MARKET INSIGHTS

SECOND QUARTER 2020

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Late March now seems like an eternity ago as we think back to those stressful days when fears of the pandemic peaked and market levels troughed. Humans have since emerged from lockdowns and begun to immerse themselves (almost) fully into society. In Vero Beach, it feels like business as usual with traffic and human flow noticeably back to normal. It will take some time, however, for the reopening to fully work itself through global economic data as second quarter figures will still be ugly. Per usual though, financial markets started to discount a reopening and a recovery well before it was visible on Main Street. The S&P 500 has rallied 39% off its March 23rd lows. Just as it was impossible to predict the bear market/recession, predicting the timing and speed of the initial projected recovery (not the recovery, itself) was just as difficult.

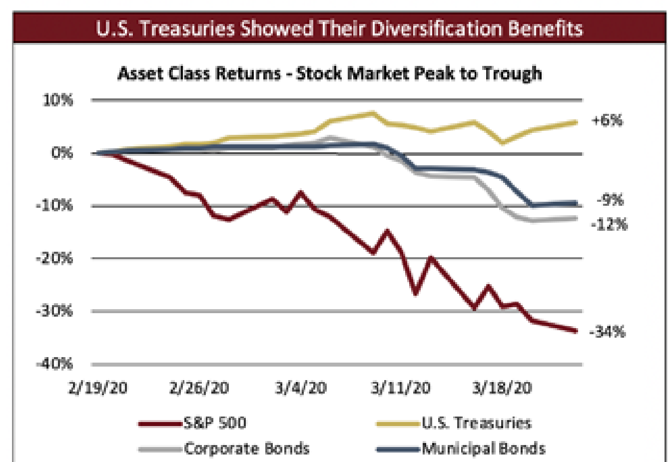
> ***Losers live in the past. Winners learn from the past and enjoy working in the present toward the future.***
>
> \- Denis Waitley

We find it helpful to look back on periods of market dislocation to identify the lessons. A key theme has been the 3 L's. No, it's not location, location, location; rather, it's liquidity, liquidity, liquidity. **Liquidity** at the investor level. **Liquidity** at the market level. **Liquidity** at the corporate level.

Starting with the investor... A typical first piece of financial advice when you start to earn a living is to "save for a rainy day." Well, we just went through a monsoon. Those that heeded the advice were better off. We stress having 6-12 months of cash for living expenses on hand to all our clients, independent of wealth or phase of life. We hope we are preaching to the choir but believe reiterating is worthwhile. Cash reserves provide a buffer (even if just a stress buffer) to declines in wages, portfolio values, and/or income from your portfolio. It also may prevent the need to raise liquidity from your investment portfolios in periods like this March and April when it is likely most **damaging** to your long-term net worth. That brings us to our next area of liquidity – the market.

Many asset classes and securities that were perceived to be liquid frankly froze in mid-March. Liquidity in this instance means an adequate number of willing buyers and sellers. Liquidity issues were visible in both equity and bond markets. It wasn't only risky securities that were experiencing issues but "safe" assets too. Those individuals looking or needing to sell corporate or municipal bonds, for example, likely would have had to do so at 5-10% haircuts to intrinsic values. This is the **"damaging"** that we are referring to above.

On the other hand, U.S. Treasury bonds, perhaps the most loathed asset class due to the paltry yield, remained liquid. If clients needed cash in March and April, U.S. Treasuries were the preferred first line of defense. While the current yields are tough to swallow and do not provide much in the way of real returns, we were reminded of their virtues from a portfolio management perspective – liquidity and negative correlation. In times of ultimate stress, when asset classes **depreciate** in unison, it is often only U.S. Treasuries that are



Source: Bloomberg, S&P Indices, BofA/ML Indices

Notes: Indices indexed to 0 on February 19th.

appreciating in value and providing diversification to the rest of the portfolio. As a result, while we typically only allocate a small percentage to U.S. Treasuries, this period confirmed the benefit of that portfolio management practice.

Finally, the corporate level… Probably never in the modern history of developed economies have so many businesses (restaurants, hotels, cruise liners, airlines, gyms, movie theaters, theme parks, etc.) experienced sales dropping to essentially $0 and, thus, short-term liquidity has never been so important. Those with adequate cash to pay bills should survive and those without liquidity will likely not. As a result, bankruptcies are expected to surge. Thanks to our liquidity criteria, we've been fortunate enough thus far to avoid any defaults in our bond portfolio.

Raising liquidity during a crisis can be prohibitive and costly, which eventually impacts a company's stock valuation and price. So not only is a strong balance sheet important in bond analysis, but it is also a key investment tenet on the equity side at VBGA. This period confirmed its virtue as, generally speaking, those companies with strong balance sheets performed better than those more highly leveraged.

> *"A good hockey player plays where the puck is. A great hockey player plays where the puck is going to be."*
>
> \- Wayne Gretzky

As much as we like to look to the past, looking to the future is our natural inclination. No doubt the pandemic will likely accelerate changes to our daily lives; shifts are already set in motion, many by technological innovation. Many of us had already become more "virtual" in our daily lives, highlighted by our shift from brick-and-mortar to online shopping. The "safer-at-home" order forced us to embrace virtual lives even further. Online shopping for groceries and pharmaceuticals had not been widely adopted yet, but this period will likely convert more. Virtual meetings have been the order of the day for business, and they will certainly remain in some form or fashion. Online banking is another trend that will likely intensify. Anecdotally, we have heard that banks have done more in the last two months than the previous 12 years to push their clientele towards online and mobile activities. The list goes on as humans have switched many physical interactions to virtual ones.

Automation of production lines has been a developing trend, and we believe the coronavirus will accelerate it. Simply put, robots are immune to viruses. Those manufacturers that had already transitioned were certainly in much better shape. Those that had business continuity issues as a result of outbreaks or social-distancing requirements will likely look to pursue higher factory automation and robot implementation to not only reduce human vulnerability to future pandemics but also reap the traditional benefit of streamlined operations.

Virtual interactions and robotics depend on technology such as network equipment, cell phone towers, fiber optics, the cloud, semiconductors, etc. When all is said and done, we believe the biggest winners from the pandemic's disruption will be the collective technology and automation segment. There is a reason why technology is typically our largest portfolio sector exposure.

We've mentioned themes - past, present, and future - that we are thinking about as we attempt to minimize risks while providing real, long-term capital appreciation of your assets. It's not easy to balance the risk and rewards, but we believe we do our best work – both on the investment and planning front – in volatile periods like the last few months. We've enjoyed working with you in the past, we are working hard for you in this difficult moment, and we are excited to continue working together in the future.

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