SEGALL BRYANT & HAMILL

3RD QUARTER
2020

SBH NEWSLETTER

Thoughts on the Current Environment

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"The deadly flu is thought to have originated in China in a rare genetic shift of the influenza virus. The recombination of its surface proteins created a virus novel to almost everyone and a loss of herd immunity...However, a first wave of influenza appeared early in the spring of 1918 in Kansas and in military camps throughout the U.S. Few noticed the epidemic in the midst of the war. Wilson had just given his 14 point address. There was virtually no response or acknowledgment to the epidemics in March and April in the military camps. It was unfortunate that no steps were taken to prepare for the usual recrudescence of the virulent influenza strain in the winter. The lack of action would later be criticized when the pandemic hit in the winter of 1918 (BMJ, 1918)."

-*The Influenza Pandemic of 1918: www.antimicrobe.org*

"What's It All About, Alfie?" Are the Markets Focused on the Right Issue?

If the stock market was the canary in the coal mine in the first quarter, signaling severe economic distress, it sang a decidedly different tune in the second quarter. The broad market average, the S&P 500® Index, rose 20.5%, one of the best quarters on record. What are we to make of this dramatic reversal by the U.S. stock market? We believe there are two plausible alternatives. The first is the stock market, in its collective wisdom far wiser than any single forecaster, has peered into the future and has seen a recovery in the economy far earlier than we do. The second option is that the market is behaving like a child on a sugar high, the "sweets" in this case being the massive amount of money the Central Banks of the world flooded into the system in the spring. As anyone who has parented knows, the aftermath of a sugar high is not necessarily a pleasant experience.

We have held the view, and still do, that the answer to the economic questions raised by COVID-19—when and to what magnitude will we resume "normal" economic activity, allowing people to regain jobs, to move about freely for travel for business or pleasure, to enjoy the simple pleasures of going shopping or to a baseball game—turns almost solely on the acquisition of a sufficiently high level of herd immunity, thought to be about 60%. Immunity is achieved in three ways: possession of innate immunity to that pathogen by genetic make-up, contracting the virus and recovering from it or being vaccinated. Either way, the body's immune system learns to produce rapidly the antibodies needed to fight off the virus. Humans have co-existed with viruses for hundreds of thousands of years in this manner, and in time, it will be the same with COVID-19. Right now, we are simply at the first encounter. Not only did we lack any herd immunity last winter, we lacked both the tools and the awareness of how we needed to organize to buy time.

"Flattening the curve" through social quarantine was an extreme, but necessary, measure to buy time. With that time, we have ramped up research on vaccines, organized to produce, distribute, and administer testing, learned better ways to protect ourselves in our daily lives and better techniques to treat those afflicted. For example, the great cry was for ventilators at the onset of the virus' attack. Now, we know that ventilators are not necessarily the best response for the seriously ill. The knowledge base is growing exponentially, and this is no trifling fact. As the focus of policy debate shifts to the so-called "second wave," that will come as the weather turns come the fall, it is important to keep in mind that while we may not have a vaccine, we will have some foreknowledge of how to avoid the replication rate from soaring again. And some yet unknown percentage of the population will be carrying its own immunity, certainly more than the 0% at the beginning of the year.[1]

Are We Trading a Headache for an Upset Stomach?

While we have learned and will continue to learn much from the experience of the first half of 2020, the old saying is true: "Experience teaches, but the tuition is high." The economic response to COVID has been very costly. A recession has begun (and may or may not have already ended), ending one of the longest expansions on record. Unemployment levels have reached record rates and the sheer volume of government intervention is unprecedented.

"Flattening the curve" is an expression not just limited to epidemiologists. It is also a term that can be applied to what the Central Banks of the world continue to do: keep interest rates, long or short, at low levels. The yield curve at June 30 for U.S. Treasury obligations ran from 0.14% for 90-day bills to 0.65% for 10-year notes. It should be of great concern that the cure could prove worse than the disease. What the Federal Reserve (Fed) and other Central Banks are doing is to distort the financial markets, allowing for what we believe to be erratic and irrational pricing in the financial markets.

Consider just two examples: 1) Companies that filed for bankruptcy by attempting to raise money by selling new issues of stock, or 2) The five largest companies in a 500 stock index, 1% of the membership, constitute over 20% of the value of that index. This so-called very safe index fund would be classified as a "concentrated" fund by the SEC if it were an actively managed fund. More about the second point a bit further on, but the point to focus on is that this suppression of market forces will inevitably produce bad capital allocation decisions. Money may not flow as easily to companies that can produce both jobs and better outcomes for their customers. Zombie companies that should have gone out of business will hang around, drawing resources away from more efficient alternatives.

[1] In the course of writing this newsletter, I linked to the Johns Hopkins COVID-19 tracking site at quarter end (https://coronavirus.jhu.edu/map.html). The big font number read that "Confirmed COVID" cases globally were 10,000,000 at that moment. (Deaths globally were 500,000). At first, I was disappointed because I thought the number would be higher, and a higher number would indicate that all who had had it and didn't die, were to some degree immune, how high we don't know but a percentage greater than zero. Then, another thought. I checked with the United Nations stats and found that the global population is now 7.7 billion people. (https://www.un.org/en/sections/issues-depth/population/index.html). Doing the arithmetic indicates that COVID cases represent 0.15% of the world's population. This scourge of mankind has had a free shot to run roughshod over all of humankind which was defenseless, and all it could do was infect a little more than 1/10 of a percent? This was its best shot. If I were the coach of Team COVID, I would be depressed as I contemplated that we had the humans where we wanted them in Game 1 of the World Domination Series, COVID-19 vs. Humans, and we couldn't close them out. Humankind will be better prepared to diagnose, track, and quarantine to shut the spread down and we are much further down the line on research efforts to a vaccine. COVID will have a much harder time from here on out. It will keep killing people, not to suggest otherwise, but I am saying that we will not encounter a time like these last six months again with this virus.

Navigating Murky Waters

All this said, until we have a firmer view of the pathway in which the "new normal" will evolve, it is impossible to form investment judgments about the fundamental valuation of companies. We don't—we can't—know who will win in the new normal and who will lose. The action of the market since March 23 seems to contradict this point of view, but we believe that the market may be more driven by flows of liquidity right now than by realistic valuations.[2]

On that basis, then how does one structure a portfolio? As always, the first step must be in understanding the purpose of the portfolio. An institutional investor, like a pension fund or an endowment, has one set of objectives. Individuals have yet another. I always marvel at market commentators who provide strong buy or sell recommendations without any knowledge of the circumstances of the reader or listener of that recommendation. What might be great for one person could be just the wrong thing for an endowment fund and vice versa. Knowing the time horizon and the ability to absorb volatility are critical for making decisions on what is appropriate and what is not.

Some Closing Thoughts on Volatility, Downside Protection, and Active Management

In times of high volatility, such as we saw in the first six months of 2020, doing less may save more. In volatile markets, trading becomes more expensive, not in the sense of commission costs but in terms of the spread in prices during even a single trading day. If one can sit tight and wait, coming out from the storm shelter after the worst has past by tends to be safer.

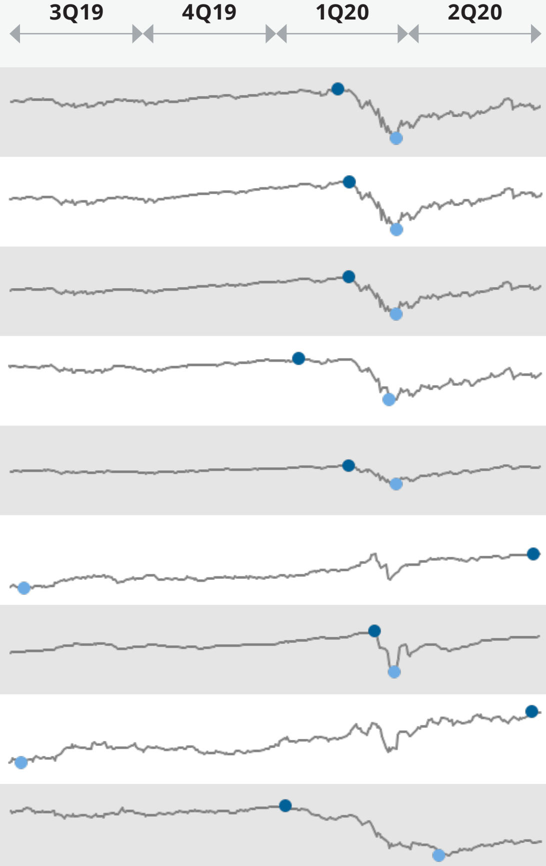
We have also observed that periods with such high volatility are ones in which our bottom-up investment philosophy with its attention to valuation and the risk-return tradeoff are factors that can lead to better-than-market returns. Better relative returns can be achieved by doing better than the market on the downside as well as the upside. It's true that the market goes up most of the time, but down markets, while generally short, can take a big bite out of returns accumulated bit by bit over a long bull market. Keep in mind the old mathematical truism: being up 50% and down 50% does not leave a portfolio even. It is down 25%. Being up 10% and down 10% doesn't leave it at breakeven, either, but at down 1%, it leaves it a lot closer.

Finally, a thought on active management. We noted earlier that the S&P 500 Index, were it a mutual fund, would have to register as a concentrated fund. Think about it this way: Assume a client came to us and suggested taking his $1,000 portfolio and investing it in 50 stocks. He might ask, how much will you put into your first buy, the "best idea we had," and assume we replied $200. That means, on average, the other 49 stocks would be sized at $16.32 each. There are many people who would react very negatively to the unevenness of that portfolio construction, but I have just laid out the relationship of the five largest holdings in the index to their 495 fellow members. Index investing, an automatic approach to investing, is considered to be less risky than active management because it begs the question of whether there is a "good" or "bad" driver of the bus. But risk can neither be created nor destroyed. It can only be re-arranged—like trading out the risk of who drives the bus and then allowing so many riders to board without enough safety restraints that the bus can become dangerously unbalanced. One cannot avert risk by choosing the passive solution; one can only substitute one risk for another.

[2]Notwithstanding this reservation, our small cap equity teams have put together some thoughts on various sectors that might be of interest, not in terms of specific stock recommendations, but in terms of opportunity, depending on how the recovery evolves. (Post-COVID Small Cap Equity Sector Themes: What's Played Out and What's to Come, Summer 2020). If you would like a copy, please feel free to reach us at contactus@sbhic.com.

MARKET BAROMETERS
AS OF JUNE 30, 2020

	July 1, 2019	3Q19	4Q19	1Q20	2Q20	Jun 30, 2020	Low	High
Dow Jones Industrial Index	26,717.43					25,812.88	**18,591.93**	**29,551.42**
S&P 500 Index	2,964.33					3,113.49	**2,237.40**	**3,386.15**
Russell 3000 Stock Index	1,743.50					1,809.25	**1,288.04**	**1,984.26**
Russell 2000 Stock Index	1,569.66					1,441.37	**991.16**	**1,705.22**
Russell Midcap Growth Index	1,158.12					1,275.66	**844.03**	**1,314.21**
Bloomberg Barclays Aggregate Index	2,169.07					2,361.51	**2,162.29**	**2,361.60**
Barclays Muni Bond Index	1,242.76					1,297.97	**1,174.65**	**1,318.95**
Gold (Price/Oz) London AM Fix	1,390.05					1,770.70	**1,387.90**	**1,775.70**
Goldman Commodity Index	2,498.30					1,650.79	**1,249.25**	**2,642.50**



Source: Bloomberg.

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