MARKET REPORT
SECOND QUARTER 2021

Key Points

- Stocks advanced nicely, logging another strong quarter.
- Non-investment grade bond yields plumbed new lows.
- Moats come in various forms. We touch on switching costs this quarter.
- We plan to return to the office five days a week on September 1.

Total Return as of June 30, 2021						
				Annualized		
	QTD	**YTD**	**1 Yr.**	**3 Yr.**	**5 Yr.**	**10 Yr.**
S&P 500	8.5%	15.3%	40.8%	18.6%	17.6%	14.8%
NASDAQ	9.7%	12.9%	45.3%	25.7%	25.9%	19.4%
Russell 3000						
Index	8.2%	15.1%	44.2%	18.7%	17.9%	14.7%
Value	5.2%	17.7%	45.4%	12.2%	12.0%	11.5%
Growth	11.4%	12.7%	43.0%	24.5%	23.3%	17.5%
Russell Mid Cap						
Index	7.5%	16.3%	49.8%	16.5%	15.6%	13.2%
Value	5.7%	19.5%	53.1%	11.9%	11.8%	11.8%
Growth	11.1%	10.4%	43.8%	22.4%	20.5%	15.1%
Russell 2000 (Small Cap)						
Index	4.3%	17.5%	62.0%	13.5%	16.5%	12.3%
Value	4.6%	26.7%	73.3%	10.3%	13.6%	10.9%
Growth	3.9%	9.0%	51.4%	15.9%	18.8%	13.5%

The Quarterly Review

In many respects, it was “more of the same” this quarter with the valuation and concentration (i.e., percentage of total market cap represented by a small number of companies) of U.S. stock averages remaining abnormally high. Volatility was subdued and excesses and distortions in segments of the markets continued to build on the back of “nearly free” capital and a cheery consensus.

Value stocks trailed their growth brethren as mega-cap technology and story stocks with potential for high growth and distant profitability (maybe) were favored. Steering clear of the folly that can be associated with new, unproven and hyped shiny objects is a high priority for us.

Regarding the market environment, our thoughts have not materially changed since last quarter. We continue to be guarded in our views and actions, yet ready to swiftly capitalize on opportunities meeting our criteria.

U.S. Equities

Stocks (S&P 500) continued their march higher during the quarter, shrugging off supply chain disruptions, a cyberattack which shut down the Colonial Pipeline (east coast fuel supply) and elevated inflation levels. Ten out of 11 economic sectors posted positive results with real estate (13.1%), technology (11.6%) and energy (11.3%) leading the way. Real estate and energy continued their rebound from 2020's drubbing and pricey technology shares advanced further. Only utilities logged a negative return, barely (-0.40%).

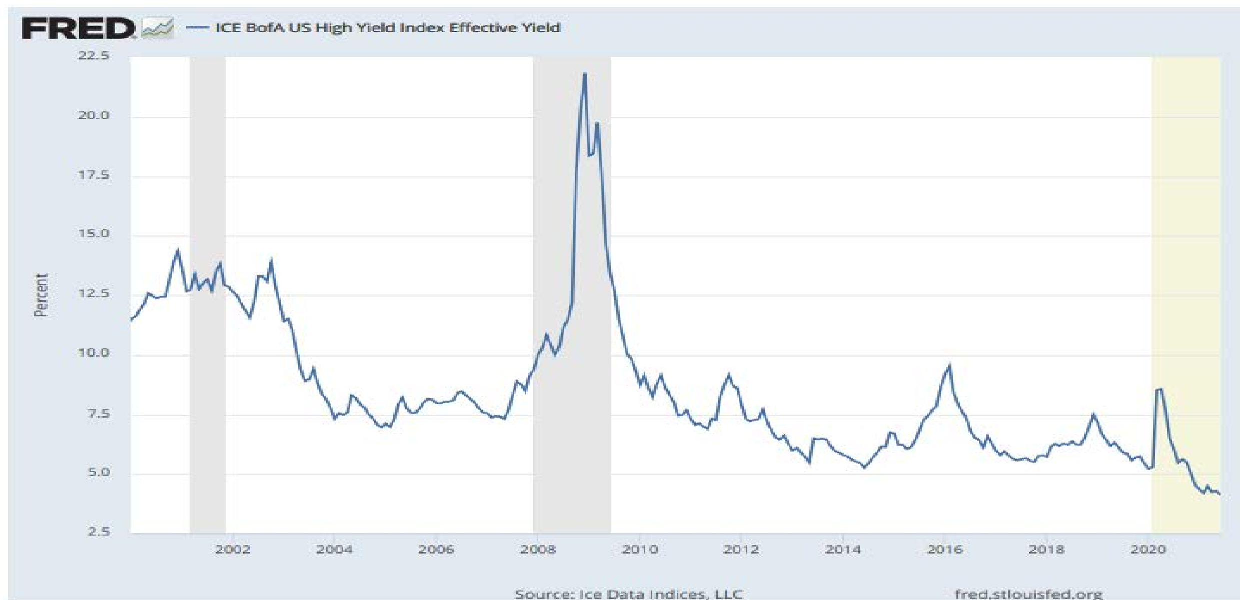
Low and declining yields seemingly brought growth stocks back into vogue. Should yields begin to rise, the valuation of these type companies could be negatively impacted the most. The historic link between bond yields and inflation is seemingly distorted by the Federal Reserve's (the "Fed") bond buying program whereby it purchases a combined $120 billion of Treasury and Agency securities monthly. The Fed has recently hinted that it may be time to begin talking about adjustments.

As always, we focus on the price of each of our holdings relative to their intrinsic or estimated value. Finding new, quality investments with an adequate margin of safety (i.e., discount to intrinsic value) in the current environment is a formidable challenge. Of course, we continue to be patient, thoughtful and disciplined.

Fixed Income & Commodities

Corporate bonds' total returns, as measured by the ICE BofA U.S. Corporates 1-10 Yrs. index, increased 1.8% during the quarter. U.S. Treasuries and Agencies, as measured by a similar index, increased 0.7%.

Yields remain low and credit spreads (difference in yield between a corporate bond and Treasury of equal maturity) tight. Below investment grade bonds, otherwise known as high-yield or junk bonds, have been trading at historically low yields in recent weeks (see chart below) as some market participants are thirsty for yield at any cost. With high yield bond prices often moving with equities, some investors may find themselves out over their skis should equity volatility increase and/or underlying credit conditions deteriorate.



Commodities, as measured by the Bloomberg Commodity Index, increased 21.1% during the quarter and 45.6% over the last year as demand increased and excess liquidity found its way into financial instruments. Oil (WTI) increased 24.2% during the quarter, 51.4% year-to-date and 87.1% over the last year – driving the commodity train – as demand picked up.

Economic Moats

An economic moat is a competitive advantage that permits a company to earn a return on its capital **above** its cost of capital for long periods of time. Excess return on capital and revenue growth builds long-term business value. Companies that exhibit such attributes are generally viewed as high-quality companies. All things equal, we prefer to own high-quality companies as we believe they will outperform over long time horizons.

Moats come in different forms, including, but not limited to: cost advantages, intangible assets, switching costs, network effect and scale. Last quarter we discussed intangible assets. This quarter we touch on **switching costs**.

Switching costs stem from inconveniences incurred by customers when changing products or services. These costs can be hard to quantify but most often come in the form of capital, time and risk aversion. Switching costs are high when significant capital is needed to research and vet a new product or service. Time is money, so when testing, training and implementation of a new product or service takes up too much of

this precious resource, customers are less likely to switch. When a new solution is potentially risky and cost of failure is high, customers will stick with the reliable and familiar. Lastly, companies that create complimentary products and deliver bundles of services tied together have a better chance of retaining customers. In general, the more friction a business or customer experiences moving away from a product or service, the less likely they are to switch. We like companies that exhibit these characteristics, creating "sticky" relationships with customers that can enhance long-term competitive positioning.

Stakeholder Update

- **Return to Office –** Team members are currently in the office four days each week with varying schedules. Beginning September 1, we plan to move to five days in the office.

- **Meetings –** We have resumed firmwide client meetings in the office as well as corporate travel.

Looking Ahead

There are an estimated 330 million people living in the United States and currently they are mostly living in a fishbowl. In other words, with international travel still challenging due to COVID-19, they are traveling and spending more domestically. This, in addition to incredible amounts of monetary and fiscal stimulus, has distorted consumer spending patterns. Absent a COVID-19 variant derailing our progress in the U.S., this fall should bring with it **an approach to normalcy** as children return to school in many parts of the country, corporations begin bringing employees back to the office and certain economic support programs wind down. Eventually, meaningful international travel will resume but this will take time due to fragmented policies.

Given the array of news related to income taxation, estate taxation, antitrust and monetary and fiscal policy that could come out of Washington during the second half of this year, we would not be surprised if volatility increased as compared to the first six months.

As always, our bottom-up value-oriented investment process will guide our actions.

Past performance is not indicative of future results. Market and economic data have been provided by third party sources. This data, while believed to be reliable, has not been independently verified by EBS.