3rd Quarter 2020

Stocks added another quarter of gains even after a rough patch in September. The S&P 500 and NASDAQ both posted strong gains in July and August before hitting a stretch of higher volatility in September led by some of the largest growth and technology names. The S&P 500 and Dow Jones Industrial Average gained 8.5% and 7.6% respectively for the quarter. Small cap stocks and international stocks lagged, but still gained over 4.5% each for the quarter. The aggregate bond index was basically flat for the quarter and the 10-year Treasury yield ended the quarter at 0.68%.

The volatility experienced in the tail end of the quarter was largely unavoidable in our opinion. A good deal of froth had built up in the market, concentrated in several highly valued growth technology names. Stocks had risen sharply from the lows and we should expect them to experience pullbacks along the way. The five largest stocks by market capitalization reached a level of over 40 times earnings during the July/August rally (up from 30 times at the end of Q2). This is not too far from the extreme level of 50 times earnings at the peak of the dotcom/technology bubble in early 2000. So, while we are very cognizant of the risks in specific parts of the market, most stocks that make up the rest of the market still trade at reasonable valuation levels. The PE ratio for the S&P 500 when excluding the largest tech names is a more reasonable 17 times earnings. We see the market as highly bifurcated and we are focused on stocks with stronger valuation support and thus improved upside to downside potential over the next 3-5 years. Many of the cyclical, value-oriented names we own trade at wide valuation discounts to the market and have shown good relative outperformance during the periods of high volatility in the concentrated growth/tech names. Over the long run there is a very strong inverse relationship between the starting valuation of an investment and the future investment return. All else equal, the lower the starting valuation the higher the forward return and vice-verse.

We think it is likely that the market is setting up for a period like the one that followed the peak in the growth stock outperformance that led up to early 2000. In the period following the tech selloff, the next year had big tech down 57% while value sectors like consumer staples, and financials were up 40%, healthcare was up 26%, energy stocks rose 18%, and industrials gained 16%. The broadening out of market leadership from a very concentrated level (like we see now too), benefited investors who stuck with good value portfolios.

Every period of a market boom/bust cycle is a bit different, but usually include the period where lagging styles and sectors play catch up. Overvalued stocks eventually fall from the weight of their own lofty valuations- but they are usually triggered by a tightening of monetary policy and rising interest rates. The Federal Reserve is expected to stay very accommodative until at least 2023 with a low rate policy, so we could be in for a period where the mega-cap names stay fairly inflated for some time (with higher bouts of volatility around them like we saw in September), while the rest of the market plays catch-up. This underscores the importance for investors of not selling out of the wrong names just because there is risk in other parts of the market.

We get asked a lot about what we think of the election and the market implications. The easy call is that there will be much more volatility in the coming weeks and months. More importantly though is how we react to it. Markets hate uncertainty—and we are amid a lot of uncertainty around the presidential election, and the congressional races and the balance of power there. It's important to keep in mind that the link between an election result and the impact it has on markets is not always clear. The 2016 election is a good example of this, when stocks sold off initially upon the election results and then went on to a strong rally to defy the pundits. The reality is that there are just too many non-election variables that play into investment outcomes over time for us to have any edge in positioning portfolios in advance of an election for any specific outcome. If you look historically, the stock market has experienced declines in election years when incumbents lose. But they have typically rebounded strongly in the following year. So, unless you have a really

short time horizon for investing, elections should not play too much into your long run thinking, nor have much effect on long term investment returns. While we do not want to make a macro call on the election, we recognize that every period is different and this one encompasses a deeply divided electorate, massive monetary and fiscal stimulus, the ongoing pandemic, and the economy recovering from the depths of a recession to name a few. More than enough to drive high levels of uncertainty and volatility. But again, the important thing is how one reacts to this. We will keep focused on the reality that good companies will perform well over time and still have the tailwind of low interest rates by the Fed.

If we do get more volatility from the election- our stance will be no different than it was in the heat of the coronavirus selloff. Know what you own and hold onto quality businesses through periods of market volatility- because drawdowns do not reflect permanent loss of capital. Low rates, a weaker U.S. dollar, low energy costs, and plentiful liquidity should all help support a recovery. But valuation support in the specific companies, sectors, etc. is what gives us more confidence in the resiliency of equity portfolios.

From a total portfolio perspective, the focus is always on a framework for the potential risks and returns for various asset classes and those investments within each asset class. The benefits of low or non-correlated investments show their merit in periods of heightened volatility and can be a source of incremental yield in a world of low interest rates. For portfolios that include fixed income, a balance can be struck between the need for stability from core bonds as a ballast and more flexible/opportunistic strategies that can be selective with credits and sectors that adequately compensate for the added risks.

While there are always short-term risks lurking, putting a high degree of conviction on any one macro outcome seems imprudent. That said, investors do need to calibrate their equity exposure to both their long-term growth goals and their level that lets them sleep well at night and not be overly fearful of stock volatility. Building out an investment plan with broad portfolio balance of risks and diversification across multiple asset classes and strategies can go a long way in helping to meet goals and stay invested during times of heightened uncertainty. We are here to help you in this endeavor to meet your goals.

Stay well and reach out at any time if we can be of help.

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