

**LEVEL FOUR®**

Capital Management

A DIVISION OF
CARR, RIGGS & INGRAM CAPITAL, LLC

QUARTERLY NEWSLETTER

3Q 2020

Is Value Investing Dead?

 **Chart 1.** Index Performance as of 06.30.2020



INDEX PERFORMANCE

Returns as of 06.30.2020

S&P 500 (SPX)	-3.09%
Dow Jones Indus. Avg (INDU)	-8.43%
MSCI U.S. Value	-16.12%
MSCI U.S. Growth	-12.15%
MSCI EAFE (Non-U.S.) (MXEA)	-11.03%
MSCI ACWI (Non-U.S.)	-6.25%
U.S. Corp High Yield	-3.80%
Alerian MLP	-35.75%

Source: Bloomberg as of 06.30.2020


At the start of the second quarter of 2020, the world was only beginning to fully grasp the tragic human impact of the COVID-19 pandemic. At the time, much was still unknown about the virus, but what we learned very quickly from an economic standpoint was the severity and speed at which the virus caused the global economy to come to a rapid halt. Overnight, jobs were lost, factories shuttered, and “working from home” took on new meaning. Indeed, 2Q20 will be remembered for a long and varied list of reasons. At Level Four Capital Management (LFCM), our focus during the quarter was to navigate the markets and the flood of news and data on behalf of our advisor partners and clients. It was a challenging quarter to say the least, and while we have seen a considerable rally off of the March 23rd lows, the market continues to be driven by daily headlines and the hope of a virus treatment or cure.

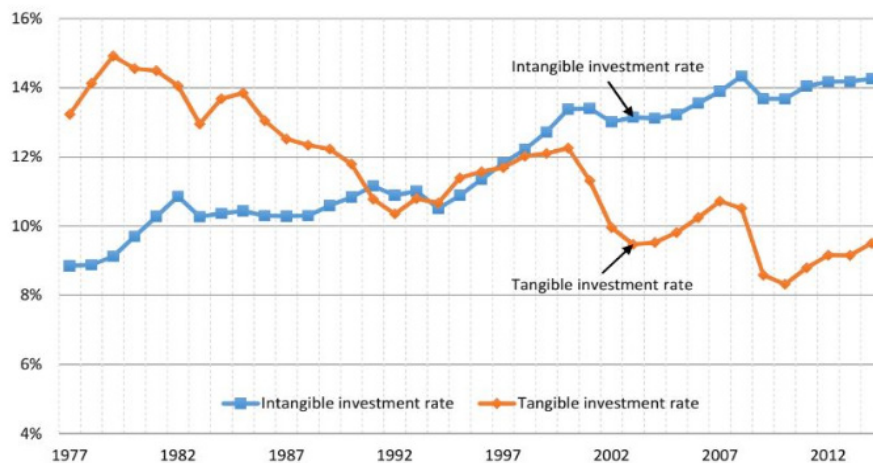
Adding to these macro headlines, we are entering another corporate earnings season, and we have an upcoming U.S. Presidential election. In this quarter’s newsletter, we address another area that is drawing considerable attention from investors, and that is the on-going debate revolving around Growth and Value investing.

IS VALUE INVESTING DEAD?

Well, that depends on how you define Value. The widely accepted definition is the Fama and French (1992, 1993) Price/Book (P/B) factor, which has been the standard since it overtook Basu's Price/Earnings (P/E). Most on Wall Street would likely agree that these are the go-to measures of Value. We, at LFCM, have discussed in many forums what we believe to be the problem with using these and other accounting based metrics as the only source of value measurement, as in our opinion, these measures are no more than just evidence of value. Price/Earnings is problematic because of the E (earnings). We know a company can easily play games with the earnings numbers that are officially reported not to mention the effect of other factors such as the significant increase in intangible asset investment as the global economy moves from a manufacturing to a service economy (See Chart 2 below).

The currently accepted quantitative factor to measure value is Price/Book. The main issue when relying on this factor is that B, or Book, could be severely understated in both Value and Growth companies, although it is typically much more pronounced in Growth companies.

 **Chart 2.** The Intangibles Revolution - U.S. Private Sector Investment in tangible and intangible capital (relative to gross value added), 1977-2014



Source: Gu, Feng and Lev, Baruch (2016). *The End of Accounting and the Path Forward for Investors and Managers*. John Wiley & Sons, Inc.

A LOOK AT INTANGIBLE ASSETS

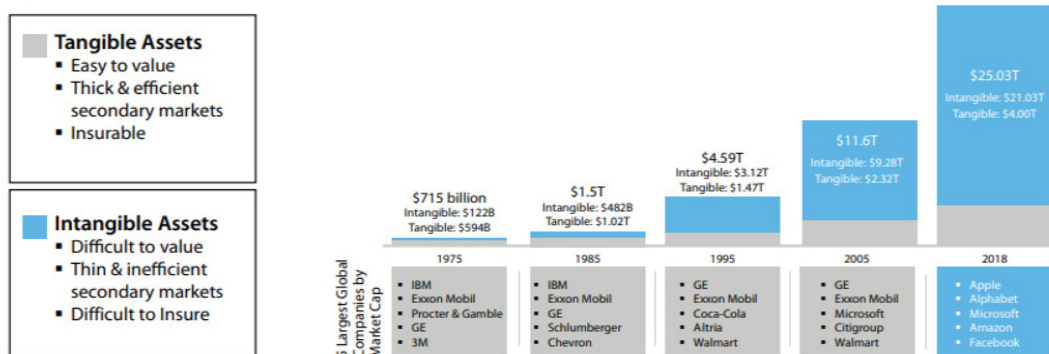
Intangible assets are assets such as brand, patents, knowledge, franchises, copyrights and trademarks as opposed to physical assets such as plant & equipment or inventory. The issue is that current accounting standards require virtually all intangible investments be immediately recognized as an expense, rather than capitalized on the balance sheet as a long-term investment and amortized over time. In a presentation by Aswath Damodaran on intangibles, he presents two relevant examples from accounting-industry thought leaders Baruch Lev and Paul Zarowin.

(Damodaran, A. (2008). *The Value of Intangibles* <http://pages.stern.nyu.edu/~adamodar/pdfiles/damodaran2ed/ch12.pdf>). Baruch Lev has argued persuasively that the way in which accountants deal with intangibles is neither conservative nor informative. Expensing R&D, for instance, does understate earnings for high growth companies, but it also overstates earnings for low growth firms. Moreover, Paul Zarowin, presents evidence that **earnings at U.S. firms have become less correlated with stock prices and he attributes this phenomenon to the failure to account for intangible assets.**

A company with a large amount of investment in intangibles, which are potentially very valuable, is typically understating the long-term book value of the firm. In the short-term it is possible that earnings could also be greatly understated due to the immediate recognition of the intangible investment as an expense. These variables can in turn correspond to potential issues regarding current reported multiples; return on equity (ROE) and return on assets (ROA).

The most interesting implication is not only the effect on the current multiples/factors observed and quoted every day, but the fact that these metrics are used to make investment decisions on a daily or even hourly basis. How meaningful is the potential impact? In the recently published 2019 Intangible Assets Financial Statement Impact Comparison Report, Aon and Ponemon Institute provide data and survey responses that lay out just how important intangible assets are today and why. The survey estimates the value of U.S. intangible assets at \$20-\$25 trillion dollars.

Chart 3. Tangible Assets vs. Intangible Assets for S&P 500 Companies, 1975 - 2018



Source: 2019 Intangible Assets Financial Statement Impact Comparison Report

Let's apply this logic to an example. An investment in Amazon 10 years ago (as of 6/30/2020) has returned 2,425%, or 38% per year. There have been many on CNBC and other outlets that have been screaming "sell" for much longer than that, and still talk about the stock as overvalued due to the lack of earnings, high P/E, or some other accounting metric. Why did some investors miss out on this investment? We believe that they missed the point that Amazon is a free cash flow machine, and in our opinion the stock performance did not correlate with reported earnings; the intrinsic value is what ultimately counts. The bigger point was the continued building of intangible investment value. Chart 4 shows the effects of the accounting metrics versus the potentially large intangible assets

Chart 4.

A/O 6/30/2020	% Wt. S&P 500	Reported P/B	Adjusted P/B	Reported P/E	Adjusted P/E
Apple Inc	5.92%	20.09	11.52	28.59	25.74
Microsoft Corp	5.77%	13.48	9.06	35.91	34.26
Amazon.com Inc	4.48%	21.04	8.15	131.5	37.83
Alphabet Inc	3.36%	4.75	3.66	29.07	20.62
Facebook Inc	2.25%	6.15	4.68	27.58	19.62
Index Top 5 Wtd. Avg. P/B Reported	14.73				
Index Top 5 Wtd. Avg. P/B Adjusted	8.26				
Index Top Wtd. Avg. 5 P/E Reported	51.67				
Index Top Wtd. Avg. 5 P/E Adjusted	29.06				

Source: LFCM, Bloomberg, as of June 30, 2020. Past performance is not a reliable indicator of future returns. Data provided is for informational purposes only. It is not possible to invest directly in an index. See the Appendix for important additional information and disclosures. Bloomberg characteristics and financial data reflect the reporting period April 1, 2020 through June 30, 2020.

that are not recognized on a reported basis. The analysis employs a conservative methodology in our opinion. We use only R&D expense to create an accumulated intangible asset that is then amortized over 10 years with no residual value.

Arguably, the useful life of some intangibles could be much longer. For example, how long is the Coke brand useful? In addition, we could capitalize other expenses that build brand or other intangibles such as a portion of Selling, General & Administration (SG&A) expense that went to brand building as an example. The recognition of intangibles can be very complicated and beyond the scope of our purposes here. The point is that this table represents what we consider a somewhat minimal adjustment, but more than makes our point. The table shows a significant change in the weighted P/E and P/B for the Top 5 holdings in the S&P 500. The Index Top 5 Weighted Average P/E goes from 51.47 to 29.06, and the Index Top 5 Weighted Average P/B goes from 14.73 down to 8.26. In our opinion, this only scratches the surface of the effects of unrecognized intangibles.

Perhaps more interesting of all is the question, do index providers of Value and Growth indices adjust these metrics? Not many, if any, do. Why? It is a challenging process to make these adjustments and the adjustments can be subjective. That means some companies considered growth or value, are potentially mis-categorized in many indices, and therefore as well as within ETFs; an important consideration for investors in understanding how their assets are invested.

WHAT IS VALUE?

That brings us to another question, what is value? At LFCM we believe value is the intrinsic value of the firm, which is the present value of future free cash flows discounted to the present. Free cash flow needs little, if any, adjustment from an accounting perspective. The adjustments in reinvestment and earnings change by the same magnitude, and therefore offset each other. An intrinsic valuation using free cash flow requires that we get the future cash flow impact of that intangible investment, as well as all investment, such as fixed capital and working capital. So, if we own a portfolio of high quality companies at a great price versus the long-term intrinsic value, the resulting behavioral advantage is one of comfort. Comfort to take advantage of market volatility and the buying opportunities that it presents.

We prefer to focus on the signal rather than all the noise that is out there regarding investing, and our definition of value is a very useful signal. The growth versus value argument is an interesting one from a historical perspective and makes great cocktail chatter. We think, however, the focus should be on the fundamentals of the business, and the levers that affect the valuation of the companies we own and not on somewhat arbitrary accounting-based measures. Part of the debate between value and growth that makes the argument less useful is that we consider growth as an input to value, and accounting metrics like P/E as potential evidence of value. One thing we believe is value exists everywhere, whether it is found in a Growth index or Value index, our job is to find it. So how can it die?

ASSET ALLOCATION VIEW – WHERE DOES THE PRICE COME FROM ANYWAY?

If the value of an investment is the present **value** of future free cash flows discounted to the present, what about today's **price**?

In our view there are 3 primary factors that the market uses to determine the current price:

1. First, let's start with the LFCM value proposition, the present value of the future cash flow discounted to the present. But discounted by what? The two components of this discounting rate are typically the "risk free rate" and a "risk premium". For this discussion, we'll focus on the risk-free rate (usually 90-day Treasury rate). As this rate and the future expectations of this rate move, investment values will be impacted. For this aspect of an investment's value, a higher rate will imply a lower value and a lower rate will imply a higher value. We believe the long-term prices of investments will reflect their value on this basis. However, in the short-to-medium term, there are other things that also help determine asset prices.
2. Second, markets are certainly influenced by the actions of the Fed. We have all heard the phrases "Don't fight the Fed", "Taper Tantrum", etc. The Fed influences asset prices through two primary means; short term interest rates and asset purchases (quantitative easing or tightening). As the Fed changes the federal funds rate and future rate expectations, the risk-free rate changes, thus changing the math on the valuation metrics stated earlier. The second tool the Fed has is to purchase or sell assets, which will increase or decrease the amount of money in circulation.

Chart 5.

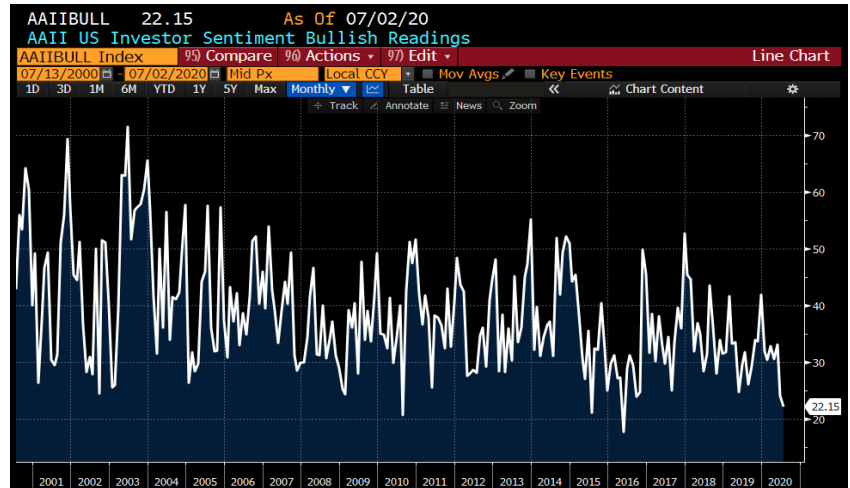


Source: Bloomberg as of 06.30.2020

In Chart 5 above, we see the size of the Fed's balance sheet as reflected by the white line. We also see the annualized Secured Overnight Financing Rate (SOFR), which is the rate which banks lend cash to each other, secured by U.S. T-Bills as collateral. The red line is the Fed Funds Rate as set by the Fed. Notice that the SOFR and the Fed rate are normally very close – but what happened in September of 2019? The answer is found in the Fed's balance sheet. As the Fed reduced its balance sheet (selling assets and pulling cash out of the system), there was a shortage of cash, which drove up the "price" of cash in the form of higher interest rates (SOFR). Also note, when this occurred, the Fed quickly started increasing its balance sheet to address the issue (September-March). In response to the COVID-19 pandemic, the Fed has further increased the size of its balance sheet from its September 2019 lows. As a result of this action, prices of financial assets are influenced higher, both from a lower risk-free rate and from "asset inflation" – the extra dollars in circulation trying to find a return. Thus, the influence on financial assets prices here are solely controlled by the actions of the Federal Reserve.

3. The final factor of influence on asset prices is investor psychology. This encompasses many things such as technical analysis, attitudes toward market bullishness and bearishness, and what's going on with the news (or today, what's going on with COVID-19). In a famous quote by Benjamin Graham, he stated "In the short run, the market is a voting machine but in the long run, it is a weighing machine." Such is the case with investor psychology which can be useful over a short run time frame, but it is often difficult to gauge and is not often impactful on long term returns. Chart 6 shows investor sentiment over the last 20 years. Apart from being volatile, this is historically contrarian. When investors are the most bearish, we have often reached a market bottom.

 Chart 6.



Source: Bloomberg as of 06.30.2020

For a given asset, the market uses all of these factors to set the current "price". At issue is which of these factors can be best utilized to make the best investment decisions? The Fed can change their policy at will; psychology never stays in one place and can literally change overnight. At LFCM our process is to focus on things we can do to add long term value to investment returns. Therefore, we prefer to be a "weighing machine" rather than a "voting machine". We believe in the long run this is the discipline and process that will result in the best returns over a complete market cycle.

IN ACCORDANCE WITH THIS VIEW, WE CURRENTLY SEE THE FOLLOWING INDICATIONS FOR ASSET ALLOCATION:

General Allocation – Most asset allocation classes were roiled by the COVID-19 pandemic, but have also staged a vigorous recovery. Equity markets were driven lower by lack of revenue and earnings visibility. Many areas of fixed income have also been affected by widening yield spreads. We recommend a quality core of equity focusing on companies with strong balance sheets and strong cash flows. For fixed income, we recommend a mix of conservative and multisector allocations. Going forward, we believe the equity markets continue to have greater potential for return than the fixed income markets. We believe that the Fed will continue to remain active, directly affecting the fixed income markets and indirectly affecting all other markets. We remain vigilant regarding our indicators and will modify overall allocations as these indicators and market environment dictates.

Equity Allocation - We continue to monitor financial conditions and market returns to determine our optimal equity asset allocation. Relative to benchmarks, we are currently overweight equities relative to fixed income due to limited potential for returns regarding fixed income going forward. We remain slightly overweight U.S. equities, and are cautious regarding small/mid-cap equities. We continue to emphasize high quality and high cash flow equities as those type of companies should emerge from the current crisis in the most favorable condition to take advantage of the recovering economy. We will continue to evolve our factor exposure as markets dictate. We continue to monitor international markets, and may move toward a more neutral weighting in the future. We see opportunity in emerging markets, especially those in east Asia that have handled the COVID-19 pandemic well.

Fixed Income Allocation – We believe fixed income going forward will be challenging. In response to the current crisis, the Federal Reserve has cut the Fed Funds Rate to 0% and has expanded their balance sheet (QE4) by approximately \$3Trillion USD with perhaps another \$1Trillion USD to go. The effects of these actions will likely be lower rates for longer. The Fed has basically begun managing the U.S. Treasury market as the large amount of current and future issuance will likely require the Fed to continue to increase the size of their balance sheet to ensure stability in these markets. Due to the lower rates seen in 2020, higher quality and higher duration fixed income have limited upside and provide lower yields. There is an unlikely tail risk of much higher rates in the event of a Fed miscalculation. Longer term rates may rise simply with the improving economy, the existing debt level, and increased future debt needed to fund Social Security and Medicare as more Boomers retire. All of this indicates a more tactical approach of fixed income management as we expect limited opportunities and significant risks in this area. We continue to monitor company health and interest rate movements closely and will adjust positioning in accordance with the evolving economic and interest rate environment.

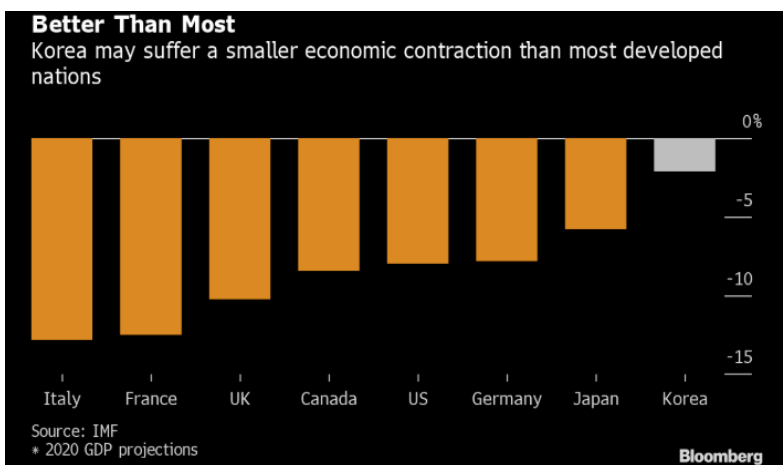
Liquid Alternatives – In Risk Adjusted Models, Liquid alternatives were helpful in reducing portfolio volatility and improving risk adjusted returns during the recent market volatility. Alternatives are an option to reduce portfolio volatility, and given the limited return potential of fixed income may be an alternative to a traditional fixed income allocation.

INTERNATIONAL VIEW

The theme of the second quarter was the reopening of the economy. Governments across the globe scrambled to find a playbook to rely on to ease lockdown measures at the appropriate pace. China and South Korea offered some guidance, showing the world that mask-wearing, temperature-checking, and contact-tracing were the new normal. Global equities largely rebounded from the bottom, signaling optimism about the recovery and the prospect of a vaccine. The MSCI World Index advanced 18.84% during the quarter, up from -21.44%. Lauded for its response to the pandemic, South Korea registered a better quarter than its peers with the KOSPI index surging 20.16%. This is consistent with the IMF forecast that South Korea's economy will suffer a smaller economic contraction than its peers.



Chart 7.



Source: LFCM, Bloomberg as of 06.30.2020

The Nikkei 225 saw a 17.82% gain last quarter, while the Euro STOXX Index increased 16.36%, and the Shanghai Composite Index lagged with an 8% gain. As always with international equities, we stay away from a one-size-fits-all approach. Instead, we look at individual regions and countries to understand the subtleties that drive these markets. The second quarter was rich in lessons as the solidity of political, economic, and social systems has been tested by COVID-19.

EUROZONE: DIFFICULT CONSENSUS

All eyes were on the European Central Bank (ECB) to draft a response to the pandemic in a timely manner. Liquidity injection was identified as the most effective tool to secure efficient market activity. The ECB promptly established the Pandemic Emergency Purchase Program to buy €1.35 trillion of bonds and expanded asset purchases by €120B by year end. On the margin, the German constitutional court ruled that the ECB's 2015 bond buying program could be illegal under German law without reasonable proof that it was justified, shaking the authority of the central bank. After initially shrugging off the ruling, the ECB sent some documents to the German supreme court that satisfied the requirements and minimized the diplomatic blow.

Germany and France proposed a €500B recovery plan to help countries the most affected by the pandemic. However, the "Frugal Four", Austria, Sweden, Denmark, and Netherlands voiced their concerns over the size and scope of the recovery fund, as well as, the moral hazard of bailing out distressed countries without conditions. There is still no consensus over whether the funds should be allocated in the form of grants or loans. Angela Merkel and Emmanuel Macron are pushing EU members to agree on the recovery plan by the end of July. The Euro slid 1.78% versus the U.S. Dollar last quarter.

UNITED KINGDOM: THE PIVOT

After initially opting for a laissez-faire response to the crisis, Boris Johnson pivoted and imposed strict quarantine measures that other countries previously adopted. To support the economy, Bank of England cut interest rates to 0.1% and announced the purchase of £300B in bonds. On the fiscal side, the government announced a £107B stimulus package (5.1% of GDP). The Brexit trade deal between the United Kingdom and the European Union was also an ongoing story last quarter as both parties failed to compromise. In a nutshell, while there is a broad agreement on signing a free-trade agreement with no tariffs or quotas, level playing field guarantees and fisheries are polarizing both sides. We will continue to monitor how this situation unfolds. The British Pound gained 0.09% versus the U.S. Dollar last quarter.

CHINA: MIXED QUARTER

China was the first country to reopen the economy, as a result, it was widely scrutinized to witness what reopening looks like. China's manufacturing PMI modestly improved from 50.1 in March to 51.2 in June. Demand from international remained a drag for the Chinese economy, highlighting the country's reliance on its trading partners to thrive. The People's Bank of China (PBOC) took a series of measures to inject liquidity in the economy. A \$60B plan was unveiled to aid small business credit. Additionally, the PBOC offered to buy back some SMB loans to encourage lenders to originate more loans. These pro-growth measures were overshadowed by geopolitical tensions that erupted with multiple countries regarding the origin of COVID-19 and China's transparency.

Another big headline last quarter was China's pivot regarding Hong Kong. Indeed, China passed a national security law that allowed Beijing to have jurisdiction over certain criminal cases committed in Hong Kong. Social unrest ensued over fear that freedom of expression would be jeopardized. The Chinese Yuan declined 0.26% versus the U.S. Dollar last quarter.

JAPAN: WHATEVER IT TAKES

Bank of Japan (BOJ) has shown no hesitancy over the years when it comes to experimenting new monetary policy tools. When the BOJ started purchasing ETFs and REITs at the end of 2010, it certainly raised some eyebrows. Almost 10 years later, it is not surprising to see the BOJ being extremely proactive on the liquidity front amid COVID-19. While short-term interest rates remained unchanged at -0.1%, the Japanese Central Bank set the 10-year yield target at 0% and announced unlimited Japanese government bond purchases. REITs and ETFs purchases doubled, while corporate bonds and commercial paper purchases tripled. Additionally, the government announced a 234 trillion-yen stimulus package (42% of GDP) to support heavily hit businesses and spark the recovery. The Yen gained 0.36% versus the U.S. Dollar last quarter.

OUTLOOK

As we conclude, thank you for allowing us to partner with you. We will continue to work through this period of uncertainty, diligently employing our investment process and managing portfolios on behalf of our advisor partners and clients. We know times are challenging. Please contact us with questions.

Thank You,
Level Four Capital Management Team

IMPORTANT INFORMATION

The opinions articulated in this document are for general information only. This information is not intended to provide specific advice or recommendations for any individual. The economic forecasts set forth above may not develop as predicted and there can be no guarantee that strategies promoted will be successful. All performance referenced is historical and is no guarantee of future results. No strategy including asset allocation assures success or protects against loss. All indices are unmanaged and may not be invested into directly.

Stock investing involves risk including loss of principal. Value investments can perform differently from the markets as a whole. They can remain undervalued by the market for long periods of time.

International and emerging market investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors.

The Standard & Poor's 500 index is a market capitalization weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. The Dow Jones Industrial Average (DJIA) is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange (NYSE) and the NASDAQ.

The MSCI World ex USA Index captures large and mid cap representation across 22 of 23 Developed Markets (DM) countries--excluding the United States. With over 1,000 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country. The CBOE Volatility Index® (VIX®) is meant to be forward looking, showing the market's expectation of 30-day volatility in either direction, and is considered by many to be a barometer of investor sentiment and market volatility, commonly referred to as "Investor Fear Gauge".

The Dow Jones Industrial Average (DJIA) is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange (NYSE) and the Nasdaq. Price-weighted means stocks with higher share prices are given a greater weight in the index. The DJIA is a stock market index that shows how 30 large, publicly owned companies based in the United States have traded during a standard trading session in the stock market. The value of the Dow is not a weighted arithmetic mean and does not represent its component companies' market capitalization, but rather the sum of the price of one share of stock for each component company.

The Russell 1000 Index is a market capitalization weighted stock market index that tracks the highest-ranking 1,000 stocks in the Russell 3000 Index, which represent about 90% of the total market capitalization of that index. The Russell 1000 is a subset of the Russell 3000 Index. It represents the top companies by market capitalization. The Russell 1000 typically comprises approximately 90% of the total market capitalization of all listed U.S. stocks. The Russell 1000 Growth Index measures the performance of those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values. Russell 1000 Value Index measures the performance of those Russell 1000 companies with lower price-to-book ratios and lower forecasted growth values.

The MSCI EAFE Index is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the U.S. & Canada. The MSCI EAFE Index consists of the following developed country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland and the UK.

The Bloomberg Barclays U.S. Aggregate Bond Index is an index of the U.S. investment-grade fixed-rate bond market, including both government and corporate bonds.

The Bloomberg Barclays U.S. Corporate High-Yield Bond Index is an unmanaged market value weighted index composed of fixed-rate, publicly issued, non-investment grade debt.

The Alerian MLP Index is the leading gauge of energy Master Limited Partnerships (MLPs). The capped, float-adjusted, capitalization-weighted index, whose constituents represent approximately 85% of total float-adjusted market capitalization, is disseminated real-time on a price-return basis (AMZ) and on a total-return basis (AMZX).

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