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SLIMMON'S TAKE > TAKEAWAYS & KEY EXPECTATIONS

Andrew Slimmon May 2020 Equity Market Commentary

SOLUTIONS & MULTI-ASSET | APPLIED EQUITY ADVISORS TEAM | SLIMMON'S TAKE | MAY 2020

AUTHOR

ANDREW SLIMMON
Managing Director and Senior Portfolio Manager, Applied Equity Advisors

1. The primary reason we like to position our strategies as "Core" is to allow us to "opportunistically invest in value".

2. The investment textbooks tell us that *investing in value stocks has delivered better returns than investing in growth stocks* OVER THE LONG RUN.[1] However the short-term can be painful…**as evidenced by the last five years.**[2] Cheap (value) stocks can remain dormant a long time before coming to life. This is particularly problematic in this age of daily account access/performance which can shorten the duration of investors' patience.

   A permanent value bias is nice when you live in the ivory towers of academia, but not so much when you are on the front lines working with clients and managing their money.

3. AEA co-portfolio manager Phillip Kim's "value spread" chart I showed last month is starting to get noticed:

   "Our US Equity Strategy team notes that the majority of investors they speak with remain skeptical of the rally and are unwilling to embrace more aggressive early-cycle positioning.

   The chart below underscores this view of the market's underlying sentiment. Specifically, it shows the valuation spread between the cheapest 10 percent of the stocks in the Russell 1000 versus the median.

   The widest spreads occur during recessions, like today, and the spread narrows as quickly as it widens as the economy recovers. Our Strategists see no reason why it won't be the same this time around."[3]

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[1] Merrilledge. Growth vs. Value: two approaches to stock investing.

[2] Bloomberg: Since 2015, the Russell Large-Cap Growth has outperformed the Russell Large-Cap Value Index by 65%.

[3] Morgan Stanley: From the Director of Research: Charts That Caught My Eye. May 27, 2020

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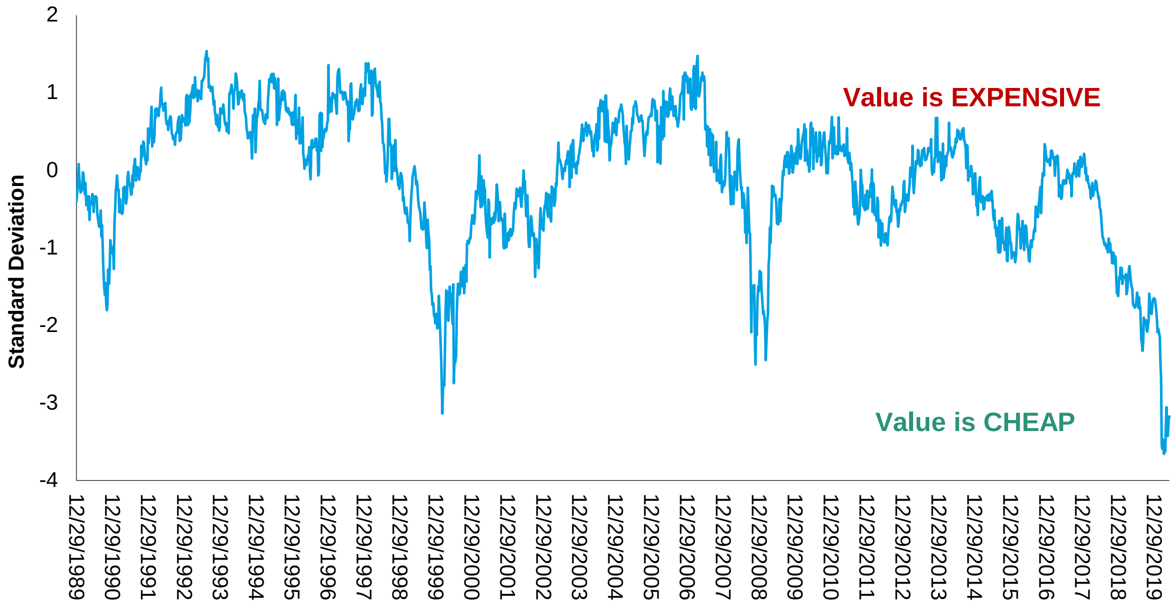
DISPLAY 1

"Value Has Always Been Cheapest During Recessions but It's Never Been This Extreme"

Value Spread
December 29, 1989 – May 29, 2020



Source: Morgan Stanley Investment Management (MSIM), Applied Equity Advisors

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4. If we know the "fat pitch" has been to buy value stocks in recessions, why don't investors just follow the script? Why, as the quote from above suggests, are they so "skeptical of the rally" and "unwilling to embrace" the opportunity?

   I believe it's due to the conflict between our human emotions, which are shaped by backward-looking recency bias, versus the pure, unemotional stock market that looks forward.

   Plus, with COVID-19 having hit so many people so close to, if not in, their homes, **the emotional conflict between recency bias and the best opportunity in the stock market has become *even more acute.***

   If you are still sheltering at home because it's too dangerous to go outside, it is difficult to emotionally conceive investing in a cruise ship or casino stock, even if those stocks are down 55% from their recent pre-COVID-19 prices.[4]

5. Our core strategies are now *opportunistically* overweighting value stocks in the US, with our largest relative sector exposures in financials, housing, and REITS.

   Keep in mind, if a stock has been sliced in half from its pre-COVID-19 high, there are a lot of potential bad earnings priced into the stock. If in fact that company's earnings are only down one-third, then the upside potential for the stock is very attractive.

   My belief is we will look back at this time and come to the realization that it was a great opportunity to

[4] Bloomberg. Average return of the three largest publicly traded cruise ship and three largest casino stocks. Peak to June 1, 2020 price return.

add high quality market leaders in economically sensitive sectors.

6. Speaking of behavioral finance, do you know why, in my opinion, we did not experience a "U" recovery, which so many originally predicted?

   Because that is the easiest scenario to invest in.

   A "U" rally would have been incredibly convenient, providing a comfortable period of time for all the prognosticators to go from bearish to bullish. That reminds me of a quote I have mentioned before:

   My experience is that the market rarely gives you what you want when you want it.

   The current "V" rally is not providing a window to re-enter equities for all the cash that is sitting on the side-lines. Classic market action.

7. My belief is we are "mostly" through pricing in the economy reopening. The S&P 500 has rallied all the way back to its 200-day moving average and is due for some pause.

   Anyone who has read these commentaries knows I always get a little more cautious in the summer months, as inevitably, some geo-political issue crops up to unnerve the market.

   I am confident that **expected** bad news (like a retransmission of COVID-19) will not cause nearly as much damage to the stock market as **unexpected** bad news. Therefore the unknown is what concerns me.

   My only reason not to become too cautious is due to #6. Too many investors want the market to go down. At worst, the market might just chop around for a while.

8. How then, does someone put money to work in equities today?

   Here are a few thoughts:

   1. If you have nothing invested in equities, you should consider putting some money to work **immediately**, regardless of current levels. In my opinion, anyone who thinks they are clairvoyant enough to have no equity exposure does not respect the market.

   2. As much as the market has increased lately, the return for the S&P 500 over the last five years is modestly *below* average.[5] It has not been a booming period, suggesting returns over the next five years could be above average.

   3. Prepare for some unexpected bad news this summer that will knock the market off-course. *Pullbacks happen for a reason*. That reason always feels far more serious than what investors desire.

   4. Weekly dollar cost averaging* over the next few months is a great way to prevent yourself from *not* buying at the time when you *should* buy. Be realistic, not bull-headed, about your emotional intelligence quotient and put a process in place that should help prevent bad outcomes.

One final note. Bears always sound smarter then bulls, but if the average stock return is roughly +10.3% per year[6], being a bear for too long has been anything but smart.

Andrew

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[5] Bespoke Investment. Last five year returns through May 31st is +9.9% versus long term average return of 10.3%.

[6] Long-term average return of the S&P 500 according to Bespoke Investments.

*** A program of regular investment such as dollar cost averaging cannot assure a profit or protect against a loss in a declining market. Since such a program involves continuous investments, investors should consider their financial ability to continue the program though all market cycles.**

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