Inverness Counsel

3Q 2020 Commentary

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The Markets Set New Record Highs

Equity markets continued to rally during the quarter. The technology-heavy Nasdaq index hit a new all-time high in June. The S&P 500 set a record high in early September, also surpassing the level we saw in February 2020. This new peak in the S&P was met with a bout of volatility, leaving the index down for the month but still up 4.5% for 2020. As we reported last quarter, we think the market is likely to remain volatile as investors grapple with the trajectory of the economic recovery and the fear of ongoing COVID-19 infections.

At its March low, the S&P was down 33.9%, near the 80-year average decline for a recession of 40%. Many stocks were pricing in a dramatic slowdown. Since then we have seen one of the biggest rallies in decades, with the S&P up 53% from March 23rd through the end of the quarter. Almost 30% of this market rebound can be attributed to the five largest companies in the S&P 500—Microsoft, Apple, Amazon, Google, and Facebook. All of these stocks have materially outperformed the S&P 500 for the year, and all reached record highs during the summer. Most client portfolios have meaningful exposure to these five names, and that has been helpful throughout the year. These five stocks now represent 23% of the market, which is well above any previous record. The 2000 tech bubble saw Microsoft, GE, Cisco, Walmart, and Exxon Mobil grow to over 18% of the index, exceeding the 40-year average of 14% (see Figure 1).

Figure 1

The Big Getting Bigger

Largest U.S. Companies by Market Cap Over Time

Rank	1960	1970	1980	1990	2000	2010	2020
1	AT&T	IBM	IBM	Exxon	Microsoft	Exxon Mobil	Apple
2	General Motors	AT&T	AT&T	General Electric	General Electric	Microsoft	Microsoft
3	Dupont	General Motors	Exxon	IBM	Cisco	Walmart	Amazon
4	Exxon	Eastman Kodak	General Motors	AT&T	Walmart	Apple	Google
5	General Electric	Exxon	Amoco	Philip Morris	Exxon Mobil	Johnson & Johnson	Facebook

Figure 1 source: Bloomberg. Data as of 9/30/20.

We Buy Good Companies, We Do Not Rent Stocks

Inverness actively manages over $3.5 billion in client assets, ranking us among the largest independent registered investment advisors (RIAs) in the United States. Our approach is to invest in a core group of companies that we believe will create long-term value for shareholders while favoring the preservation of capital. Although our Commentaries typically include many observations on the macro environment, we always rely on our "bottom-up" process to drive portfolio decisions. We then tilt exposures based on our view of the global economy. This approach resulted in us preserving capital earlier in the year during the market meltdown, but it also allowed us to be opportunistic during the volatility and to purchase some superior companies at very attractive valuations. We believe this is a good environment for active management.

Inside

The motto above has always served as the foundation of our investment process. Our investment team focuses on the long term and uses both 12- to 18-month and three-year target prices when evaluating an investment. This is one way we differentiate ourselves. We also use downside scenarios to help us manage risk and be ready to spot opportunities during a downturn. These tools have all been put to the test in 2020, and the team successfully navigated very treacherous waters.

For many years, our investment process has led us to have substantial exposure in the Technology, Healthcare, and Communication Services sectors. Many of these businesses are benefitting from long-term secular themes, and often have strong fundamentals, sustainable competitive advantages, and superior management teams. The majority of the gains this year have come from these sectors and primarily from the largest names in these groups. Valuations for many of these companies are now elevated, and we are managing our exposure in these areas carefully.

At the same time, about half of the stocks in the S&P 500 have negative returns for 2020, and over 150 stocks remain down 20% or more. Many of these companies are high-quality, well-run businesses that are operating below capacity due to restrictions put in place to slow COVID-19 infections; some of these businesses are more economically sensitive and experienced weakness during the recession in the first half of the year. Given our long-term focus, we are looking beyond the current pandemic, and many of the companies we have purchased recently need to rebound by more than 50% to get back to where they were at the beginning of the year. For the market to move higher from here, we expect to see greater participation from these companies.

.A Return to Pre-COVID Life

There are currently more than 250 COVID-19 vaccines in development (see Figure 2). This arms race includes Merck, Johnson & Johnson, and numerous biotech companies. The news out of some of the trials has been encouraging, and many expect a successful vaccine to be ready in the first half of 2021, if not earlier. Should a vaccine be approved by the FDA, it would still take a few more months before enough doses could be produced for distribution to the general public. Moderna, Johnson & Johnson, and Oxford-AstraZeneca each aspire to manufacture up to one billion doses in 2021, for a total of three billion doses (if all are successful), which would be enough to vaccinate nearly 40% of the world's population.

While there is some skepticism about how effective the vaccine(s) will be, a vaccine would improve the quality of life for many. A vaccine may not be a panacea, but it would reduce the transmission of the disease and ultimately mean fewer deaths. The whole population does not need to be vaccinated in order for deaths to be meaningfully reduced.

As we wait for a vaccine's approval, some are pointing to quick diagnostic tests, such as Abbott's BinaxNOW, as a potential means of resuming normal activities. For the time being, Abbott's antigen test needs to be administered by a health care professional, but it is possible that other tests will be approved that can be self-administered. This shift in testing could give more people the confidence to resume what were previously normal activities, such as flying on airplanes, attending concerts, and even going out to eat.

Figure 2

Number of COVID-19 Vaccines Currently in Development

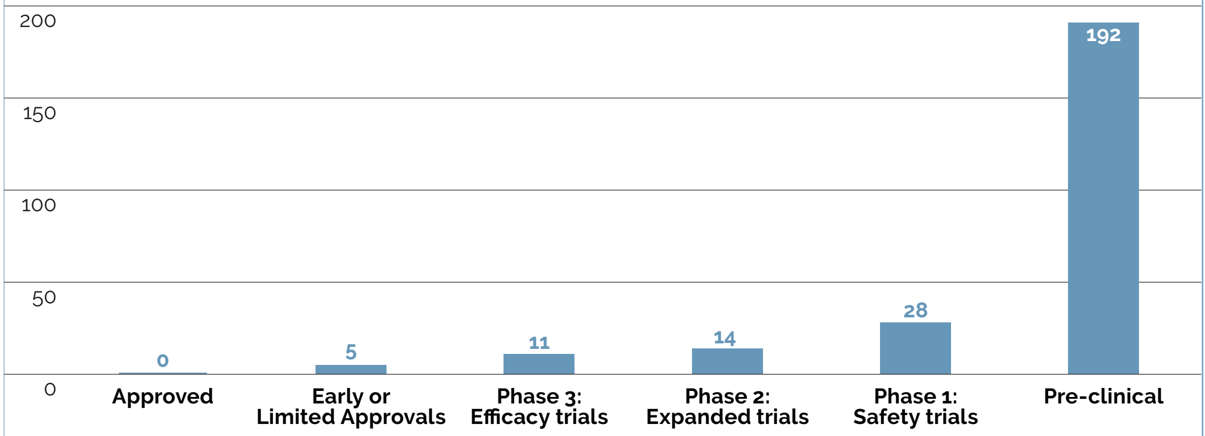

Figure 2 source: World Health Organization & New York Times. Data as of 9/30/2020.

A Healthy Consumer Ready to Spend

The consumer has remained resilient during 2020 with help from record-sized stimulus plans (CARES Act, Payroll Protection Program [PPP]), and consumer confidence never collapsed to the levels we experienced in other recessions (see Figure 3).

Figure 3

U.S. Consumer Confidence During Pandemic Resilient Compared to Prior Recession Periods

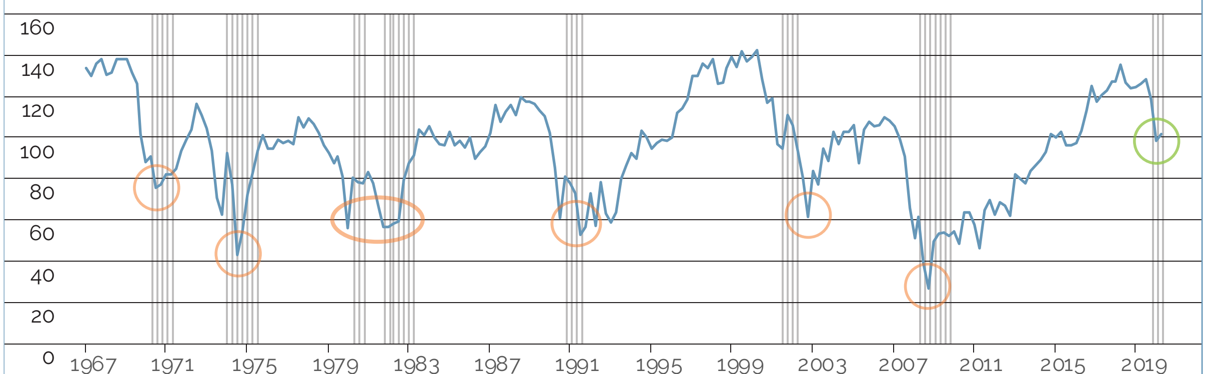

Figure 3 source: Bloomberg. Data as of 9/30/2020.

One of the most challenging and confusing realities of the current period is the disparate impact on the general population. Households with incomes below $35,000 were hit the hardest during this pandemic-induced recession, with over 50% of workers in this bracket laid off or furloughed. The financial well-being of this cohort has been aided by responses from the federal government, which likely contributed to the personal savings rate climbing to a new high. Some simple math points to an applied annual income rate of $57,000, assuming a person receives the unemployment benefit maximum plus a weekly $600 aid boost for a full year. For context, a full-time job with an hourly rate of $15 equates to $31,000 per year. Many of these people have now returned to the workforce, although some remain unemployed, and a new benefits program has not yet been passed by Congress. In contrast, those households earning more than $75,000—which represent the majority of consumer spending in the U.S.—reported significantly less employment disruption (see Figure 4). In the longer term, the social issues will be a challenge the country will have to address, but the economy and the consumer come out of the lockdown with enormous reserves of dry powder that will likely be put to work.

Figure 4

An Uneven Recession: % Share of Households That Have Lost Employment by Income Cohort

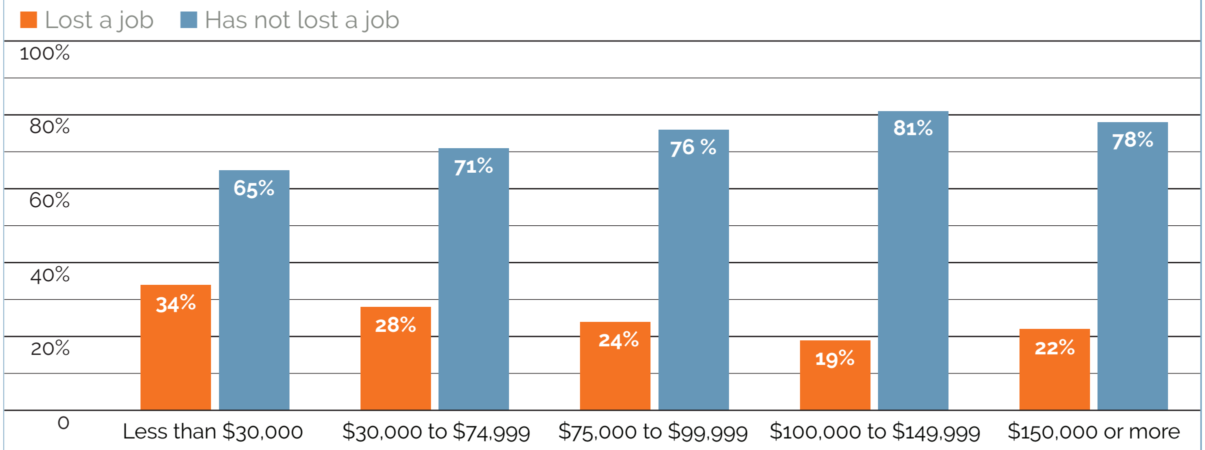

Figure 4 source: U.S. Census Bureau; Statista. Data as of 9/30/2020.

Course of Action

Federal Reserve policy is to remain accommodative for years, and no hikes in interest rates are expected until the economy sees meaningful improvement and inflation overshoots the Fed's 2% target. This environment should be supportive for equities as artificially low interest rates further increase the attractiveness of equity returns. We expect to see some volatility as we get closer to Election Day, but in general we view this environment as an opportunity. Consumer spending accounts for more than 70% of the U.S. economy, and the consumer is in good shape. The housing market remains robust, and savings rates are at record levels.

Key fundamentals such as consumer spending and industrial production continue to recover from the recession we experienced in the first half of 2020. With a possible end to COVID-19 on the horizon, we expect to see the consumer spend significantly more money on travel, leisure, and restaurants.

We have added equity exposure in the areas most affected by the pandemic and/or economic weakness. At the same time, we continue to monitor our exposure to the five largest companies in the S&P 500 to manage risk in this area. We expect to see market participation broaden in the next 12–18 months and have adjusted portfolios accordingly. At the same time, this rotation may be a bumpy process, and we have sized positions to take this expectation into account.

Disclosure