Key Points

- The world is currently experiencing a one-of-a-kind recession, and surprises should be expected.
- Among the surprises so far has been the sharp recovery in stock prices since the low on March 23rd.
- We believe much of the recovery can be attributed to investors removing a potential "Great Depression II" from the range of possibilities for the future for two primary reasons:
    1. The policy response from both fiscal and monetary authorities around the world was swift and massive, enabling financial markets to remain open and liquid.
    2. Scientific progress on COVID treatment protocols for those who contract the disease, as well as potential vaccines to prevent its spread, has been as hopeful as anyone could have expected at this point in the pandemic.
- Now that stock prices have presumably removed the worst-case-scenario from the range of likely outcomes, the next phase of market action should be driven by a process of discovery regarding the likely contours of the world on the other side of COVID.
- By far the most important factor in the outlook from here is the evolution of the virus.
- Future policy actions at all levels of government should also have important consequences, and we expect the November elections to influence market prices more decisively during the second half of the year.
- We believe investment portfolios should be designed with a healthy respect for the very wide range of possible futures we face, and we plan to err on the side of caution.
- Even so, we believe portfolios can include at least some exposure to vulnerable industries where prices remain depressed, and turnaround potential is enticing.
- Regarding the November elections, we expect to make portfolio adjustments at-the-margin to prepare for potential election outcomes, but we do not anticipate a major overhaul under any foreseeable scenario for the elections.

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Too Far Too Fast?

The dramatic recovery in stock prices since the low on March 23rd has been shocking to many observers, including us. It serves as a stark reminder that we are experiencing a one-of-a-kind disruption, and surprises should be expected. Indeed, "humility" might be the best word of advice for all investors right now.

The disconnect between massively disrupted conditions on Main Street, and a V-shaped recovery on Wall Street, leads many to question whether stocks have come too far too fast. The answer to this question will depend first and foremost on the future path of the virus. Considering that the world's collective understanding of COVID-19 spans a whopping six months, humility seems warranted here too. In this highly uncertain environment we are framing our investment decisions around the following observations:

- The COVID pandemic has accelerated many trends that were already in place, including the digitization of business; remote everything – particularly office work, medicine and education; a widening gap between winners and losers in business and employment; political polarization; and a re-imagining of global trade relations and supply chain structures.
- Policy makers have demonstrated a clear preference to pursue "whatever it takes" to support ailing industries and workers.
- Large publicly traded companies employ just 10% of the domestic workforce,[1] yet they are the primary beneficiaries of the massive wave of liquidity unleashed into the financial markets by the Fed and other central banks since March.
- On one hand, corporate profit margins face downward pressure from the re-location of supply chains and actions necessary to protect the hygiene and safety of workers and customers…
- …But on the other hand, the accelerated adoption of digital tools and business models might *improve* the productivity of many companies.
- Corporate profits face a binary step-change in tax expense depending on the outcome of the November elections.
- The "other side" of COVID-19 will likely include stubbornly high unemployment due to the damage already done to industries that thrive on social gathering, and the devastated budgets of state and local governments that employ approximately 20 million people – almost as many as the manufacturing and construction sectors combined.[2]
- Overleveraged businesses in the most vulnerable industries like airlines, hotels, restaurants, and cruise lines currently face a liquidity crisis, with many likely to experience a solvency crisis.

[1] Source: Deutsche Bank referring to the employment of companies in the S&P 500 Index.
[2] Source: U.S. Labor Department

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- Regardless of the path of the virus, total debt among governments and corporations is on track to be the highest it has ever been, both absolutely and relative to the size of the economy.
- Excessive debt tends to serve as a drag on future economic growth and inflation, likely supporting low interest rates for the foreseeable future.
- In addition to fundamental forces holding interest rates down, central banks worldwide should be highly incentivized to pursue low interest rate policies due to the damage higher rates would cause for both government and private sector finances.
- Looking beyond the next year or two, a *potential* counter to ultra-low interest rates might be rising inflation.
- Unlike the policy response to the financial crisis a decade ago, which focused on repairing the *financial* economy, the current policy package puts money into the pockets of *main street* consumers and businesses via direct income support, loan guarantees and grants.
- Case in point, the broadest measure of the money supply grew 25.5% in the 12-months through May, a post-WWII record.[3]
- We plan to track inflation trends carefully going forward.

The November Elections

It surprises many people to hear that the stock market has performed best historically when one party controlled congress and the white house, *but it didn't matter which party*.[4] In the post-WWII era the S&P 500 Index delivered average annualized gains of roughly 16% under Republican control, and 14% when Democrats were in charge. By comparison, the cumulative annualized return for the entire period from 1945 through 2019 was 10.8%.

We mention this up front to illustrate our application of politics to investment strategy. Yes, politics matters. Yes, we reflect policy actions in our investment decisions and risk management. What we do not do is assume a binary path for the future based upon the outcome of any given election, including the elections coming up in November.

Speaking only to investment implications, the most direct cause-and-effect we envision from the November elections is a potential step-change impact on tax policy. Analysts at Goldman Sachs estimate that every percentage-point change in the effective corporate tax rate should impact earnings per share for the S&P 500 Index by about 1.2%, or $2 per share. Should a Biden-led administration push the tax rate up to 28%, as he has signaled, Goldman's earnings estimate for the index in 2021 would fall by roughly 12%, to $150 per share. At its recent quote above 3,000, the forward price-to-earnings ratio (P/E) for the S&P 500 would be just over 20 today under this scenario, which is on the very high end of the historical range for this valuation metric.[5]

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[3] Source: Institute of International Monetary Research; Wall Street Journal
[4] Source: The source for all data in this paragraph is DataTrek Research and Barron's
[5] Source: Bloomberg; References to Goldman Sachs estimates quoted from Barron's

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Certain companies stand to be more affected than others from a change in the corporate tax rate, allowing for some degree of risk management around this issue through stock selection. Even so, we do not intend to allow the "tail" of taxes to wag the dog, so portfolio adjustments are likely to be at the margin.

The other election issue we will watch closely is the potential for an infrastructure program. We suspect some kind of infrastructure bill might be a priority for either party in the first 100 days after the election. The variable to watch from an investment perspective will be the priorities embedded into whatever infrastructure bill might be developed.

Strategy Updates

The remainder of this report provides a brief update on the recent activity and positioning for each of our investment strategies.

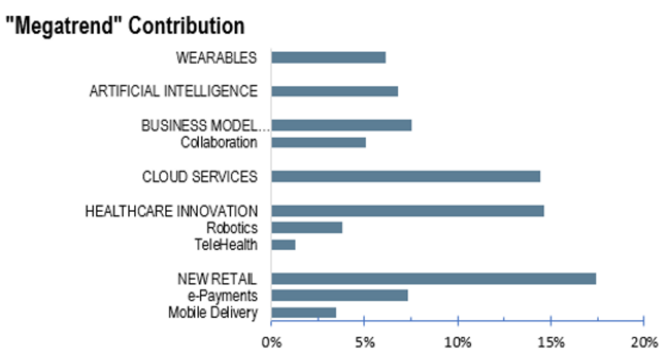
Individual Equity Management

A focus on "balance" serve the Managed Equity strategies well during the historic volatility in the first half of the year. *Managed Equity Growth* is performing comfortably ahead of the S&P 500 Index year-to-date, while *Managed Equity Dividend* pulled roughly even with its benchmark by quarter-end, despite having de-risked the strategy to a lower yield during the shutdown.[6]

Managed Equity Growth

We used two key approaches to help maintain balance in this strategy. For one, we concentrated on a diversified set of leaders of what we believe to be some of the global economy's most attractive value creation trends. The other approach was the very deliberate use of cash as "risk management" and "risk capital."

The following illustration shows some of the strategy's primary investment themes. We believe the economic shutdown accelerated these and certain other trends.



Source: Orion as of June 25, 2020.
The chart shows positions in companies we believe have leadership positions in the listed themes

[6] Source: Bloomberg, Orion

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The use of cash as a "risk management" tool serves to balance the potential volatility impact of certain stocks with substantial long-term return potential, but also a wide range of possible outcomes. By balancing these positions with some cash, we can participate in more of them than we otherwise might.

In the "risk capital" role, we can use cash to buy into attractive opportunities upon times of market volatility without having to sell other investments at depressed prices. During the height of the economic shutdown for instance, we bought **NVIDIA (NVDA: ~$385**), a leader in cloud-based artificial intelligence (such as speech recognition) and high-end computer graphics. We also increased positions in selected established holdings such as **PayPal (PYPL: ~$177)**, a leader in the global trend towards secure electronic payments. The illustration below shows approximately what percentage of the strategy was held in cash before the corona shutdown happened, during the height of stock market downturn, and after the market recovery.

Source: Orion, Bloomberg through of June 25, 2020.
The chart shows positions in companies we believe have leadership positions in the listed themes

Managed Equity Dividend

During the economic shutdown we focused on companies with proven management teams, strong balance sheets, and solid competitive advantages. Those new additions included **Home Depot (HD: ~$249), Texas Instruments (TXN: ~$126)** and **Fastenal (FAST: ~$44)**.

As the market environment improved, we carefully diversified into a handful of higher-yielding positions such as **United Parcel Service (UPS: ~$115), AGNC (AGNC: ~$13)**, and **Ares Capital (ARCC: ~$15)** (we re-initiated the Ares Capital position at a lower price than we had exited the stock early in the downturn).

Our objective is to keep the strategy's cash yield at or above 4% during "normal" periods. Several of the positions we initiated when the dividend yield was well into the 3s have since seen the yield dip into the 2s due to price appreciation. We have begun a process of shifting some of these highly appreciated positions into higher-yielding securities, and may continue to do so over near-term without substantially changing the strategy's "balanced" mix.

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Individual Bond Management

Our individually managed taxable (corporate focus) and tax-exempt (municipal focus) bond portfolios are customized according to three broad priorities – Liquidity, Income or an Aggregate of the two. A Liquidity portfolio invests exclusively in high credit quality securities and short-term maturities to ensure stability of principal and ready access to capital. An Income portfolio extends further out on the yield curve and includes a broader range of credit quality to generate a higher level of income. The Aggregate approach incorporates elements of both designs for a "core" exposure to the fixed income asset class. **We continue to prefer an "up-in-quality" bias across all bond portfolios.**

By structuring bond portfolios in a "ladder" with maturities typically contained within the 1-to-10-year range, the cost of being wrong should be minimal unless rates rise significantly. If interest rates rise, the ability to reinvest nearer-term bond maturities into a higher rate environment helps to offset the negative price change among the longer-term bonds in the ladder (over time….not month-to-month). When interest rates trend lower, price gains at the long end of the ladder serve to offset the lower reinvestment rate from maturing bonds, and the portfolio is supported by higher cash flows among the longer-dated bonds in the ladder.

We seek to enhance the benefit of the laddered portfolio structure with active management. By deliberately emphasizing certain maturities, and diversifying across different sub-sectors and credit profiles, we hope to optimize the risk and return profile of our fixed income strategies. In all cases we will not reach for yield unless the merits of the underlying strategy prove worthwhile relative to the risk.

Managed Credit Strategies

The investment grade corporate bond market rebounded significantly in the second quarter following the Federal Reserve's announcement of multiple bond buying programs. Companies rushed to the new issue market to refinance debt along with increasing existing debt levels at very low borrowing costs. With this backstop, it seems the worst may be behind us in market illiquidity and price degradation. That said, approximately 50% of this markets' issuers are still rated "BBB" by major rating agencies, the last rating level that is still considered investment grade. Ongoing fears of a wave of downgrades to sub-investment grade could continue to be cause for concern should we see another wave of volatility.

Within our *Managed Credit Strategies*, we have attempted to tilt the portfolios towards better credits, with on average ~70% of our clients' exposure to companies currently rated A- or better. Although the outlook looks less murky than originally prescribed for corporate America in the near term, we want to remain well balanced and under-exposed to lower quality credits. We do believe our BBB exposure has better balance sheets than the broad market, and we are willing and able to further reduce this exposure should we see specific situations worsen.

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Municipal Bonds

In what is traditionally a less volatile asset class, the municipal bond market also fell into the trap of significant price declines in March. Concerns increased over the stresses being put on state and local governments' budgets as widespread shutdowns occurred. Significant mutual fund and ETF outflows probably contributed to these negative price moves. However, since then, multiple municipal bond centric programs have been initiated by the Fed to help stabilize the flow of capital during these seemingly troubling times.

While we do agree with these credit concerns, we have attempted to build our clients' *Municipal Bond* portfolios with a focus on "AA" and above credits with strong debt coverage and liquidity profiles. We have also intentionally over-weighted essential service revenue bonds (water & sewer, utilities, etc.) and general obligation bonds with an average portfolio credit quality of "AA".

An important ingredient for municipal borrowers is the debt service reserve fund designed to get issuers thru difficult periods. In addition, municipal borrowers usually have very wide debt distribution schedules, which tends to smooth out refinancing risks in the near term. Lastly, although not popular in tough times, municipal issuers have some revenue durability to increase tax rates, or other price-setting mechanisms to ensure timely bond payments. This is why investment grade municipal bonds have some of the lowest default rates amongst most major fixed income asset classes.

ETF Bond Models

Within our *Aggregate Bond* (ETF) strategy we continue to emphasize "defined maturity", investment-grade corporate bond ETFs. As a reminder, these funds include all the features of a traditional fixed income ETF with one important difference: a specific maturity date. These funds are populated with bonds that all mature in the same calendar year. During that year the ETF terminates, and the fund's net assets are distributed to shareholders as cash, similar to what happens when an individual bond matures. We can all be thankful that the market has settled down since the Fed initiated programs to help support the ETF market and allowed for a more "normal" functioning market than what was witnessed during the last two weeks of March.

Within our *Income Bond* (ETF) strategy, we have focused on maximizing cash flows within the construct of "balancing risks." As highlighted in our year end Overview, we took advantage of the tightening in credit spreads in Q4 2019 and reduced our corporate bond exposure to ~50% of the model, while increasing the allocation to AAA-rated government-guaranteed mortgage bonds to ~35%. This helped materially in Q1 as credit underperformed, but slightly detracted performance in Q2. We also continue to hold the **SPDR DoubleLine Total Return Tactical ETF (TOTL: ~$49**) whose active risk management, higher quality bias, and limited corporate credit exposure has proven to be extremely helpful in providing some downside protection in these extremely volatile markets.

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Tactical Global Growth

This strategy invests across nine major risk markets globally to enhance portfolio diversification and participate in the long-term appreciation potential of risk assets broadly. The strategy recovered nicely during the second quarter, consistent with the turnaround in virtually all risk markets globally since late-March. All nine sectors within the portfolio enjoyed a strong quarter with gains ranging from 7.4% to 26.2% for the period.[7] Even the beleaguered real estate sector enjoyed a strong recovery, with the MSCI REIT Index advancing roughly 37% from its low on March 23rd to the end of the quarter.[8] Real Estate was over-weighted throughout this period, enabling the strategy to participate fully in its recent bounce. Subsequent to quarter-end the target allocation in real estate was reduced substantially, from 17% to 5%.

The table below reflects the positioning of the portfolio for the upcoming quarterly holding period. Domestic markets and large-cap companies receive a materially heavier weighting relative to international markets and small-caps. This design favors the more defensive assets within the strategy's nine-sector universe, while under-weighting the more economically sensitive sectors like emerging markets and small-caps.

Tactical Global Growth
Sector Allocations
7-2-2020

Asset Class	Current Weighting
Large-Cap Growth	Overweight (17%)
Large-Cap Value	Overweight (17%)
High-Yield Credit	Overweight (17%)
U.S. Mid-Cap	Neutral Weight (11%)
International	Neutral Weight (11%)
International Small-Cap	Neutral Weight (11%)
Emerging Markets	Underweight (5%)
Real Estate	Underweight (5%)
U.S. Small-Cap	Underweight (5%)

[7] Source: Morningstar
[8] Source: Bloomberg

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Tactical Dynamic Allocation

The global COVID pandemic has been particularly challenging for this strategy in 2020. The historically unprecedented speed of the decline in stocks over the span of 34 days in February/March happened too fast for the quantitative signals in the strategy to keep up.[9] While the strategy was successful in mitigating nearly half of the ultimate drawdown, it was still down approximately 18% at the low on March 23rd.[10]

The V-shaped recovery in global equity markets presented a second challenge for this strategy because the moving average trend lines that signal re-entry for each sector never had time to drift downward before markets started their rapid ascent. We anticipated this challenge and responded by temporarily shortening the moving average look-back period to 20-days (from a range of 150-180 days depending on the sector). This adjustment enabled the early re-entry of the S&P 500 Index ETF in time to capture a good portion of the rebound. Other sectors have been slower to return into the portfolio.

We feel it is important to point out that even though the recent market environment has been extraordinary, the results for this strategy still fall well within the range of our expectations at the time the strategy was designed a decade ago. To illustrate what we mean by this, consider the historical data for the S&P 500 Index over the post-WWII era from 1945 through 2019:

S&P 500 Index
Buy & Hold vs. Moving Average Rotation Rule
Jan. 1, 1945 to Dec. 31, 2019

	Buy & Hold	Tactical Rotation
Annualized Return	11.10%	11.99%
Best 12-Months	61.18%	60.98%
Worst 12-Months	-43.28%	-20.78%
Best 3-Years	136.90%	138.21%
Worst 3-Years	-40.88%	-20.44%

Source: S&P 90 Index calculated by Ibbotson from 19245to 1956; S&P 500 Index from January 1956 to Dec 2019. Note: Cannot invest directly in above mentioned indices. Please note that this market study does not represent actual portfolio performance. It is not possible to invest in an index. Supplemental to compliant presentation. See disclosures on last page.

[9] Source: Bloomberg
[10] Source: Orion

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Using a simple trading rule to own the S&P 500 Index in months following a positive moving average reading (as measured as of the previous month-end), and switching to a bond market index in months following a negative reading, the dynamic trading rule in the historical study above out-performed the buy-and-hold return for the S&P 500 over the entire period.

Note the worst-case outcomes above among every 12-month and 3-year holding period throughout the 74-year history of the study (measured after every month-end between 1945 and 2019). By comparison, as of March 31, 2020, seven days from the low for the pandemic, the trailing 12-month return for the Tactical Dynamic Allocation strategy was -13.89%, while the trailing 3-year return was -3.64% (cumulative). Both of these outcomes are considerably better than the worst-case periods for the historical study of the S&P 500 Index shown above (-20.78% for 12-months and -20.44% for 3-years).

To be sure, a study of the S&P 500 Index on a stand-alone basis is not an apples-to-apples comparison with the multi-market approach employed by the Tactical Dynamic strategy. That said, the reason for including multiple asset markets, and rotating their measurement periods weekly, is to reduce the probability for worst-case outcomes that can occur with a single-market, once-monthly trading rule. More importantly, the study above suggests the recent results of the Tactical Dynamic strategy need not derail the potential for a very satisfactory longer-term outcome.

International Focus

The *International Focus* strategy delivers broad exposure to the global equity markets outside the United States. The strategy seeks to capture a return premium relative to common international equity benchmarks through disciplined exposure to three market factors that have demonstrated a long-term history of producing attractive risk-reward characteristics – value, momentum and low market capitalization, or “small-cap.”

International markets recovered nicely in the second quarter, allowing this strategy to re-capture much of its drawdown from the lows in March. Even so, broad benchmarks for the international equity markets were still in the red on a year-to-date basis as of quarter-end. This is due in part to the structure of the global economy outside the U.S., which includes greater emphasis on more cyclical industries in the industrial, materials and financial sectors, and considerably less participation in the “pandemic-winner” subsectors of technology and e-commerce. This dynamic might serve as a catalyst for out-performance for international markets if/when social distancing fades through therapeutic and behavioral remedies, and ultimately a vaccine.

7-2-20

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The **S&P 90 Index** is a predecessor to the S&P 500 Index reported by Morningstar Ibbottson for years prior to 1956.

The MSCI REIT Index seeks to track the yield and price performance of publicly traded real estate companies structured as real estate investment trusts (REITs).

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