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ECONOMIC & MARKET UPDATE

The first half of 2020 will long be remembered as one of the more unusual and difficult periods in investment history. While stocks were at all-time highs, a pandemic began spreading across our country, causing an extreme recession, setting off a severe bear market in stocks, followed quickly by a sharp recovery, all of this while bond yields were falling to record lows. As we enter the second half of the year, the pandemic rages on, leaving investors in a state of uncertainty. It has been a difficult environment, to say the least, and while returns improved in the second quarter, there is still work to be done.

"The best prophet naturally is the best guesser; and the best guesser, he that is most versed and studied in the matters he guesses at, for he hath most signs to guess by."
– Thomas Hobbes, Leviathan

We live in a time of great uncertainty, perhaps more so than any other time in recent memory. Not only are we dealing with a pandemic that is proving to be a formidable adversary, but, as a result of the pandemic, we also find ourselves having just completed what is expected to be the greatest single quarterly contraction in the economy since the Great Depression. We desperately want answers—answers to the questions of how long the pandemic will last, if we will get a vaccine, if we will ever get back to "normal," how quickly will the recession end, and what the longer-term effects on the economy and our collective psyche will be? Yet Hobbes, the famous 17th-century English philosopher, reminds us that of the future we can only guess. We just don't know.

Hobbes does, however, go on to offer a glimpse of hope. He suggests that the ones who are most "studied in the matters" have the most signs to guess by, and, by implication, have at least a chance of perceiving the outlines of the future. We do not profess any particular expertise in seeing the future, but we can draw on our experience as investors for a few guideposts that we believe can help us make our way into the future. And, as it concerns that future, we will restrict ourselves to the economy and investments.

We have often noted that all investments are about the future and the possibilities for earning a return on the investment. This is the ultimate challenge of investing: considering the uncertainty of the future, how can we invest in such a way that we can have some degree of confidence that our investments will be profitable?

We offer a set of investment operating principles that we believe can be helpful: 1) consider the lessons of history, 2) invest for the long term, and 3) invest in quality. These three elements have been fundamental tenets of our investment approach, and we believe portfolios built around these principles have a more than reasonable chance of success.

THE LESSONS OF HISTORY What can history teach us about future economic activity? Perhaps nothing precise, but history would certainly suggest that economic growth will resume and be sustainable. Recall that the concept of economic growth only became a reality in the late 18th century. Prior to that, there were many centuries of stagnant to no economic growth in the world. With the Industrial Revolution came technological advances that vastly improved productivity, leading to a more egalitarian economy, spreading wealth that led to increased demand and investment, and the beginning of growth as a permanent fixture of economic activity. Although halting at times, standards of living have been advancing ever since. The combination of these factors still exists, and in our country the profit motive is a strong mobilizer of economic activity. Yes, these trends do get interrupted periodically by recessions that are typically caused by imbalances or extremes that need to be corrected, either naturally or by policy. That is what's so unusual about this recession: it was not caused by naturally corrective or policy measures. It was an exogenous event that hit us from outside and had nothing to do with the basic functioning of the economy. For this reason, once the pandemic is behind us, economic growth should resume. Caution is in order, however, for in all recessions there is the risk that future economic activity can be compromised by the length and depth of the recession. It is imperative that we emerge from this recession as soon as possible in order to limit future negative effects on the economy.

History can also be helpful in an investment sense. We don't need to go all the way back to the 18th century to learn about the positive impact of consistent economic growth for equity and fixed income investors. Looking back over the last 90 years or so, stocks in general have compounded at an annual rate of around 10%. Bonds have returned less, as expected, since they are a less risky investment. Because our economy continues to mature, 10% may not be achievable in the future for stock investors, and for at least a few years, bond investors will certainly have to content themselves with lower than historical returns. But the ongoing opportunities for investment seem secure. In the short run, the economy and stocks do not march in lockstep, but over the longer term there is a strong correlation. While we do not know the precise dimensions of the future, we assert our belief that based on history, economic growth should be sustainable, and rewarding investment will follow.

INVEST FOR THE LONG TERM The longest running recovery/expansion in U.S. history ended suddenly in February, reminding us again that recessions are a part of the economic order. When they occur, they inevitably cause short-term pain, particularly for stock investors. Stocks always decline in recessions. Even though the U.S. economy has consistently demonstrated resilience and recovery, many investors fear the damaging effect of recessions on their stocks. Some succumb to these fears and try to get out of the market in order to protect their assets. Unfortunately, they often find themselves left behind as the stock market begins to recover well in advance of economic improvement. This is very disruptive to an ongoing investment program. Better to believe in the economy and the companies that have the ability to withstand or recover from the short-term effects of recessions and stay invested throughout. In essence, this approach emphasizes the staying power of the companies and their ability to perform over time. Guessing what the market will do over the short term is futile; staying with it over time will be rewarding. For investors who place a higher value on protection of capital, the preferred approach is to have balance in the portfolio, for bonds tend to do well in recessions, thereby helping to protect value and provide income. But above all, investors should commit to a program and stay invested. If ever there was evidence of the importance of staying invested, one has only to look at what happened in recent months with the dramatic decline and impressive recovery of the stock market in such short order.

INVEST IN QUALITY Over the history of our firm we have always focused on quality as the most important characteristic we can build into a portfolio. We believe it offers the best opportunity to successfully navigate an uncertain future. Whether in stocks or bonds or some combination of both, we strive for quality throughout the portfolio. A consideration of quality is especially appropriate in this time of great uncertainty about the future, for quality, we believe, is one of those guideposts that helps an investor move into the future with more confidence.

How do we define quality? It can be defined in several ways, but for us it is about predictability more than anything else. This element of predictability is very attractive in times of uncertainty, for quality tends to narrow the range of potential outcomes of an investment. It provides a higher probability of achieving acceptable returns in an uncertain future. We like companies that give us a high degree of confidence that they will be able to execute their businesses in such a way that we can grow with them and receive consistent, growing dividends along the way. And the dividend, we have found, is the best way to discern that predictability. If a company has been able to raise its dividend consistently, it reveals a lot about the company. It indicates that it is a growing enterprise, its business has a degree of stability, and its capital allocation decisions consider the wellbeing of its shareholders. In addition, companies that have this pattern of consistency in their dividend are likely to be conservatively capitalized, own substantial market share positions, and be well managed. Put together, these characteristics should enable investors to predict future earnings and dividends with a greater level of confidence than is possible with low-quality companies. The vision of the future is not perfect, but much better.

Beyond the dividend, there are other measures of quality, though less quantifiable. Some companies are so well-endowed with resources, experience, and vision that they actually benefit from disorder. In times of distress, these companies are strong enough to enhance their competitive positions. Also, it is a sign of quality when companies actually get better at what they do as they grow larger. These types of companies are not easy to find, but they are out there, and we are in constant search for them.

CONCLUSION We have affirmed our belief that this period of great uncertainty will yield to a more secure future. We believe the economy will recover and that investment will again be profitable. History supports these assumptions, and investing in quality over the long term has proven to be an effective means of achieving investment objectives. Our longer-term optimism does not ignore the risks we face over the short term. We are not out of this yet. We again acknowledge our inability to predict the future, but by following the investment approach outlined above, we look forward to getting to the other side of this period of uncertainty and to a return of more stable conditions. As economic and market events transpire, we will keep you posted on our thinking.

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