Colchester Investment Counsel LLC

2020 Second Quarter Investment Review

Few investors will forget the first half of 2020. **The worst first quarter in many decades was followed by an almost equally furious spring rally that enabled stocks to recoup much of what was lost earlier this year**. The equity rebound followed a long-held script: US stocks performed better than those overseas, and "growth" equities left "value" in the dust. **Investors continued to pile into FAAMG** (Facebook, Amazon, Apple, Microsoft and Google), **which now accounts for 22% of the total value of the S&P 500**, and reflects a market that is now more concentrated than during the 2000 peak of the internet bubble. The rally off the March lows was largely powered by these, and other, world-class technology businesses. Illustrating the extent of their influence on the major indices, the capitalization weighted S&P 500 finished the June quarter down just 3% for the year, while the equal weighted S&P declined a far greater 12%. **Adding to the powerful move were more speculative issues** that caught the imagination of those willing to assume considerable, and perhaps excessive, risk.

Fixed income investments provided low single-digit returns in the second quarter, and it seems reasonable to expect similar results for some time as "zero interest rates are here to stay through 2022" according to Federal Reserve Chairman Powell. While modest, these returns exceed inflation, and are a stabilizing element to balanced portfolios.

The COVID crash and subsequent surge illustrate once again the enormous impact of emotion on investment decisions. In March, the majority of investors were distraught as stocks plummeted. This environment provided investors a chance to buy best of the best businesses on sale, though the opportunity was somewhat fleeting as the government reacted dramatically, printing and providing trillions of dollars to individuals, businesses and markets in record time. **Most everyone believed a big bounce was due after the crash, but almost no one foresaw the extent of the rebound**. **At this point, and with the character of the quick reversal in stocks so startling, we are now counseling caution.**

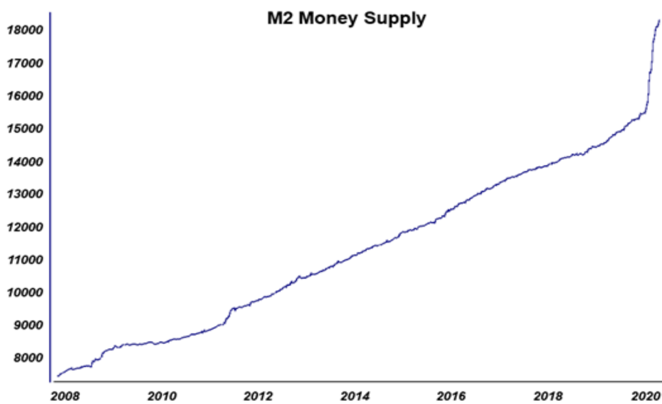
Just as we urge clients to be calm and constructive (buy when others are selling, think long-term, stick to your plan) in the midst of turmoil, now is a time to be more careful, and to monitor the speculative market party that started in April.

Making Sense of What Might Not Make Sense

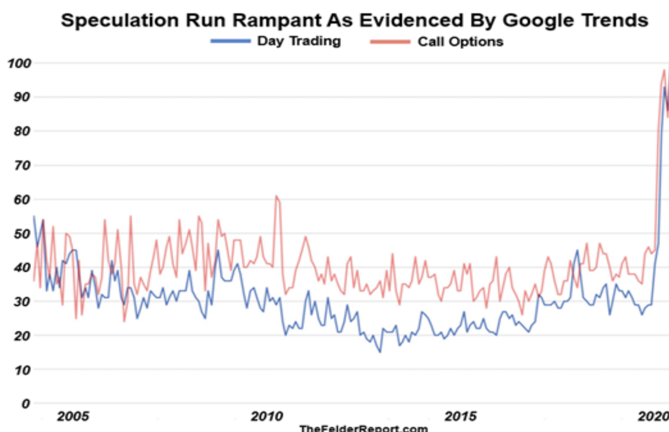
No doubt, **less bad is often quite good for financial asset prices,** and improved news surrounding the virus, together with the economic re-opening around the country, has heartened investors. **Yet, the chasm between stock prices and stock fundamentals seems to have reached astounding proportions.** The world is combatting the greatest pandemic in a century, and the worst economic contraction since the 1930's Great Depression. The stock market, however, reputably an indicator of future prospects, has approached 2019 year-end levels despite little evidence that supportive fundamentals will return anytime soon.

Some of the market's move must be attributed to the "better" virus and economic news noted above. But, while markets always look to the future, the fact remains that 1) the damage to economic and corporate earnings prospects is difficult to quantify at this point, 2) uncertainty exists over the timing of any vaccine and COVID-19 has recently spread to parts of the country that had been largely spared, and 3) equity valuations have become stretched again almost regardless of how strong the recovery unfolds. Moreover, it must be noted that the coming fall election offers uncertainty as to future economic and tax policies. **The bottom line is that some recovery in equities was to be expected, but was the magnitude justified?** With all this as backdrop, we are often asked, "what is going on?"

Put simply, **the relief rally that occurred when the worst case virus/economic fears did not develop has morphed into a liquidity and speculation driven phase**. The chart below reflects M2, which measures the money supply in the US.



The US government has printed trillions of dollars over the past decade or so, with the amount exploding in recent months, and a meaningful portion has found its way into stocks and bonds. Having announced in the spring its intention to buy bond funds (and more recently individual bonds), the Fed is now already one the biggest holders of the largest bond ETF's. Many believe, and this would not be a surprise to us, that the Fed will buy stocks before too long. Bailing out "zombie" companies, nationalizing credit markets, and convincing investors that the Fed has put a floor under stock prices is controversial in some circles; we will leave the "moral hazard" conversation to others. **From an investment perspective, it is clear that these circumstances have fostered a speculative environment**, one in which fundamentals and valuation appear to be of limited relevance for now. **Investor sentiment has moved from guarded to greedy**, with the current mood reminding us of the internet bubble days of the late 1990's. The chart below leaves little doubt that speculation has returned as a driving force behind the current move in stocks.



Retail investors appear to have had as much influence, or more, on the recent rally as data, policies, or valuation. With sports shut down and casinos closed, millions of first time investors have "gambled" (their words) the proceeds of government stimulus checks into risky stocks, including bankrupt firms like Hertz and J.C. Penney. The equity value of bankrupt companies is almost always zero; this irrational behavior easily matches that witnessed during the internet bubble. While speculative markets can l ast far longer than anyone imagines, invariably those periods do not end well. **Icing the cake, so to speak, on this period of wild activity is a quote from the widely followed founder of a pop culture blog: "I'm sure Warren Buffet is a great guy, but when it comes to stocks, he's washed up"**. Also, "stocks only go up, this is the easiest game I've been part of". Our reaction is a simple and yet emphatic **Hmmmm**.

Three months ago, our letter noted that severe pullbacks have occurred regularly throughout history, yet have always offered an opportunity to buy quality companies on sale. We further opined that panic is not a strategy, but prudently taking advantage of opportunities presented by others who are panicking most always generates favorable results. **Your portfolio reflects this advice, as a number of wonderful companies provided generous entry points in recent months**. Yet just as panic is not a helpful emotion, neither is greed. Legendary investor Howard Marks once noted "in the real world, things generally fluctuate between pretty good and not so hot. But in the world of investing, perception often swings from flawless to hopeless and back". Roller coaster rides may be fun for a while, but the enjoyment is most always ephemeral. To the contrary, **a steady, sensible and objective investment process, focused on quality, discipline and long-term considerations typically provides a lasting framework for solid investment returns and the assumption of far less risk**. **This approach has been, and will continue to be, the foundation of our service to Colchester clients**.

As always, we appreciate you taking the time to read our quarterly review and look forward to your thoughts and questions.

Neil S. Kenagy

440 Main Street
Ridgefield, CT 6877

www.colchesteric.com

Phone: (203) 438-0046
nsk@colchesteric.com