Artemis
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Market Outlook & Strategy

First Quarter of 2020

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Executive Summary

- Global equity markets turned sharply lower in Q1 in response to the uncertainties associated with the global COVID-19 pandemic. U.S., international and emerging market equities all sold off in tandem, ending the quarter some 20-25% lower.

- U.S. equity returns did vary sharply across style, with U.S. large company growth stocks declining by only -14%, whereas smaller, more valued oriented companies got hammered losing over -35% for the quarter. Declines also varied by sector with energy, financials, industrials hard hit, as were hospitality, travel and commercial real estate.

- It was even tougher going in the bond markets. Bond markets started to face liquidity issues in mid-March and the "dash for cash" became extreme a week later, prompting the U.S. Federal Reserve to cut short-term lending rates to zero and announce they would buy "unlimited" amounts of U.S. Treasuries and (insured) mortgage-backed securities to inject cash into the system.

- As a result of heavy support from the Fed, the U.S. 10-year Treasury yield dropped from 1.92% to 0.63% over the quarter (meaning the price these bonds rose in value) providing some nice portfolio insurance. In contrast, higher-yielding segments that saw little or no government intervention were hard hit, including emerging market bonds, commercial mortgage-backed securities, high-yield and floating rate bonds.

- This quarter's report is dedicated to how best to position portfolios in a post-coronavirus world. We think there are opportunities for specific themes (e.g. cloud computing) and specific geographies. We also think it is time to get a little more defensive by focusing less on smaller companies and more on those that are better equipped to navigate a difficult and uncertain environment.

- Finally, and very importantly, we provide you with an update on ESG investing with new data showing that a wide variety of ESG index funds have been outperforming standard indices in recent years and held up better during the sharp downturn in March. All told, it's time to more dollars into these funds and we plan to do so as we reposition portfolios and take advantage of tax-loss harvesting opportunities.

Q1 in Review

Global equity markets turned sharply lower in Q1 in response to the uncertainties associated with the global COVID-19 pandemic. U.S., international and emerging market equities all sold off in tandem, ending the quarter some 20-25% lower, even despite a very late quarter uptick. See Figure 1. U.S. equity returns did vary sharply across style, with U.S. large company growth stocks declining by only -14%, whereas smaller, more valued oriented companies got hammered losing over -35% for the quarter. This pattern is not new as small and value have struggled for some time, with the last 12 months an extreme. See Figure 2.

Figure 1. Asset Class Returns in Q1 2020

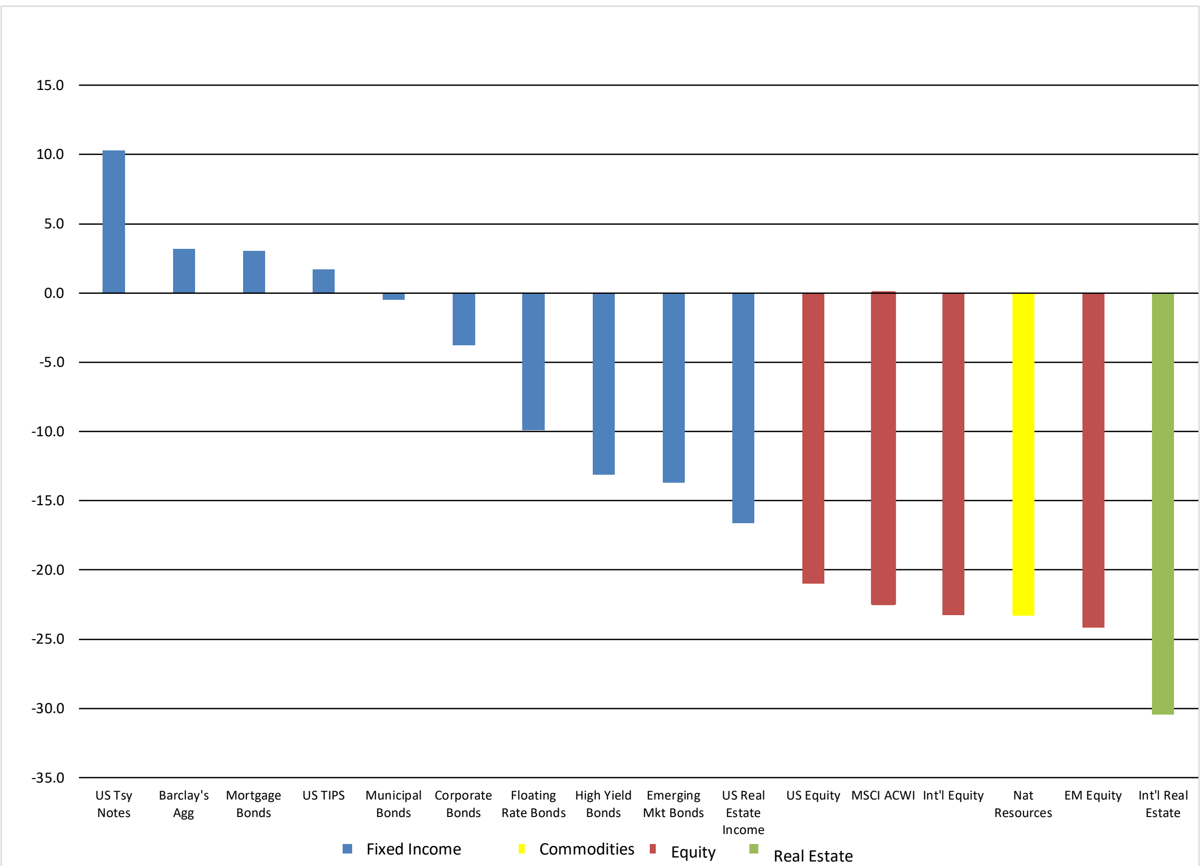


Figure 2. U.S. Equity Returns By Style, Q1 2020 and Last 12 Months

QTD

	Value	Core	Growth
Large	-26.73	-20.22	-14.10
Mid	-31.71	-27.07	-20.04
Small	-35.66	-30.61	-25.76

1 Yr.

	Value	Core	Growth
Large	-18.13	-9.09	-0.26
Mid	-25.01	-19.30	-10.62
Small	-30.60	-24.79	-19.20

Declines also varied by sector with energy, financials, industrials hard hit, not to mention the carnage in hospitality, travel and commercial real estate. Energy, in particular, suffered with the sudden onset of an oil price war. Information technology, communications and healthcare sectors held up better, albeit with what would be considered steep falls in any other quarter.

It was even tougher going in the bond markets. Bond markets started to face liquidity issues in mid-March and the "dash for cash" became extreme a week later, prompting the U.S. Federal Reserve to cut short-term lending rates to zero and announce they would buy "unlimited" amounts of U.S. Treasuries and (insured) mortgage-backed securities to inject cash into the system. The Fed also announced a variety of other credit facilities to reduce stress in the corporate and municipal bond markets and short-term money markets. The amount of support is unprecedented in both scope and speed.

As a result of heavy support to U.S. Treasuries, the U.S. 10-year yield dropped from 1.92% to 0.63% over the quarter (meaning the price these bonds rose in value) providing some nice portfolio insurance. In contrast, higher-yielding segments of the market that saw little or no government intervention were hard hit, including emerging market bonds, commercial mortgage-backed securities, high-yield debt and floating rate bonds.

In addition, Congress weighed in with a $2.2 trillion stimulus package designed to support individuals with so-called helicopter money ($1,200 checks to start), loans to small and large businesses and a $600 per week top-up for those (22 million souls and counting) who have applied for unemployment benefits.

Governments around the world responded similarly – The European Central Bank announced a ~$900 billion bond-buying scheme and several spending packages to help businesses and households. China and Japan also announced a mixture of interest rate cuts and tax and spending measures.

Investment Opportunities in a Post-Coronavirus Era

While it is very difficult at this stage to know with any certainty how the world the world is likely to change after the pandemic subsides, we need to start forming some view in order to anticipate and act on investment opportunities that might arise. How should we be positioning portfolios both for defense and to take advantage of new opportunities This section lays out our thinking to date, some of which we are going to act on soon.

Thematic Opportunities

I believe we have an opportunity for upside capture by selectively adding to our global technology themes. All of the four thematic investments we have made over the last couple of years outperformed the broader market during the downturn, and also performed nicely last year. Some new areas we are actively looking into are the following:

1. **Communications/Cloud Computing Infrastructure** – The basic idea is that working from home is likely here to stay at some level, even after the crisis abates, and as a result, communications and cloud computing software and infrastructure are only going to continue to grow.
2. **Health Care Advancements** – The death rate in nursing homes and assisted living facilities is startling and the risks imposed on healthcare workers untenable. As such, we think there is potential for outperformance with a health-care oriented fund that focuses on system capacity outside of hospitals and nursing homes such as home care, telemedicine technology and the like.
3. **Drug Development** – Prior to the crisis, we implemented a new allocation to a genomics ETF, which is aimed at genomic sequencing and the way biological information is collected, processed and applied. We are looking to expand on / complement this theme.

Geographic Opportunities

The U.S. market has outperformed the rest of the world for the past decade, yet the U.S. severely underperformed in the decade prior to the Great Financial Crash of 2008. The key question is whether this outperformance is going to continue or, whether the timing is ripe for a market rotation.

My view is that the U.S. market is going to continue to outperform over the next few years for the following reasons:

1. **Size and Magnitude of Fiscal and Monetary Policy Response** – What the Federal Reserve and Congress are throwing at the problem is mindboggling in size and unprecedented in history and no other country has the same horsepower to throw at the problem. I do believe the $2.2 trillion (and counting) Congress has approved thus far, and the virtually unlimited amount of liquidity the Fed is injecting into the system, are the key reasons why the U.S. (and frankly global) markets haven't fallen further.
2. **Europe Likely To Have Another Euro Crisis** – The news out of Europe is not great. Basically, the northern countries (e.g., Germany, Netherlands) are faced with the choice as to whether they are going to bail out Italy and provide more support to France and Spain. This is similar to the crisis they faced with Greece a few years ago. The problem this time is that Italy is rather bigger than Greece, its banks are in terrible shape, and its debt to GDP ratio is a whopping 136%, and projected to rise to 180% in two years. And then you couple this problem with the more structural ones such as the lack of technological innovation in the EC, aging populations, rise of populism, etc. and you are not left with much of an investment thesis.
3. **Emerging Markets a Question Mark** – Apart from some northern Asian countries (namely China, Taiwan, Korea), the virus is only now starting to arrive in many developing countries so the worst is yet to come. We do know that governments of these countries do not have the fiscal and monetary firepower to respond, nor do they have the healthcare infrastructure to support those most affected. Moreover, the economies of many of these countries are highly levered to global trade, which was already contracting before the onset of the virus. Less well known is the fact that the index fund we utilize is heavily weighted toward China, with China and Taiwan combined representing 60% of the overall index. The next biggest countries are India at 9.3%, Brazil at 5.8% and South Africa at 3.3%. The index's heavy Asia weighting toward countries that are recovering earlier from the pandemic and

restarting their economic activity goes a long way in explaining why overall performance of the index hasn't been much different than overall U.S. market performance. As such, I'm tempted to assign emerging markets an overall neutral weight in our global equity allocation. This is our current stance so I don't plan to change our allocation.

Valuation-Based Opportunities

This is the toughest piece to tackle. Valuation measures are telling us that smaller companies and more valued oriented ones are screaming "buys". The real question is whether these segments of the market are cheap for a reason or simply oversold and therefore due for a strong bounce back once some of the uncertainty recedes.

Smaller companies are typically more vulnerable to economic downturns as they are generally less well-capitalized and have lower earnings. If so, then we should expect them to outperform once investors start to focus on the prospect of an economic recovery. As several clients have pointed out, the problem with this argument is that smaller companies were underperforming before the coronavirus when economic growth was robust. As such, other factors must be at play. We think some of them might be:

1. **Lack of an Anti-trust Regime** – The lack of anti-trust regulation has increased the power of larger firms over smaller firms in the U.S. and I suspect the fallout from the current crisis will push the issue of anti-trust regulation further down the political agenda regardless of who ends up in the White House in November.
2. **Support Measures Favor Large Companies** – While the Fed and Congress are trying very hard to support both large and small companies, the Fed's main corporate credit facilities directly benefit primarily investment-grade credit thus far, which tend to be mostly larger firms. More recently, we have learned that large companies stepped in and took advantage of the loan program specifically targeted to smaller firms.
3. **Consumer Behavior Patterns Favor Very Large Firms** – It's early days but reasonable to surmise that changing consumer patterns due to the coronavirus seem likely to be favoring the big tech firms (Google, etc.) and firms like Amazon, which combined make up the entire top five in the U.S. stock market. For one, their business models generally involve comparatively little face-to-face interaction, although some are vulnerable to global supply chains. Moreover, they have mountains of cash give

them an unmatched advantage over smaller companies to take full advantage of current distressed opportunities.

For all of the above reasons, we have reduced our overweight to smaller companies in favor of larger ones for now. We will be looking to pick up some more focused smaller cap exposure as we expand on our technology themes.

Regarding value, value stocks are those that tend to trade at a lower price relative to their fundamentals such as earnings, sales and book value. Stock prices can be low for a variety of reasons such as the company is under stress and so trading at a discount. But value stocks can also be those of companies that are nicely profitable but are not growing rapidly (think utilities) and so are happy to return profits to their shareholders in the form of dividends. We think the near-term opportunity is in the latter category given widespread uncertainty and plan to focus on quality dividend payors with good profitability and low leverage. As such, we will be restructuring our value allocation accordingly.

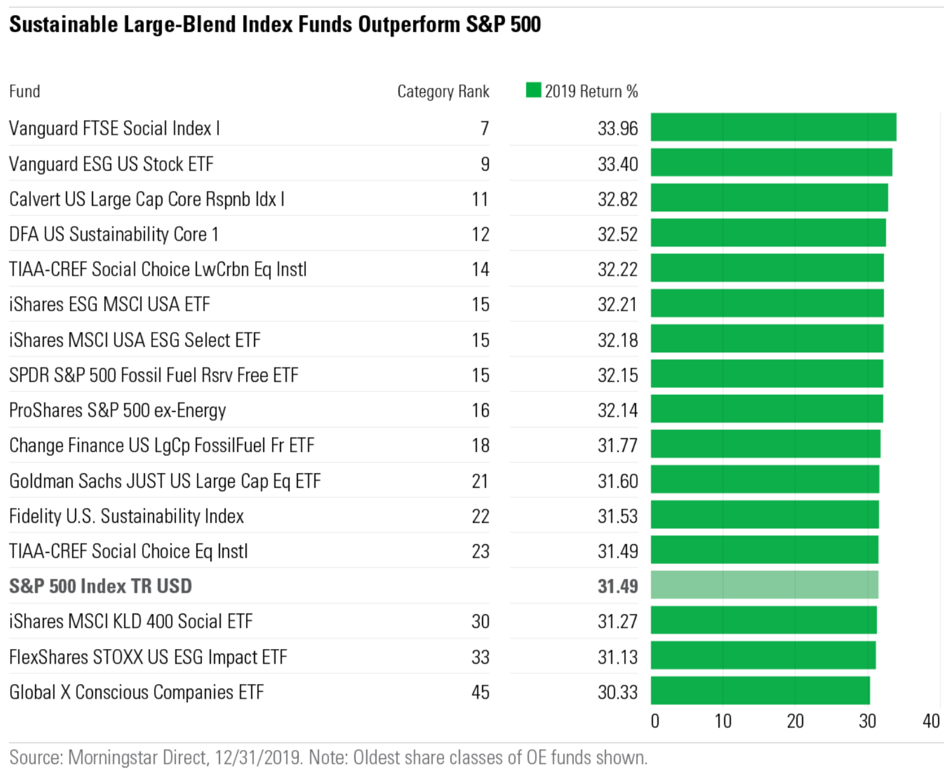
Environmental, Social and Governance (ESG) Investing

I have been writing a lot about ESG investing in my quarterly reports over the past couple of years but basically leaving it to clients to tell us whether they are interested or not. Just prior to the pandemic, we had completed an educational presentation on ESG investing with plans to invite clients to individual meetings to learn more. We still plan to do this. However, the time is now in my view about using our dollars to reward those companies who are performing better on a range of ESG risk factors. Why? Irrespective of the dire climate change issues we face and social and moral imperative of improving worker safety etc., (all good reasons alone to focus on ESG), funds with a sustainable mandate have proved their mettle, and now appear to be routinely outperforming other similar funds.

Figure 3 below shows the performance of leading U.S. large cap ESG index funds in 2019 and compared to the return of the S&P 500. Fully 13 of the 16 leading funds matched or outperformed the S&P 500 in 2019. (The fund we use most is the Calvert fund – third on the list.)

The same pattern holds when examining international funds as shown in Figure 4 below. (In this table, the fund we use most is also the Calvert fund – second on the list.)

Figure 3: Performance of U.S. Large Cap Blend Sustainable Funds in 2019

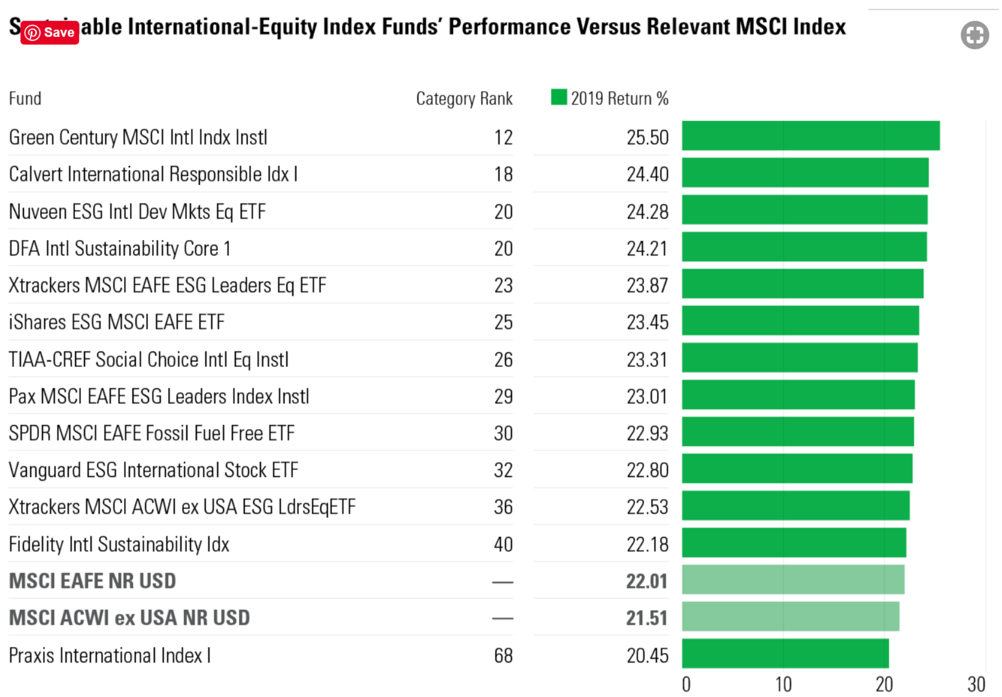


Moreover, this same pattern appears to be holding in the current bear market. For example, while the YTD (through March 31) return of the S&P 500 was -19.6%, the Calvert fund we use returned -18.3%. Likewise, international markets (as measured by the EAFE index) returned -23.3% in Q1 of this year, the international Calvert fund we use returned -21.5%. And this pattern holds over the various up and down markets we've have in the last five years.[1]

[1] For more performance data over the last five years, see Hale, John, Ph.D., CFA "U.S. ESG Funds Outperformed Conventional Funds in 2019." Morningstar Report, April 16, 2020.

Some of you might argue that this outperformance is largely due to the fact that sustainable funds in general underweight energy in their holdings, and energy has indeed massively underperformed of late. But new research is showing that energy underweighting alone, does not fully explain the relative outperformance of sustainable funds.

Figure 4: Performance of International Large Cap Blend Sustainable Index Funds in 2019



Source: Morningstar Direct, 12/31/2019. Note: Oldest share classes of open-end funds shown.

There is much more to be said on this topic but the bottom line is that ESG investing is a viable and attractive opportunity in a post-coronavirus world for a whole bunch of reasons and we are going to get going on this in a much more meaningful way than we have up to now.

Fixed Income Opportunities

There are basically two reasons to have fixed income in portfolios – for steady income and portfolio insurance. As we are all now (painfully) aware, the only segments of the fixed income universe that supplied robust portfolio insurance during the recent market tumult were the ones that the Fed committed "unlimited" support to – U.S. Treasuries and agency (insured) mortgage-backed securities. But the trade-off is that the yield such bonds provide is very low (and frankly approaching zero now) so the insurance comes at a price.

Thus, our strategy has been to invest in a wider array of fixed income, which effectively means we have been willing to trade off some insurance to gain some yield. Last year, we increased our exposure to safer segments of the bond market when we exited high yield and floating rate allocations and swapped that exposure for safer bonds. But that still left about 30% of our average overall bond allocation in emerging market debt and commercial real estate income, both of which were hit very badly recently. We will continue to invest this way but I do plan to customize our allocations over the next year to better reflect individual needs and preferences, which vary quite a bit.

Summary

There’s a lot to think about here and those of you who have been clients for some time will know that we don’t take big bets, especially in a time of extreme uncertainty. We are looking for incremental avenues of outperformance over the next period through reduced risk and added “alpha” (industry parlance for added return), but remain mindful of the associated risks and challenges.

Market Index Descriptions (for Figure 1)

Equities:

The **Dow Jones U.S. Total Stock Market** is a market cap-weighted index providing broad-based coverage of the U.S. stock market. Considered a total market index, it represents the top 95% of the U.S. stock market.

The **MSCI EAFE + Canada (net)** is a market cap-weighted equity index that is designed to measure the equity market performance of developed markets, excluding the U.S.

The **FTSE Emerging Markets All Capitalization China A Inclusion (net)** is a market cap-weighted index representing the performance of large-, mid- and small-capitalization stocks in emerging markets.

Fixed Income:

The **Bank of America Merrill Lynch U.S. Treasuries 7-10 Year** measures the performance of U.S. Treasury securities that have a remaining maturity of at least seven years and less than 10 years.

The **Bank of America Merrill Lynch U.S. GNMA Mortgage Backed Securities Index** is a market cap-weighted index, including generic-coupon Ginnie Mae mortgages, with at least of $150 million principal amounts outstanding.

The **Barclays Capital 1-15 Year Municipal Bond** measures the performance of tax-exempt investment grade debt of U.S. municipalities having at least one year and less than 15 years remaining term to maturity.

The **Bank of America Merrill Lynch U.S. Corporate 5-7 Year** measures the performance of U.S. dollar denominated investment grade rated corporate debt having at least five years and less than seven years remaining term to maturity.

The **J.P. Morgan Emerging Market Bond Global Core** is a broad, diverse U.S. dollar-denominated emerging markets debt benchmark that tracks the total return of actively traded debt instruments in emerging market countries.

The **Bloomberg Barclays U.S. Treasury U.S. TIPS** measures all publicly issued, U.S. Treasury inflation-protected securities that have at least one year remaining to maturity.

The **Bloomberg Commodity Index** is a broadly diversified commodity price index that tracks the prices of futures contracts on physical commodities on the commodity markets.

The **Fidelity Real Estate Income Composite** is a benchmark that combines the total returns of the Merrill Lynch Real Estate Corporate Bond Index (40%), Morgan Stanley REIT Preferred Index (40%), and the FTSE NAREIT All REIT Index (20%).

The **Dow Jones Ex-U.S. Select Real Estate Securities** measures the performance of equity REITs and real estate operating companies (REOCs) traded globally, excluding the U.S.

The **Bank of America Merrill Lynch U.S. High Yield Master II** tracks the performance of U.S. dollar denominated below investment grade-rated corporate debt publicly issued in the U.S. domestic market with a maturity of at least one year remaining.

The **S&P/LSTA U.S. Leveraged Loan 100** reflects the performance of the largest facilities in the leveraged loan market.