Michael D. Axel, CFA

Jacob D. Benedict, CFA

Ryan A. Kay, CFP®, AIF®

"If you stick around long enough, you'll see everything in markets, and it may have taken me to 89 years of age to throw this one into the experience, but the markets, if you have to be open second by second, they react to news in a big time way." – Warren Buffett[1]

"I'm really stunned at how tough it is to go through this – the medical costs, the economic costs, the psychological costs; everybody's lives have been completely upended, and that's not just the United States, it's the entire world…I wake up every morning and think 'Is this real or is this something I had a nightmare about?'" – Bill Gates[2]

Warning: This quarterly edition is a bit longer than usual. We apologize, but it's been quite an eventful few months. In addition, we want to offer another warning – there are a lot of unknowns, both about the coronavirus and the economic impacts, and *nobody* has a crystal ball. We will offer our opinions and perspectives, but we hope you treat them as that – opinions and perspectives (not facts). Finally, we encourage you to please reach out to us if you would like to discuss your investment portfolio or risk tolerance in more detail.

Stocks started the year off strong but then witnessed their fastest drop in history, quickly falling over 30% from their highs before ending the quarter down 20% year-to-date. International stocks fell approximately 23% during the quarter. U.S. Treasury bonds rose 5%, although other parts of the bond market performed worse in the midst of a global "flight to safety."

We watched with some concern as coronavirus case counts increased in Italy in late February and early March. We even took a few defensive actions within our portfolios. But we *did not* foresee a near-worldwide economic shutdown and the associated implications on markets and some of our portfolio holdings. Indeed, the Asian countries that first confronted the virus (China, South Korea, Singapore) had decent success controlling it and began to re-open their economies within a few weeks or months. South Korea has kept its case counts around 10,000 and deaths relatively limited through intensive early efforts around testing and isolation. It seemed as if this potential epidemic would follow the patterns of earlier epidemics such as SARS or MERS. Unfortunately, the Western world has not been able to replicate this success, in part due to the fact that this is a new risk for us (whereas Asian countries battled epidemics before, including SARS in 2003). Indeed, the US now has more cases than any other country with over 500,000 and growing (and likely many more undocumented cases). And even the Asian countries that showed initial success are now battling re-introduction of the virus.

The entire world faces an extremely challenging period where fighting the virus has resulted in a near total shutdown of the economy. Restaurants and bars are closed. Events are cancelled. Schools have been suspended. Airports are empty. Modern global capitalism is built around commerce and even deep recessions see a baseline of economic activity.

It should also be noted that there was a second global punch that has been less discussed in the news media. In the midst of the economic shock, OPEC+ essentially fell apart. OPEC+ is an informal alliance of oil-producing countries that work to support the price of oil. It was widely expected that OPEC+ would keep in place current production limits in order to support oil prices during a period of weak oil demand.

---

1 Interview with Yahoo! Finance, March 12th, 2020
2 Interview with Fox News, April 5th, 2020
3 As measured by the S&P 500 index.
4 As measured by the relevant MSCI international indices.
5 As measured by the FTSE 1-10 Year Government Bond index.

However, Russia and Saudi Arabia didn't see eye-to-eye, and Saudi Arabia essentially went for the nuclear option, vowing to produce to the hilt and thereby crush oil prices. Back in the day, this would have been good news for the American economy since we used to be oil importers and US consumers would have benefitted from lower prices at the pump. But over the past decade America has become a leading oil producer given improvements in oil extraction technology (indeed, this is what spurred our economic recovery immediately following the financial crisis). Saudi Arabia's goal seems to be to weaken the U.S. oil industry and this will have negative impacts on the wider US industrial base. Oil prices fell by two-thirds during the quarter, exacerbated by a historic drop in demand for energy as planes and cars sat idle. Thankfully, OPEC+ recently returned to the negotiating table and enacted material cuts, although it is still to be seen whether these cuts will be enough to support the market given the steep drop in demand. Warren Buffett referred to the development of the coronavirus and oil price war as a "one-two punch" for markets during the quarter.

Both central banks and federal governments are taking extreme action in an effort to "bridge the gap" during the virus-imposed shutdown, rolling out programs that would have been unthinkable in earlier times. Their efforts are clearly helping support the markets, although it is unclear whether it will be enough to mitigate all of the risks that come with such an unprecedented situation.

How long will this shutdown last? We wish we knew the answer to that. We've read too much about the coronavirus and its many dimensions, as we are sure many of you have. Experts seem to think a permanent solution won't be reached until we have a vaccine in *perhaps* 12-24 months. But life could start to return to a quasi-normal state much sooner than that if several things occur: (a) the case counts peak,[6] (b) the country is able to roll-out much more comprehensive testing services, and (c) drug companies confirm an effective antiviral treatment for the virus using existing medicines (several trials are underway, with some reason for optimism). The economist Peter Orzag recently wrote:

> With a therapeutic drug that makes it possible for more people to easily weather and survive Covid-19, those who have not yet had the disease could feel more comfortable returning to work in the office, shopping at stores, and engaging in other in-person commerce. And with an effective antibody blood test, we would know who already has had the disease and is presumably immune to a recurrence. Both these innovations are likely to be available well before a vaccine is. Without them, we will need to cycle through intermittent rounds of broad social distancing measures to limit mortality — with ongoing economic damage. With them, much more targeted measures are possible.[7]

But it may be awhile before we all start crowding into gymnasiums and concert halls again. Longer-term, there are some who are prognosticating that this episode will create a permanent change in how we work, travel and behave. This creates a lot of uncertainty as we try to think about the long-term value of potentially impacted industries.

We liked to remind clients that not every recession is as deep as the 2008-09 financial crisis. We thought the next recession might resemble a more "garden variety" recession, perhaps similar to 2001. But this pandemic has created material economic and humanitarian risks. The underlying economy was in fundamentally good shape in January, with many businesses reporting their best month ever. And this crisis emanated from well outside the economic or financial system. The challenge is that a solution also must ultimately come from outside the economic system, i.e. an effective treatment for the virus.

In a recent note, we observed that even a deep recession shouldn't impact the long-term value of high-quality businesses. We continue to believe that this is true. But we also have to keep in mind another observation: "In order to finish first, you must first finish." The speed and severity of this decline has threatened even strong businesses. As the investment firm AQR recently wrote:

> When economic historians write the story of 2020, they may find a very complex mechanism through which the health crisis affected the economy. For the folks on the ground now, it seems fairly simple. A huge amount of

---

[6] The case counts will continue to rise for some time even if the actual number of cases starts to slow because the it takes time to roll-out testing. The death count may be a better indicator of how well social distancing measures are working to slow the spread of the virus.

[7] "Four Inevitable Results of This Pandemic," *Bloomberg*, April 6th, 2020.

> production and consumption has stopped. Revenues at businesses have plummeted. Many businesses which were completely viable in January are unable to meet their expenses or pay their creditors in March. There is the potential for a negative chain reaction among these creditors which are banks, investors, states and then ultimately the federal government. This is another way of saying the economic system can't function when activity completely stops for a period of weeks and months.[8]

Picture a beloved, longstanding restaurant in the heart of a major metropolitan area. The restaurant business can be a tough business, but "cultural establishment" restaurants are fine enterprises. Even if this restaurant carried no debt, their survival is not assured. Absent government action, there would be no way for this business to support its operations, which include wages, rent, utilities, etc. Government grants have been approved to try to help this company bridge the gap, but how quickly will business return to normal? Even after the country relaxes the lockdown, will people rush back to restaurants? Will life snap back to normal? What are the implications for the company that owns the building where this restaurant operates? How will it pay its mortgage? Should investors in these companies try to sell their interests into a depressed market? Should they hold on and try to make it through? We've been wrestling with these questions the past month and we can't say we've arrived at satisfactory answers.

The fear is that even as we start to attempt a return to normalcy in the next few months, there will be a segment of the population – the elderly, the worried, or those with underlying medical conditions – that continue to avoid certain economic activities (travelling, dining, etc.). Even if the "average" consumer returns to their pre-virus habits, the absence of these "marginal" consumers could have a big impact on effected industries and the economy at large.

Naturally it is easy to look back and wish that we would have acted more defensively then we did when we first started to grow concerned about the virus' toll in Italy. But this is a dangerous game to play. There will be a lot of stories about individuals – investors, epidemiologists, etc. – that saw this coming. And they probably did. But for every risk that metastasizes, there are nine other risks that peter out. For instance, we also grew concerned in January of this year when the U.S. and Iran engaged in a tit-for-tat. There seemed to be a non-trivial possibility that a major conflict might ensue, which could have also brought pain to the economy and stock market. But the two sides quickly eased off and the world went on uninterrupted. Clearly, the coronavirus has turned into a real and present danger for the economy and the stock market. But it can be dangerous to fool ourselves that we saw it coming and should have known what to do.

We have decided that the best course of action over time is to build a diversified portfolio that includes both high-quality bonds and high-quality stocks and to ride out the inevitable storms. This is why it is so important that only *long-term* dollars are invested into the stock market. This makes sense to us on a theoretical level, but periods like this sure do test one's mettle.

One of our mentors gave us a simple blueprint that we still use today when underwriting stock investments:

1. Does this company make a necessary product or provide a necessary service?
2. Is this company conservatively financed?

In this environment, however, the bar for assessing these qualities has risen. Necessary takes on a whole new meaning akin to a Zombie-apocalypse – all anyone wants to seem to buy today is hand sanitizer and toilet paper. "Not too much debt" becomes "no debt." To be sure, some of the best investments made in this environment will likely be in companies that appear as if they may fold but ultimately survive, either through good fortune or external assistance. But these are hard situations to predict and they entail a lot of risk. Other investors will make attractive short-term returns buying lower-quality companies at heavily discounted prices. But we believe the best *risk-adjusted* returns will come from buying the great, enduring companies at fair prices.

Investing during periods like this is challenging. We wish we could tell you that we have all of the answers, but we don't. And no one else does either. If anything, this episode has made us even more suspect of expert opinions. Nevertheless, we continue to believe that high-quality, well-financed companies will be worth more five or ten years from now and that

[8] "Once Again, A Crisis Like No Other," March 31st, 2020.

they are much better investments than cash or government bonds, which now yield less than 1%. But as we've been telling clients for the past month, it could get worse before it gets better. Things are not going to go back to normal next week.

We have no way of timing the bottom of this bear market. Based on history, the market should bottom *before* the economy and virus case counts bottom. As the investor Howard Marks noted in a recent interview:

> I think the outlook for the economy is weak. The outlook for the disease is bad. On the other hand, there's good value in the markets.[9]

These things are not incompatible. And history teaches that some of the best stock market returns occur when fear is at its highest. It is a dangerous game to jump out of the stock market when fear and panic are high. Consider the fact that the stock market quickly rallied over 20% in just one week after its recent bottom on March 23rd! The graph below shows that through early April, the S&P 500 had bounced back to levels above those seen at certain points in 2018 and 2019, despite the material economic risks from the coronavirus:

But we want to be realistic – this is going to be a very uncertain time for both the stock market and the country. It is impossible to predict with any accuracy what a "restart" of the economy looks like after a near total shutdown.

Yet we believe in America. We believe the country will figure this out and get back to work. There are things to criticize about our country, but at its core we are a nation of tough, innovative, entrepreneurial individuals. Just witness some of the advancements that are already occurring: Abbott Laboratories developed a coronavirus test that produces results in just five minutes; biotech companies are working to develop a vaccine in record time; auto manufacturers have switched production from cars to ventilators; etc. The Federal Reserve has shown that it is willing and able to provide needed liquidity to financial markets. An investment in U.S. stocks is a bet on America. There is no such thing as a sure bet, as this episode reveals, but we aren't throwing in the towel. Our core belief in America is a fundamental principle of our firm.

Our hearts go out to everyone being impacted by the pandemic. We are especially thankful for all of our healthcare workers. They are making great sacrifices to serve their patients and save lives. We will continue to keep them in our thoughts and prayers. The great Mr. Rogers once said, "When I was a boy and I would see scary things in the news, my mother would say to me, 'Look for the helpers. You will always find people who are helping.'" During this time of stress and anxiety, we are doing the same.

[9] Interview with Yahoo! Finance, March 29th, 2020.

Many of you have reached out to us via phone calls, emails and notes to see how we are doing during this unprecedented time. We sincerely thank you for your well wishes and support. We feel incredibly blessed to have such a great roster of clients. Together we will get through this. Stay safe!

Please don’t hesitate to contact us if you have any questions or concerns. As always, we thank you for your continued confidence.

Sincerely,

Michael D. Axel, CFA
Jacob D. Benedict, CFA
Ryan A. Kay, CFP®, AIF®