THIRD QUARTER 2020

Matt's Market Update

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Market Review

Led by a powerful rally in technology stocks, global equity markets posted strong gains in Q3. For the quarter, the NASDAQ gained +11.24% with an amazing +45% return over the past two quarters. The S&P 500 and Dow Jones Industrial Average gained +8.93% and +8.22% respectively while the MSCI ACWI ex US index of foreign markets gained +6.25%. The broad-based gains included a sharp market pullback in September that produced declines of -2% to -5% depending on the index. In fact, it was the worst performance for U.S. stocks during the month of September in nearly a decade according to the Wall Street Journal. Performance this year is very dependent on how much exposure a portfolio has to technology and large-cap growth stocks. While the NASDAQ has an astounding +24.46% total return this year, the S&P 500 is positive with a gain of +5.57%, but the Dow Jones Industrials remain slightly negative thru Q3 while the Russell 2000 index of small-cap stocks lags far behind with a decline of -8.69% this year.

The continuation of the equity rally that started in Q2 can be attributed to several factors. First, an economy that has shown strong improvement from the depths of the crisis in Q1. The widespread efforts to re-open the economy has naturally resulted in improved trends related to employment and consumer spending. However, it must be emphasized that the economy has yet to climb all the way back to pre-pandemic levels of activity. In fact, the positive momentum displayed in many of the economic statistics is starting to fade as we approach year-end. It's no surprise that this lagging momentum has coincided with the ending of many government stimulus programs designed to provide temporary income and debt relief during the crisis. At quarter-end, new stimulus measures are being discussed, but the announcement of further aid packages seem unlikely prior to the election. The other factor at play in Q3 was the Federal Reserve. They've essentially told market participants that they would be holding short-term interest rates at these very low levels for the next few years. This has forced more capital into equities in an effort to seek returns, despite the inherent volatility and risk involved. Valuations for equities sit near all-time highs at quarter end. As you'll note from the chart on this page, the P/E ratio for the S&P 500 index is nearing levels last seen during the internet stock bubble of '99-00.

S&P 500 PRICE TO EARNINGS RATIO

Source: FactSet. As of September 30, 2020.

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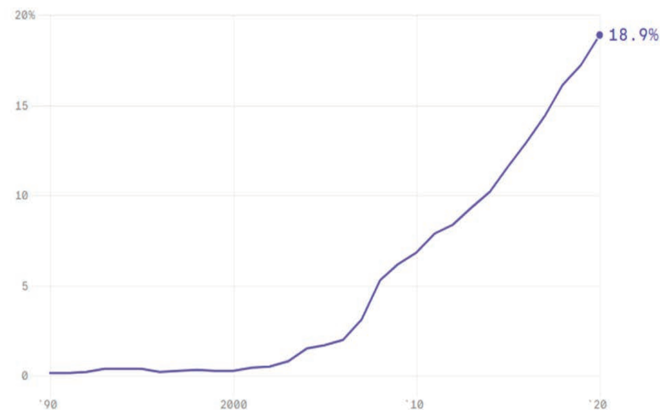
Beware of Zombies

Over the years, we've written extensively on the Federal Reserve and its ongoing impact on markets. As a result, we've witnessed lower interest rates, inflated asset valuations, increased private and public debt and higher budget deficits. Another impact has been the rise of "zombie companies." Zombie companies are defined as firms whose debt servicing costs are higher than their profits, but are kept alive by relentless borrowing. In other words, through the Fed's extensive efforts to eliminate recessions, they keep unproductive firms alive by keeping interest rates low, which ultimately lowers the growth rate of the economy.

As the chart of zombie firms demonstrates, this is not a new concept or a byproduct of the Covid-19 crisis. Years of low interest rates intended to spur economic growth has led to nearly twenty percent of publicly traded U.S. firms achieving zombie status. The cheap financing available through rock bottom rates are enough to allow zombies to survive, but never grow out of their increasing debt obligations. This delays the ultimate day of reckoning for these firms and means the Fed must provide ever more support to the market for these firms to survive. For now, investors seem willing to keep purchasing the debt of these companies with the mindset that the Fed has their backs and won't allow the zombies to fail. While unknowable, it's fair to ask how long can the creative destruction that defines capitalism be delayed?

PERCENTAGE OF U.S. "ZOMBIE" FIRMS (1990-2020)



Source: Datastream, Worldscope, DB Global Research; Chart: Axios Visuals

Survey Says

American Century Investments conducted its 8th annual survey of retirement plan participants at the beginning of the COVID-19 pandemic. Although respondents could not have anticipated the coming weeks and months, they expressed their regrets about past saving behavior, the value they place on the roles of their employers and interest in holistic advice and a retirement income solution. Here is a summary of their findings:

- 80% have "some" regret about not saving more for retirement, while 3 in 10 have a "great deal" of regret.
- 90% consider their retirement plan "one of the most important benefits at work."
- Nearly 80% want a "slight nudge" of encouragement from their employers to focus more on saving.
- 70% believe automatic enrollment should be implemented at a 6% contribution rate.
- Two-thirds support automatic enrollment with automatic increase of contributions.
- 80% would be more likely to leave money in the plan if employers offered an investment option specifically to allow retirees to draw income during retirement.
- 75% would find it attractive if their employers offered holistic financial advice, a significant increase from the 2019 survey.

Be Specific with Investment Goals

There is an old adage "Failure to plan is planning to fail." The same can be said for investment goals. If you do not create a plan for accomplishing each of your investment goals than you are most likely creating a plan to not meet them. Whether it is saving for retirement or planning for college expenses you want to make sure you have a sound plan to accomplish each goal.

When you're setting financial goals for yourself you want to be as specific as possible. For instance, you know you want to retire, but when? You know you want to send your child to college, but will it be a private college, a trade school or to the community college down the street? Writing down and

prioritizing your investment goals is an important first step towards developing an investment plan. This sets the foundation for how much you will save and invest towards that goal.

Once you have your goals listed, the next step is determining your investment time horizon. This is the number of years you have to invest toward a specific goal. Each investment goal you set will have a different time horizon. For example, some of your investment goals will be long term (15-20 years to plan), some will be intermediate (5 and 15 years to plan) and some will be short term (5 years or less to plan), Establishing time horizons can help you determine how you will need to invest to accumulate the amount needed to help meet your goals.

After you have listed your goals and confirmed the time horizon, you want to determine how much you should allocate towards each goal. Start by determining how much you'll need to set aside monthly or annually to meet each goal. Although you'll want to invest as much as possible, choose a realistic amount that takes into account your other financial obligations, so that you can easily stick with your plan. In addition, be on the lookout for opportunities to increase the amount you're investing, such as dedicating a portion of every raise, bonus, cash gift, or tax refund you receive to meeting your investment objectives.

The last step would be to determine what your investments should be. Regardless of your financial goals, an important consideration is your tolerance for risk. All investments involve some risk, but some involve more than others. How well can you handle market ups and downs? Are you willing to accept a higher degree of risk in exchange for the opportunity to earn a higher rate of return?

Whether you're investing for retirement, college, or another financial goal, your overall objective is to take the appropriate amount of risk per your comfort level and the financial goal. In addition, you want to ensure the investments are consistent with your goals and time horizon.

Creating an investment plan to achieve those goals can certainly be challenging. You want to take some time to review carefully and set yourself on the correct path. Should you need help in going through the process, it may be valuable to seek the assistance of a Certified Financial Planner™ to help guide you and set you on the right track to accomplish your goals.

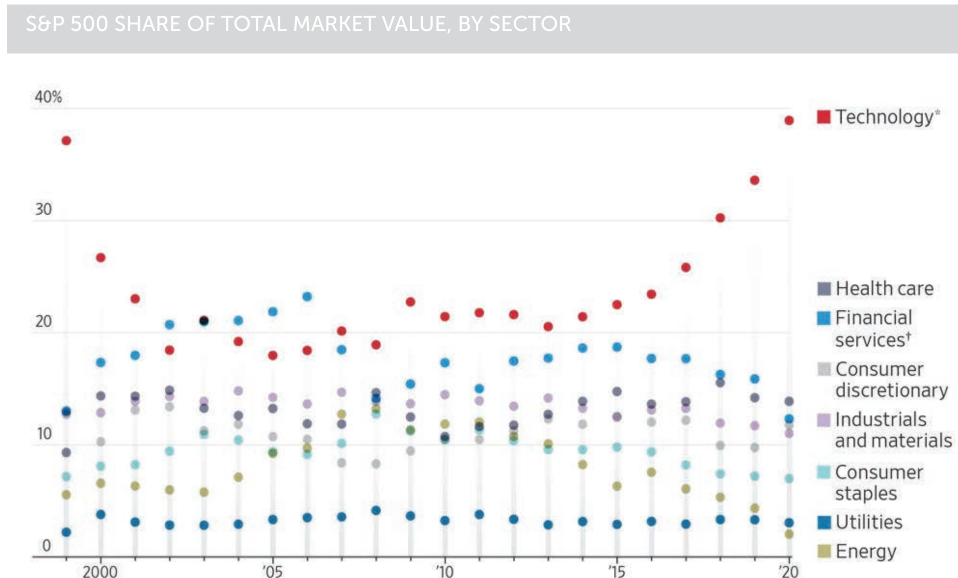
Our Portfolio Strategy & Allocation Outlook

It was a very quiet quarter in terms of actual changes within both our private client and retirement plan portfolios. We had taken action in Q2 to place added emphasis on our highest conviction themes in 2020: tilting exposure to growth strategies, adding gold for diversification and emphasizing active management in the fixed-income and foreign equity segments. To answer a question we get often, we don't make portfolio changes in anticipation of election outcomes. Our approach is always long-term and strategic in nature, which matches with our long-term financial planning philosophy. Looking ahead, here's a short summary of the broad themes our investment committee has been discussing which may (or may not) lead to future changes in the portfolios.

1. **Inflation. Is it a threat?**
   The Federal Reserve hasn't been shy regarding their desire to create more inflation. They're pulling on every lever they can to keep interest rates low and stimulate the economy in order to drive an inflationary outcome. So far they've failed, but will fiscal stimulus in the form of massive new government spending finally lead to inflation?

2. **Positioning in fixed-income.**
   With interest rates at record low levels, will bonds still provide the diversification benefits versus equities as they traditionally have? The pandemic has placed great stress on corporate borrowers, especially those below investment-grade. Without further government and monetary stimulus, will there be a large increase in defaults and insolvencies?

3. **When does diversification work again?** As you can see from the market returns listed below, the NASDAQ (home to large-cap growth stocks) has been the one true driver of returns in 2020. The technology sector is now a 40% share of the S&P 500 market cap, which eclipses the prior record of 37% back in 1999. Value stocks are very cheap based on a number of valuation measures, but have no earnings visibility and have no obvious catalysts for performance. Foreign markets have been challenging for investors as well. Post-election, when investors focus primarily on the global economy, can returns continue to be driven higher by a handful of highly priced technology stocks? We don't believe so.



Source: Dow Jones

Finally, it's time for our annual book recommendation. After taking a year off in 2019 (frankly nothing rose to the level of a recommendation), we found a number of titles this year that are well worth your time. But, one book stands head and shoulders above the rest and is destined to be recognized as a classic in our opinion. Whether you're just starting your saving and investing career, or a seasoned investment professional, you should read this book.

The Bitcoin Standard. By Saifedean Ammous. What is the top performing asset class this year? Over the past ten years? The answer is the same: Bitcoin. This book is part history of money and part explanation for why the world will benefit from a return to a "sound money" standard. A must read for anyone who desires to understand why Bitcoin has massive potential to alter the future of the world's financial monetary system.

Please let us know if you'd like to discuss your personal investing and financial planning needs.

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Market Scoreboard

Index Returns (%)	Q3 2020	YTD	1 Year	3 Year	5 Year	10 Year
S&P 500	8.93	5.57	15.15	12.28	14.14	13.74
DJIA	8.33	-0.91	5.70	9.98	14.01	12.69
NASDAQ	11.02	24.46	39.61	19.79	19.30	16.77
Russell 2000	4.93	-8.69	0.39	1.77	8.00	9.85
MSCI ACWI Ex USA	6.25	-5.44	3.00	1.16	6.23	9.85
Barclays Aggregate Bond	0.62	6.79	6.98	5.24	4.18	3.63

Source: Morningstar

S&P 500 TR: A market capitalization-weighted index of 500 widely held stocks often used as a proxy for the large-cap segment of stock market.

Russell 2000 TR: Consists of the smallest 2000 companies in the Russell 3000 Index, representing approximately 7% of the Russell 3000 total market capitalization often used as a proxy for the small-cap segment of the stock market.

Barcap Aggregate Bond TR: The Barclays Capital Aggregate Bond Index is a market capitalization-weighted index, meaning the securities in the index are weighted according to the market size of each bond type. Most U.S. traded investment grade bonds are represented. The index includes Treasury securities, Government agency bonds, Mortgage-backed bonds, Corporate bonds, and a small amount of foreign bonds traded in U.S.

MSCI EAFE NR USD: Widely accepted as a benchmark for international stock performance, the EAFE Index is an aggregate of 21 individual country indexes that collectively represent many of the major markets of the world.

DJ US Industrials TR USD: Computed by summing the prices of the stocks of 30 U.S. companies and then dividing that total by an adjusted value--one which has been adjusted over the years to account for the effects of stock splits on the prices of the 30 companies.

NASDAQ: Measures the performance of all issues listed in the Nasdaq Stock Market and is often used as a proxy for the large-cap technology segment of the U.S. stock market.

DJ/UBS Commodity: The DJ-UBSCI is composed of futures contracts on physical commodities and is often used as a proxy for broad-based exposure to the commodity markets.

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