INVESTMENT COMMENTARY

At a Glance

Equity and credit markets posted positive returns in the third quarter with the MSCI AC World Index and the Barclays US Aggregate Bond Index returning 8.13% and 0.62% respectively. The Global Wealth Strategy portfolio modestly participated in the move higher in global financial markets with a net return of 1.02% for the third quarter. Although we are disappointed that we underperformed in the third quarter, we believe we are prudently positioned defensively given the current global markets conditions.

Market Recap

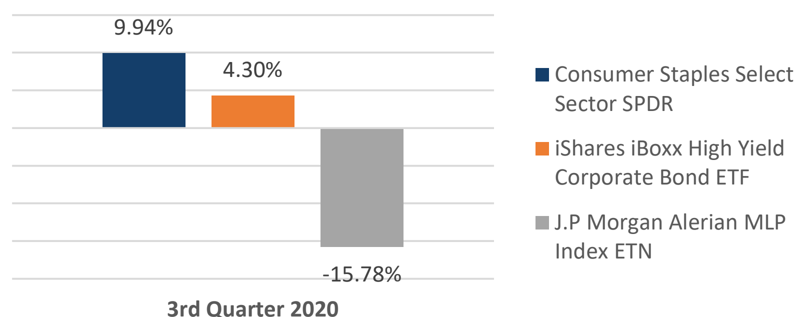
The potential of a second stimulus package and growing confidence that the reopening of the economy would continue helped drive markets higher in July and August. The biggest beneficiary was US large cap stocks that were led by the technology sector. A major contributor to the sectors performance in July and August was Apple (AAPL). AAPL was up an incredible 41.75% in the first two months of the quarter and catapulted its market-cap value above $2 trillion, making it the most valuable company in the world and receiving the highest value ever by a company in history. Much of the gain, however, was driven by P/E multiple expansion as opposed to earnings growth (more on this later).

The final month of the quarter saw markets decline and was a stark reminder of how quickly market conditions can change. Valuation concerns along with an increase in the number of daily COVID-19 cases sparked a sell-off in September. The MSCI AC World Index was down as much as -5.96% during the month before bouncing back in the last four days of September to finish down -3.22% for the month.

Emerging market equities also had a strong quarter and edged out US markets with the MSCI Emerging Markets Index up 9.56% compared to 8.93% for the S&P 500 Index.

The US Federal Reserve's commitment to keep interest rates low for the foreseeable future helped fuel equity and fixed income markets to finish the quarter higher. In addition, high yield, investment grade credit, emerging market bonds and treasuries all posted positive returns for the quarter.

What Helped and What Hurt?



The biggest positive contributor to the portfolio's return was the Consumer Staples Select Sector ETF. This sector's performance was largely driven by investors rotating out of growth and into more defensive positions at the end of the quarter.

Credit spreads in high yield bonds narrowed meaningfully during the quarter helping the iShares iBoxx High Yield Corporate Bond ETF to be one of the portfolios top contributors. MLPs were the biggest detractor and the only segment of the portfolio that finished the quarter in negative territory. A pullback in oil prices over concerns of waning demand and OPEC

overproduction weighed on MLPs during the quarter. We continue to evaluate the risk of MLPs as high, which kept the allocation to the J.P. Morgan Alerian MLP Index ETN to just 1.30% vs its average historical allocation of 4.60%. This helped to minimize the positions impact on the portfolio.

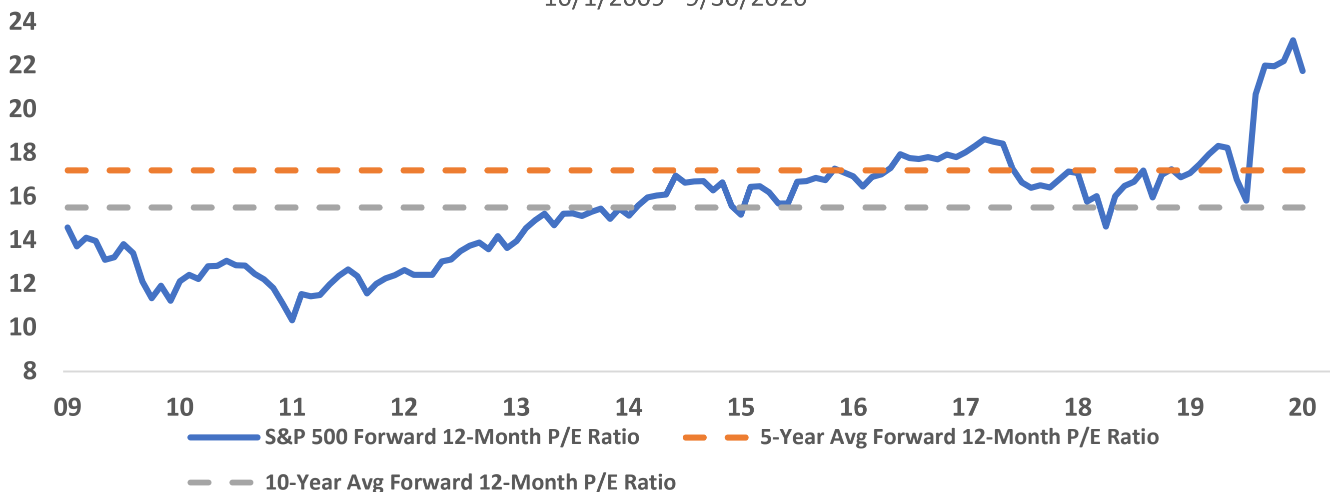
Final Thoughts

The potential headwinds to the economic recovery that we outlined in our second quarter commentary still exist today. In fact, some of them are actually starting to materialize:

- A resurgence in COVID-19 cases appears to be developing. According to the CDC, the 7-day moving average of new cases of COVID-19 has been trending higher since mid-September.
- The last round of stimulus to support the economy expired on July31st. The bill to fund an additional round has been tabled until after the election.
- The Department of Labor reported that 661,000 jobs were created in September which was well below the estimate of 865,000. They also reported that continuing unemployment claims remain above 10 million as compared to just under 2 million in late January of this year.

Our risk management process is constructed to identify risk in both down and up markets. Based on our evaluation of current market risk, the extreme move higher over the last four months has created an elevated risk environment. By the end of the third quarter, equity valuations rose to levels not seen since the late 1990's. What followed was a -37.61% decline in the S&P 500 Index from 2000-2002 and even worse performance for the technology sector which was down -72.58%.

The forward 12-month P/E ratio of the S&P 500 Index at the end of third quarter of 2020 was 21.7 which is 26% above its 5-year average of 17.2. Keep in mind, this is using an earnings estimate for the next 12-months. So even if companies deliver the results analyst expect, valuations will remain significantly well above the 5 and 10-year moving averages. The chart below compares the current P/E ratio of the S&P 500 Index to its historical averages.

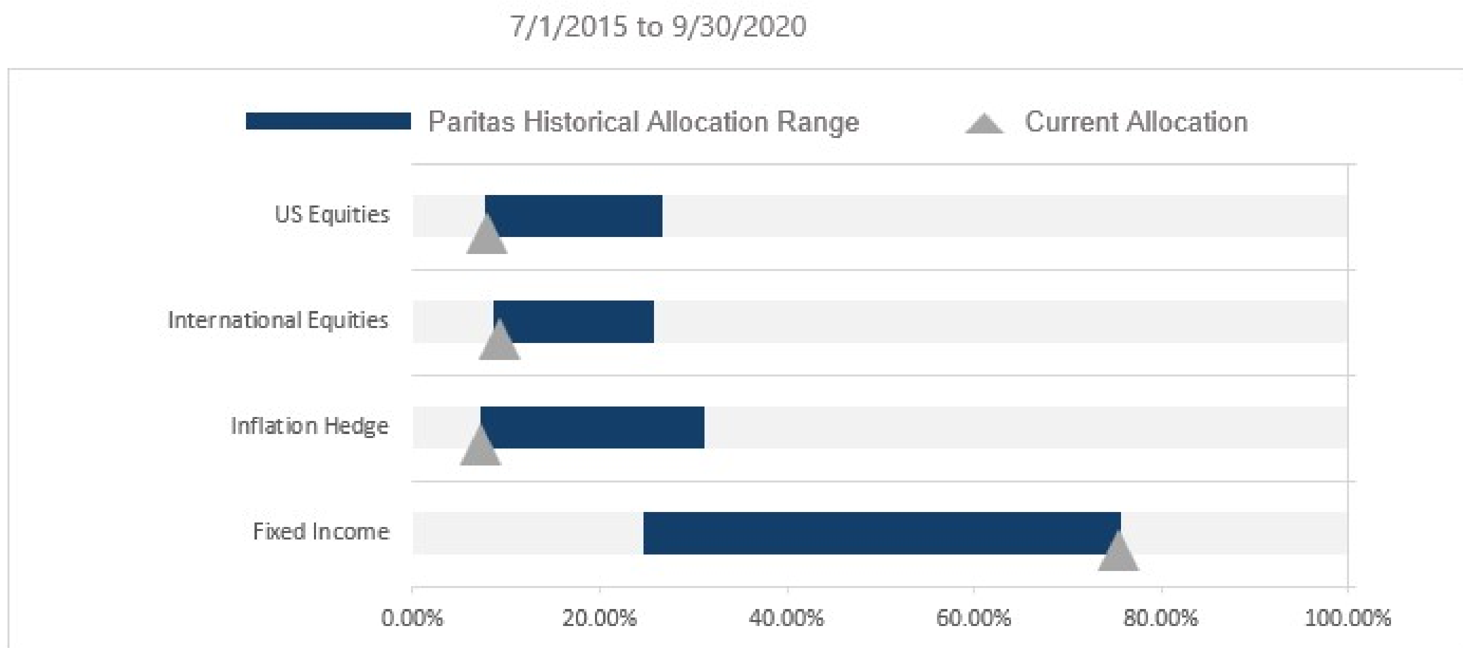


At the extreme ends of the spectrum, there are two outcomes that could cause the S&P 500 Index's P/E ratio to fall back to the 5-year average of 17.2. On one end, the index either needs to decline by -23% or earnings need to come in 31% above current estimates on the other end.

If the overall market were to experience a decline, that does not necessarily mean that all sectors will suffer large losses. We believe some sectors are more exposed to a correction than others. For example, the consumer discretionary sector's forward 12-month P/E ratio of 38.5 is significantly higher than its 5-year average of 21.7. In contrast, the consumer staples sector's P/E ratio of 20.9 is just above its 5-year average of 19.3. Our model identified the risk differential between these two sectors and thus the portfolio is overweight consumer staples and underweight consumer discretionary.

No one has a crystal ball, but in my 36 years of investing, when markets become significantly distorted, each time they have reverted back to historical averages. In fact, as the legendary Warren Buffet advised investors, "Be fearful when others are greedy, be greedy when others are fearful." Our current evaluation of market risk is telling us to be fearful, which is why the portfolio has a significant overweight to US treasuries.

Current Portfolio Positioning



Source: Financial data provided by Factset

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