Colchester Investment Counsel LLC

2020 First Quarter Investment Review—April 2020

"In the 20th century, the United States endured two world wars…the Depression, a dozen or so recessions and financial panics, oil shocks, a flu epidemic…yet the Dow rose from 66 to 11,497." Warren Buffett 2008

Our most important and sincere concern is for anyone who is sick or at high risk during this difficult time. Kathy, Evan and I hope that you and your loved ones are healthy.

After a strong start to the year, **the onset of the coronavirus triggered a massive sell-off in financial assets worldwide**. Despite a late quarter rally, stocks were decimated, ending the 11 year old bull market with a speed and magnitude never before witnessed (36% drop from peak to trough in 4 weeks). **The driving forces behind the rapid collapse in equities, and dramatic widening of bond spreads between quality and "junk" credits, were the forced selling of passively managed index investments (i.e. mutual fund redemptions), the partial unwinding of massive leverage built up since the financial crisis (hedge fund margin calls), and the escalation of algorithmic computer trading**. The dash for cash resulted in the often indiscriminate selling of stocks and bonds, both the highest quality and the most risky. Within fixed income, high yield bonds took the worst toll, but even AAA rated issues were sold at any price for a time.

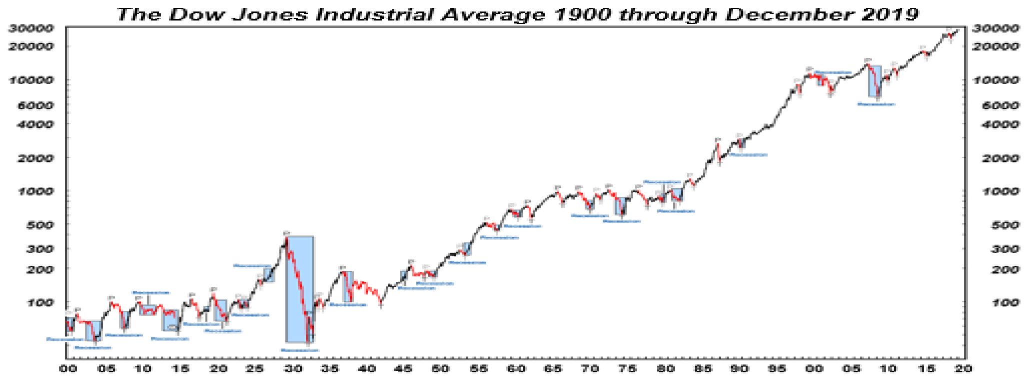
These actions were caused by both fear of the virus in the present and longer term uncertainty regarding economic conditions. **While history is littered with examples of the harmful impact that fear based selling has on investment returns, when crises occur, the common reaction of the human condition is to panic**. Many sell to stop the pain, others because, as noted above, they have no choice. As panic recedes, investors will assess the damage created by the virus, and price in expectations accordingly. With millions of small businesses shuttered, and possibly multiples of that number suddenly unemployed, a recession is clearly in our near future. Predictions for its severity are all over the map with some calling for a short and sharp drop in economic activity, followed by a "V" recovery, and others suggesting the onset of another great depression. No one knows how long our lives and the economy will be impacted, with the unknowns being the length and depth of the virus, and the effectiveness of government efforts to combat its impact.

Indeed, **volatile market conditions are likely to continue due to lack of clarity with respect to the return of social and economic normalcy. What is clear, however, is the extent of support contained in the government's stimulus bill and, even more so, the unprecedented actions taken by the Federal Reserve**. Hopefully, the $2 trillion stimulus will allow businesses to survive and employees to be paid. This dollar figure exceeds most estimates of the economic damage that will be caused by the virus. As important, the effects of the Fed's recent initiatives are already apparent, as credit markets have calmed and bond spreads narrowed. Without getting into the weeds of monetary policy, it is clear that the "lender of last resort" moniker has taken on a whole new meaning; the Fed's expanded programs are truly vast and powerful. Suffice to say that, for now, these policies are needed and will be instrumental in repairing our economy.

Our Strategy

Recognizing, of course, that it is always difficult to watch portfolio values fall, owning high quality securities, together with maintaining cautious asset allocations within balanced accounts, have helped to cushion the blow of this tumultuous market environment. **We hope you find it helpful to know that while this market decline is different in one respect, due to the human suffering involved, it reflects many characteristics that are quite typical of most bear markets**. These include heightened volatility, seemingly irrational day-to-day trading activity, and a myopic investor focus on the short-term and negative events close at hand. **It is, therefore, critical to remember that scary pullbacks have occurred regularly through history, yet have always offered an opportunity to buy quality companies on sale**. Put succinctly, panic is not a strategy.

Our strategy is to remain calm and patient, to prudently take advantage of opportunities presented by others who are panicking, to be comforted by the history of US market recoveries, and to heed Warren Buffett's commentary that introduces this letter. Indeed, **over time, stocks have suffered through wars, recessions, and financial crises, and have always rebounded, as shown in the following chart**.



We have started the process of buying the best of the best companies, and will continue to do so in coming weeks on days when the market is down. These businesses all have balance sheets capable of surviving the worst imaginable recession, and histories of success that have made them terrific investments over long periods. We will not get the bottom tick, but all of the equities on our list have been hit hard in this market freefall, and currently sell at valuations that should offer excellent returns over any meaningful period. **The historic returns of stocks after steep sell-offs such as the one we are currently experiencing are illustrated below**. Thus far, the current downdraft, from top to bottom, is between 35-40%. Long-term returns have been healthy from this level and there is no reason to believe this time will be any different. Bonds will continue to provide stability to portfolios, as they did in the first quarter, and have for years.

Percent From High	3 Months	6 Months	1 Year	3 Year	10 Year	20 Year
0%-5%	2.0%	4.1%	8.3%	8.3%	6.6%	6.1%
5%-10%	1.8%	3.6%	7.1%	6.8%	6.4%	6.5%
10%-15%	2.2%	3.6%	7.1%	6.7%	7.6%	8.0%
15%-20%	0.9%	1.7%	9.3%	5.7%	8.5%	9.1%
20%-25%	1.3%	3.5%	9.5%	8.4%	7.9%	9.0%
25%-30%	2.4%	3.8%	8.4%	8.5%	6.9%	9.6%
30%-35%	5.2%	8.6%	13.7%	9.3%	7.0%	9.0%
35%-40%	1.7%	7.8%	14.0%	9.5%	7.2%	9.5%
40%-45%	4.6%	13.7%	23.8%	12.2%	8.2%	9.9%
45%-50%	8.7%	19.2%	34.8%	16.0%	10.0%	10.4%
50%+	24.2%	36.8%	53.1%	22.7%	14.2%	*Data from Ycharts*

The shape of the inevitable economic and earnings recovery is unknown, and will be for some time. While 2020 projections are worth little, it seems fair that 2021 earnings could return to year-end 2019 levels, meaning that the market is currently trading near its long-term average P/E of 15. While not dirt cheap, this valuation is quite reasonable in a zero percent interest rate environment. **We have long noted the importance of not just financial capital, but of mental capital as well in the investment process. This means the ability to mute negative headlines, control emotions, and buy when others are unable to.** This is not easy, and the timing of the eventual turn is impossible to ascertain, but this is the time to deploy mental, as well as financial, capital. We are here to help you navigate this difficult period, and put you in a position to prosper from the better days that surely lie ahead.

Please stay healthy, and never hesitate to let us know if we can help you and your families in any way.

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