North American Management

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INVESTMENT
LETTER

Continued Recovery, and a Correction

The rebound in global stock prices continued this quarter, led by the U.S. which was, in turn, led by large-cap technology shares and almost anything exhibiting positive momentum characteristics (stocks with momentum characteristics refer to the tendency of winning stocks to continue to do well). The tide turned in September, however, after investors discovered that a large private equity fund (a "NASDAQ Whale" in the press), owning about $30 billion worth of call options on various technology names, wished to exit its positions at a profit. The positions, large enough by themselves, turned out to be the tip of a rather large iceberg. According to the *Financial Times*, "trading volumes for calls connected to the top five S&P 500 stocks averaged $125bn a day in the last week of August, up from $29bn in the same period last year…" So after being up over 13% for the quarter through the end of August, global equities declined almost 4% in September, but large-cap technology stocks were a crowded theater – the NASDAQ 100 index, which holds the top five S&P 500 stocks at a 47% weight, dropped 11% in three trading days. Less-diversified investors in particular, many of them new entrants to markets, were reminded how powerful and sudden reversals can be. That said, the broader NASDAQ index is still up 31% this year and the technology sector has attracted enormous amounts of capital despite – or perhaps because of - the pandemic.

Stocks and bonds logged another strong quarter, despite a 10% correction of the S&P 500, and a 15% drop among mega-cap tech stocks.

The table below shows a variety of index returns by quarter, year-to-date 2020 and for the full year 2019. Note the widely referenced fixed income benchmark, the Bloomberg Barclays Aggregate, has outperformed all others year-to-date in the table, save for an index of Quality factors (many constituents are large tech stocks with minimal debt), through September 30th. On the heels of a year like 2019 (far right column) when investors embraced risk and the S&P 500 rose 31.5%, it is not unusual for the equity market to go sideways, or down, as strong rallies often outpace earnings. In a pandemic, it is expected that bonds will outperform as they have. While the amount of coordinated fiscal and monetary stimulus put in place early in the crisis surely helped stabilize and liquify frozen credit markets, and while equity market leadership has broadened somewhat, we are not out of the woods yet. In the meantime, real interest rates (the difference between yields on U.S. Treasuries and inflation) are negative. In this environment, companies that can issue long term debt at negative real rates are locking in a significant benefit for their stockholders. On the other hand, given today's low rates we question whether certain fixed income instruments will be able to offset equity risk as well as they have in the past, particularly if inflation rises faster than yields. Certainly the Fed and the U.S. Treasury would prefer rates to stay lower for longer, at least until the economy returns to historical levels of growth and employment.

"Fixed income is now 100% fixed and 0% income."
Jan Loeys
J.P. Morgan

Total Returns as of September 30, 2020	Year to Date	3rd Quarter	2nd Quarter	1st Quarter	2019
MSCI USA Quality Index	**11.7%**	**9.8%**	**19.8%**	**-15.0%**	**39.1%**
S&P 500® Index	**5.6%**	**8.9%**	**20.5%**	**-19.6%**	**31.5%**
MSCI All Country World ex USA Index	**-5.4%**	**6.3%**	**16.1%**	**-23.4%**	**21.5%**
MSCI USA Min Vol Index	**-1.6%**	**5.6%**	**12.7%**	**-17.3%**	**27.1%**
MSCI USA Value Index	**-11.5%**	**5.5%**	**13.0%**	**-25.7%**	**25.7%**
Bloomberg Barclays U.S. Agg Index	**6.8%**	**0.6%**	**2.9%**	**3.2%**	**8.7%**

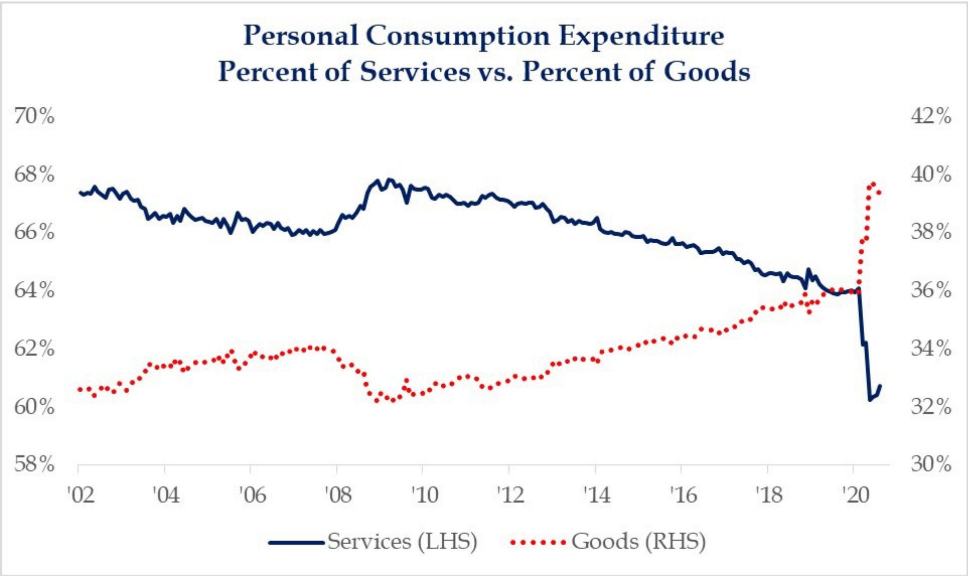
K-shaped Recoveries and Divergent Markets

Various commentators have described a worrisome "K-shaped recovery" wherein some enjoy job security and thriving investment portfolios while others suffer. This is actually not a unique characteristic of recessions, as 90% of employees keep their jobs throughout and stock markets tend to discount a brighter future and rebound faster than companies can hire new employees. This pandemic, however, may have created a class of industries whose ability to return to 2019 levels employment is legitimately in question. Some were already in the crosshairs of disruption (banks, energy companies) and have been reducing headcount for years, while others could fall victim to abrupt changes in consumer tastes and lifestyles due to Covid (office real estate, malls, cruise ships, casinos, airlines, mass transit).

Experiential companies (theme parks, casinos, resorts) used to be viewed as "disruption-resistent." In a pandemic they are an albatross.

As we observed last quarter (Aftershocks), many of these "epicenter" companies carry a lot of debt and depend on large clusters of people spending freely in order to make money. Fortunately for investors most of these highly leveraged companies do not represent much of the S&P 500. When we are asked about the divergence between the economy and the stock market in this particular recession, the relative contribution to U.S. corporate earnings (and to earnings growth) between a company like Netflix and a nearly bankrupt theater operator like AMC is a big part of our answer. In 2020, investors are bullish on *distribution models* and bearish on *density*." The difference is not the product (movies), it is the delivery. The same could be said for energy (why go to a gas station when you can plug in at home?), face-to-face meetings, on-line gambling and e-commerce in general. People will always want to socialize, but they may be more selective about where, when and why they do it.

"An inordinate amount of capital is flooding into the companies that need it the least."
Louis Gave, GaveKal Research



Our Perspective

Unlike the last recovery when monetary stimulus was a highly successful - if blunt - tool, far fewer wounded companies will be rehiring in large numbers just because borrowing costs are low. While some businesses will rebound sharply once there is a vaccine, Covid will likely hasten the demise of others. While our economic system encourages, funds and rewards disruptors, however, things can break down if the pace is too rapid. This includes our fractured politics, already simmering for years under myriad pressures from globalization. However when things get bad enough, as they unquestionably have in 2020, politicians and central bankers are actually capable of acting together for the common good. Furthermore the U.S. economy is highly elastic in aggregate. The chart above illustrates how quickly consumer behavior can change, with a sudden decline among service industries being largely offset by a sharp increase in consumption. This is, perhaps, the more relevant "K" shape for investors to consider. For every failure there is a success: ask a real estate agent, a homebuilder, a bike shop owner, a supermarket, an electric car start-up, a virtual meeting or streaming platform how they are doing in 2020. Most of them have never seen better times. To paraphrase a recent observation from the large fixed income manager, TCW, today some businesses are on a bridge through tough times to a

Ultra-low interest rates won't immediately fill empty airplanes, theme parks, or offices. For companies that can survive, however, there is pent-up demand.

prosperous future, while others are on a pier. It is our job, and the job of managers we select, to differentiate the long term survivors and winners from the rest. From an asset allocation perspective, we continue to consider the combination of declining fixed income utility and rising potential for inflation, and some changes in portfolio holdings during the fourth quarter, or in the first quarter of 2021, may occur. As vaccines and therapies come online in 2021 and interests rates rise, we need to be vigilant about reversion among various asset classes, factor risks and companies. Investors got a glimpse of what is possible this quarter, and it was powerful.

Robert G. Scott	**Fraser J. McLean**
Chairman & CEO	*Chief Investment Officer*

Endnotes

Sources of graphs and data not specifically cited: FactSet and Strategas Research. Referenced indexes in U.S. Dollars, unless otherwise stated. All equity returns include reinvestment of dividends, except where stated to be price returns. The MSCI Factor Indexes are rules-based indexes that capture the returns of systematic factors such as low volatility. All return data through September 30, 2020, unless otherwise stated. All data is in U.S. Dollars (USD), and Total Return represents the sum of the dividend, changes in earnings and multiple estimates for each ETF. Investors cannot invest directly in an index, nor is an index subject to fees and expenses associated with investment funds or accounts.

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