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Large Cap Value Commentary

October 14th, 2020

Gerald Sieb of the WSJ recently wrote about how a year as eventful and memorable as 2020, is likely to be an inflection point in history:

> Americans define turning points in their national life by the year in which they arrived. In 1861, Abraham Lincoln took office as president and the Civil War began. In 1932, the Great Depression approached its peak and Franklin Roosevelt was elected to usher in a new era of Democratic dominance. And in 1979, an energy crisis and stagflation froze the economy, Iranian students seized the American embassy in Tehran and the Soviets invaded Afghanistan, creating an air of national despair that paved the way for Ronald Reagan's conservative revolution. These inflection points tend to occur not when one shocking event arrives, but when such events pile up, one on top of the other. By that standard, 2020 increasingly appears to be just such a moment.

An inflection point implies a change in direction, a different path ahead than the recent past. While Sieb is mainly talking politics, the memorable "the economy, stupid" statement from the 1992 election season reminds us of the clear connection between the two worlds.

So what would we be inflecting toward, and so that we are clear, what would we be inflecting away from? Addressing the latter question first, while there have been some "COVID beneficiaries" such as the home exercise bike maker Peloton Interactive (PTON) and Zoom Video Communications (ZM), the remarkable aspect of the market in 2020 has been that the leaders of the past few years have generally strengthened their position as the result of the pandemic. Apple, Amazon and Facebook were popular before 2020, but the pandemic has only amplified their prominence in American households, culture and within the equity market. We have owned a few "beneficiaries" such as the gaming company Electronic Arts (EA), and the COVID test manufactures and administrators Danaher (DHR), Thermo Fisher (TMO) and Labcorp (LH). Unfortunately, given the severity and breadth of the economic damage caused by the virus, more companies, both public and private, find themselves on the other side of the coin, with declining profits as the result of lower demand and activity. While the economy was strong in 2019 with the lowest unemployment in decades, it was slowing, in part due to the trade rift between the US and China. That deceleration was reflected in the markets with declining bond yields, and the underperformance of the more economically dependent stocks. The result of this has been that the tech and healthcare heavy indices such as the NASDAQ 100 and even the S&P 500, have pushed even further ahead of the broader indices or more economically dependent stocks.

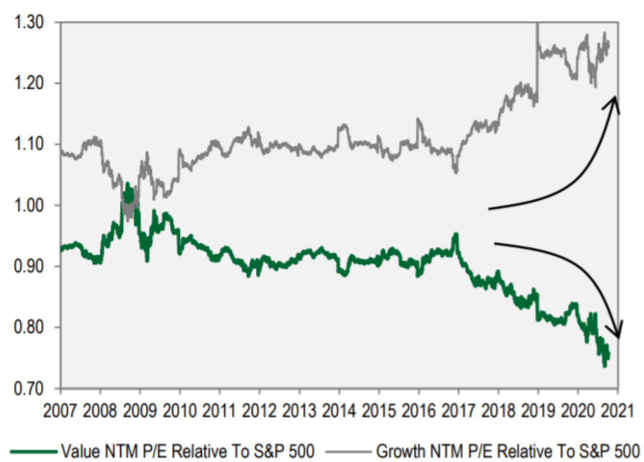
Getting back to the first part of the question posed above, if the inflection would be away from today's tech and healthcare giants, it might be toward the companies that have been hurt by the effects of the virus (restaurants, oil & gas, banks and retailers), but a vaccine or better control of the virus is likely required. That certainly could be the direction the markets take given the amazing efforts directed to the development of a vaccine. According to the World Health Organization, there are 24 candidate vaccines in clinical evaluation with another 142 candidate vaccines in preclinical evaluation. Since the world has never developed a vaccine this quickly, there is good reason to be skeptical, but we are clearly moving in the direction of a solution, and treatment and containment are helping to control the severity and spread of the virus. Complicating this inflection path or reversal is the concern that we are likely moving away from a low tax, low regulation Washington. Businesses and consumers have broadly benefited from the Trump tax cuts, and while fiscal discipline has not been a strong point of the current administration, Trump continues to poll ahead of Biden in Americans' opinion on his ability to improve the economy. In summary, lingering social effects of the virus, coupled with these two concerns, put into question the likelihood of a passing of the baton within the market from Apple (AAPL), Amazon (AMZN) and Facebook (FB) to the likes of Bank of America (BAC), Exxon (XOM) or

American Airlines (AAL).

The most interesting aspect of markets is deciphering what is already reflected in today's price. While the fundamentals are currently supportive for the current market leaders, three observations point to a possible inflection. This summer, we read that the quarterly fund manager survey administered by Bank of America/Merrill Lynch found that US tech stocks were not only viewed as the most crowded trade in the market, but this was the highest reading in the survey's history. Secondly, relative valuations between these two groups have only become more extreme (see below). At some point, they have to matter. Lastly, if September was a sign of things to come, it may end up being a case of falling less than others, as September was one of the first months in which value indices and the more cyclical stocks of the market outperformed the growth and more popular tech giants as markets drifted lower.

We recently added a few new positions to the portfolio that we would be happy to introduce to you at a later time. One stock that has taken off quickly is a name that probably needs an introduction, Elanco (ELAN). Elanco produces medicines for pets and livestock to treat and prevent diseases. It was spun out of Eli Lilly in 2018, and on August 3rd it completed the purchase of Bayer's animal health division. The merger with Bayer will create a significant amount of cost savings that will be realized over several years. Bayer also brings a higher mix of revenue from the faster growing pet care segment, which will now account for half of ELAN's total revenue. The stock trades at a 45% discount to its closest peer Zoetis (ZTS), likely due to its lower margins and weaker growth rate. We believe that the merger with Bayer will help address those two issues, thus we expect a narrowing of this valuation gap.

As always, please know that we are working hard to manage your portfolio to the best of our ability. While the current environment is challenging and an inflection of some sort might occur, we are sticking with our process of looking for quality and value within the market.



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[1] Gerald Sieb, WSJ 10/5/20 2020 Now Represents a Turning Point, Toward Parts Unknown