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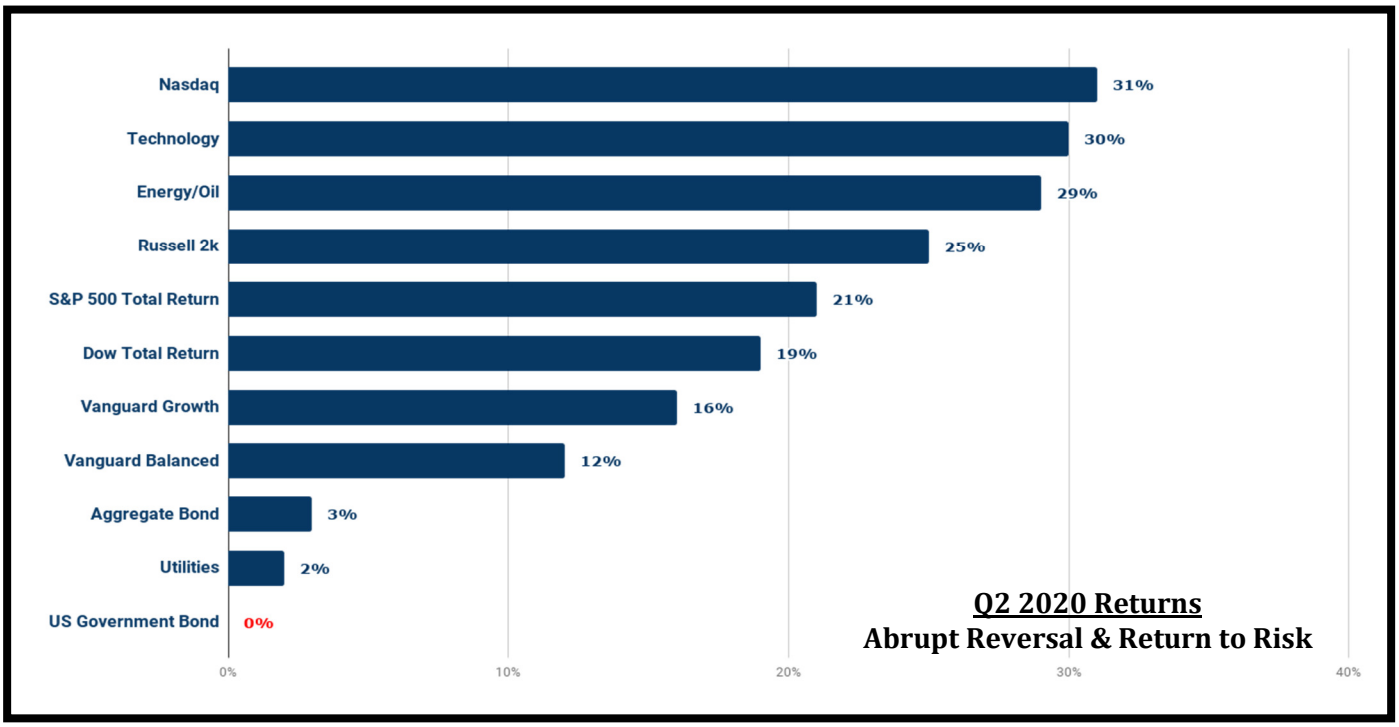
Second Quarter 2020 Market Commentary

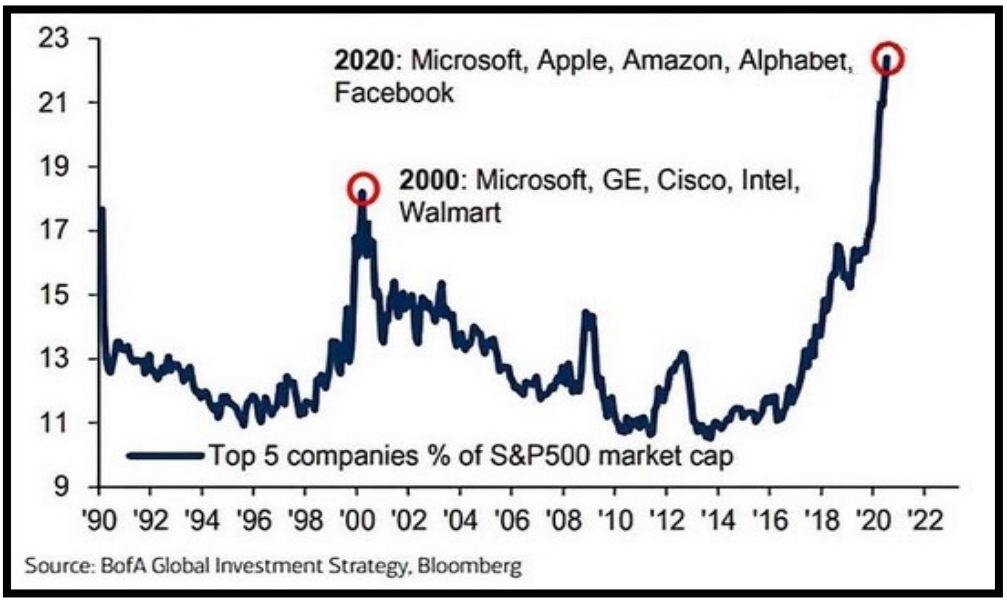
Market Performance and Analysis

While the nation went on lockdown the stock market broke out. Stocks rose all three months of the second quarter for an abrupt reversal of March's bear market.

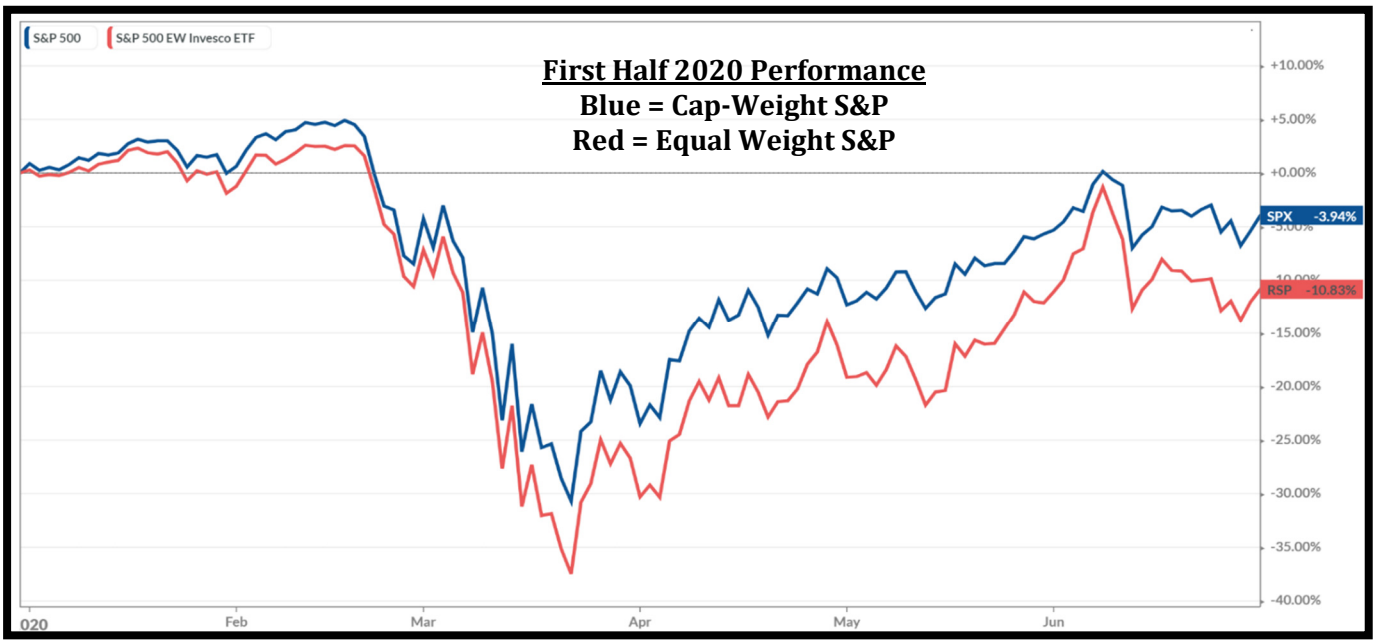


Risk was back on in the second quarter as every asset outside of treasury bonds (which outperformed earlier this year) rose appreciably. Technology and growth stocks led the field as America's largest tech companies, the so-called FAANG stocks (FaceBook, Amazon, Apple, Netflix, and Google) continue their domination of stock market gains. In fact, the top five companies in the S&P 500 now make up about 21% of the index, as you can see on the chart nearby. While mid-size, small, and value stocks performed well in the second quarter, there is no denying the market's preference to keep bidding up our biggest tech companies

►Top 5 stocks in S&P 500 now make up over 21% of the index; surpasses "Dot-Com" era concentration.



The next chart shows the year-to-date performance of the cap-weighted S&P 500 (in which the top five constitute 21%) and the equal-weight S&P 500 (in which all 500 companies are counted equally). You can see that even with last quarter's push, the giant tech weighting helps the cap-weighted index come out on top. This further extends tech and growth's decade of dominance over all other asset classes.



Investors Signal Confidence in Economic Recovery

The contradictory nature of the market's second quarter move—its best quarterly performance in 20 years amidst a crippling pandemic—confounded many who expected a protracted decline. The unprecedented economic stoppage, so this thinking goes, introduced extraordinary uncertainty that would caution against investing in companies struggling through the unknown. Investors roundly rejected this premise in a vote of confidence in America's businesses, its economy, and its people. Cynics are quick to dismiss the market's rally as unthinking exuberance, as an unjustified overcorrection for the fastest-ever bear market that is disconnected from reality.

However, in this case, we believe investors have made the rational calculation that present pain does not necessarily become the future status quo, particularly where the economy came to an artificial—i.e., not caused by an internal economic failure—standstill. Investors absorbed the initial blow of COVID-19 in March. This led to the bear market -34% reduction in the value of the S&P 500. Following this they made, and continue to make, the deliberately reasoned decision to put their money to work in American business.

Rebound From March Bottom (as of June 30)

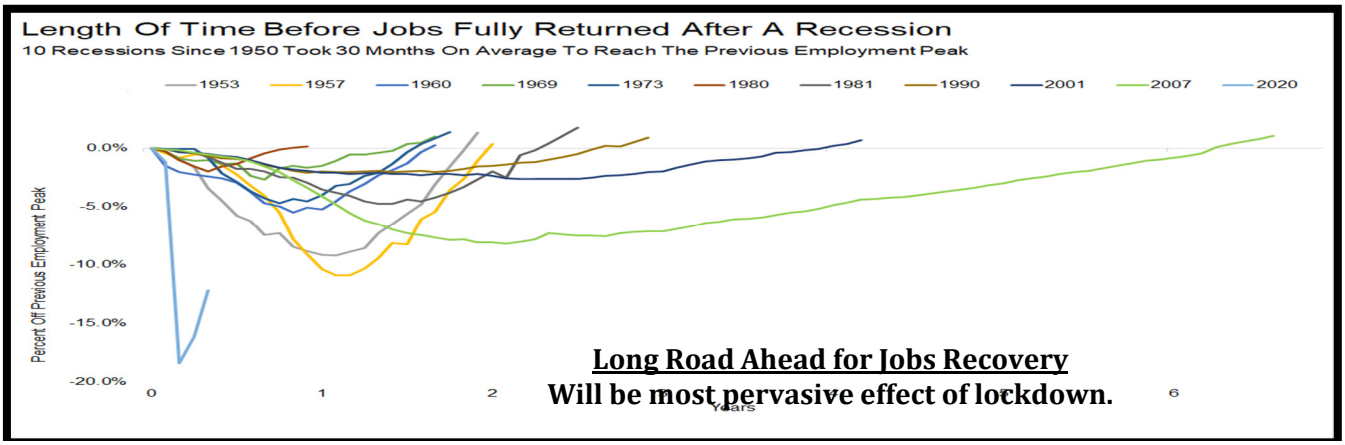
- S&P 500 + 39%
- Dow + 39%
- Russell 2k + 45%
- Nasdaq + 47%
- Technology + 48%

The criticism of the second quarter rally also fails to appreciate why wealth is allocated to the stock market in the first place: investment. Investing by its definition ("to spend or utilize for future advantage or benefit") sets forth the idea of expectation of *future* benefits. The stock market, therefore, is a leading indicator. Its behavior tells us how the majority of investors feel companies will perform going forward. The stock market isn't the economy, but it is a significant component of it; and the market, like humanity, is often irrational. But in this instance, we heartily concur in its judgment. We believe in the resilience and dynamism of the American people and its public companies. Our robust economy took a breather for the greater good in the second quarter. As restrictive lockdown constraints are removed and the government provides just compensation for its lockdown imposition we are encouraged by the possibility of the economy hitting the ground running in the second half.

At this point we are far enough away from the depths of the most stringent lockdown measures to have ample evidence of their effect on the economy. The economic freeze was profoundly deleterious: the unemployment rate rose to 14.7% as millions of mostly lower income Americans lost their jobs (the worst recorded unemployment rate since the Great Depression); manufacturing and service industries fell into and exceeded their deepest contractions since the Great Recession; and the Federal Reserve Bank of Atlanta estimates the economy shrank -35% in the second quarter. But, as shown by the stock market's behavior as described above, nearly all of these consequences were anticipated and priced in soon after the necessity of the lockdown became apparent. The question then became exactly how quickly can the world's most dynamic economy be revived from flatlining back to full health?

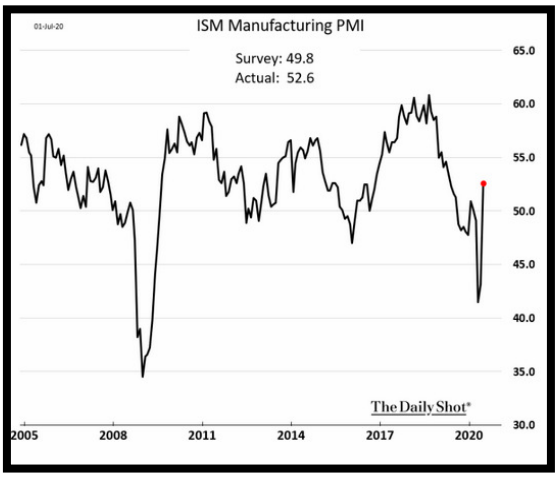
Unemployment peaked in April and improved in both May and June and currently sits right now around 11%. Continuing unemployment claims and unemployment classified as "permanent" remain frustratingly high. The

labor market will likely be the most difficult to recover to pre-pandemic strength when the unemployment rate was 3.5%, the lowest in almost half a century. See the chart below for a depiction of the depth and speed with which jobs fell off.

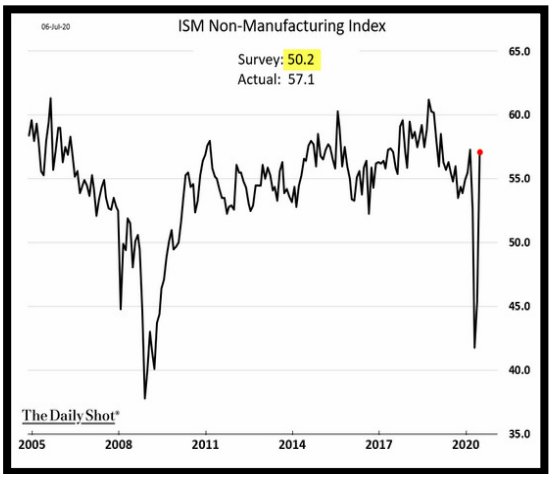


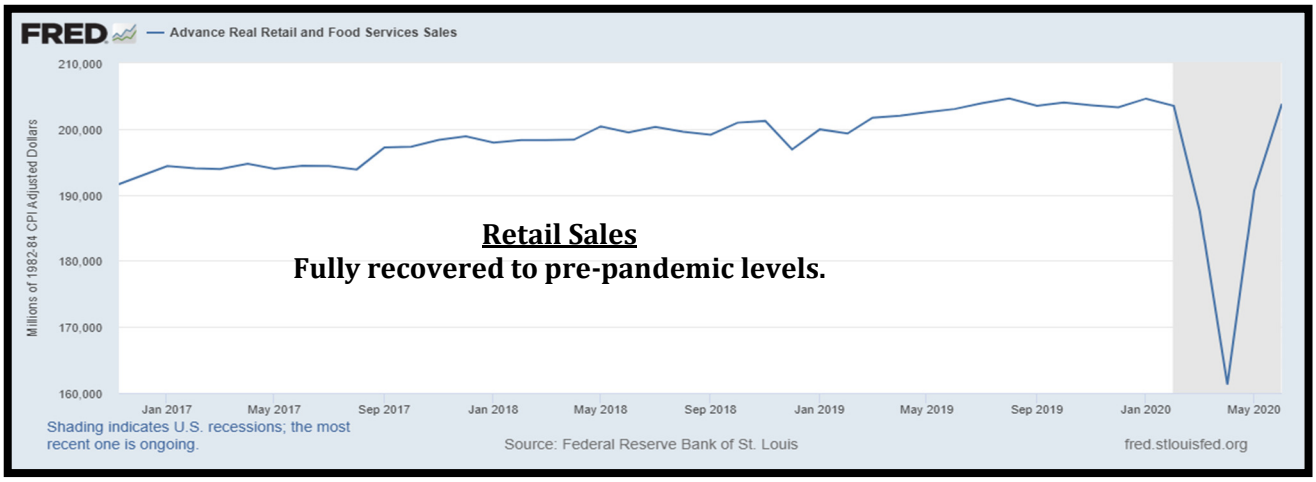
Source: Twitter @ryandetrick

Other monthly data released post-lockdown has given us hope that the economy is primed for recovery once lingering uncertainties are resolved. Both manufacturing and services indexes recorded expansion-level numbers in June. See the graphs below for evidence of their sharp recoveries. Small business owners, the lifeblood of local economies, have been hit hard by the lockdown. Nevertheless, the latest survey of small business optimism showed a sharp reversal of April and May's pessimism. Similarly, consumer sentiment is improving as COVID runs its course. Consumer spending recorded its largest monthly increase in history from April to May and retail sales in June are back to pre-pandemic levels.



■Manufacturing and Non Manufacturing (Services) Indexes Back at Expansion Levels (≥50).

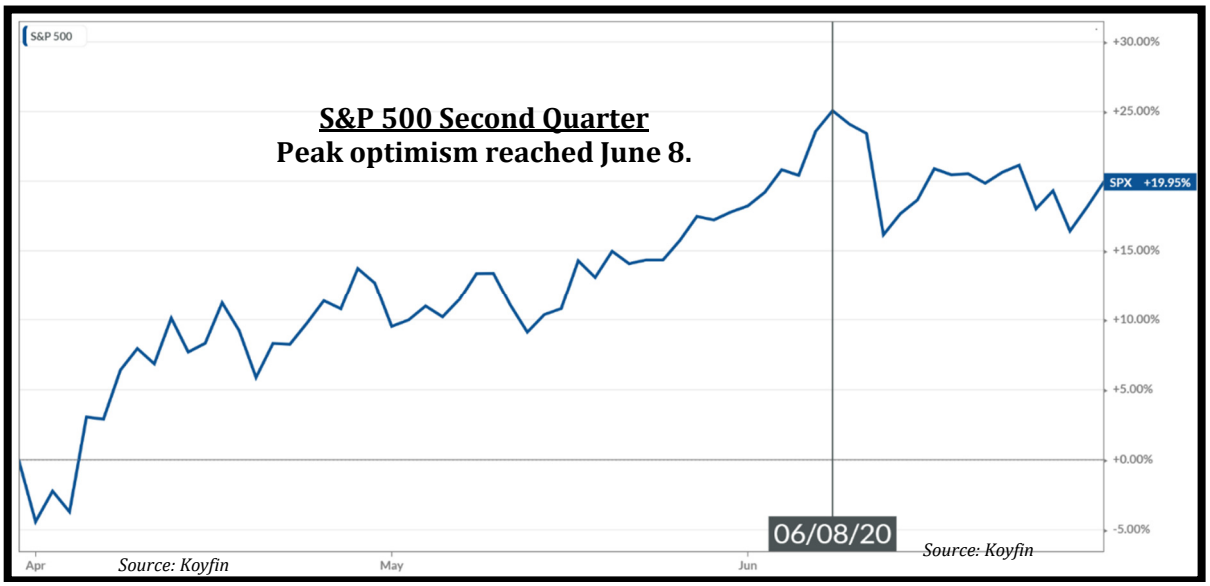




The improved data and sentiment serve notice to observers that Americans by and large are prepared for things to get back to normal. Moreover, the data support the assertion that an economic recovery isn't the fever dream of obtuse investors but a reality not too far afield.

Investment Strategy Going Forward

As we write this in July stocks are in a holding pattern after having rallied so strongly off of their bear market lows. Optimism about containment of COVID peaked on June 8th, as you can see on the chart below



This range-bound fluctuation will likely predominate in the near-term. There remain significant outstanding uncertainties for this market: the intensity of the second COVID wave, the breadth of the next government stimulus package, and the looming presidential election. With these uncertainties come volatility. In fact, the

index of expected volatility, the VIX, spiked in March and has persisted at multi-year highs. Market participants are approaching the last half of the year with clear eyes: anticipating a recovery but not oblivious to risks and the volatility that always accompanies them.

We aim to approach the next half in much the same way: participate intelligently in the market and be prepared for all events. This is the philosophy of our portfolio management software: proactive portfolio allocations adapted to the market's current behavior. Recent innovations now enable our tactical portfolios to be even more responsive in reaction to Black Swan events like the COVID pandemic. The innovation, called Black Swan Interrupt, enhances portfolio sensitivity in getting defensive in times of severe market stress without also acting as a barrier to market reentry. Regardless of what the second half brings, our tactical and strategic portfolio solutions will help us to navigate through it.

Performance Disclaimer

No investment strategy or methodology can guarantee profits or protect against losses. Investment risk is inherent in every individual portfolio and no computer model or modeling program used or relied upon in making investment choices for a portfolio can eliminate risk.

Sources:

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