Market Report
Third Quarter 2020

Total Return as of September 30, 2020						
				Annualized		
	QTD	**YTD**	**1 Yr**	**3 Yr**	**5 Yr**	**10 Yr**
S&P 500	8.9%	5.6%	15.1%	12.3%	14.1%	13.7%
NASDAQ	11.2%	25.4%	40.9%	21.1%	20.7%	18.2%
Russell 3000						
Index	9.2%	5.4%	15.0%	11.7%	13.7%	13.5%
Value	5.4%	-12.2%	-5.7%	2.1%	7.4%	9.8%
Growth	12.9%	23.0%	36.1%	20.7%	19.5%	16.9%
Russell Mid Cap						
Index	7.5%	-2.4%	4.6%	7.1%	10.1%	11.8%
Value	6.4%	-12.8%	-7.3%	0.8%	6.4%	9.7%
Growth	9.4%	13.9%	23.2%	16.2%	15.5%	14.6%
Russell 2000 (Small Cap)						
Index	4.9%	-8.7%	0.4%	1.8%	8.0%	9.9%
Value	2.6%	-21.5%	-14.9%	-5.1%	4.1%	7.1%
Growth	7.2%	3.9%	15.7%	8.2%	11.4%	12.3%

Key Points

- The U.S. faced numerous challenges during the quarter.
- The Federal Reserve (the "Fed") updated its policy on inflation and employment.
- Ultra-low interest rates are promoting a misallocation of capital, in our view.
- Valuations impact future returns.
- Focusing on controllable elements, we believe, is key to navigating the current investment landscape.

The Quarter in Review

The Nation's challenges continued during the quarter as wildfires raged in the west, hurricanes blew in the south, COVID-19 persisted nationwide, and many businesses grappled with changing employee work preferences. On the bright side, the pace at which multiple COVID-19 vaccine candidates have advanced is remarkable.

U.S. equities (S&P 500) were resilient, shrugging off a roughly 10% intra-month decline during September to finish the quarter higher. The environment today reminds us of the '98-'99 era when many large growth type companies, especially technology, were being held in very high regard and their share prices reflected the enthusiasm. However, trees do not forever grow upward.

The Fed updated its long run policy on inflation, now targeting **average** inflation of 2%. This change will allow inflation to run above trend longer before rates are increased to cool the economy. It also tweaked policy language regarding employment, with an eye toward supporting labor markets, especially in "low-and moderate-income communities," when it believes employment is below its maximum level.

Chairman Powell went on to say, “This change may appear subtle, but it reflects our view that a robust job market can be sustained without causing an outbreak of inflation.”

U.S. Equities

As a refresher, our value-oriented investment process has two primary tenets: **intrinsic value and margin of safety**. In deriving a company’s intrinsic value, we generally estimate its future free-cash flows, assume a required rate of return and discount back to present. If the intrinsic value on a per share basis is greater than the market price, a margin of safety is said to exist. The greater the intrinsic value is than the market price, the greater the margin of safety. Of course, having a margin of safety does not always prevent a loss but it certainly improves the batting average.

Corporate managers and the market at times become enamored with growth for growth’s sake and neglect the importance of earning an adequate return on a company’s capital. For example, if the cash an investor contributes to a company is greater than the value of the discounted free cash flows received in future years, value is destroyed, not created. In a growth-starved world, we believe this is something to be even more aware of than usual.

Speculation comes into play when market participants turn their attention from how much free cash flow a company (or other asset) can produce over time to what the next person in line will pay. **Eventually**, there is not a more gullible person in line to buy the asset at a higher price and prices reset lower to what underlying fundamentals can support. We do not believe we have any unique ability to add value in speculative issues, and therefore steer clear of such activities.

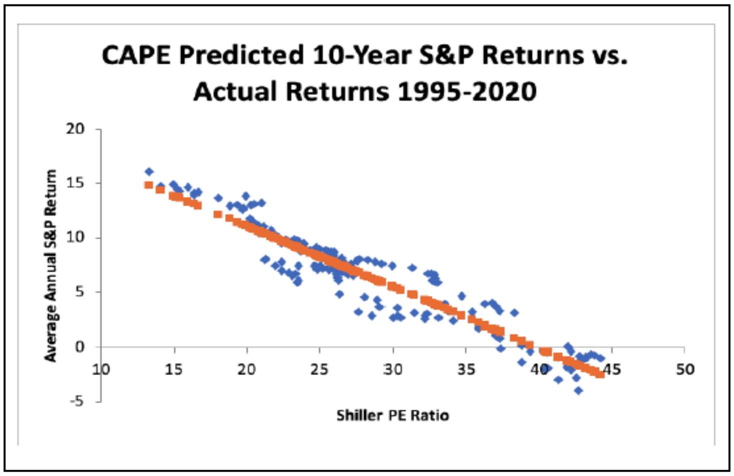
The current period of ultra-low interest rates is promoting the **misallocation of capital** at an accelerating pace, in our view. Because of the persistent and expected ultra-low interest rate environment, many market participants are taking on more risk in pursuit of a given return. Low financing costs continue creeping into the transaction values of private and public companies alike. We believe maintaining **valuation-discipline** will be an important factor in determining long-term success.

We see an **increasing number** of speculative type behaviors in the marketplace. Examples include investors funding an elevated number of special purpose acquisition companies (SPACs or blank check companies), unseasoned investors buying securities they do not understand and share prices of certain companies lifting markedly, seemingly because they simply split.

The following words of wisdom from Berkshire Hathaway's 2000 Annual Report seem appropriate:

> The line separating investment and speculation, which is never bright and clear, becomes blurred still further when most market participants have recently enjoyed triumphs. Nothing sedates rationality like large doses of effortless money. After a heady experience of that kind, normally sensible people drift into behavior akin to that of Cinderella at the ball. They know that overstaying the festivities – that is, continuing to speculate in companies that have gigantic valuations relative to the cash they are likely to generate in the future – will eventually bring on pumpkins and mice. But they nevertheless hate to miss a single minute of what is one helluva party. Therefore, the giddy participants all plan to leave just seconds before midnight. There's a problem, though: They are dancing in a room in which the clocks have no hands.

Valuations matter when it comes to long-term investment returns. If you were to ask a random group of individuals in the financial services space, "What do you think U.S. equities will return over the long-term?", you would likely get responses along the lines of: "The S&P 500 has returned around 10% historically, so that seems like a logical assumption going forward." **We disagree**, as this simplistic approach minimizes the impact of valuations, at the time of investment, on long-term returns.



To illustrate our point, we turn to the cyclically adjusted price to earnings ratio (CAPE ratio) and recent work done by Michael Finke, PhD, a professor of wealth management and the Frank M. Engle Distinguished Chair in Economic Security at The American College of Financial Services:

"The predicted values are in orange and the actual values in blue. The standard deviation of the error (how far off the prediction was from the actual value) is 1.37%." **So**, "67% of the time the return was plus or minus 1.37% from the CAPE model prediction; and 95% of the time the actual return was within 2.74% of the future 10-year predicted returns." For the statistically inclined, the R-squared has been greater than 0.7 since 1970.

At the end of August, the CAPE ratio stood at 30.63, based on data gathered from YCharts. Applying this value to work done by Dr. Finke suggests S&P 500 returns over the next **decade** will be **around 5.0%** per annum. Of course, valuations are of little value in predicting short-term (i.e. months and quarters) investment returns.

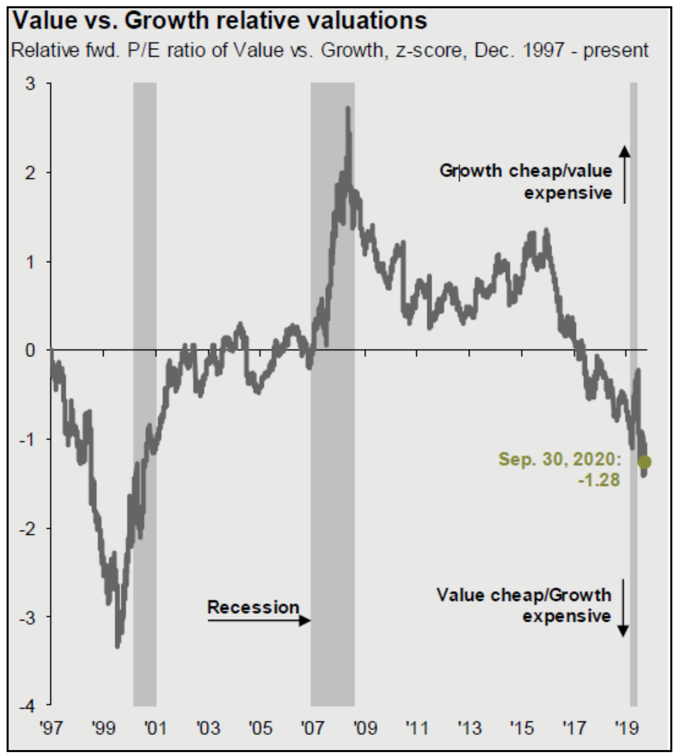
Most of our investment strategies which call for equity exposure hold only **25-40 individual stocks**. Although market conditions are tough, from a valuation perspective, we like the **flexibility** that owning fewer companies provides and **believe** it will be a larger advantage than usual over the coming decade.

Value type stocks, as compared to growth, are approaching **relative undervaluation** levels last seen in late-'99/early-'00 (as noted in the chart to the right). A move to more balanced expectations between growth and value would lead one to expect higher relative returns from the value camp over the coming decade.

Here is a more granular look at value, blend and growth stocks by market cap:

Current P/E as % of 20-Year Average P/E			
	Value	Blend	Growth
Large	126.3%	139.7%	163.6%
Mid	125.6%	136.9%	187.4%
Small	123.9%	174.6%	193.8%

Source: Guide to Markets 4Q 2020



Source: Guide to Markets 4Q 2020

While no market cap segment is cheap, value-oriented stocks are cheapest regardless of market cap range.

Fixed Income & Commodities

Fixed-income markets had an uneventful quarter. Corporate bonds' total returns, as measured by the ICE BofA U.S. Corporates 1-10 Yrs., increased 1.5% during the quarter. U.S. Treasuries and Agencies, as measured by a similar index, increased 0.2%. Corporations continued taking advantage of low yields, as reflected in the high volume of gross bond issuances. Markets absorbed the volume with ease. Shorter term BBB yields declined around 0.21% during the quarter and credit spreads tightened roughly 0.16%.

Commodities, as measured by the Bloomberg Commodity Index, increased 9% for the quarter and declined 12% YTD. Oil (WTI) priced at $40.22 on September 30, was up 2.4% for the quarter and down 34% YTD. COVID-19 related travel restrictions have suppressed demand for gasoline and jet fuel.

The chart to the right illustrates **Moving 12-Month Total Vehicle Miles Traveled** as prepared by the St. Louis Fed through July 2020. Miles traveled have generally increased over the years with three notable exceptions prior to COVID-19: gasoline price increases in the '70s and '80s and in the aftermath of the Great Recession. The recent pullback is **more significant** than any of the three prior events.

The number of travelers going through TSA checkpoints in the U.S. can be an indicator of jet fuel demand for passenger travel. On September 30, 2020, 634,046 travelers passed through TSA checkpoints, as compared to 2,082,179 on the same day a year ago – **a 70% decline**. Until corporate travel policies change, airlines, hotels and restaurants will continue to struggle.

Looking Ahead

Investing in public securities, in some ways, is a lot like farming. In both cases, there are certain variables that can be controlled and others that cannot. For us, **we can control the execution of our investment process and the level of service we provide.** We cannot control the behavior (euphoric-like, at present) of other market participants, the significant regulatory and tax shifts that can result if there is a change in administrations or the possibility there is no clear winner on election night. We will continue focusing on the controllable elements of the equation, as always, and are prepared to capitalize on opportunities as they arise.

As we move into the fourth quarter, remember, news outlets are not in the business of providing valuable insights into complicated matters like investing. They are in the business of generating high ratings and generally do so by featuring outspoken mediagenic guests who provide information of little substance. Consider yourself warned (humor intended).

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.