ADKINS SEALE CAPITAL MANAGEMENT, LLC
Investment Commentary
October 8, 2020

Dear Clients:
Events of today bring to mind Walter B. Wriston's (CEO of Citibank 1967-1984) book – Risk and Other Four Letter Words and more specifically the chapter named "Going to Hell on a Best Fit Curve." This chapter discusses the natural human tendency to extrapolate recent events into the future since humans think they "know" what has happened and lacking any better knowledge of the future, assume the recent past will continue. As Wriston so clearly articulates, "Regression analysis of historical data rarely validate extrapolation because most history is never written down. It is literally impossible to obtain enough data, not only on events but on man's motives, to make an extrapolation valid. The best-fit-curve, so useful in engineering, cannot be laid out in human affairs because we simply do not have enough data points." Wriston goes on to cite a few classic predictions of human limitations (i.e., Malthus) and failures (i.e., The Marshall Plan) that proved wildly off the mark.

Today, we see quite a few examples of the extrapolation tendency driving social commentary. In the investment world, the powerful surge in the stock valuations of the top five companies in terms of market capitalization (aka index weight) in the S&P 500 Index has resulted in those stocks comprising almost 25% of the total index. The cumulative returns for the each of these five stocks over the five years ended September 30, 2020 were as follows: Amazon.com +575%, Apple +354%, Microsoft +422%, Alphabet +130%, and Facebook +191%. In contrast the comparable return for the Index was 94% or about 14% per year. All five of these companies have generated above average sales growth and all but Amazon.com have profit margins substantially above average. The outperformance in stock prices for these companies has continued over the last three year and one year periods as well. Will the observed parabolic growth in sales, profits, and market value continue or will competitive market conditions act to dilute the historical advantages created by these enterprises?

Mean reversion in investment markets is a powerful force that has been observed continuously over that last century. This force primarily results from innovations and policy initiatives. Above average profit margins nearly always stimulate innovation and attract aggressive price competition; think Walmart and Amazon.com. No one knows when or how such mean reversion will be realized or if it will be realized at all. Common sense and basic logic tells us to expect continuous disruption and to hedge our investment bets with sound diversification among multiple asset classes with expected returns over the expected rate of price inflation. Passive investing in broad markets remains an attractive strategy since this approach gives investors exposure to both the known and unknown "parabolic" growth stories held by index funds. As is well known but sometimes forgotten, market capitalization index funds are continuously buying winners and selling losers, actions frequently difficult for humans to take. While successful active stock selection remains an attractive source of wealth creation, such remains much easier to talk about than to deliver in practice.

Much commentary in the media today emphasizes the negative future outcomes of current events - think climate change, identity politics, undisciplined politicians, over-priced stocks and bonds. Fortunately, none of these concerns are likely to evolve as badly as envisioned. As Wriston so eloquently wrote – "Our inability to predict what will happen tomorrow with any accuracy is fortunately offset by man's ability to cope with the unpredictable. This is a recurring theme in the long history of mankind, and the major reason we have survived."

Investment Market Returns as of September 30, 2020
The broad US stock market returned 9.2%, including dividends, for the recent quarter, a continuation of the expectation for a recovering economy from the pandemic shutdown. The trailing twelve month return for US stocks was 15%, resulting almost entirely from the strength of US large cap stocks, particularly those highlighted above. Returns for non-US stocks were a positive 6.3% for the quarter, reflecting the absence of "parabolic growth stories" for these stocks. The trailing twelve month return for non-US stocks was a pedestrian 3%, appearing favorable only in comparison to bonds.

Returns on fixed income assets remained relatively robust for the quarter and year to date as yields continued to decline. The broad US taxable bond index returned 0.6% and 6.8%, respectively, for the two periods. Current annual yield to maturity on the broad US investment grade bond index is about 1.2%, now resulting in a negative real return net of expected annual inflation. The broad non-US taxable bond index returned 4.0% and 5.1%, respectively, and ended the quarter with an annual yield to maturity of about 0.4% or almost certainly negative net of inflation. Market signals from bond markets suggest a benign inflation environment and possibly a weak economic outlook which possibly contradicts the signal from the equity market.

Returns on hedge strategies were mixed for the quarter with trend following slightly negative, while option based and allocation strategies generated returns of about half of equity returns. On a year to date basis, essentially all hedge strategies trailed the equity market recovery after having proven beneficial in the first quarter. The year to date return on the SPDR Gold ETF was 24%, possibly reflecting growing concerns on the health of the global economy.

Cash returns remain essentially zero, acting only as a store of "dry powder" to deploy if stock and bond prices fall.

Our Look Forward

We continue to expect mid-single digit annual returns from US large cap stocks and upper single digit annual returns from mid to small cap US stocks and non-US stocks over the next ten years. Investors should not be surprised by volatility spikes as unexpected events will probably have a pronounced impact on "growth" stocks with very high price multiples. Stock prices remain vulnerable to a change in bond market pricing to include a larger yield premium over the expected rate of annual price inflation. Investors today may have too much comfort in the ability of central banks around the world to hold down bond yields in the face of massive monetary stimulus.

Bond yields offer an unambiguous and unattractive forward return opportunity. The benefit of holding such assets derives from being able to take advantage of lower prices for stocks and other assets in the future. We continue to believe this benefit has merit but investors must lower portfolio return expectations to account for the price of this "opportunity cost."

As we have counseled in the past, investors and our clients in particular may well look to using higher equity allocations to achieve desired portfolio returns. Such an approach makes sense where the client has an appropriate time horizon and emotional construct to "stomach" the volatility in market prices and an ability to adjust periodic withdrawals in periods where market values decline significantly.

In Closing

We look forward to visiting with each of you about your investment results and expectations for the future and to make sure your portfolios are aligned with your specific circumstances. We greatly appreciate the opportunity to serve as your investment adviser and pledge our best efforts to meet your expectations.

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