2nd Quarter 2020

Stocks experienced a strong rebound rally in the second quarter, posting a 20% return. This, following the coronavirus-led selloff just one quarter earlier where stocks declined by 20%. The quarter was characterized by massive levels of fiscal and monetary stimulus to support the stalled economy and periods of volatility surrounding the shape and durability of the economic recovery. In the end the major market averages were all positive. The S&P 500 index rose 20%, the Dow Jones Industrial Average gained 18%, the NASDAQ was up a strong 31%, MSCI EAFE International stocks were up 14% and the aggregate bond index was up by 2.4%. The S&P 500 index and the Dow Jones are both still down on a year to date basis by 4% and 10% respectively. The Value Line Geometric Index (a very broad measure of the median stock's performance) is still down 22% year to date; which reflects the broad weakness among stocks outside of the largest capitalization names that dominate the S&P 500 index.

For much of the quarter investors were fully willing to embrace risk-taking as the market cheered the stimulus and liquidity support and looked past the Covid-19 induced lockdowns to begin pricing in a strong economic recovery. In our last quarterly review we included a chart that illustrated the point that major declines in stocks (while painful at the time), are typically followed by sharp rebounds – and we made the point that it is not advisable to sell stocks in the heat of a decline. We were rewarded for following that advice and added to exposure on the weakness. The new chart below from Bespoke Investment Group includes the data from the recent rebound from the March quarter. The rally in the second quarter was well ahead of the average rebound following a major decline.

S&P 500 15%+ Quarterly Drops

Quarter Ending	% Chg	Next Qtr %	Next 2 Qtrs %	Next Year %
Dec-29	-28.88	17.20	-4.62	-28.48
Jun-30	-18.62	-9.14	-25.02	-27.52
Dec-30	-17.48	8.80	-3.32	-47.07
Sep-31	-34.52	-16.37	-24.72	-16.79
Dec-31	-16.37	-9.98	-45.44	-14.78
Jun-32	-39.40	82.39	56.21	146.28
Mar-33	-15.46	86.50	66.15	81.54
Dec-37	-23.33	-19.43	9.57	24.55
Mar-38	-19.43	36.00	44.00	29.18
Mar-39	-16.44	-1.09	16.48	10.93
Jun-40	-18.06	6.81	6.01	-1.30
Sep-46	-18.83	2.27	1.40	1.00
Jun-62	-21.28	2.78	15.25	26.70
Jun-70	-18.87	15.80	26.72	37.10
Sep-74	-26.12	7.90	31.19	32.00
Dec-87	-23.23	4.78	10.69	12.40
Sep-01	-15.00	10.29	10.23	-21.68
Sep-02	-17.63	7.92	4.04	22.16
Dec-08	-22.56	-11.67	1.78	23.45
Mar-20	-20.00	19.95	?	?
	Average	12.09	10.35	15.25
	Median	7.36	9.57	12.40
	% Positive	70.0%	73.7%	63.2%
Avg. All Other Periods		1.37	3.44	7.34

The pace of the rally has slowed recently as the market digests the strong gains in light of the renewed fears from rising Covid case counts and the pressure this is putting on the re-opening process in many parts of the country. Prior to the recent uptick in the number of new cases, much of the high frequency economic data was signaling a strong rebound in activity from the lows as the economy reopened. The Federal Reserve's own short-term gauge of activity, the Weekly Economic Index, bottomed out in April and has been rising. Market leadership was confirming this breakout with strong performance from cyclical stocks. The Fed has clearly adopted the "do whatever it takes" mentality to support the economy and markets and the Congress is working up plans for even more fiscal stimulus. These are powerful forces indeed. But as we saw with the first roll-out of stimulus (the PPP program and the direct payments to individuals), the execution can be clunky and inefficient at times.

The biggest risk to the growth outlook that got underway in April is still the virus. This will remain as a source of headline risk in the absence of a vaccine. While we may be able to avoid the large-scale lockdowns, regional lockdowns or scaling-back on re-openings are very possible (and occurring now in some places). Balancing this risk is the reality that the medical experts have come a long way in understanding this virus and discovering breakthroughs in treating severe cases to reduce deaths. So even as the new case trend is rising again, an encouraging sign is that the new death rate is lagging this increase in spread.

As for market risks, we see valuations as challenging for the broad market. The S&P 500 trades at a PE ratio of 21 x forward earnings estimates. The median PE of the 5 largest stocks in the S&P 500 is 30 x. The market capitalization of the S&P 500 has continued to rise even as corporate profits peaked in 2015 and were already moving lower even before the Covid-19 crisis hit. The last period in market history where prices diverged so widely versus the profit trend was in 1999. When the gap widens too large between prices and corporate profits, it tends to close by prices reverting to the mean. Six of the largest technology stocks make up over 22% of the market-cap weighted S&P 500 index and exert upward pressure on the index as more flows come into the large cap index space.

While prices have rebounded sharply, FactSet data has S&P 500 earnings projected to decline by 22% in 2020. This same projection at the beginning of this year was for earnings to grow by 9%. The uncertainty around near-term earnings is exacerbated by the large number of companies that have withdrawn their earning guidance for this year due to the extreme level of uncertainty in the current business environment. This makes valuation analysis more difficult. At the same time, it reinforces the point that we adhere to which is to err on the side of a lower valuation in terms of what to own. Conversely, be careful about owning highly valued, priced-for-perfection companies in an imperfect environment.

Our equity portfolios are concentrated in companies that trade at a valuation discount to the broad market, and where we see several years of price appreciation potential more than what the market is priced to deliver. The bidding up of the market multiple, and its top-heavy concentration in a handful of the largest technology names, increases the odds of more market volatility to come. And with that, comes the potential for the price to value gap to close suddenly with any disappointments around earnings or the economic recovery. There is an old saying on Wall St. that stocks tend to fall like you are taking the freight elevator on the way down and rise like your climbing the stairs up. That is certainly true of the action that we've see in stocks for the first and second quarters of this year. This is typically the way market action works after sharp declines. During periods where the market is climbing back from a sharp decline, there have been and typically are sharp periods of volatility during the climb. It's very hard to know at the time whether the market is moving to a re-test of the lows when stocks start to fall, or whether we are off to the races in a new bull market when they continue to climb. So, it is imperative for investors to anchor to something. What we choose to anchor to is not the movement of the market but rather the individual qualities, and the individual valuations, the individual price targets on normalized earnings and cash flows for each of the companies in which we invest. It is much easier to keep your cool and stay invested when these are the areas of focus as opposed to an overall call on the market's direction. As we've seen, the market has experienced a strong rebound from the lows in March. Where we go from here is less certain and we've highlighted a few of the risks. While we can say that the broad market valuation is challenging from these levels,

we see plenty of opportunity for companies whose risk/reward is superior and not fully reflecting the future growth potential in better economic times. In other words, they are priced for performance, rather than perfection.

Thank you for your trust and confidence.

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