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2020 Second Quarter Review
"Partying Like It's 1999"

At the end of the first quarter, we had just survived one of the fastest market declines in history and were left with the possibility of several types of recoveries: among them, "L" shaped, "U" shaped, "W" shaped, and "V" shaped. With massive financial intervention by the Federal Reserve and the United States Treasury, one of the fastest declines in stock market history has been followed by one of the fastest market recoveries on record. The verdict is in. The recovery so far, at least in the stock market, is "V" shaped. After previously dropping 35% through March 23rd, the Dow Jones Industrial Average ended the second quarter down 9.5%. The S&P 500, previously down by over 30%, finished the quarter down 4% from the beginning of the year, and the Russell 2000 index of smaller companies finished down 13.5% year-to-date. With short term interest rates headed to zero and massive liquidity pouring in from the Fed and the Treasury, tidal waves of cash flowed back into stocks as many investors concluded that "There Is No Alternative," and we got the "TINA" rally mentioned as a possibility in last quarter's letter.

Although the headlines are dominated by news of the COVID-19 pandemic and a second wave of infections, the stock market's action seems to be overwhelmingly influenced by the massive liquidity infusions from the government and the lack of ample returns available in any other investment sector. The size and scope of the economic dislocations and market movements have been historic, but they are not entirely without precedent. As I mentioned last quarter, this is my fifth market crash. Although this one is historic, I am seeing some similarities to one we experienced 20 years ago.

As the year 1999 drew to a close, the nation was transfixed by two things: the promise of the profound revolution brought by the birth of the internet and the specter of massive disruptions to be caused by the "Y2K" computer bug when the year turned to "00" on January 1, 2000. Internet stocks were already heating up as speculation in technology stocks drove the stock market ever higher. As the fateful date neared, the Federal Reserve panicked and flooded the system with liquidity to forestall economic disruption caused by the Y2K glitch. As it turned out, the Y2K glitch was a non-event and technology stocks were free to soar to new heights untethered by traditional financial limits to valuation. The "Internet Bubble" was born. Valuation no longer mattered. "Concept stocks" with no hint of profitability were rewarded with huge stock prices, and "eyeballs" replaced revenues as measures of growth. Speculation grew rampant and valuations rose to levels seldom,if ever, seen in American markets.

However, it all came to an ugly end the next year after peaking in March of 2000. The NASDAQ Index (the current market darling) hit heights in that period that it would not see again for *15 years.* The internet was real, and the changes it brought would be profound, but the prices for those stocks had risen so far above their intrinsic value that the subsequent declines were devastating. Even buying an undisputed technological winner like Cisco Systems stock in 2000 would leave you with an almost 40% loss to this very day, *20 years later*. The point is that you can be correct in predicting the beneficiaries of technological and economic change, but if you pay too much for the shares of stock, you can still lose substantial amounts of money. And since preserving your capital is our primary concern, we think about that a lot.

We may very well be in the midst of another financial bubble (à la 1999) created by the massive intervention undertaken by the Fed and the Treasury into the US economy. Warren Buffett has given us many pearls of wisdom in his long investing career. One of the best is that, on the short-term, the stock market is a "voting machine," but in the long run is a "weighing machine." Bubbles don't weigh very much. And when they deflate, they do it quickly. Until then, however, many investors are happy to dance with Prince and party like it's 1999.

IF we are in another financial bubble, it can go much farther than reason would dictate. That is why trying to call a top in the market, or "fighting the Fed" in such a case can be so perilous. As long as stocks are competing against low-yielding bonds and zero interest rates money funds, they may maintain their relative attraction. This is particularly so in stocks of companies that have good balance sheets, stable businesses, and are paying a healthy and sustainable dividend. Those, therefore, are the investments we will continue to focus on. We don't want to pay too much even for a good company's stock only to have to wait 15 years to recover from a subsequent market swoon. That is why we will remain sensitive to valuation and may not chase the hottest, most popular, and perhaps most expensive stocks that you may read about in the news.

Speaking of financial news, the "Robin Hood Day-Trading" crowd has garnered much attention lately for creating dramatic runs in speculative and often low-priced stocks. These are often home-bound day-traders exchanging ideas on internet message boards and piling into often small and speculative stocks, producing huge price swings. For example, the bankrupt Hertz company stock went up over 600% over a few days in early June before sinking back to near its previous level, even though it is generally agreed that the stock will become worthless in the coming bankruptcy proceedings. (I remember people quitting their day jobs in 1999 to day trade stocks because it was so easy and fun.)

Another recent story that captured the public's imagination was the decline in the price of oil to a *negative number* at the close of the May commodity futures contract. The most egregious misinterpretation of that contract-expiration anomaly was best expressed by the investor who wondered if the oil companies would *pay him* to fill up his car with gas. These news stories are interesting but are not valuable guides for serious investment. In fact, following them can be hazardous to your financial health. (Hertz stock soon fell back below $1 a share and oil prices soon climbed back over $40 a barrel.)

Because the Federal Reserve stepped in and "back-stopped" the money markets, we have recently switched our cash reserves back to the higher yielding money funds that we held before the pandemic hit. Since money market funds of all types are yielding so little, we are also taking some positions in medium term corporate bonds and funds that appear to give us the opportunity for better a yield without taking on inordinate amounts of additional risk. Otherwise, we will continue to invest while paying attention to valuation so that we may not see our profits entirely vanish if/when "the music stops" and there aren't enough chairs to go around.

If, however, you feel the need to invest more aggressively, please give us a call and we can help to translate your ideas or outlook into an appropriate investment strategy.

Your second quarter reports and statements are enclosed. Please review them at your convenience and check in with us to review your positions and any changes that you would like to make.

We thank you for the opportunity to work with you in these unusual times and will continue to strive to do our best for you as well.

Sincerely,

Claude R. Carmichael CFA