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Memo to Clients and Friends:

Re: Q3 Review

We just finished another raucous quarter, but this time all the indexes turned in positive performance as noted below. However, large divergences between different sectors of the stock market remain. The performance difference between the S&P 500 and the Russell Value Index is easily apparent below and unusually wide. Will the real stock market please stand up?

Short and medium-term bonds did not do much while long term fixed income securities moved higher, indicating that interest rates for that sector of the bond market came down. The year to date numbers produce above average bond returns and brings the return differences back to a more normal configuration.

Benchmark Index Returns	Quarter Ending 9/30/2020	YTD Ending 9/30/2020
Lipper Balanced Fund Index	6.60%	3.51%
S&P 500 Dividend Aristocrats	7.80%	-2.60%
S&P 500 Stock Index	8.90%	5.60%
Russell 1000 Value Index	5.60%	-11.60%
3-month US Treas. Bill Ending Yield	0.94%	0.94%
S&P-7-10-Year-US Treas. Bond Index	0.26%	11.48%
S&P U.S. Gov & Corporate 20+ Year Bond Index	9.24%	16.22%

If the differences between the various stock market averages were wide, it was even more so when looking at different sectors within the market. Through the end of September, the energy sector declined almost 50% during 2020 while technology at the other end of the spectrum returned almost

30%. And while energy was once over 20% of the S&P, today it has shrunk to less than 3% while technology now represents nearly 30% of the entire stock market – and technology was reduced earlier this year by the reassignment of many internet stocks to other sectors. These include stocks like Amazon, Alphabet and Facebook. Add these and others back into technology and the weighting and performance moves even higher.

The managing of portfolios has always involved seeking high returns over time but constrained by assuming a level of risk appropriate to each client's specific objectives. If the task is to return more than the S&P 500 while maintaining reasonable diversification to create moderate risk, this has now become virtually impossible. The concentration of holdings necessary to achieve high performance objectives flies in the face of a desire to keep risk under control. This really raises questions as to whether or not the S&P 500 is still an appropriate judge of an investor's equity performance in the context of a reasonably diversified portfolio.

An example to demonstrate this point is the performance of the largest stocks in the S&P in comparison with the rest of the market. A company's size matters because the S&P performance is weighted by size. The largest companies by total market value get the biggest weighting in the index.

At the present time, the largest five companies in the index as measured by S&P are Apple, Amazon, Microsoft, Alphabet and Facebook, all related to either the internet or technology. At a recent date, if one had owned equal amounts of each of these stocks since the beginning of the year the return would have been a very handsome 40%. But if instead, you had owned the other 495 stocks the return would have been a negative 5% suggesting that we are still in a bear market. So which number better represents the stock market as a whole?

Another way of looking at this is through valuation, most simply characterized by the price to earnings ratio. The market recently has been said to be selling at about 25 times earnings. This is historically high but given near zero interest rates, can be somewhat justified – today stocks have no competition for investment return.

However, when looked at similarly to the analysis above (on an equal weighted basis) the average PE of the S&P 500 based on 2020 estimates is a lofty 57 times earnings. Wow! Again, which number best represents the market?

We like bull markets as much as anyone. It keeps both clients and investment managers happy. But we all eventually have to return to the question of risk. So, while we all have enjoyed the ride, we should be somewhat skeptical of the best performing portfolios. At market turning points, portfolio balance becomes just as important as previous performance.

We would characterize the current stock market as high risk based on the many uncertainties mentioned below as well as current high prices. But that does not mean it cannot keep going higher, at least for a while.

In the meantime, the economy continues to improve, though more slowly than it has over the past several months. Unemployment is now estimated to be under 8%, a huge improvement from its 14% peak only a few months ago. In spite of this, Covid-19 will continue to have a major impact going forward. The actual approval of an effective vaccine will give the market a boost but not necessarily for

very long. While approval will likely happen before the end of the year, headwinds will remain until a reasonable percentage of the total global population has been vaccinated.

The election may be the other dominant factor for the economy and the stock market between now and the end of the year, but it is almost impossible to tell how the market will react to the election of either candidate. A Biden win would potentially result in a change in many economic policies while the market today most probably reflects the impact of Trump. Historically, a Democrat in the White House has not been bad for markets, so that is to the good. And as has been said for most elections, markets have traditionally not cared who wins, they just want certainty.

But there are two changes being talked about by Democrats that could potentially bring a major shock to security prices – corporate tax increases and environmental policies - with the former theoretically paying for the latter. All of us want a cleaner environment with more efficient energy and less dependence on fossil fuels. More and more of the American public support at least some effort to move the environmental needle now, not later. But the issues are more complex than is usually admitted, and it is often unclear where our efforts are best placed. Add into the mix the fact that the efforts of Europe and the US could be futile if the world's other major polluters like China, Russia and India fail to jump on board. If US companies are put at a competitive disadvantage due to environmental regulations, we could end up pushing more and more manufacturing overseas to other countries with significantly weaker regulations and if tax hikes go through, lower tax rates.

It is easy to be supportive of solar energy and battery powered cars, and most of us are, including all of us at LIM. It is harder to think through all the potential expenses and outcomes of many of the sweeping changes that are being proposed. Because strict environmental policies come with extremely high costs in the near future, and many unknowns, at least as currently proposed, passage of something like the full Green New Deal would likely have a negative impact on the market, and perhaps a significant one.

Whatever you are feeling about individual tax rates and equity, corporate tax cuts have provided a boost for US companies. An increase in corporate taxes would mean an immediate hit to reported earnings and probably to stock valuations and prices as well. It could also cause many companies to leave the U.S. for lower tax havens, as that was happening before the tax cuts were enacted. Neither outcome would be good for the stock market or the U.S. in the long run.

Given all the uncertainty suggested above, the market as a whole has done reasonably well so far in 2020. It is difficult to predict where it might go after November 3.

Conclusion

We would like to let you know that we have updated our website. If you would like to take a look you can find it at www.loudoninv.com. We would be most appreciative of any feedback you are willing to provide.

The stock market has held up quite well this year and has moved higher in the quarter just ended. Considering all that has happened in 2020 this has been an excellent showing. High valuations, Covid, the election and the internal structure of the stock market all appear to be in a higher than normal risk mode. This has been the case most of the last twelve months but so far has produced very little more than high volatility.

The technology stocks are way ahead of the market (old tech as well as new) this year creating an unusual performance imbalance that at some point is likely to normalize itself. This matters to index investors as well as those who own individual securities as some not insubstantial pain is likely to be felt as it occurs. And given the performance of the largest companies in the market (prices for the best have moved higher well ahead of earnings) substantial price risk remains. And perhaps the biggest risk would come if S&P index investors decide the pain becomes a little too intense and decide to sell en masse.

While we may not be in a formal technology "bubble" it certainly feels like one to those of us who have been around long enough to see it before.

So, we have been generally accumulating dividends and interest as they have come in rather than reinvesting in the stock market. Many clients now have cash positions higher than normal across most client types. We plan to generally sit tight, at least until after the election.

Sincerely,

Loudon Investment Management, LLC

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