CAPITAL STRATEGIES
FINANCIAL CORPORATION
Navigating Financial Security

October 23, 2020

Financial Markets Commentary 3rd Quarter 2020

Summary

The U.S. stock market gained 8.9%[1] last quarter as investors gained confidence that the worst of the COVID 19 crisis was behind us. Still, it has been a tumultuous year and the risks are not all behind us. The S&P 500 is up 5.6% year-to-date, but the Dow Jones Industrial Average, which has less technology exposure, is still down -0.9%. Ten of the eleven industry sectors gained ground last quarter, four of them by more than 10%. The sole loser, energy, lost a whopping -19.7%. This highlights the huge difference between winners and losers this year. Technology stocks are up 28.7% and consumer discretionary stocks (think Amazon) are up 23.5% while energy stocks are down -48.1% and financial stocks are down -20.2%. All of the industries associated with higher dividends (energy, financials, utilities, and real estate) are down, while the next three (consumer staples, communication, and health care) are up only single digits. 2020 has been about buying companies poised to grow from the surging online economy. This just makes sense given our new COVID world. The problem for investors is that many of these companies – Roku, Shopify, RingCentral, for example – <u>are still losing money</u>. <u>Others like Zoom and Tesla trade at price-to-earnings multiples north of 500</u>. For context, the long-term price-to-earnings average for the stock market is around 16-17. There is no way to determine whether or not the online economy companies are fairly priced, since so much optimism seems to be baked into their stock price. Therefore, it is our belief that they are less of an investment and more of a speculation.

It is interesting to note the following regarding the S&P 500 Index as of October 16. The big five in the S&P 500; Apple, Microsoft, Amazon, Google and Facebook, since February 9th are up 33% while the other 495 stocks are <u>down nearly 1%</u>. Given that these five stocks make up 23% of the stock market's value on a capitalization basis, not owning them has been detrimental to most investors' performance during the same period.

Overseas, the returns were also pretty good. The MSCI All world ex-USA rose 6.2%[2] in dollar terms, with Europe gaining 4.5%, Japan gaining 6.9%, Asia ex-Japan soaring 10.7%, and Latin America falling -1.3%. All of these regions save Asia ex-Japan are still down year-to-date. Just like in America, the more the region featured technology the better it performed.

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[1] Source for all U.S. market and industry returns is JPMorgan Asset Management, 3Q20 Guide to the Markets, page 14.

[2] Source for region and country returns is Morgan Stanley Capital International, per Morningstar Workstation.

Those areas that were more natural resource dependent, such as Australia, Russia and Latin America tended to lag. A world caught in recession where demand is falling is likely to continue to see weak commodity prices. At the opposite end, Taiwan (all tech, no resources) rocketed up 16.5%.

Bonds are starting to feel the economic recovery as well. Modestly rising yields all but wiped out the quarterly gains on treasuries while riskier categories of the bond market had yields high enough to register very decent returns. (Remember, as yields rise bond prices decrease, and vice versa) Overall, the bond market gained 0.6%.[3] Inflation protected Treasuries (TIPs) soared 3.0% as inflation expectations rose. Straight treasuries gained just 0.1% at both the short and long ends of the maturity spectrum. Corporate bonds gained 1.5% as a whole, with A rated bonds up 1.1% and high yield "junk" bonds up 4.6%. Emerging market debt returned to positive territory on the year with a 2.4% gain. The relatively weak performance of the U.S. dollar this past quarter improved the return of foreign bonds to dollar-based investors. It should be noted that more than 100% of the bond gains in the third quarter came in July and August; yields were backing up in September and that has continued into October due to expectations of a stimulus package.

Activity

As it became clear that the economy had bottomed in the second quarter, we began to take our cash levels down last quarter. Not that we believe the economy is "out of the woods", so to speak, but the market clearly wanted to position itself for a post-COVID environment. Because we are deliberately avoiding the more speculative areas of the market, we have turned to hybrid securities – securities which have characteristics of both bonds and stocks, such as convertible bonds – to try to improve returns. We have also added either utility stock funds or hedged equity funds to try to more safely participate in the market advance.

Outlook

Politics can bring out strong emotions, but investors should tune out the noise and focus on the long-term because there is no major difference in market performance by party in the White House. See Figure 1. As long as the government continues to function post-election, we'll be okay. The markets care about corporate profits, both short and long-term. They will adjust to whatever reality they are presented with, but we can tell you the ONLY scenario they really fear is a protracted period of uncertainty.

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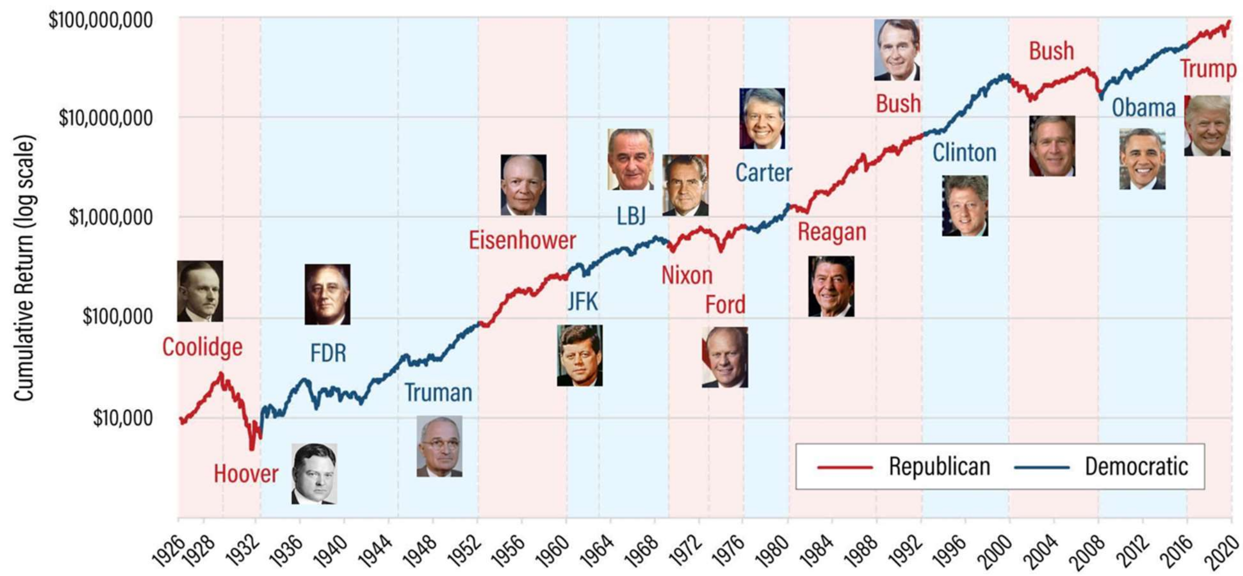
[3] Source: Barclay's Aggregate Bond Index per Morningstar Adviser Workstation

Figure 1: S&P Returns Through Presidential Cycles



Source: Affiliated Managers Group

The main areas of uncertainty today are the length of the pandemic and whether or not our government is able to pass an economic stimulus package that includes direct transfer payments. The recipients of those payments tend to be lower income individuals who spend them quickly thereby spurring real economic growth. Therefore, if 2021 brings a reliable vaccine and a robust stimulus bill, we expect economically sensitive industries like machinery, banking, and energy to outperform technology and health care.

Commentary – Winning the Loser's Game

Charles Ellis formulated one of the seminal ideas of investing in 1975. Titled "The Loser's Game" he argues there are two types of games, winner's games (in which you play to win) and loser's games (where you play not to lose). A winner's game, like golf, cannot be won by making par on every hole. Each participant has to strive to do better than everybody else, which necessitates a fair amount of risk taking. On the other hand, loser's games, where Ellis believes investing falls, simply requires one to play not to lose. Because there is no prize for coming in first, there are many risks Ellis argues investors should not take. If you can avoid big losses, you can stay in the game (invested) for twenty or thirty years - maybe more if you're young enough. It's almost impossible for your assets not to grow if your money is invested in a prudent manner for that long, he argues.

As you read the previous paragraph, you should notice two big caveats; "*if you can avoid big losses*" and "*in a prudent manner*". Of course, if you were to have bought Microsoft in 1986 and held it, or Apple in 1992, or Amazon in 1997, etc. you might laugh at the idea of caveats. At some point your portfolio might have been 90% in one of those one amazing stocks, and it still worked out for you.

Unfortunately, most of us are not going to have that kind of experience. We are not going to find that home run stock way before everyone else, and even if we did, we would probably not be able to hold it during protracted downturns. Would you have held Microsoft when it lost over 50% between December 31, 1999 and the end of May 2008? Could you have held it while Exxon and other oil stocks were almost tripling over the same time period? How about over the next nine months from June 2008 to February 2009, when Microsoft would lose a further 40%?

The point is, building considerable wealth by finding and holding one or a small handful of stocks is very difficult. It's not something we can plan on. Hindsight bias makes us think we would have held on to Microsoft but sold General Electric (which has lost over 80% from its peak), but we would probably be kidding ourselves. If we accept that we are unlikely to strike it rich, we are left with managing our portfolio as a loser's game – acting prudently and striving to avoid permanent loss of capital by employing diversification and patience.

Under all but the most dire historical circumstances, diversifying by industry type, market capitalization (company size), and geographical location has helped one avoid really big, permanent, losses. More than four hundred years ago financiers put together syndicates to finance merchant shipping, because nobody wanted to be ruined if all their wealth was in one ship and it sank in a storm. Today we can use asset classes such as bonds, precious metals and private real estate to better hedge against the risk of large losses. The tools are there for us to "win" the loser's game. The trouble is investors often are their own worst enemies.

It is very tempting to want to believe you can out-think everyone else. For example, you may feel the impulse to sell due to the political party in charge of the White House. As we highlighted in Figure 1 above, that's been a bad long-term strategy. Additionally, the idea that one can extrapolate industry winners from political events is just as misguided. You couldn't have done much worse than buying solar stocks when Obama was elected, unless you switched to oil stocks when Trump took office (in both cases you would have lost over half your money)[4]. Of all the harmful forms of conventional wisdom investing, election-related is among the worst.

Right now, investors are very enamored of technology stocks. This makes sense given how rapidly we are adopting new technologies since the onset of COVID. That said, the prices we are paying for MOST technology companies are ridiculous by any traditional valuation metric. Every so often, the valuation rules are re-written to accommodate a hot sector – be it technology, pharmaceuticals, energy, etc. This lasts until the expectations priced into the stocks get to a point where they cannot be supported by *any* growth scenario.

[4] Using Invesco Solar (TAN) as a proxy for solar stocks and SPDR Energy Select Sector (XLE) as a proxy for the oil market.

Eventually, investors start to realize that everybody else knows this too and the industry "reprices" significantly lower. One cannot predict when we will reach that point, only that we always have in the past. Nobody hands out free money[5] and the mathematics of recovering from steep losses are very daunting.

If this sounds a lot like the slow and steady wins the race argument, that's because it is. You want to be the "house" in Las Vegas, not the gambler on a hot streak. There has been a huge, and growing, gulf between winning and losing stocks and industries over the past decade. It reminds this multi-decade market veteran of past investment manias that ultimately didn't end well, and so, recall Charley Ellis and his wisdom: keep your losses manageable. Diversification doesn't help you win the investing game, but if properly done it ensures that you won't lose it.

A quote from Jack Bogle (the founder of Vanguard Funds) "Your success in investing will depend in part on your character and guts and in part on your ability to realize, at the height of ebullience and the depth of despair alike, that this too, shall pass."

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[5] **Once again Warren Buffett said it best "Nothing sedates rationality like large doses of effortless money" in Berkshire Hathaway's 2000 Annual Report.**