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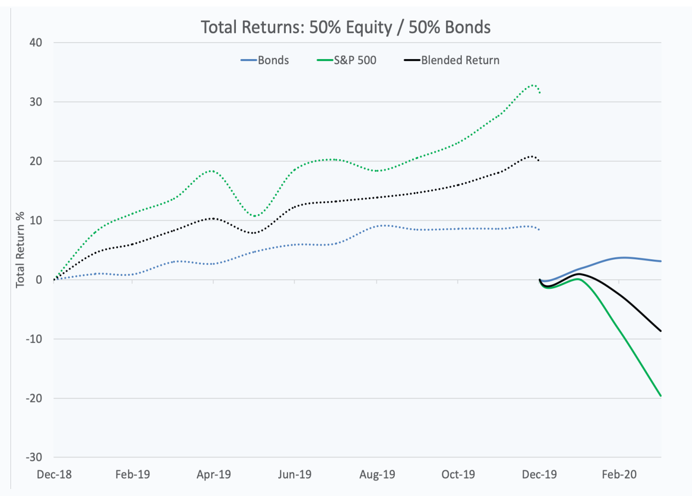
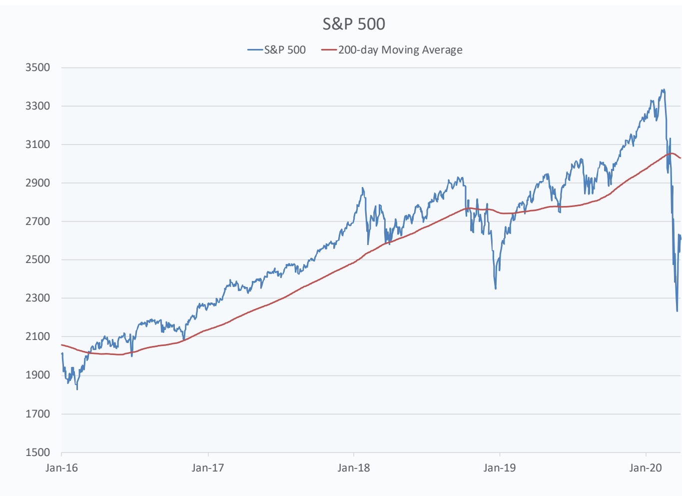
WHERE WE STAND – Q1 2020

The S&P 500 Total Return Index was down 19.6% (including dividends) in Q1 2020. See the solid green line to the right in the chart below. The Aggregate Investment Grade Bond Index (including interest) was up 3.1% for the quarter (blue line). If your portfolio comprised 50% S&P 500 and 50% Bonds, your YTD return would be -8.6% (black line). Data for 2019 is shown, broken lines, to the left.



Overview

The S&P 500 index collapsed by 20% in the 1st quarter, at one point, intra quarter, erasing all gains since late 2016. Investors marked down valuations of global equity and fixed income securities, as the certainty of a severe



international recession, brought on by the spread of a global pandemic, Covid-19, became a reality.
The damage across various international equities was severe. European Equities down 27.3%; Emerging Market Equities down 25% to 50%.

In response to equity market stress, and perhaps even greater dislocations in the mechanics of the global fixed income and foreign exchange markets, the Federal Reserve rushed to reduce their policy interest rate to effectively 0% from 1.5% at the beginning of the quarter (down from 2.25% a year ago) and pumped incredibly vast sums of liquidity into the US and global monetary system. These are highly significant actions and are unprecedented in size and aggressiveness.

By quarter end, some of the severe dislocations in security pricing, resulting from wholesale panic-led liquidations by completely offside investors in equities and credit-compromised fixed income securities, abated. Investors were somewhat placated by the actions of the Federal Reserve and its global counterparts. Helping too, were efforts by the US congress to institute a multi trillion dollar fiscal program to provide some sort of relief to an economy morphing into virtual paralysis as the pandemic spread. Again, these actions dwarfed those taken by the federal government in the great recession.

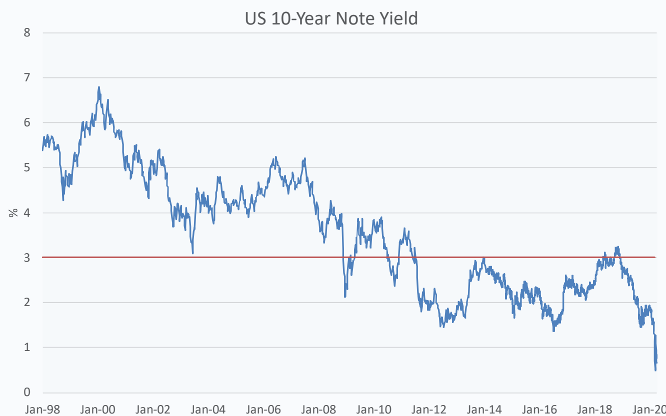
But, entering the second quarter, as community lockdowns are instituted and extended, the grim realization that the economy may be in for a more protracted recession continues to weigh on investor sentiment.

Exiting Q1 2020, lets summarize what has changed so we can determine how to respond.

1. Recession has arrived, to some extent or another, globally. Its important to note, too, that investors had drifted into complacency: thinking that the end to the expansion was indeterminate. Of course, this thinking was sucker punched by an

unprcedented total collapse in economic activity. This explains the severity and suddeness of the equity market collapse: the worst quarter in history.

2. Interest rates for non-stressed assets have collapsed, led by the US base rate at now 0% and



the US 10-year treasury rate at the lowest ever rate of now around 0.65%. Remember, ultimately, this is the rate from which all discount rates (plus a risk premium) are used to value financial assets. All things being equal, the lower the discount rate used to value a future cash flow stream that an asset generates, the higher the present value (or price) of that asset.

3. Equity markets (and various fixed income markets like High Yield bonds and Municipal bonds) corrected during the quarter, in some cases, markedly. Thus the potential for future asset returns has concomitantly risen if economic growth returns.

For us, we need to navigate this new landscape, if possible, in an opportunistic way.

We'll have to attach some probalistic outcome to the following questions.

1. How severe will the recession be and which securities will have their future cash flows affected the most and which the least.
2. When we apply the now lower discount rate to those expected cash flows, which securities are being valued too negatively, in which case we can invest in them.
3. What will happen to investor confidence? Will investors panic (as they did in 2009) and cause a wholesale rout in financial assets, or will we see improving statistics regarding Covid-19 and, aided by the fiscal and monetary stimulus mentioned above, return to normalcy relatively soon?

Where We Stand

For a while now, our strategy has been one of capital preservation, realizing that at some point we would come to the end of the current economic expansion and begin a new investment cycle.

Over the last year, according to our models, forward expected returns from equities had sunk to extremely unattractive levels. So we went liquid: assigning a value to the optionality of being in quasi-cash and, at the same time, we were earning as much as 2.5% on our short term money market investments.

Capital preservation is always important to us, and all our investments need to be of the highest quality in order to avoid devestating loss (losses one cant recover from over time), but the facts have changed and with the onset of recession, we can probably conclude that we are in the process of beginning a new investment cycle. When you look under the hood, there are some important investment categories that have been in a bear or corrective phase for some time now. For example, the Russell 2000 Index, an index of smaller US companies, peaked in August 2018 and at one point last month, was down 45% from that level. For US investors, European equities peaked in January 2018, and are off 43% from their highs.

Our strategy, therefore has shifted to being somewhat more opportunistic. Last quarter, our valuation models underwent the most dramitic shift that we have ever seen when looking at normalized earnings for US blue chip companies. Companies that, as a universe, will by and large survive recession and at some point point return to potential. The collapse in equity prices along with the sharp fall in interest rates meant that our internally generated Equity Risk Premium (the expected excess return from equities over risk free bonds) rose substantially to levels we cannot ignore. These numbers need to be adusted for reduced corporate buybacks, possible dividend cuts, reduced top line or sales growth, but still, we are entering a value zone.

As a result, having preserved capital in Q1, we started to allocate some of our cash to equities. Baby steps.

In addition, due to stress in various fixed income investments we found some opportunities to allocate funds into that universe too.

Going forward, our portfolios will start to take on a different complexion. Instead of static (or slowly rising) market value and steady low-ish income returns, they will become somewhat more volatile, with steadily increasing income, and ultimately capital returns. For example, we have made an allocation to a Prefered equity fund during the sell-off that yields 6%, from our money market fund

yielding now 1% (on the way to yielding less then 0.5%). While this is a diversified long term secure investment, it is subject to more volatility. But the return potential is greater.

The Covid-19 virus is no joke and we get that. The economic fall out could be enormous and we may be on the cusp of an intensifying bear market that still has further room to go. Technical analysts rightly point to the deterioration in the technical structure of various markets and we respect that and will handle our allocations accordingly.

As value investors, our plan is to patiently and cautiously, structure our portfolios into this new market phase, and with a medium to long term outlook in mind, build income generating, capital appreciating portfolios to benefit in the next investment cycle.

"In the world of securities, courage becomes the supreme virtue after adequate knowledge and a tested judgment are at hand"

Benjamin Graham