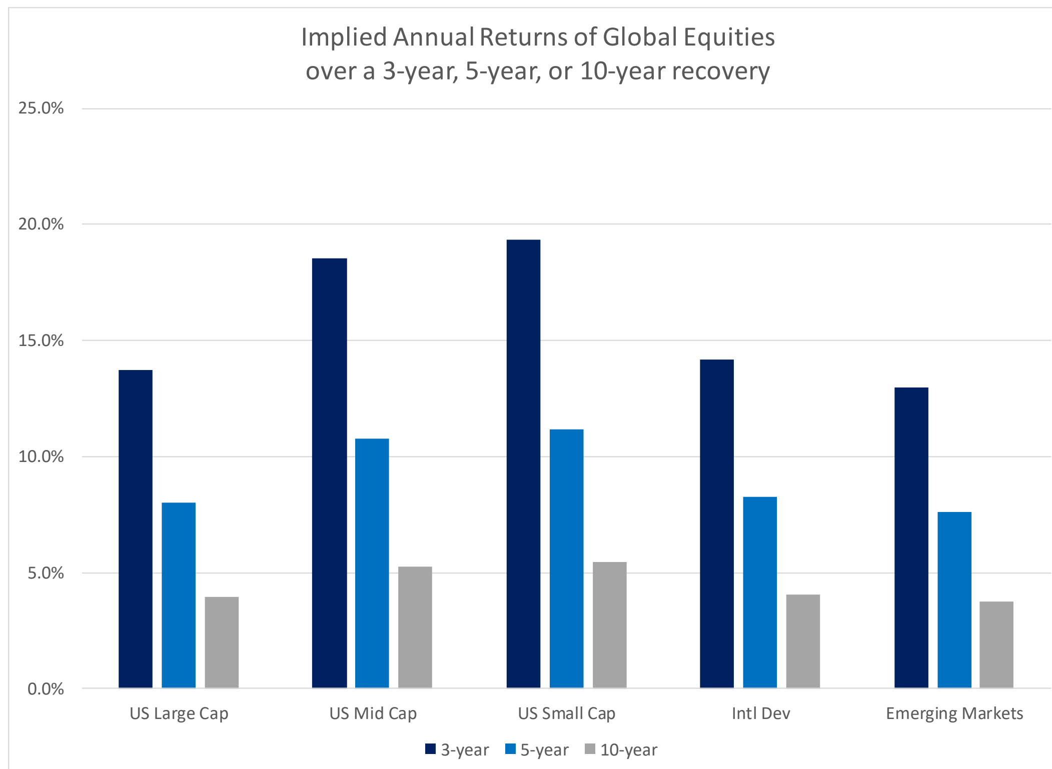
SPECIAL MARKET UPDATE: THE BABY WITH THE BATH WATER - THE WORLD IS NOT ENDING
March 23, 2020

How do you eat an elephant?
With daily briefings from the White House Coronavirus Task Force and state Governors, emergency meetings held by global Central Banks, and weekly conference calls from equity strategists and economists across the major Wall Street asset management firms, GDP and Earnings forecasts are being revised faster than information can realistically be consumed and properly analyzed by bottoms up investors.

As a result, the stock and bond markets are experiencing extreme volatility and individual securities are being treated ubiquitously, with many equity and asset class correlations approaching 1.0. Unless you truly believe that this virus is the end of the world as we know it (in which case you should put down this newsletter and immediately seek food and shelter from your underground bunker), this high level of correlation implies that investors are shooting first and asking questions later, creating opportunities for patient capital to swoop in and make strategic investment purchases that take advantage of this type of mispricing. Thus, the subject of this week's market update – how long shall we remain patient and what sub-asset classes, sectors or individual securities, are we at Collective Family Office starting to focus our attention towards.

First Step, Valuations
As we have noted in the past, this has been the most abrupt bear market in US history, with the S&P 500 declining 32% from its peak of 3386 on Feb 19 to 2304 last Friday (March 20, 2020). Regardless of how quickly you believe the disease will peak, the consensus of the scientific community is that a vaccine will be developed and deployed in the next 12-18 months. Historically markets recover prior to the economy, but even if the stock market takes 3 full years to revisit its February 2020 highs, that would imply a 13.7% annual return to owners of the S&P 500 at today's prices. If it were to take 5 years to recover, that would imply an 8% annual return, and if it were to take 10 years, that would imply a 4% annual return.



Compare that to a 3-year, 5-year, and 10-year bond, which pay investors between 0.85% and 1.1% and has zero appreciation at maturity. That is not even half the dividend yield of the S&P 500 (2.7%), and far below the implied growth rate, even if it were to take a decade for the market to recover. While the market can certainly go lower, even a draconian 5-year recovery scenario suggests that the US equity market is cheap.

Setting Up Portfolios for the Long-term

The problem, of course, is fear and uncertainty. The US is arguably two weeks behind Europe, which is itself four weeks behind Asia in terms of the spread of the coronavirus. At this stage, we will likely continue to see the number of infections rising by 200% per week for many weeks to come. This weekly tripling of cases is very difficult to internalize. When you are dealing with exponential curves where the X-Axis is time and the Y-Axis is death, humans tend to act even more irrationally. But brains and courage will prevail, and the time to begin putting capital to work is now.

Next Step, Tax-Loss Harvesting

If the first step is valuations, the net is tax loss harvesting. This is the process of selling sub-asset classes (such as US Large, Mid or Small Cap) in order to generate realized long-term and short-term losses, and replacing these position for at least 30 days with similar exposure through securities such as ETFs and Index Funds to insulate yourself from any potential market rallies. By maintaining the same asset class exposure, and harvesting losses, we are turning paper losses into future profits without taking on any meaningful risk in the portfolio.

Third Step, Rebalancing

A 60% Stock / 40% Bond portfolio at the beginning of the year looks more like a 52% Stock / 48% Bond portfolio today due to market fluctuations. In other words, the market has already de-risked portfolios through its daily price movements. As we approach the end of our 30-day tax-loss harvesting period, we

will begin to rebalance portfolios back towards their target weightings. While this may sound simple enough, practically speaking, this forces investors to purchase equities at depressed prices and sell bonds near historical highs, setting clients up to benefit over the long-term from the inevitable market recovery. While many will have capital gains to contend with, recent market declines have dramatically reduced the cost of rebalancing, and future returns should overcome these costs for most investors.

Fourth Step, Tactical Allocations

Equity prices have fallen across the globe, with YTD performance ranging from -22% to -42% depending on the sub-asset class. This causes many to wonder, are there areas of the globe we should be paying particular attention to?

	YTD Return		YTD Return
US LARGE CAP	-27.21%	INTL DEV VALUE	-36.27%
US LARGE CAP GROWTH	-22.36%	INTL DEV SMALL CAP	-38.40%
US SMALL CAP	-38.46%	INTL DEV SMALL CAP VALUE	-39.06%
US SMALL CAP VALUE	-41.36%		
US MID CAP	-36.79%	EMERGING MARKETS	-29.32%

Valuation disparities that persisted before the recession, such as value vs. growth, international vs. domestic, and municipal bonds vs treasuries continue to occur, and in many cases have further expanded. Additionally, the performance differentials between the various sectors of the economy have led us to begin to analyze those that are systemically important, such as the financial, healthcare, and energy sectors. We are paying particular attention to closed-end funds, conglomerates and publicly traded private equity managers, many of which are providing investors the opportunity to buy dollars for 60-70 cents, as they trade well below the Net Asset Value of their fund holdings. Finally, we are interested in dividend paying and preferred stocks of companies with low payout ratios, high retained earnings, and historical buybacks, all of which provide cushions to the dividend recipient.

We believe it is too early to implement these specific types of trades, yet is time to begin our due diligence such that we are in a position to consider reallocating a portion of US Large, Mid or Small Cap towards these types of themes later in the year.

The weeks and months ahead

As we enter a period of weak fundamental economic data (GDP, retail sales, unemployment, industrial production) that will prove to be more negative than we have ever seen during our lifetimes, offset by unprecedented fiscal and monetary policy intervention from both the Federal Government and the Federal Reserve, we would expect increased volatility to provide opportunities to enter some of the tactical themes referenced above. It will be months before we have a real feel for the impact of the social distancing recession on GDP, and weeks before we have clarity as to when we will begin to re-start our economy (hint – it will not be in 15 days). During that time corporate earnings are likely to turn negative, GDP may decline at a 20% annual rate (~$1T in a single quarter), and unemployment will likely rise above 10%. Yet, a disciplined process of rebalancing and repositioning in-line with long-term target weightings will prove to be the most effective means of taking advantage of the current market dislocations.

For those investors with cash, we continue to recommend a dollar-cost averaging approach to reinvesting capital, investing four tranches as the market breaches -25%, -30%, -35%, and -40% levels

compared to year end 2019. The bleakest of these situations may not materialize, but by that time there will be more clarity on thematic ways of participating in the rebound.

Ultimately, there are six conditions under which the market can begin to price in a recovery, as Goldman Sachs suggests. These include

- A stabilization or flattening out of the infection rate curve in the US and Europe
- Visibility on the depth and duration of disruptions on the economy
- Sufficiently large global stimulus
- A mitigation of funding and liquidity stresses
- Deep undervaluation across major assets and position reduction
- No intensification of other tail risks

Until that time, we will follow the advice of Warren Buffet - most investors cannot resist the temptation to constantly buy and sell, yet lethargy bordering on sloth should remain the cornerstone of an investment style.

As always, feel free to call if you have any questions, or would like to discuss further.

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