have Outperformed Small Caps

Index	Total Return (YTD thru 5/15/2020)
S&P 500	-10.69%
Russell 2000	-24.25%

2 Growth Has Outpaced Value

Index	Total Return (YTD thru 5/15/2020)
Russell 1000 Growth	-0.14%
Russell 1000 Value	-22.44%

3 Investors Have Favored Innovation-Focused Sectors

Index	Total Return (YTD thru 5/15/2020)
S&P 500 Health Care	4.89%
S&P 500 Technology	2.35%
S&P 500 Consumer Discretionary	-3.40%
S&P 500 Energy	-9.20%

Source: Bloomberg. Data as of May 15, 2020. For illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment. Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment. **Past performance is not a reliable indicator or guarantee of future results.**

The speed of the equity market reversal in late March and April has stunned many market watchers, who ask how markets can rally in the face of rapidly deteriorating economic and employment data, both in the United States and around the world. The simple answer is that markets have always been forward looking; they sold off before the negative data materialized, and bear markets historically have reached their lows and begun to rally well in advance of the end of a recession.

However, a closer examination of equity markets shows this rally is more nuanced than the early pricing of a simple "return to normal" scenario for the economy. Quite the contrary, performance across market capitalizations, industries, and other important factors–growth and value, for example–has been extremely varied (see illustration), suggesting that for some parts of the equity market, investors appear to be anticipating some lasting effects beyond temporary economic damage.

Which Companies May Survive ...

Markets, looking beyond the immediate economic data, appear to be contending with two major questions. First, which companies are likely to survive and which are not? Large cap companies often have more operational flexibility, more resources, and better connections with government entities and financing sources than smaller businesses. Smaller businesses are often more at risk for supply chain disruption as well, without the robust operational redundancies that larger companies typically enjoy. Given this competitive landscape, it makes sense that large caps have outperformed small caps. It is worth noting, however, that small caps have often led protracted market rebounds in the past. Though not yet the case, as uncertainty wanes, we would expect select, growth-oriented companies in the small cap arena to lead again.

Value companies are also more at risk during an economic slowdown than growth companies because they are more economically sensitive, typically have higher leverage, and are in industries with lower gross margins than their growth counterparts. Though investors often think of growth as "high beta," the cyclicality and risk of value companies is actually a primary reason investors historically have demanded higher returns from this group. The pace of change and disruption has not been kind to value companies even before this pandemic, and we think the market is rightly judging that pace to be faster in the future, putting many value business models at risk of displacement.

... and Which May Thrive?

The second major question the market is considering is: Which industries and business models are expected to thrive in the new economic reality post-shutdown? Some industries are highly vulnerable to the effects of the measures to curb the virus, beyond the economic impact that affects all companies. Cruise lines, hotels, airlines, restaurants and many other industries have high overhead, and require a critical volume of business to stay afloat – volume that may not materialize until it is too late.

Some industries will be resilient, especially those featuring innovative growth companies that thrive on change. Many of these can be found in the healthcare sector; of course, not only those that are directly developing treatments and helping manage through the effects of the coronavirus but also companies that address longer-term issues associated with an aging population and a constantly changing industry landscape. Information technology companies that enable remote working and productivity enhancement in a changing world also stand to benefit despite an overall decline in economic activity.

Summing Up

Of course, not every troubled value company will default, and not every winner of the COVID-19 era will continue to deliver on its potential. While successful managers can help to identify winners and losers during this period of change, we would suggest that traditional style boxes may be overly reductive and fail to differentiate between companies with past growth and those that are reaching an inflection point of their innovative potential. Similarly, "value" can include dividend-heavy, maturing businesses, highly regulated financials, or troubled energy companies, yet there are many other firms in this category with the resources and dynamism to dominate their industries as we emerge into a new and different environment. The COVID-19 virus has unquestionably changed the world. We believe that flexible investment mandates and deep, industry-focused research capabilities will prove to be crucial in adapting to this new investment landscape

A Note about Risk: The value of investments in equity securities will fluctuate in response to general economic conditions and to changes in the prospects of particular companies and/or sectors in the economy. While growth stocks are subject to the daily ups and downs of the stock market, their long-term potential as well as their volatility can be substantial. Value investing involves the risk that the market may not recognize that securities are undervalued, and they may not appreciate as anticipated. Smaller companies tend to be more volatile and less liquid than larger companies. Small cap companies may also have more limited product lines, markets, or financial resources and typically experience a higher risk of failure than large cap companies.

No investing strategy can overcome all market volatility or guarantee future results.

Forecasts and projections are based on current market conditions and are subject to change without notice. Projections should not be considered a guarantee.

This article may contain assumptions that are "forward-looking statements," which are based on certain assumptions of future events. Actual events are difficult to predict and may differ from those assumed. There can be no assurance that forward-looking statements will materialize or that actual returns or results will not be materially different from those described here.

Statements concerning financial market trends are based on current market conditions, which will fluctuate. There is no guarantee that markets will perform in a similar manner under similar conditions in the future.

Glossary of Terms

Beta is a measure of a stock's volatility in relation to the overall market. By definition, the market, as represented by the S&P 500 Index (see below), has a beta of 1.0, and individual stocks are ranked according to how much they deviate from the market.

An **investment mandate** is an instruction to manage a pool of capital—a particular pile of funds—using a specific strategy and within certain risk parameters. The mandate will vary depending on the goals the owner has for that money.

A **style box** is a nine-square grid that provides a graphical representation of the "investment style" of stocks and mutual funds, covering the ranges of market capitalization (small, mid, large) as well as value/blend/growth categories. The concept was developed by Morningstar Inc.

The **Russell 1000® Growth Index** measures the performance of those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values.

The **Russell 1000® Value Index** measures the performance of those Russell 1000 companies with lower price-to-book ratios and lower forecasted growth values.

The **Russell 2000® Index** measures the performance of the 2,000 smallest companies in the Russell 3000 Index, which represents approximately 10% of the total market capitalization of the Russell 3000 Index.

The **S&P 500® Index** is widely regarded as the standard for measuring large cap U.S. stock market performance and includes a representative sample of leading companies in leading industries.

Indexes are unmanaged, do not reflect deduction of fees and expenses and are not available for direct investment.

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