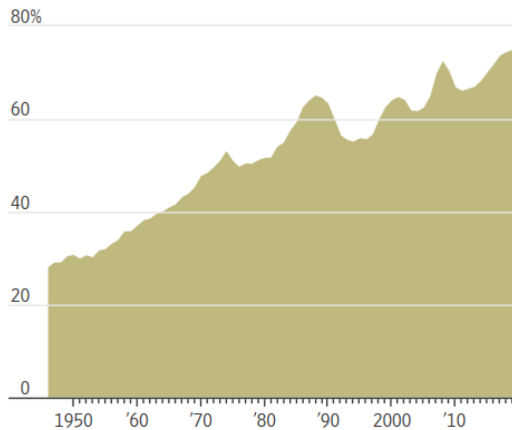
Investment Commentary **April 2020**

We are saddened by the suffering caused by the current health crisis, made worse by the fact that those fighting it must do so in isolation from their families. With perhaps 30 million people out of work, COVID-19 has exacted a costly economic toll, and for those most at risk, the health scare is especially real. We are grateful to those among us who are on the front lines – everyone from doctors and nurses to the people up and down the food supply chain, all of whom are risking their own health for the good of society. In time we will overcome this as a society, as we have persevered through so many other challenges throughout history.

We want our clients to know that we remain on duty. From an investment perspective, this period provides a very clear example of the importance of owning a portfolio of well-financed, competitively entrenched businesses that can absorb economic shocks. In these pages we review the market backdrop that preceded the crisis, our response to the fall in share prices during the first quarter, and our assessment of the current investment landscape.

The Backdrop

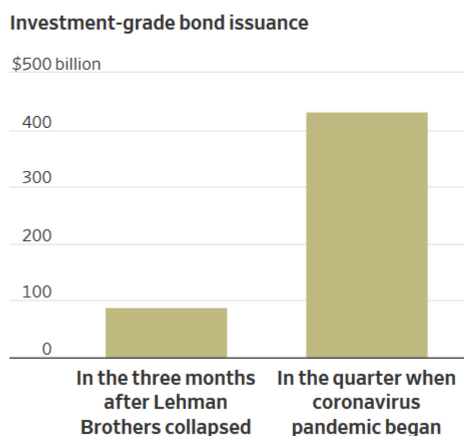
In 2019 the multiple of trailing twelve month earnings on the S&P 500 rallied to 25x, a level that reflected more risk than value. Compared to the long-term median multiple of 15x, the index was priced about 65% above fair value. Adding to the risk equation, corporate leverage rose to an all-time high.



Source: WSJ

We made just one new investment in all of 2019, and we spent our time researching many companies that we wanted to own if given the opportunity to buy them at better prices. As stocks sold off by 35% through the March 23 low due to COVID-19, we got that chance. The earnings multiple fell below 17x, and multiples for certain segments of the market declined to ten-year lows. During this period we initiated positions in six companies, and we personally invested alongside our clients, as is our standard practice. We are closely monitoring a number of other companies as potential investments. As always, our two unwavering principals are the avoidance of both risky balance sheets and exuberant prices. To bridge the economic crevasse from COVID-19, balance sheet strength is essential, and liquidity is increasingly a precious resource in the current era of record high debt levels.

Since early March, when the global response to the pandemic essentially ground economic activity to a halt, the Federal Reserve has injected significant liquidity into the financial system. In recent weeks, shares have been thrust 25-30% higher from the combination of the Fed's actions, fiscal stimulus, and flattening COVID curves globally. Surprisingly, the Fed is buying investment-grade and even junk-rated corporate bonds. With that federal support, new corporate bond issues have spiked, unlike during the 2008 financial crisis.



Source: WSJ

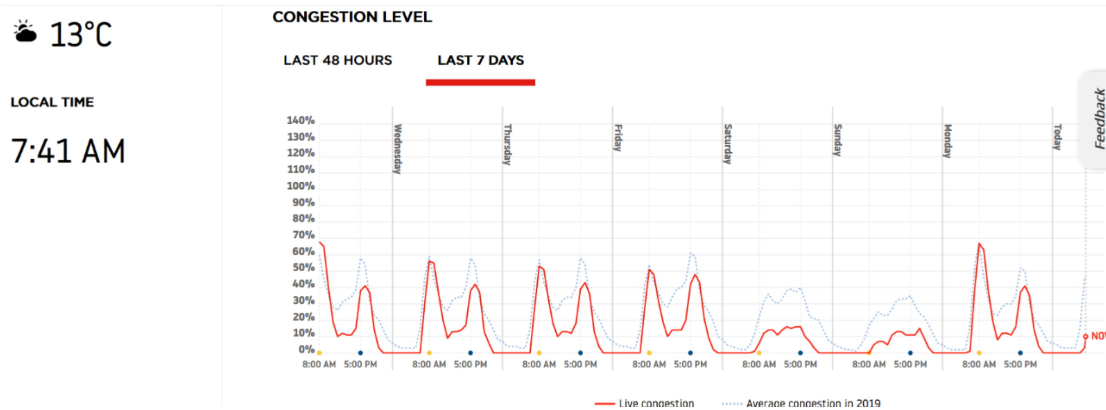
What Now?

Turn on the financial news these days and you'll see a ping-pong of opinions, each proclaimed with certainty, that the stock market bottom is in, or that we should brace for new lows ahead, or that central banks' currency debasement should push everyone into gold or bitcoin. The greater the conviction expressed does not correlate with the prophecy's ultimate precision.

Investing is a discipline that rests on probabilities rather than certainties. An investor's process should begin by filtering out all opinions, as well as his or her own biases, so that the data can be

assessed objectively. Returns in stocks approximate earnings growth, which in the long-run forms a fairly even trajectory, but in the short-term is quite variable. The shifting emotions of investors amplify that near-term variability.

In terms of economic recovery, Wuhan provides a model of what things may look like on the other side of this mess. There the lockdown has ended. Malls and restaurants have reopened, but they are still largely empty. Businesses are testing employees for fear of recurrence. In order to leave Wuhan, the government requires people to get tested. In other areas of China, traffic levels are back to ~80% of pre-virus levels during the week (the government has mandated employees return to work), but less than half of pre-virus levels on the weekend (more representative of free will).



Source: Tomtom
Note: "Today" was Tuesday April 14th 2020

The recent rally in the broad US stock market is discounting a fairly quick return to normalcy, and that does not seem to match economic reality. The S&P 500 is back to levels seen just last summer, at 21x trailing earnings, yet unemployment now is nearly 20%. That said, the spike in unemployment is likely to be temporary. If you've just lost your job in this economy, you may not be staring at the abyss like the guy working at Lehman Brothers was in 2008. A lot of the unemployed now are just furloughed. Small businesses are particularly vulnerable to a lengthy suspension of activity, but between unemployment benefits and the SBA payroll program, perhaps the gap can be bridged without too much lasting economic damage. The banking system is in very good standing, with banks holding considerably more equity capital per assets than in 2008.

Most importantly, from an investment perspective, while the overall US market does not offer great value at current levels, certain pockets of the market are very attractively priced. In the last five years, the S&P 500 Growth Index has increased about 58%, while the S&P 500 Value Index has increased just 9%. Even more stark, the S&P 600 Value Index (small-cap value shares) has declined 24% over the last five years. Similarly, international stocks have dramatically underperformed those in the US, as illustrated in the following chart.

We are finding compelling investment opportunities in these areas of the market, but we are also ready to take advantage again if pessimism returns to the growth end of the market, as we have opportunistically over the last several years. Our investments are not restricted to any particular market cap, style, or geographic category. Rather, our primary criteria are simply that the business and balance sheet are both durable, and the shares are available at a material discount to intrinsic value. Though we were far from shy in March about investing our clients' substantial cash balances, we maintained a reserve to capitalize on still better prices should volatility again spike. As long-term investors, we believe the economy will get through this difficult period, and we are bullish on the ultimate prospects for our portfolio holdings.

As always, please contact us with any questions or comments.

Sweetbay Capital Management

Important Disclosures:

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