Independent Investment Advisory

GKV Capital Management

Quarterly Update

Third Quarter 2020

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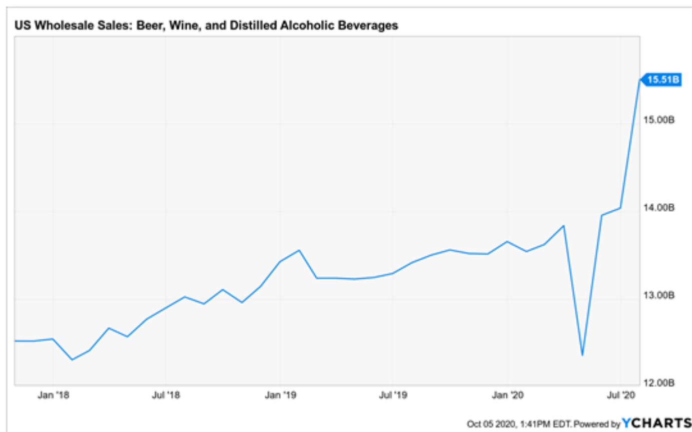
Opening Thoughts

2020 by all accounts has been a difficult year. A pandemic, social unrest, vast economic disruption, accompanied with the usual and unusual natural disasters, have affected us all. It is difficult to quantify the impact of the disruption of daily life which has occurred in a myriad of little ways. We are now used to wearing masks. Stuck at home, remodeling projects are booming. At least toilet paper and paper towels are back on the shelves. Travel is out. Sports are out. Going to the gym is out. Restaurants are a rare treat. Movies at home. Alcohol sales fell with the closure of restaurants and bars only to hit new highs this summer as we started drinking more at home.

Surprising many, the stock market has remained positive. Well, mostly positive. Just like disruptions in our daily lives, the events of 2020 have had a profound disruptive impact on certain sectors. While the broad S&P 500 index closed the third quarter with a 4% gain, the figure belies the significant turmoil below the surface. The energy sector has lost more than 50% of its value since January 1st. The banking sector has been hit particularly hard down nearly 25% over the same period. Advertising is down 32%, luxury goods down 32%, hotels and cruise lines as well as the airlines are all down 44%. Really, just two sectors are keeping the index in the black this year. Consumer discretionary, which includes homebuilders and consumer electronics and of course, Amazon and Tesla. The other bright spot is information technology. Working from home, seeking entertainment from home, shopping at home, businesses are either enabling a better at home experience or they are selling online, requiring increased investment in information technology. A new webcam is harder to find than trying to find toilet paper back in April.

The groupthink has concentrated investment dollars in the few areas that are thriving in the disrupted economy. We have overweight investments in the areas that have benefitted from the disruptions in 2020 enabling significant outperformance of the S&P 500 index this year. It is important to remember that the stock market is not the economy nor is it indicative of what is happening in the world. The value of stocks is based on the long-term earnings expectations of individual companies. We continuously monitor the expectations of those future earnings in our investment selection. As we approach an historically contentious election, it is important to keep these facts in mind.



3Q20 Data Points

DJIA YTD	**-2.7%**
S&P 500 YTD	**4.1%**
NASDAQ YTD	**24.5%**
US Bond YTD	**7.0%**
10-Year Treasury Yield	**0.69%**
S&P 500 LTM Dividend Yield	**1.9%**
S&P 500 EPS Next 12-MTH	**$154.80**
S&P 500 P/E	**22x**

Third Quarter Review

U.S. stocks continued to recover in the third quarter from the March lows. At the close of the third quarter, the Dow Industrials were down 2.7%, the S&P 500 posted a gain of 4.1% while the technology skewed Nasdaq composite index gained an impressive 24.5%. The Dow Jones Industrial Average has historically been used as the primary index to gauge the performance of the U.S. stock market; however, the S&P 500 is a far better benchmark. Only 30 companies comprise the Dow and the value of the index is calculated using a price weighted methodology. The S&P 500 by contrast, includes a greater number of companies and is weighted by total market value rather than stock price. Since the low on March 23rd, the S&P 500 has gained 50%. The recovery in the second and third quarters of this year was the strongest two-quarter performance since 2009.

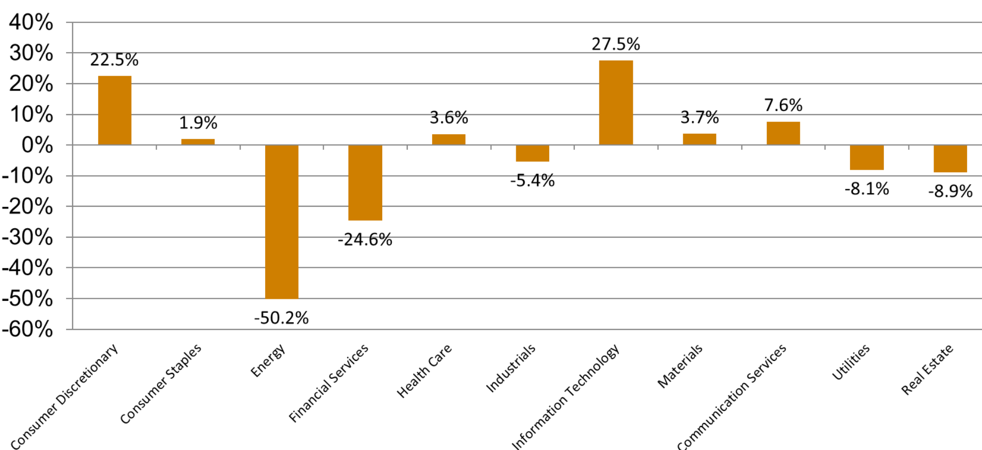
The economy has been improving, although the data is well behind where we were in February before the extent of the coming pandemic was known. The tremendous government stimulus to keep consumers and businesses afloat combined with a view that the worst of the economic impact of the pandemic is behind us gave the markets confidence to look beyond 2020 to recovery in 2021.

The performance of the broad market indexes is not indicative of the tremendous dislocation among industry sectors, however. Additionally, smaller company stocks have not shared equally in the stock market recovery. The Russell 2000 small cap index fell 41% at the low this year and while it has regained much of those losses, the small cap index is still down 9.6% at the close of the third quarter.

Every sector in the S&P 500 gained in the third quarter except for the beleaguered energy industry. For the first three quarters the energy sector is down more than 50% followed by the financial services sector which closed the quarter down 25%. The pandemic has dramatically curtailed the demand for oil worldwide causing an acute supply imbalance. For an industry used to small percentage changes in demand year-to-year, the pandemic has wiped out any profits for the entire sector. The financial services sector has a different set of problems due largely to the steep decline in interest rates as central banks moved to bolster their economies to recover from the worldwide, self-induced recession.

The leading sectors have experienced outsized performance as investors piled into the few areas expected to have strong performance despite (or because of) the pandemic. Both consumer discretionary and information technology sectors have soared this year gaining 23% and 28% respectively this year through the third quarter. Information technology has been relatively immune to the impacts of the shutdown and gradual reopening. In the March quarter, technology contributed more than one-third of all earnings for the S&P 500. The consumer discretionary sector includes retail computer and electronics sales as well as home improvement, appliances, and importantly, both Amazon and Tesla. The sub-sector hotels, resorts and cruise lines, which are down 44%, is also part of consumer discretionary, however its poor performance was totally eclipsed by the likes of Amazon, Tesla and even Home Depot.

Stocks are ultimately driven by earnings. Even in a pandemic, investors are looking to future expected earnings to determine what a company should be worth. Sometimes excitement gets carried away and perception of what a company can earn is greatly exaggerated causing the stock to be overvalued in the short-term. As a realistic outlook for earnings emerges the stock always corrects. Estimates for earnings of the companies in the S&P 500 began the year at a cumulative $183.37, representing 18% growth over the $155.84 recorded in 2019. With the pandemic estimates for

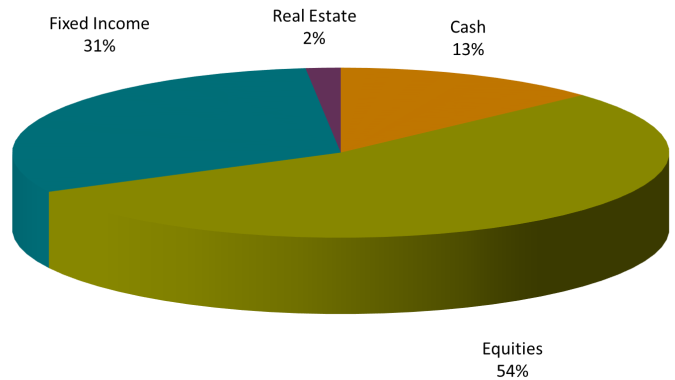


2020 were slashed with analysts forecasting $109.06 for the year back on June 30th. With reopening and an improving economic outlook, the current forecast is for earnings to be $114 in 2020. While this is still a far cry from the old $184 estimate, the revisions are getting better rather than worse. The current forecast for 2021 is for earnings to reach $164 per share, which would put us slightly ahead of 2019.

The U.S. equity markets have fared far better than much of the world. The MSCI EAFE (Europe, Australia, Far East) closed the third quarter down 9%, Europe declined 7%, and emerging markets closed 3% down through June 30th. Global GDP growth is expected to shrink 5% in 2020 due to the pandemic. Prior to Covid-19, the estimates were for GDP growth of 3.3%. The IMF anticipates a reacceleration in 2021 of 5.4% global growth.

Unemployment spiked to 14.7% in April and has subsequently declined to 7.9%. For context, following the 2008 recession, the high point for unemployment was just over 10% in October of 2009. The September figure of nearly 8% unemployment is high but we anticipate continued improvement as conditions improve although the pace of improvement is slowing. Consumer spending has remained positive due in part to the significant stimulus. This includes payments made to individuals, extra unemployment checks and payments to small businesses. We are starting to see a decline in disposable household income due to job losses after a spike upward earlier this year due to stimulus. Job losses eventually will impact household income which will eventually impact household spending which will cause slower economic growth.

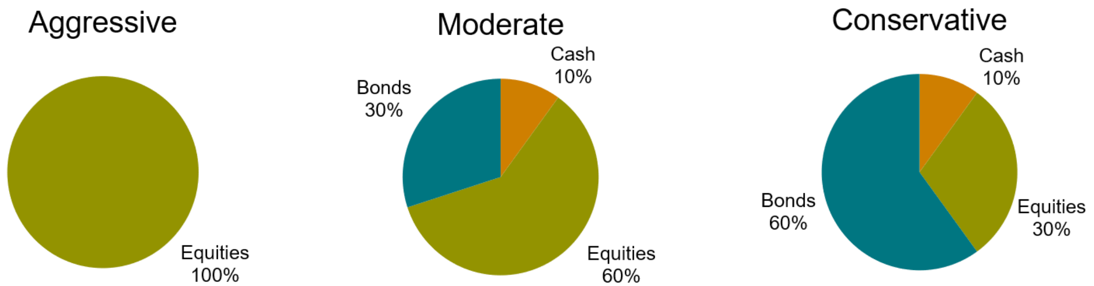
GKV Firmwide Asset Allocation



Interest rates around the world have been slashed largely to zero in an effort to encourage borrowing and bolster economic growth. The dramatic decline in interest rates has had a positive impact on fixed income investments. The 10-year U.S. Treasury yield ended the third quarter at 0.69%. The Barclays Global Bond Index closed the third quarter with a gain of 5.7% while the U.S. Bond Index gained 7%.

We ended the quarter with some cash reserves to take advantage of a possible correction, particularly in technology. Our equity holdings totaled 54% and are overweight technology and companies that are benefitting from the results of the pandemic. We do have significant fixed income positions with 31% of assets in bonds which have performed very well as interest rates declined. The fixed income portfolio does provide some insurance against our equity holdings effectively reducing volatility.

Long-Term Historical Portfolio Returns and Volatility



	Aggressive Total Return	Aggressive Std. Deviation	Moderate Total Return	Moderate Std. Deviation	Conservative Total Return	Conservative Std. Deviation
3 Year	12.7%	12.1	9.1%	8.2	6.5%	5.4
5 Year	9.5%	12.0	6.7%	8.1	4.8%	5.5
10 Year	11.2%	12.5	7.9%	8.6	5.7%	5.5
15 Year	6.8%	13.6	5.5%	9.2	4.7%	6.0

Performance Data for periods ended December 31, 2019
Annualized monthly standard deviation
Bond Index is Barclays US Agg TR USD
S&P 500 Index Total Return

Election 2020

"George Washington is the only President who didn't blame the previous administration for his troubles."

- Joey Adams, Comedian (1911-1999)

Every four years we get to talk about another national election and what it means for the economy. With a particularly contentious election looming, the stakes seem higher than usual this time around. Conventional wisdom dictates that the president and the administration has significant sway over our economic fortunes prompting investors to ponder how an election may impact their portfolio. Some investors, fearing severe volatility, believe that they should significantly modify their investment positions as an election approaches, because if their preferred candidate does not win, they anticipate dire financial consequences.

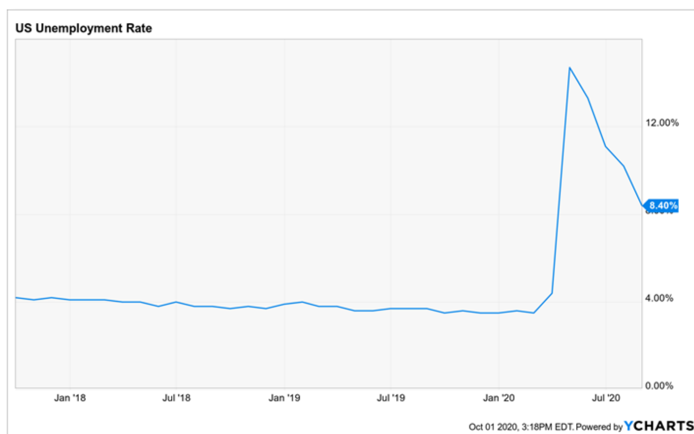
The importance of the position of the president is without equal. However, the president has little direct influence over the economy. An administration can and should be held accountable for many things, but economic success is more likely to be due to favorable timing in the economic cycle than any policy of the administration.

Taxes and spending which is referred to as fiscal policy, has possibly the most significant direct impact on the economy. While the president's administration can make recommendations, this is the purview of Congress. Only Congress can modify tax rates and allocate spending. Stimulus to get through an economic crisis, such as the recession in 2008 and the shutdowns this year require action from Congress. While the president submits a budget annually, Congress makes the ultimate determination as to where dollars will be spent.

The other most direct government tool for managing economic growth is monetary policy. Monetary policy is the control of money supply (lending to banks) and interest rates. This is controlled by the Federal Reserve which manages interest rates to prevent recessions and control inflation. While the president appoints its seven-member board of governors (14-year terms), the appointees maintain independence.

The president has the most direct control over regulation and its enforcement. While regulation can impact the cost of business for affected industries, both positively and negatively, the effect on economic growth is less direct and generally takes time to have a material impact. Strict EPA regulations can make the cost of producing fossil fuels more expensive, for example. Tariffs have recently been used to increase U.S. manufacturing to little effect. Some level of regulation is necessary as fraud and graft are detrimental to an economy and erode confidence for market participants. Too much regulation and it becomes unnecessarily costly. To keep foreign actors from stealing technology, for example, requires a government that can protect our investment in that technology.

The reality is our economy is largely driven by the consumer not the policies of the administration. The health of the economy is dependent on the availability of jobs and income from those jobs. While it is true that politicians may make us more or less optimistic about the world, no one is deciding whether to upgrade their phone based on the president. Today, the equity markets are less concerned about the election and more concerned with getting through the pandemic without the permanent loss of too many jobs leading to a long-term reduction in household income.



The stock market, as a rule, doesn't like uncertainty. After all investors are trying to predict the future. Anything that deviates from the current, known paradigm is, well, unknown. To effect significant fiscal policy change, the Democrats would need to win the White House, maintain control of the House and get to at least 50-50 member parity in the Senate (remember the VP gets to vote in the case of a tie). In our

view, the best case for the market would be for control of the House and Senate to remain split with the Democrats maintaining control of the House and Republicans in control of the Senate. Under this scenario, little would change economically no matter the winner in the White House.

The two scenarios in the coming election that would cause substantive change in fiscal policy require either party to control both houses of Congress and win the White House. Either a Trump or Biden victory without control of Congress would create little economic impact. Changes to tax rates do not occur very often simply because they require control of both branches of our government. President Obama was able to enact fiscal stimulus and increase taxes on the wealthy in 2009 after Democratic election victories in Congress. Shortly after, in 2010, Democrats lost control and ended up with spending cuts (remember sequestration?). The Trump administration was able to pass the Tax Cut and Jobs Act in 2017 which reduced the corporate tax rate to 21% from 39% with a Republican majority in both the House and Senate. Republicans subsequently lost control of the House in 2019. While the first round of stimulus was passed with bipartisan support earlier this year, the two parties have, so far, been unable to compromise on a second round despite the widely accepted need for more.

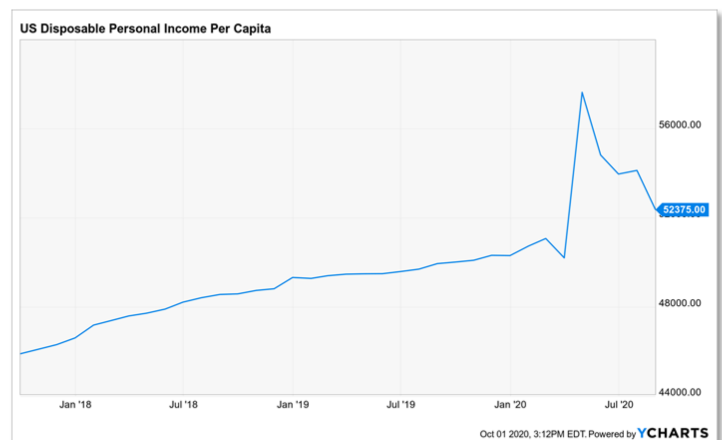
A Trump victory in November would largely maintain the status quo. It appears unlikely that the Democrats would lose control of the House of Representatives. President Trump has indicated a desire for further tax cuts but has offered few details. With Republican control of the Senate at risk and an unlikely change of Democrat control in the House, the details are moot. Since this is the current situation, we would anticipate little reaction from the markets.

A Biden win, with a retention of control in the House (which is likely), and a 49/51 split in the Senate in favor of the Republicans would lead to changes in regulation, particularly around environmental issues, but would eliminate any likelihood of a substantive change to fiscal policy. This scenario would have little impact on the stock market, in our opinion.

A Biden win, with Democrats in control of the House and 50/50 or greater split in the Senate for the Democrats would enable changes to both regulation and fiscal policy. In this scenario we would anticipate a tax hike on corporations and higher earners which would be perceived somewhat negatively by the stock market. An increase in the corporate tax rate to 28% from the current 21% would reduce corporate earnings precipitating a reevaluation of stock prices based on marginally reduced earnings. Biden's tax plan would also include an increase in the minimum tax rate on overseas profits to 21% from current 10.5%. The plan would also reverse the 2017 tax cuts for higher earners, raise social security taxes for those earning more than $400,000 and taxing capital gains as ordinary income for those earning more than $1 million.

We would also anticipate the likelihood of a public healthcare option open to all individuals. This would be far more modest than the Affordable Care Act, since fewer individuals are currently uninsured than in 2010. Such a program may come with some action to address rising drug prices which could affect stocks in the pharmaceutical and biotech industries, however.

We would also expect to see a proposal for a raise in the Federal minimum wage to $15 per hour. Some have argued that such a move might increase unemployment although we would anticipate a negligible impact. A higher Federal minimum wage would increase costs for some industries but little impact on the economy or stock prices in general.



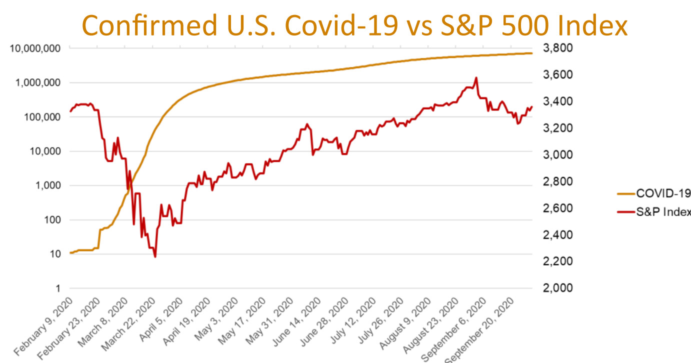
This is the most polarized and contentious election cycle in recent memory. While the election is important, keep the economic implications in perspective. The Federal Reserve will remain accommodative regardless of who wins. Jobs and household income matter more to economic health of the economy than which party is in power. Employers, entrepreneurs, workers and consumers have more power over the health of our economy than our government does. Getting past Covid-19, getting the economy fully open, getting people back to work is more important than the election. Presidents do not create jobs. Congress does not create jobs. At least not private sector jobs. Successful businesses create jobs. Fortunately, this country is filled with millions of hard-working entrepreneurial people that create jobs for themselves and for others.

Looking Ahead

The major stock indexes have recorded tremendous gains since the lows of late March. As soon as the rate of growth in new Covid-19 cases began to plateau, the recovery in the market began in earnest. The chart to the right plots the value of the S&P 500 index versus the rate of growth in new cases of Covid-19 in the U.S. As is apparent in the chart, the market rapidly began to recover as the growth in new infection rates slowed. Stocks rapidly sold off as investors could only speculate as to how bad the fallout from the pandemic could be. As soon as tangible data developed showing a floor to new infection rates coupled with a strong economic response from The Federal Reserve and stimulus from Congress, investors began looking for oversold opportunities.

Now that the S&P 500 has rallied 50% off the lows, we are asking ourselves whether we have recovered too far too fast. While the worst is certainly behind us, significant economic hurdles remain. Economic activity is recovering but the rate of growth is slowing, and we are well behind where we were when we started the year. Some companies, such as Tesla have had terrific gains and while the future is bright for the company, the price of the stock cannot be justified by any traditional valuation metrics.

The S&P 500 as a whole appears expensive even as sectors, such as energy and financial services remain near the lows for the year. Current analyst forecasts estimate S&P 500 earnings to be a combined $164.28 per share in 2021, which assumes a complete recovery in earnings back to 2019 levels from a disastrous 2020. We view that forecast as possible but not without risk. Assuming this optimistic forecast, it puts the market at 20 times earnings at the close of the third quarter. Since 1988, equity valuations have averaged 18 times next year's earnings. The bullish argument is that historically low interest rates result in an equity premium and justify the higher multiples of earnings for the price of stocks. In our experience, we find that over time the market reverts toward historical averages rather than obediently following the latest "this time is different" justification for high prices.



The market may yet move higher as the economic recovery continues. Significant disruption and economic dislocation always create opportunities as capital is reallocated. We will continue to watch the economic data. If it appears that the recovery is stalling we will continue to increase our cash allocation with the expectation of repurchasing leading companies at more attractive prices.

Importantly, there is a lack of investment alternatives to U.S. stocks. With record low yields on government bonds around the globe, the U.S. stock market has been one of the best places to make money over the last several years. With a limited supply of alternatives, money continues to flow into U.S. stocks. We are cautiously positioned, but anticipate that for the near-term, demand for leading companies may push prices higher.

S&P 500 Earnings and Index Valuation

	2014	2015	2016	2017	2018	2019	2020E	2021E
S&P 500 EPS	$113.01	$100.45	$106.26	$124.52	$151.60	$155.84	$113.84	$164.28
EPS y/y growth	5%	-11%	6%	17%	22%	3%	-27%	44%
S&P 500 Index	2059	2044	2239	2673	2507	3231	3363	
Index y/y return	11%	-1%	10%	19%	-6%	29%	4%	
Trailing P/E	18.2x	20.3x	21.1x	21.5x	16.5x	20.7x	28.9x	
Forward P/E	**20.5x**	**19.2x**	**18.0x**	**17.6x**	**16.1x**	**28.4x**	**21.7x**	**20.5x**

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Independent Investment Advisory

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Client accounts are separately managed and tailored to meet the specific needs, including risk tolerance, investment objectives, and tax consequences of each client. Client assets are held at an unaffiliated brokerage firm.

With extensive expertise in security analysis, we make direct investments on behalf of our clients buying individual securities. This eliminates costly mutual fund fees and increases the flexibility to manage volatility. We actively allocate capital to take advantage of investment opportunities altering exposure to individual companies, industry sectors, and asset classes in anticipation of the changing investment and economic environment.

We are transparent in all facets of our asset management practice and believe it is important for our clients to know what they own, why, what their performance is, and what they are paying in fees.

We build comprehensive portfolios for our clients with a goal of reducing volatility and producing prudent growth. We protect and build wealth at GKV Capital.

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