

## MARKET REPORT FIRST QUARTER 2021

### Key Points

- A lot has changed since 1Q 2020.
- Nutty behavior by some market participants is increasing.
- SPACs are all the rage. A fair warning seems in order.
- Intangible assets can be an economic moat.
- Advantages are important. We touch on a few of ours.

### A Lot Has Changed in Four Quarters

We generally tailor our quarterly updates to the current quarter and provide an overview of the year in the 4Q letter. Given the significance of what has transpired on the medical, economic, financial and unemployment fronts over the last four quarters, we are going to make an exception to our normal schedule and revisit “then” (1Q 2020) versus “now.”

Roughly one year ago this quarter, policymakers, medical professionals, scientists, educators, business owners and management teams were staring down an invisible adversary – COVID-19. It crippled healthcare systems, economies, capital markets, supply chains and stoked fear among the population as it spread unabated with no quick solution in sight.

The S&P 500 declined 34% in the 23 trading days ended March 23, 2020. Corporate bond yields spiked higher, credit spreads (number of basis points a corporate bond yields over a Treasury of equal maturity) widened and commercial paper markets ground to a halt. Capital markets were frozen. The Federal Reserve (the “Fed”) pulled out all the stops on the morning of March 23, supporting Main Street and Wall Street. The magnitude and pace of the monetary response (stimulus) was unprecedented.

What we said “then” (in our 1Q 2020 letter, select excerpts):

- *Equity and fixed-income markets became dislocated and we worked diligently to capitalize on opportunities.*
- *Historically, during times of economic crisis, the pace at which stimulus programs were implemented and the size of those programs were key factors in determining America’s economic trajectory during the recovery. Generally, quicker and bigger is better. We highlight various stimulus programs implemented through quarter-end below to give you a sense of the current effort. Collectively, the programs have been implemented faster and are larger than ever before. We like the prospects for America emerging from this period stronger and better, albeit different.*
- *Acting rationally and not rashly during these periods is a key element of long-term investment success.*

Total Return as of March 31, 2021						
	Annualized					
	QTD	YTD	1 Yr.	3 Yr.	5 Yr.	10 Yr.
S&P 500	6.2%	6.2%	56.4%	16.7%	16.3%	13.9%
NASDAQ	3.0%	3.0%	73.5%	24.6%	23.5%	18.3%
<b>Russell 3000</b>						
Index	6.4%	6.4%	62.5%	17.1%	16.6%	13.8%
Value	11.9%	11.9%	58.4%	11.0%	11.9%	10.9%
Growth	1.2%	1.2%	64.3%	22.4%	20.9%	16.4%
<b>Russell Mid Cap</b>						
Index	8.1%	8.1%	73.6%	14.7%	14.7%	12.5%
Value	13.1%	13.1%	73.8%	10.7%	11.6%	11.1%
Growth	-0.6%	-0.6%	68.6%	19.4%	18.4%	14.1%
<b>Russell 2000 (Small Cap)</b>						
Index	12.7%	12.7%	94.9%	14.8%	16.4%	11.7%
Value	21.2%	21.2%	97.1%	11.6%	13.6%	10.1%
Growth	4.9%	4.9%	90.2%	17.2%	18.6%	13.0%

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- *As in all environments, price-to-value relationships guide our actions.*
- *Although it may be difficult to see at present, the current situation is **temporary**.*

While we **firmly believed then** that equity and fixed-income market dislocations were providing outsized investment opportunities that should lead to better than average results over the coming 5-7-year period, we have been surprised by the swiftness of the recovery. When you stop and think about it, it is hard to imagine that roughly four quarters ago the globe was being gripped by a pandemic, the U.S. economy was essentially shut down and there was no vaccine for COVID-19. Medical professionals and other front-line workers were working an incredible number of hours in challenging conditions. Old business models were destroyed, and new ones created almost instantaneously.

**Today**, vaccines are being administered at an accelerating pace, the economy is advancing, equity markets are charting new highs, the cost of debt capital is nearly free (not good, in our view) and the unemployment rate is down to roughly 6.0% (from 14.8% in April 2020). While there is **plenty to worry about**, like ultra-low yields, elevated equity valuations, incredible deficit spending, the prospects of increased regulations and corporate/individual income tax rates, as well as irrational investor behavior – it is nevertheless **remarkable** where we are today versus a year ago. There could have been alternative outcomes much worse.

**However**, through our lens, the price-to-value relationship (generally expensive), ultra-low yields and tight (narrow) credit spreads keep us **on the defensive**. The titanic-sized dose of stimulus and continued easy money policies are arguably making it difficult to assess the underlying health of the economy as price discovery has seemingly been compromised. Knowing the investments, you own, why you own them, and their estimated value is always important but even more so in today's environment.

## U.S. Equities

Value stocks trounced growth stocks during the quarter, again (see table, page one). With value-type stocks being generally less expensive than their growth brethren and perceived beneficiaries of an economic "reopening," investors bid up prices during the quarter. Growth-type stocks, generally viewed as more expensive, lagged during the period as their lofty valuations seemingly caused investors to take pause.

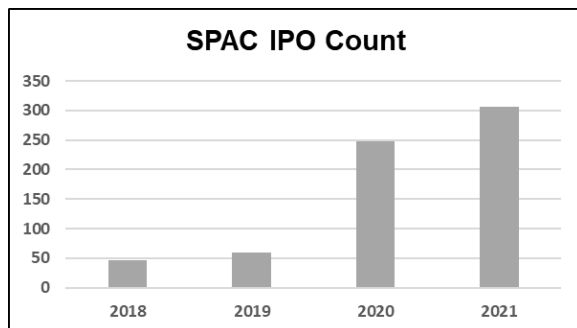
We continue to see nutty behavior by some market participants. For example, during the quarter a particular game-related stock went from \$19.26 at year-end to an intra-day high of \$483.00 on January 28 as a group of social media platform participants banded together – seemingly to drive the stock higher in an effort to force a group of hedge funds, who were short the stock (i.e., would benefit from the stock falling, not rising) into a short squeeze. The company **has not been profitable** in recent periods. The price action defies logic.

Another example is the recent sale of a "digital art" piece by Christie's in the form of an NFT (non-fungible token) for \$65,000,000. An individual bought an original file of an image. We do not pretend to understand.

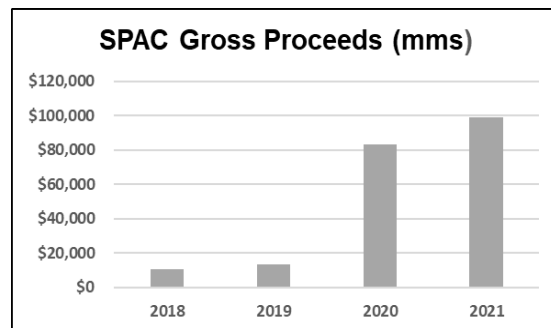
Lastly, given that SPACs (special purpose acquisition companies) are **all the rage** on Wall Street, we thought it worth sharing a little about them in **the spirit of a fair warning**. SPACs, otherwise known as blank check companies, were first popularized in the 1990s. They are shell companies with no commercial operations and are formed by a "sponsor" strictly to raise capital. Once the capital is raised via an IPO, the SPAC pursues a target company (typically a private company). Units or shares are typically offered at \$10.00 each and have warrants attached.

The proceeds from the IPO are placed in a trust account until the SPAC's management team identifies and acquires an operating company. There are time limits on how long the capital can be held in the trust, typically 18-24 months, before it must be returned, or the time frame extended via a proxy vote. If the SPAC successfully completes an acquisition of a private operating company, the private company succeeds to the SPAC's public company filing status, becoming a public company.

SPAC activity has ballooned (see charts below) in recent years with some sponsors taking on a rock star like status and celebrities lending their fame to help gather capital. In our view, outsized enthusiasm for an investment, or class of investments in this case, **rarely bodes well for investors' future returns.**



Source: Spacinsider.com. 2021 is as of 4/12/21.



Note: Includes over-allotment proceeds.

Here is where things get interesting! Sponsors generally **only invest** an amount equivalent to **3%-4%** of the IPO proceeds to ultimately receive **20% of the common equity** (think warrants). Investment banks are getting paid well along the way too.

Historically, SPACs generally focused on positive EBITDA companies; however, in 2020 **pre-revenue story** companies began entering the mix. Armed with the experience of having been through numerous market cycles, we are skeptical of SPACs working out well for retail investors investing in the IPOs.

### Fixed Income & Commodities

Corporate bonds' total returns, as measured by the ICE BofA U.S. Corporates 1-10 Yrs. index, decreased 2.1% during the quarter. U.S. Treasuries and Agencies, as measured by a similar index, decreased 1.7%. Treasury yields rose at the two-year mark and beyond with the 10-20-year segment of the curve increasing the most by 80 and 84 basis points to 1.72% and 2.24%, respectively. Yields within the BBB (lowest investment grade rating) space increased at the one-year mark and beyond, and credit spreads widened to varying degrees along the 1-year to 10-year segment of the curve.

Continuing with our nutty theme from the equity section, German Banks tell depositors to pay or leave (WSJ 03.02.2021). Although interest rates have been negative in Europe for years, the increased amount of savings that mounted during the pandemic caused Deutsche Bank and Commerz Bank to begin telling new depositors to pay 0.5% per annum to park large sums of money with them. Reportedly, the banks can no longer absorb the negative interest rates charged to them by the European Central Bank. Here in the U.S., the Fed seems to have no appetite for negative nominal yields – thankfully. After peaking at \$18.4 trillion on December 11, 2020, negative yielding debt (globally) has declined to \$13.4 trillion at quarter-end – still an enormous amount.

Commodities, as measured by the Bloomberg Commodity Index, increased 6.9% during the quarter and 35.0% over the last year as liquidity has found its way to financial assets and commodities alike. Oil (WTI) increased 21.9% during the quarter and 188% over the last year.

### 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.

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

Intangible assets generally take the form of brands, patents, proprietary technology and regulatory licenses that provide pricing power by keeping competitors distanced. Brand equity often occurs in business-to-consumer models and can be the best vaccine against private-label products. Patents provide a period of protection from competitive forces and therefore pricing power. The length of time remaining on a patent and the pipeline of new patents are considerations. Proprietary technology can increase switching costs for a customer, reducing the risk of them shopping for another solution. Lastly, regulatory licensing can provide pricing power on one hand by keeping competitors out of the market, but be limiting on the other. Intangible assets are often accompanied by other moats as well.

### Looking Ahead

To produce acceptable long-term results, an investor must have an advantage. We believe **our advantage** is rooted in our time-tested investment process, long-term investment horizon, like-minded client base and flexible equity, balanced and fixed-income strategies. The **flexibility** to hold extra cash or fixed-income, depending on the strategy, **can be useful** when compelling investments are not available for purchase. Given the general frothiness in markets and increasingly irrational behavior by market participants, **we remain guarded**. 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.*