<u>Third Quarter 2020 Commentary</u>

The U.S. and most of the world continues to be engulfed by the coronavirus pandemic. The third quarter saw a decline in new cases, but as of this writing the number of cases are starting to rise again in about half the states. As time goes by, the country is closer to a vaccine and treatments get more efficient. The market took comfort in that, sending stocks higher. For the quarter the S&P 500 rose 8.9%, while the Dow Jones Industrial Average gained 8.2%.

On D.C.

We love talking with our clients. Any time our phone rings or email inbox pings, we get excited about communicating with you. Whether we're fielding a question about retirement planning, or discussing a particular company in your portfolio, or just serving as a sounding board for an idea you have, we truly enjoy each one of our interactions. In normal times, the topics of these conversations range all across the spectrum of finance and life.

In the last couple of months, though, nearly every single question that has been raised to us has been some form of, "The news coming out of Washington, D.C., terrifies me, and I don't know what that means for my portfolio." Our client base covers the political map, some on the far left, some on the far right, and most somewhere in the middle, but we have recently heard from each of these cohorts asking about the possible impact the upcoming elections might have.

Will a Biden White House mean doom for your portfolio, because he's sure to scale back the tax cuts Trump pushed through a few years ago? Will a second Trump term mean further economic pain, because of his inept response to the coronavirus? What if the parties occupying the White House and Congress are split, resulting in at least another two years of political gridlock?

This is a perennial—or quadrennial, to be more precise—worry of stock market investors, and we have addressed it in-depth before. Eight years ago, in the final weeks of the race between Obama-Biden and Romney-Ryan, we wrote an article entitled, "Which Presidential Candidate Will Have a Better Effect on the Stock Market?" In it, we looked at the historical record of presidential terms going back to the Great Depression of the 1930s.

As it turned out, we found that stock market returns in the ten Democratic presidential terms significantly outpaced those of the nine Republican ones, which was a counter-intuitive result given the fact that the Republican party is the one supposedly more aligned with business interests.

Eight Years Later

We have recently updated our analysis to include the two most recent terms: Obama's second and Trump's first. While the two presidents are nearly polar opposites of each other in every respect, the U.S. stock market performance in those two terms was nearly identical: up 71% in the years 2013-16, and up 62% from 2017 through the time of this writing. To be sure, more than a third of that 62% increase under Trump was due to the lowering of the corporate tax rate, but the end results were almost the same.

Therefore, our conclusion from eight years ago remains unchanged. As we said at the time, market forces are going to do their thing based on many other criteria than the affiliation of the leader of the Executive Branch of our government. Stocks will be driven more by free market forces such as interest rates, employment statistics, international trade, and even good old fear and greed, all of which are out of the realm of control of our Commander in Chief.

What Ever Happened to Fundamentals?

Speaking of economic fundamentals, why is it that we are in the midst of a global pandemic, businesses everywhere are suffering, U.S. unemployment is high and holding steady, and yet the stock market has returned 15% over the twelve-month period which ended September 30? Yes, it was a wild ride for the S&P 500 from 9/30/19 to 9/30/20, first advancing 15% through February, then plunging 32% by the end of March, then advancing from that point 47% by the end of September. But the fact is irrefutable that the market returned 15% over those 366 days.

Is the state of American business really 15% better now than it was a year ago? How are some stocks advancing during this maelstrom when others like airlines and banks are suffering so badly? And, most importantly, why are our portfolios not keeping pace with this mind-bending advance in the stock market?

In short, the answer comes down to two answers: liquidity and the rich getting richer.

Liquidity simply means that the Federal Reserve has been printing money at an astonishing clip. In June 2020 the U.S. created more new money than it had in its first two centuries combined. Nearly $3 trillion worth of new money has been created and flooded into our economy this year, which has helped stave off an otherwise certain economic collapse due to the coronavirus fallout.

But that money has to go somewhere, and much of it has ended up in the stock market. The S&P 500 is a capitalization-weighted index, which means that the biggest companies in it (e.g., Apple, Amazon) account for an ever-growing proportion of the total. For instance, at 9/30/19 Apple accounted for less than 4% of the size of the S&P 500 index, but after more than doubling it now accounts for over 6%.

It's not just the stocks of big companies that have enjoyed success this year due to the Fed's ever-expanding balance sheet. "Hot" stocks—those that were already selling for lofty price/earnings multiples—are now even hotter. The stock of Tesla, for instance, has increased by a factor of 9x in the last twelve months! Though it produces a tiny fraction of the number of cars of its much bigger competitors, Tesla's stock market capitalization is now larger than Toyota, Volkswagen, Honda, and General Motors *combined*.

To extract the noise from all of this, one simply needs to look at something called the Equal-Weighted S&P 500 Index. This index allots exactly 0.2% to each of the 500 largest public companies in America. This reduces the impact that the largest technology companies have on the overall index, and it amplifies the effect of other nuts-and-bolts parts of our economy, such as food, energy, insurance, airlines, and so on.

The 9/30/19 – 9/30/20 return of the equal-weighted S&P 500 index was a paltry 1.8%. Underlying stock prices did not at all budge during that time; the entire return was due to dividends.

Conclusion

We are never going to buy hot stocks in the hope that they will become hotter, we are never going to buy the biggest stocks in the hope that the Fed will continue producing more money to be thrown their way, and we will certainly never invest your money based on the latest political polls.

We will continue doing what we have always done: invest your money based on time-tested business principles. Eventually, hot stocks cool off, and the Fed can't keep printing money forever. When those events have run their course, look out below. But if we have done our jobs well and invested your capital into solid enterprises that will stand the test of time and weather the economic storms, then we can all sleep more soundly each night.

Thank you for entrusting your hard-earned money to our care. We look forward to reporting to you again early next year.

Sincerely,

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