

From: Aequitas Investment Advisors

Wagner / fm

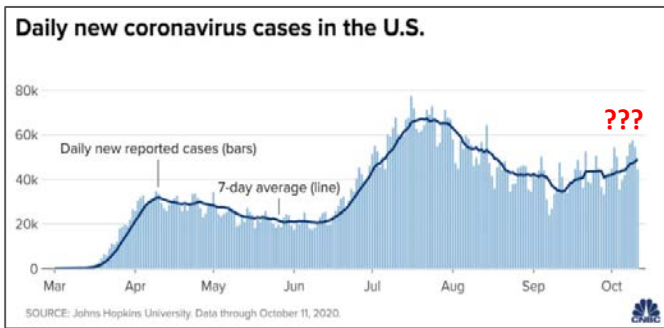
Re: Maintaining Balance in Troubling Times

This year has been nothing short of calamitous as we have faced a seemingly endless series of unfortunate events which has created anxiety and consternation for us all. The greatest calamity, of course, has been the coronavirus pandemic which has claimed more than 216,000 lives in the U.S. and more than one million lives worldwide (as of this writing). While the U.S. economy has partially recovered since the depths of one of the most sudden and severe recessions on record, the unemployment rate remains elevated at just under 8% with many millions of workers wondering whether their jobs will ever come back. Against this backdrop, we have been dealing with racial justice protests, civil unrest and a changing climate which has led to a near record number of destructive tropical cyclones, devastating wildfires and record-high global temperatures. As if these events were not bad enough, we must endure what has become a particularly contentious presidential election with the possibility of political turmoil should the outcome be significantly delayed.

A Resurgence in the Making?

Much of the fate of our economic recovery lies in our own hands (literally) and how we and our fellow citizens practice safe behavior (or not) during the pandemic. We know we will only fully control the virus once a vaccine is widely available, but that is probably many months off at best. Between now and then, however, as a nation we need a more coordinated effort to encourage the practice of safe human interaction, including wearing face masks in public places,

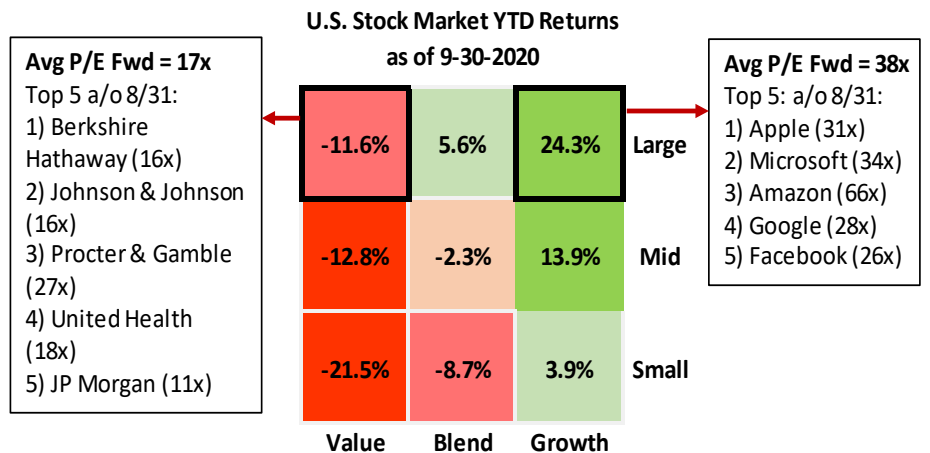
practicing social distancing and using basic common sense. We all know the drill, but as one can see from this recent CNBC chart to the left illustrating daily new coronavirus cases in



the U.S., it looks as though another surge is in the making (we're seeing a similar pattern developing in Europe). Such an uptick comes at a very unfortunate time given our strong desire to reopen schools, further reopen businesses, restore employment and get our lives back to some semblance of normalcy, especially as we approach the traditional flu season. Many health officials predicted early on that we might experience another wave in the fall and winter months, so perhaps this should be unsurprising. We'll take another look at the economic outlook further on, but first, let's review some relatively good news.

Update on the U.S. Stock Market

Despite the aforementioned calamities, stock prices around the globe have been clawing their way back since the depths of the downturn reflecting generally improving economic activity in the U.S. and around the globe, albeit, with further progress dependent upon the path of the pandemic. In our June 30th quarterly letter, we reported on the extremely wide dispersion between the returns of the various asset class components within the U.S. stock market. For example, at the time, the "spread" in year-to-date performance between U.S. Large Growth stocks and Large Value stocks was about 28%, i.e., Large Value stocks were down by 16% and Large Growth stocks were up by 12%. In the nine-square asset class style box below, note that U.S. Large Growth stocks gained 24.3% for the year through September 30th while U.S. Large Value stocks were still in negative territory at -11.6%, a spread of about 36%. These pandemic-related returns have contributed to what has become the widest rolling three-year return spread

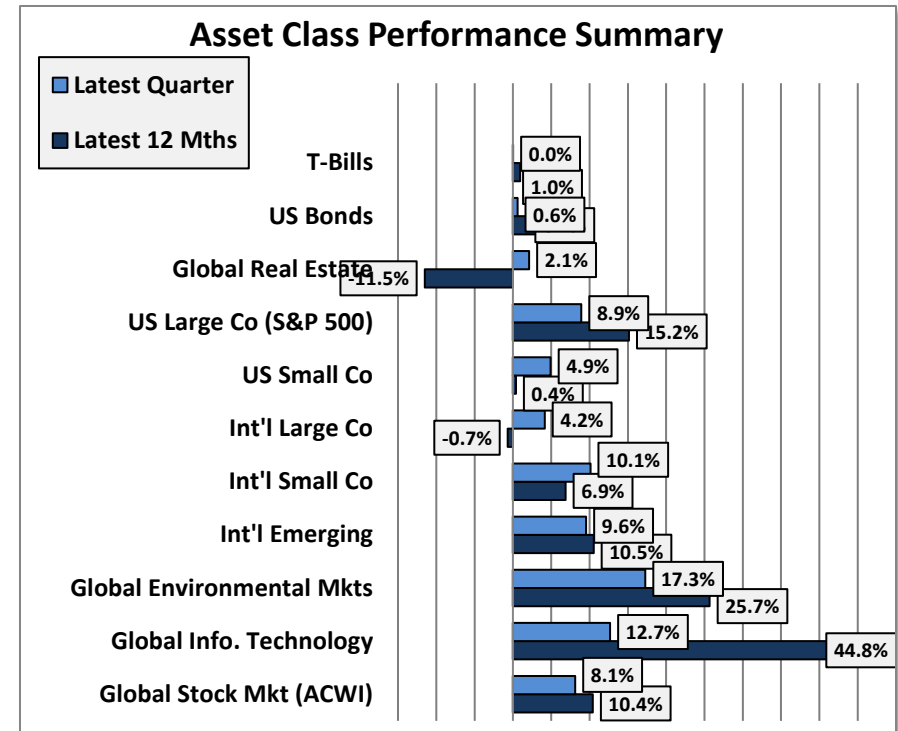


between Growth and Value stocks *on record!* Bear in mind, however, that history is on the side of Value stocks. Over the past ninety years, Value stocks have *outperformed* Growth stocks *two-thirds of the time* in rolling 3-year periods. Based upon our own experience over the past thirty years and substantial academic research, we are confident that Value stocks, as well as Small Cap stocks, will rebound on a relative basis, especially as the economy inevitably reverts to a more normalized state.

Returning to the nine-square style box on page one, 2020 has been a year of the haves (in green) and have nots (in red). As of September 30th, the haves included the largest five companies by market capitalization in the U.S. stock market, i.e., Apple, Microsoft, Amazon, Google and Facebook, which have prospered during the coronavirus pandemic (this group of five companies is sometimes referred to by the acronym FAAMG). The have nots include the largest five stocks in the U.S. Large Value category, i.e., Warren Buffet's Berkshire Hathaway, Johnson & Johnson, Procter & Gamble, United Health and JP Morgan; companies which have been highly successful in the past, but which have languished during the pandemic compared to many of the Large Growth stocks. The Growth stock advantage may well continue for a while, but if the most recent data is any indication, it appears that investors may be rotating into some of the most depressed asset classes, including U.S. Small Value stocks which have gained more than 20% for the trailing three months through October 9th compared to about 11% for U.S. Large Growth stocks. (The U.S. Small Value asset class is trading for an average P/E Ratio of about 12 times earnings with some of the largest holdings being Textron, Ally Financial, Lear Corp, BorgWarner, Snap-on Tools and Oshkosh Corp.)

Asset Class Performance Review

For the latest quarter ending September 30th, all of the major asset class returns were positive with the all-encompassing Global Stock Market gaining 8.1%. The greatest gains were in Global Environmental Markets (+17.3%) and Global Information Technology (+12.7%) which are two important components of our recommended portfolio structure. Next in line were International Small Co's (+10.1%), Emerging Markets (+9.6%) and U.S. Large Co's (+8.9%). U.S. Small Co's (+4.9%), Int'l Large (+4.2%) with Global Real Estate (+2.1%) ending up in last place among the stock asset classes. T-Bills came in at 0% (yes, rates are now near zero once again following actions by the Fed) and U.S. Bonds eked out a small gain of 0.6%. It was a strong quarter for most of the stock asset classes as investors were encouraged by the sharp rebound in economic growth following the disaster in the second quarter.



Returns over the trailing twelve months were generally strong with the Global Stock Market gaining 10.4%. As with the latest quarter, the strongest returns were in Global Information Technology (+44.8%) and the Global Environmental Markets (+25.7%). Following the leaders in order from highest to lowest were U.S. Large Co's (+15.2%), Emerging Markets (+10.5%), Int'l Small Co's (+6.9%) and U.S. Small Co's (+0.4%). Posting a small loss were Int'l Large Co's (-0.7%), but Global Real Estate (-11.5%) fared the worst given the adverse impact of rising vacancies and delinquent rental income. T-Bills gained 1% and U.S. Bonds gained 6.4% as falling interest rates created even higher bond prices.

Good News - the S&P 500 Index was Up by 5.6% for the Year!
Bad News - the Average Stock in the S&P 500 was Down by 4.8%!?

How can the S&P 500 Index be up by close to 6% for the year-to-date through September 30th while the average stock in the index is down by close to 5%? The answer is that the S&P 500 Index is capitalization-weighted which apportions a greater weight in the index to companies with the largest market value. For example, Apple is currently the largest position in the S&P 500 with the value of

its outstanding shares being worth approximately \$2 trillion as of September 30th. The entire market value of all 500 companies in the S&P 500 on the same date was \$28 trillion. By being market capitalization weighted, Apple's portion of the index would be \$2 trillion divided by \$28 trillion, or about 7%. If Apple were merely weighted on an equal basis relative to all 500 companies in the index, its share of the index would only be 0.2% (1/500) rather than 7%. When adding the value of Apple to the market value of the next four largest companies in the S&P 500, i.e., the FAAMG companies mentioned previously, we find that the largest five companies comprised about 25% of the market capitalization of the S&P 500 on September 30th which, by the way, set a record for the level of concentration in so few companies. Concentration in the top five companies, coupled with strong performance during the pandemic, helped propel the S&P 500 Index to record high levels with a gain of 5.6% for the first nine months of the year whereas the S&P 500 Equal-Weighted Index posted a loss of 4.8% for the same period (a spread of 10.4%). Over the long-term, however, investing in the Equal-Weighted Index has been more profitable with an average annual return of about 1% higher than the S&P 500 Index over the past thirty years. It is noteworthy that there have only been two other periods when the S&P 500 Index significantly outperformed the Equal-Weighted Index, and both were during months near the end of speculative periods (July of 2000 and November of 2008).

One might ask why equally weighting S&P 500 Index has been more rewarding? According to the author of [Non-Correlating Stock Ideas](#) published on *Seeking Alpha*, the economics of large numbers has a lot to do with it. "Maintaining growth rates at such a large size of business becomes increasingly difficult, and eventually the rate of growth slows more in line with the general economy. Thus, over time the smaller weighted stocks in the S&P 500 have grown at faster rates, and thereby generated greater stock performance than their largest peers. This phenomenon spans decades, and the oddity are the periods when that trend reverses." This rationale is supportive of our recommended portfolio structure which includes a significant tilt toward stocks of smaller companies.

Update on the Shape of the Recovery

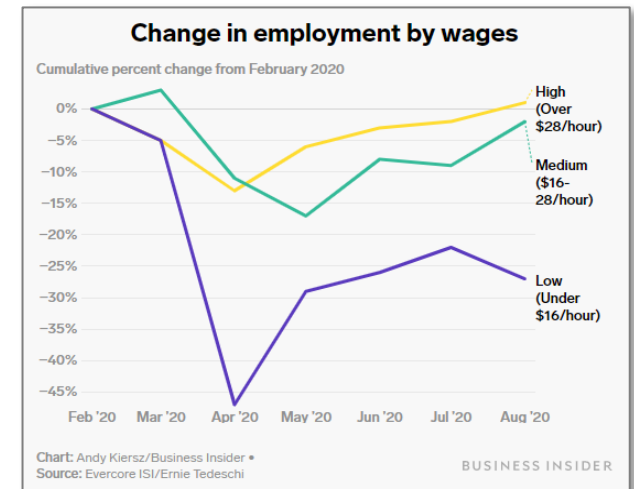
In the past two quarterly letters, we have examined several economic recovery scenarios which have been represented by various shapes. Currently, the most widely accepted shape for the recovery is a reverse square root which suggests that while the economy has rebounded sharply since March, we've reached a point where growth may plateau or stall for the next 12 months, or so, until the pandemic has been



brought under control, vaccines become widely available and consumers and businesses feel more confident about the future. In the meantime, requests for additional fiscal stimulus by politicians have been joined by many economists, including Federal Reserve Chairman Jerome Powell who spoke recently at the [National Association for Business Economics Virtual Annual Meeting](#) where he identified two major risks to the economic outlook at this early stage of recovery:

- "One such risk is that COVID-19 cases might again rise to levels that more significantly limit economic activity, not to mention the tragic effects on lives and well-being. Managing this risk as the expansion continues will require following medical experts' guidance, including using masks and social-distancing measures."
- "A second risk is that a prolonged slowing in the pace of improvement over time could trigger typical recessionary dynamics, as weakness feeds on weakness. A long period of unnecessarily slow progress could continue to exacerbate existing disparities in our economy."

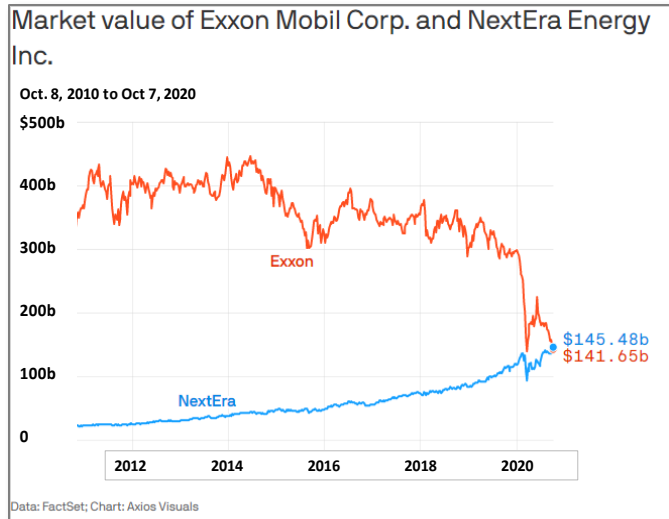
Powell identified economic disparities which have disproportionately impacted communities of color and working women who overwhelmingly have the added burden of childcare and managing distance learning during the pandemic. On this point, the chart to the right illustrates how higher paid workers have fared during the recovery compared to lower wage workers. Employment in the two top wage brackets has either fully or almost fully recovered back to pre-pandemic levels. Employment in the lowest wage bracket, i.e., those making under \$16 per hour, was still down by more than 25% at the end of August according to an article on the [Unequal K-Shaped Recovery](#) by Joseph Zeballos-Roig of *Business Insider*. Bear in mind that 42% of the U.S. workforce earns less than \$16 per hour! Jerome Powell understands the critical nature of this statistic, which is why he is calling on Congress to end the gridlock and provide an additional lifeline of fiscal stimulus especially for those who have been hardest hit.



Sustainability Gaining Greater Traction: Move Aside Exxon

By Tim Nash

You may recall that as recently as 2013, Exxon (XOM) was the most valuable company on the planet based upon stock market capitalization (a position now occupied by Apple as mentioned previously). As an early indication of the benefits of our portfolio strategy's commitment to Sustainability, the world's



largest solar and wind power generator, NextEra Energy, has now surpassed ExxonMobil in total stock market value. This reflects a more favorable outlook regarding expectations for a changing energy system amidst an uncertain outlook for oil demand. So, while we remain committed to Value stock investing, we have recognized that “value”

can take different forms. In other words, while Price-to-Book Ratio remains an effective valuation measure, the more fundamental outlook for clean energy relative to big oil is much brighter as investors and energy consumers look to cleaner and more sustainable forms of energy to power their growing levels of consumption.

Michael Porter, a professor at Harvard Business School, developed a model on competitiveness and profitability known as Porter's Five Forces that shape industry competition, profits and ultimately contribute to the direction of stock prices. Using this framework as a guide, we can review the competitive dynamics of the oil industry which is dramatically underweighted in our strategy, while the results of our commitment toward Sustainability continue to unfold:



The Dual Threats of New Entrants and Substitute Products: Solar, Hydro Power, Cogeneration, Geothermal, Waste to Energy, Wind Power – all of these relatively new entrants are applying tremendous competitive pressure on big oil, adding to the already existing pressure from natural gas, a “cleaner” existing substitute for crude oil.

Industry Rivalry: Like wildebeests and zebras in search of water during the dry season on the Serengeti, competition will continue to intensify as more hybrid and electric vehicles replace gasoline-fired combustion engine vehicles over time. Simultaneously, members of OPEC like Venezuela, Iran and Saudi Arabia will continue to squabble over prices and quantities of oil production with limited power over controlling the pricing and production levels of non-OPEC countries like the US and Russia.



The Dual Bargaining Power “squeeze” by Customers and Suppliers: As energy customers, we have a growing list of choices. We can replace our oil-fired furnace with natural gas or solar powered electricity. We can replace our combustion engine car with a hybrid or an Electric Vehicle (EV). Similarly, as big oil's primary “supplier,” Mother Earth is facing an increasing need for protection from fracking, climate change, wildfires, oil spills, hurricanes, floods and earthquakes as new technologies and de-regulation continue to allow the United States to be the world's largest oil producer—for now. As consumers, we are increasingly aware of how unsustainably devastating these forces are for our

own long-term survival, and how big oil companies must continue to face the increasingly apparent threat from new entrants, substitutes and existing rivals, forcing big oil to confront a far more constrained ability to compete effectively in their traditional manner in the global energy markets.

For these and other reasons, we remain steadfast in our conviction that investing in sustainable companies is much more than a passing fad, and worthy as a component in our long-term investment strategy as market forces continue to reward companies that keep themselves on the right side of economic and environmental history – doing well by doing good.

Closing Thoughts – E Pluribus Unum

We opened this letter citing a litany of unfortunate events which have besieged our nation and the world in 2020. As an investment management and financial planning firm acting in our clients best interests, our mission is to partner with our clients to plan for the future in a balanced way which takes into account both fortunate and unfortunate potential future events. This year has been a *real* challenge, yet we are gratified to know that our defensive portfolio measures proved beneficial during the downturn and that our clients' financial plans remain intact. We also know we have a new set of economic and societal challenges that lay before us which require our careful consideration.

As Jerome Powell and others recognize, the economy and our social fabric are intrinsically intertwined which is why as a nation we need to come together to solve our greatest challenges. If you happened to view the Royal Wedding in 2018 uniting Prince Harry and Meghan Markle, you may remember the impassioned sermon delivered by Episcopal Bishop Michael Curry. In his latest book, *Love is the Way* with the subtitle, *Holding on to Hope in Troubling Times*, Bishop Curry asks, "How do we make *e pluribus unum* – out of many, one – real, without obliterating anybody? This is our nation's challenge. It is the world's challenge. How do we walk together as brothers and sisters, united by some ancient and venerated values and hopes, when we also have significant difference and disagreement." He goes on to say, "We need *e pluribus unum* now more than ever – because if we don't work together, we'll likely work against all our interests....When we're busy wagging fingers at each other, we can't move away from the nightmare and closer to the dream. The planet is suffering and if we don't heal her, we're about to feel the blunt impact – some more than others, but eventually, all of us. We're in this together."

