NAPATREE CAPITAL

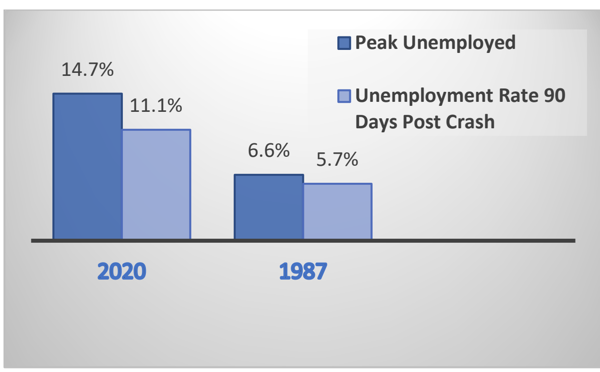
Viewpoints | July 25, 2020

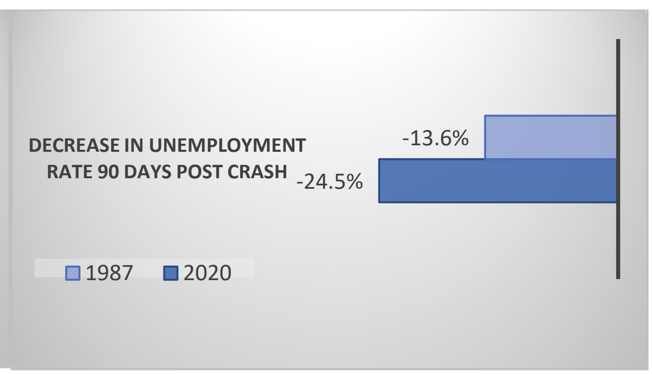
THE SIX-MONTH HEADACHE

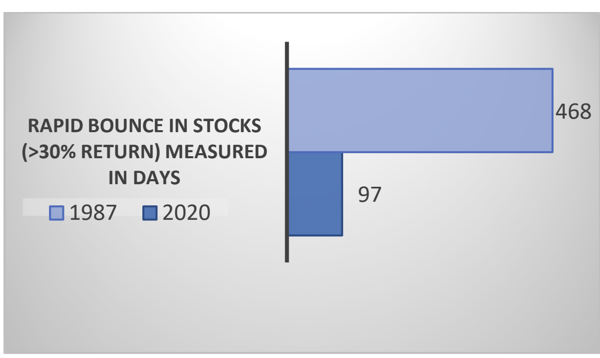
Well, *that* was an interesting six months. The stock market has gone from extreme panic to near euphoria in about 90 days. In our March 15 note, titled "Coronavirus Crash. What Now? What Next?", we highlighted the extreme selling pressure and why history was on the side of buyers, not sellers:

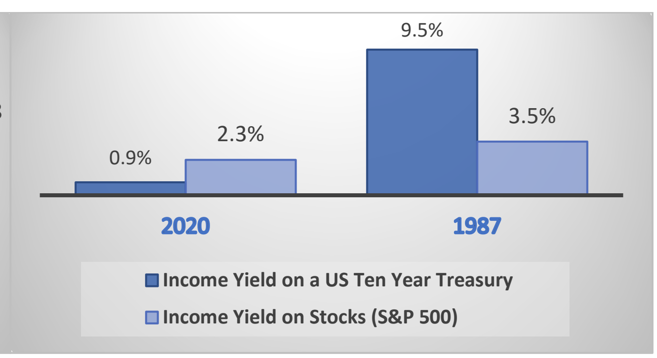
> *The level of selling in the stock market is nearly unprecedented. On Wednesday and Thursday of this past week, stocks gave up more than 16% in value. That has only occurred one other time in history: Black Monday, October 1987. If an investor held through that turmoil, she was rewarded as stocks returned between 25-30% a year later.*

Stocks bottomed on March 23, four trading sessions after we sent out that note. We are not market timers, but we pay especially close attention to data during tumultuous periods. Investors were soon rewarded for their patience as the market cratered. Let's look at some further comparisons using 1987 as a parallel to the coronavirus crash:









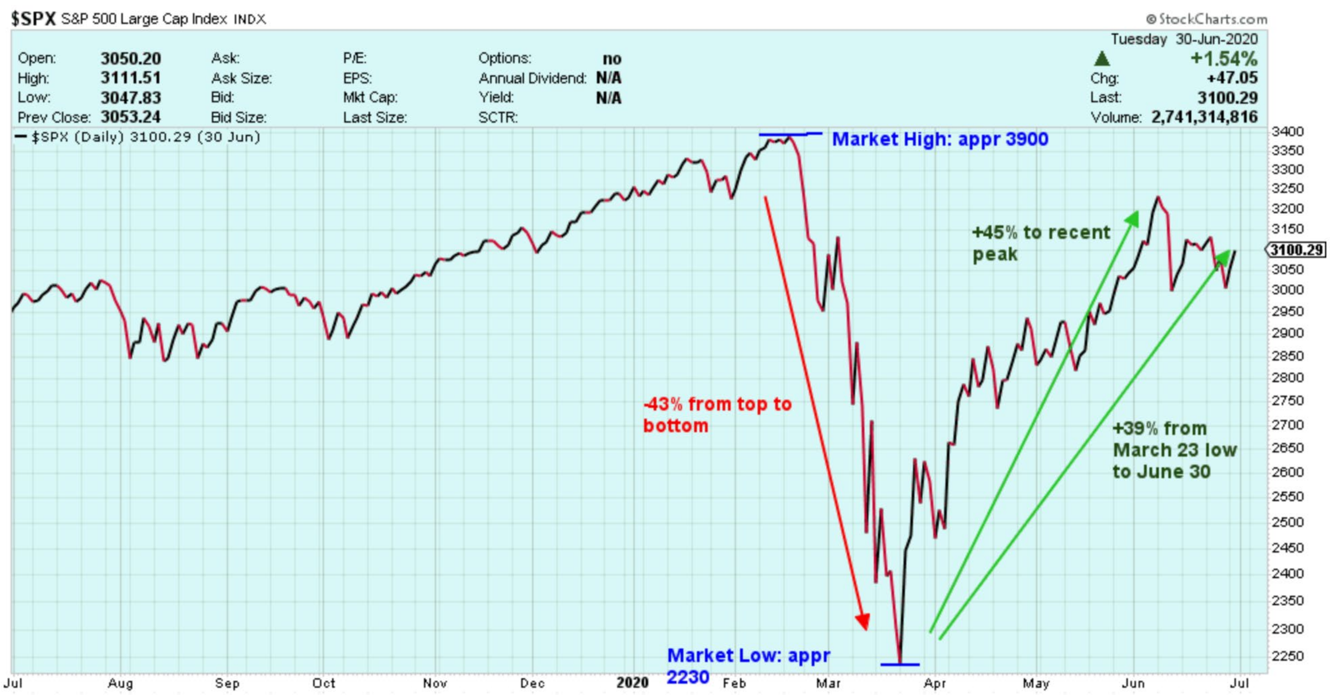
The labor trend seems to be similar. Unemployment spiked, virtually overnight, to a peak of 14.7%, considerably higher than the 1987 peak. However, the rate of decrease is much greater, as seen in the top right-hand chart. Examining the 90-day post-crash period, we see that the unemployment rate has declined much more sharply than in 1987, but it is currently still almost twice as high as it was then. Investors will be paying close attention to the weekly new unemployment claims, a decent leading indicator of the economy.

While the top two charts illustrate the damaging economic effects of the Coronavirus, the bottom two help convey the speed of the recovery in stocks, and hint toward a reason why.

Here's an illustration, using the Napatree investment committee's pragmatic approach to investing. If an investor had only two choices – stocks, as represented by the S&P 500, or bonds, as represented as a 10-Year US Treasury bill (which is risk free) – how might she or he evaluate that decision?

Typically, investors rush into less risky assets (bonds) as stocks collapse, forcing income yields lower for bonds. Following the 1987 crash, an investor could generate 2.7x more income from bonds than from stocks, with virtually no risk to principal. After the March crash this year, income yields for stocks were considerably higher than bonds; an investor can now generate 2.5x more income from stocks. It is almost the complete inverse situation. One important distinction: a 10-Year US Treasury bill yielded 9.5% in the 90 days after the 1987 crash. Presently, that same treasury bill yields 0.7%. Now add in nearly $2 trillion of government stimulus, which is almost 10% of our current GDP and the most fiscal support in history, and it isn't difficult to understand why stocks have had such a forceful recovery.

Looks like a "V-shaped" recovery so far…



Despite our March note highlighting why we thought stocks were close to a bottom, this is not a victory lap. Candidly, the market behavior from February to mid-April was some of the most turbulent we've ever experienced, and we felt the incredible pressure, stress, and disbelief that most others felt. If you recall, we lowered our equity exposure early in the year (see our note titled "Time to Play Defense", January 13, 2020). Perhaps our one mistake is that we didn't then increase our equity exposure in March.

In the spirit of full transparency, these are the actions we undertook in our investment strategies during that period.

PORTFOLIO TURNOVER

Tax Loss Harvesting

Trading activity in your account was likely much higher than usual during the March – May time frame. Our investment committee made several changes to our proprietary strategies. We also took advantage of realizing losses in some stocks and exchange traded funds (ETFs) and simultaneously reinvested the proceeds. This is a portfolio management approach known as "tax loss harvesting." While accumulating *losses* may seem antithetical to producing investment *gains,* the effect potentially boosts longer-term returns. Accumulating losses offsets gains when a security is sold for a profit and reduces an investor's tax liability.

As a refresher, Napatree Capital employs the following proprietary strategies. Your portfolio may be constructed using one strategy or a combination of several.

Name	Style	Description	2020 Return*	Benchmark**
Focused Value	Equity	Concentrated value portfolio using individual stocks based on fundamental & technical research - financial statement analysis, qualitive and quantitative metrics - meant for long term investing. Benchmarked against the Russell 1000 Value index; currently produces dividend income in excess of the S&P 500. Typically invest in 30-50 stocks.	-13.4%	-16.2%
Strategic Equity	Equity	Diversified equity portfolio using exchange traded funds (ETFs) benchmarked against MSCI ACWI Index. High correlation to US and International stock markets. Actively managed through tactical investments and consistent rebalance discipline.	-9.4%	-6.3%
Strategic Fixed Income	Fixed Income	Diversified fixed income portfolio using short- and intermediate- term investment grade, US, credit and exchange traded funds (ETFs) benchmarked against Barclays Global Aggregate Index. Duration managed based on proprietary research and yield curve analysis.	4.5%	3.0%
Short Term Fixed Income	Fixed Income	Short duration treasury portfolio recommended as 'cash alternative for investors. Invests in debt with explicit or implicit backing of the United States Treasury and/or money market instruments.	N/A	

** Returns based on model performance, but closely reflects actual account with no investment restrictions*

*** Benchmarks vary by strategy; see 'Description' for the actual benchmark used*

Actual Trades

Between February 27 and March 26, we exited eight holdings across two of the equity strategies and initiated 15 new investments.

FOCUSED VALUE STRATEGY

BUYS

Date	Symbol	Co Name	Sector/Industry	Return to June 30
5-Mar	PINS	Pinterest	Communication/Internet Svcs	27%
16-Mar	NTAP	NetApp	Technology/Hardware	11%
16-Mar	MMM	3M Co	Industrials	21%
16-Mar	MDC	MDC Holdings	Consumer/Home Construction	71%
16-Mar	GSK	Glaxosmithkline	Healthcare/Pharma	19%
16-Mar	FDX	Fedex Corp	Industrials	81%
16-Mar	CAH	Cardinal Health	Healthcare/Med Supplies	30%
16-Mar	ADBE	Adobe	Technology/Software	44%
16-Mar	XOM	Exxon	Energy	26%
18-Mar	SIVB	Silicon Valley Banl	Financial/Banks	52%
19-Mar	ROKU	ROKU Inc	Technology/Hardware	109%
19-Mar	AMZN	Amazon	Consumer/Retail	61%
			avg return	*46%*
			Russell 1000 (from March bottom)	*34%*

SELLS

Date	Symbol	Co Name	Sector/Industry	Return to June 30
27-Feb	AMCX	AMC Networks	Consumer/Broadcasting	-13%
6-Mar	EOG	EOG Resources	Energy	-10%
9-Mar	RCL	Royal Caribbean	Consumer/Cruise Lines	55%
12-Mar	STAY	Extended Stay Am	Consumer/Hospitality	64%
16-Mar	PACW	Pacwest Bancorp	Financial/Banks	-3%
			avg return	*24%*
			Russell 1000 (from March bottom)	*34%*

STRATEGIC EQUITY

BUYS

Date	Symbol	Co Name	Category	Return to June 30
25-Mar	EFV	iShares MSCI Value ETF	International Developed Markets	16%
25-Mar	IEMG	iShares MSCI Core ETF	International Emerging Markets	29%
26-Mar	RYPNX	Royce Opportunity Fund	Small Cap	26%
			avg return	*24%*

SELLS

Date	Symbol	Co Name	Category	Return to June 30
25-Mar	SCHF	Schwab Int'l ETF	International Developed Markets	22%
25-Mar	SCHE	Schwab Emerging Markets	International Emerging Markets	30%
26-Mar	SCHA	Schwab Small Cap ETF	Small Cap	27%
			avg return	*26%*

The results are promising thus far, though it has only been a few months. We work diligently to adhere to disciplined investing and keep your portfolio positioned for the long term. Our investment committee reacted to the data and took advantage of the weakness, investing opportunistically on your behalf.

AFTER THE CRASH: A POTENTIAL BUBBLE?

It's hard to believe that there is talk of a bubble so soon after a major market collapse. Below is a list of factors that support that narrative:

- ✓ Commission-free trading
- ✓ Access to fractional share ownership
- ✓ Robinhood traders
- ✓ Increase of initial public offerings (IPOs) for companies with no earnings
- ✓ Speculation leading to sharp swings in little known companies
- ✓ Anecdotal evidence that "making money in stocks is easy"

While much of this concerns us as experienced investors who manage risk for a living, we do not believe this is the summer of 2000, which was the beginning of the end for tech stocks. First, the level of optimism for investing was uniformly euphoric in 1999, which our team is uniquely qualified to discuss. Prior to and during the tech crash of 2000-2001, two of us were NASDAQ traders on a very active trading desk for a well-regarded Boston-based investment bank. We are not looking at a redux of 2001…*yet*.

We would welcome a pullback in the coming months. We believe that growth stocks are overinvested, and value stocks still have a long runway. But we've believed that for quite some time.

Still, a "party like its 1999" wouldn't be terrible: stocks rallied nearly 25% from the autumn of 1999 to the spring of 2000. But don't break out the bubbly just yet.