CAPITAL ADVISORS

Market Comment

- The market environment has changed dramatically over the past three weeks, and we are adapting.
- There have been two step-change events that forced investors to re-think major assumptions about the "right" price for just about everything – government bonds, airline stocks, energy producers, high-yield bonds, video conferencing, telemedicine…you name it.
- First was the spread of COVID-19 outside of China, which was confirmed decisively over the weekend of February 22-23, leading investors to imagine the potential economic fallout of a global pandemic for the first time.
- The second step-change event occurred last Sunday when Saudi Arabia "went nuclear" in its retaliation against Russia for abandoning the OPEC+ alliance that had been cooperating to stabilize the global oil market since 2016.
- Recent wild swings in the stock market reflect a collapse in confidence among investors about the value of everything they own.
- Almost any financial asset is worth one price if COVID-19 turns out to be a short-term shock, and something different if widespread social distancing persists into the summer, or beyond.
- After Sunday this dynamic was compounded exponentially for any company tied to the energy sector…a prolonged price war delivers one value, while a reconciliation of OPEC+ yields another.
- When no one can be confident about the correct price for anything, it is easy to fall victim to the feeling that someone knows something you don't.
- This sentiment enables falling prices to become self-reinforcing, and vice versa when prices rise, as uncertain investors follow the herd for lack of better information to go on.
- Our approach to this environment involves activity on both sides of the risk spectrum.
- On the side of risk reduction, we have reduced exposure to energy and financial stocks, sold a position in the hotel industry, and accelerated the "market share" of companies that score well for balance sheet strength within our Managed Equity strategies.
- We note that risk management within these strategies did not begin with the COVID-19 outbreak.
- In January – with the stock market near an all-time high – we scoured client portfolios for outsized single-security risk positions and took actions to reduce them.
- We entered the New Year with a healthy cash reserve in the *Managed Equity Growth* strategy, and having deliberately re-balanced the strategy to reduce its allocation to the "FAANG"[1] stocks that led the previous market regime, while adding to companies with value characteristics that might perform better in a different market regime.

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[1] FAANG is a commonly used acronym for a handful of market leading technology stocks comprised of Facebook, Amazon.com, Apple, Netflix and Google. Although not formally included in the acronym, Microsoft is frequently included in this group when describing stock market leadership.

- In the *Managed Equity Dividend* strategy we were already well on our way through a re-prioritizing of balance sheet strength before COVID-19 was known, and one the larger energy holdings **(Chevron: CVX ~$84)** was sold before the Saudi bombshell on Sunday.
- The Dynamic Allocation strategy has shifted nearly half of its assets into short-term Treasuries and cash reserves, with a further shift in this direction expected by the end of this week.
- We are also taking action at the other end of the risk spectrum where opportunities lie, and we are working diligently to identify more ways to participate in an eventual recovery.
- For example, we added to an airline stock that might lead the market higher when COVID-19 begins to fade, and also added to a domestic grocery store chain that should be more resilient to a protracted downturn.
- *Before* the COVID-19 outbreak we initiated a new position in the world's leading provider of telemedicine, **Teledoc (TDOC: ~$139)** within the *Managed Equity Growth* strategy.
- We shifted away from companies with direct credit market exposure to a leading semiconductor company – **Broadcom (AVGO: ~$250)** – and a global pharmaceutical company **Abbvie (ABBV: ~$86) –** at buy-in dividend yields of 4.6% and 5.2%, respectively.[2]
- In terms of our outlook going forward, we expect the period of maximum economic stress from COVID-19 to be relatively short, with people returning to social settings – most notably work – within the next several weeks, rather than months.
- If this outlook turns out to be more right than wrong, investors will be best served to ride out the volatility between now and then, while opportunistically putting capital to work in risk assets that stand to benefit from an eventual return of confidence in the market climate.
- We note that investment grade corporate bond yields are historically low, and have remained stable throughout the market turmoil, unlike during the financial crisis when global credit markets broke down.
- Governments worldwide are designing fiscal policies to address the loss of income among their most affected citizens.
- If/when investors can remove the worst-case scenario from their probability tree for COVID-19, there are numerous assets that need to re-price *materially* higher than current levels, and we would expect the re-pricing to happen *quickly*.
- We do not fault anyone for reducing their stock market exposure if recent market behavior revealed a mismatch between their stated risk tolerance, vs. actual risk tolerance.
- We also encourage anyone with a more pessimistic outlook than ours to take whatever action might be needed to align their investments with their perspective.
- However, we discourage anyone from completely abandoning a prudently designed portfolio to "wait for clarity" about the future.
- When the re-pricing comes, it will probably be too fast to catch for anyone who wasn't already in the game to at least some degree.

[2] Source: Bloomberg

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