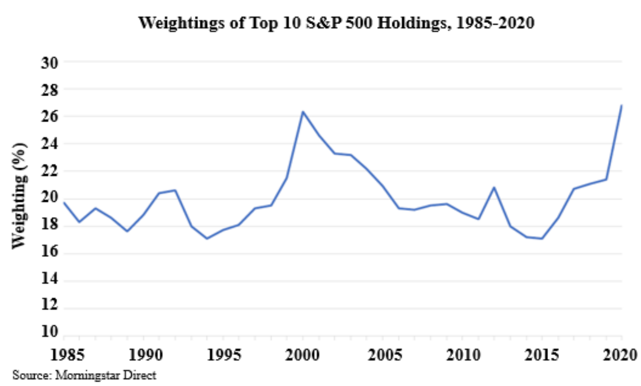
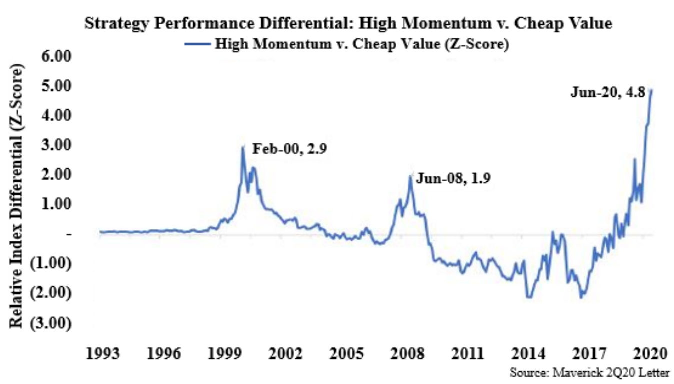
Colchester Investment Counsel LLC

2020 Third Quarter Investment Review

"Bull Markets are strongest when they are broad and weakest when they narrow to a handful of blue chip names"
Wall Street legend Bob Farrell's Rule #7

Despite a September swoon, stocks here and abroad advanced nicely in the third quarter, while fixed income returns were only slightly positive. **There was little "new news" during the summer, though the favorable trends and narratives established in the spring remained intact**. They include near-zero percent interest rates and staggering support (money printing) from central banks, generally better data on the Covid front, and not unexpected bounces in economic activity and corporate earnings. With no obvious reason to change, investors remained loyal to equities and strategies that have been successful for a number of consecutive years: technology in general, large companies as opposed to small, US relative to international and, most consequentially, growth vs. value. While the technology FAANG+ companies receive well-deserved attention and accolades, **most of the major indices remain down for the year; in fact a significant majority of individual stocks have suffered losses thus far in 2020. Moreover, the trend of "growth" stocks, specifically large companies, outperforming "value" is unprecedented** (32% year-to-date through September), as illustrated below.





These charts show that the S&P 500 Index is more concentrated than at any other time in history. Clearly, the top-weighted US stocks are stretched, from both valuation and performance perspectives. We are gratified to own a number of the superior companies that have prospered during this Covid-influenced time, but are also sensitive to the risk presented by rich valuations. This does not imply an exodus from these stocks that you own. Rather, it suggests that **a greater focus on certain out of favor market sectors (financial, industrial and consumer to name three) is warranted**, within the context of our discipline that emphasizes high quality and reasonable valuation. **The pandemic, and accompanying economic shock, has punished these groups. This is likely to change at some point.**

We are mindful that most successful investors zig when everyone else zags. Indeed, regression to the mean, where asset prices and returns eventually revert to their long-term averages, is a powerful investment tendency. This concept has proved remarkably consistent over numerous market cycles. Yet knowing that markets will revert to their mean does not suggest when this will occur. The catalyst is rarely obvious and patience is often required.

While we appreciate the current argument for owning dominant growth stocks, **investing is not an either/or pursuit**. In this context **we are a bit puzzled by the market's relative disdain for dividend payers. Companies that pay and consistently grow their dividends have outperformed the market averages over most all time frames**; these are high-quality organizations that have long track records of success, strong balance sheets, and business models with sustainable competitive advantages. **It seems reasonable that these stocks should be all the more valuable, and attractive, in a near-zero rate world where generating income is difficult**. There is no doubt that near-term headwinds cause uncertainty for many businesses; the coronavirus, potential for major changes in tax and regulatory policy after the coming election, and tough economic sledding for an unknown period fall into this camp. Yet, **from a longer-term perspective, many dividend "aristocrats", and others with stellar histories, appear to offer solid risk adjusted return potential and do not depend upon the euphoria that currently supports the imbalanced S&P 500**. Of course, your portfolio includes a number of these outstanding companies, and we will likely be adding to them in coming months.

It's Still About The Fed

The overwhelming force in today's financial markets continues to be central bank policy, both here in the US and around the world. Their policies are controversial. Defenders note that zero or negative interest rates and mountains of liquidity are necessary for economic stability. Detractors fret about potential longer-term consequences, including a weakened US dollar, meaningfully higher inflation, and moral hazard (bailing out failing companies and supporting the stock market). **One thing we know for sure is that current interest rates make fixed income investing a challenge**. As with equities, there is an overwhelming consensus in the credit markets; interest rates are expected to remain low (the Fed has promised as much for short-term rates), inflation meager, and the yield curve (difference between 2 and 10-year treasury yields) narrow. **Just as some quality dividend payers are relatively cheap, securities that protect against increased credit market volatility, higher expected inflation, and a steepening yield curve can also be owned today with a solid risk/reward outlook**. One of these investments was added to your portfolio during the recent quarter.

Final Thoughts

Low interest rates and dramatic money supply growth continue to be bullish factors for financial assets. But markets appear increasingly less stable, as evidenced by the above-noted macro uncertainties and somewhat fragile underpinnings. **History illustrates that excitable conditions often spur investors to do the wrong things**, such as buying risky stocks when they are already up in price because a story sounds good. The same concept also applies when stocks are falling, and fear becomes a natural reaction. **It is essential, therefore, to control emotions that can get in the way of making sound investment decisions**.

Part of this process should incorporate time-honored assumptions. To start, **the world typically faces major disruptions at least once a decade**. Looking back through history, it is notable how consistently these occur. The cause may be related to the economy, social strife, war, politics or a combination. **Knowing that these events are to be expected will hopefully make them less jarring, and help all of us stick with thoughtful investment plans**. Another important theme is that trends do not last forever. Just as bull markets ultimately run out of steam, bear markets do not persist. All of this is obvious, yet often difficult to remember during the highs and lows that mark investment cycles. This is why, regardless of the challenges presented at any given moment, a steady hand and disciplined investment philosophy are critically important in achieving your investment and life goals.

We are always pleased to answer your questions and be helpful in any way possible.

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