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PORTFOLIO UPDATE – JULY 22, 2020

For the first time since late March, we have taken tactical action in our portfolios, increasing our commitment to US corporate (investment grade) credit and duration and reducing our cash position to demonstrate a full commitment to risk assets. At the same time, we slightly moderated our commitment to the equities of those same US companies, preferring to increase investment in the Eurozone as they have tamed the COVID lion and instituted a zone-wide economic action plan.

It is important to pause here and draw the distinction between financial markets and economies. Particularly in the United States, important segments of the economy have been deeply wounded by the pandemic itself as well as the societal response in terms of shuttered businesses, schools, public venues, recreation, entertainment and social services. In an extremely rapid surge, unemployment rose to match and even exceed the levels of the Financial Crisis, and the ripples of economic damage are still propagating outward. American small business has taken the brunt of the commercial hit, but we see it as an ongoing challenge in areas like real estate as employers and individuals perhaps permanently change shopping, working, commuting, and other activities.

We also remain on the precipice of a housing crisis as temporary eviction moratoria roll off the books and we see struggling renters and homeowners facing impossible choices between housing, food, healthcare and other essentials without access to employment. And lastly, we collectively have not even begun to thoroughly comprehend and discount the consequences of lower economic activity in terms of a shrinking tax base that will strain state and local coffers at a time when communities likely need more, not less, from their governments. For instance, those landlords who have been constrained from evicting renters for lack of ability to pay during the COVID emergency will be less able to make their own remittances of property taxes, and local sales tax receivables from closed store fronts will be choked off as a large quantity of in-person purchasing has been pushed online.

So how, in the spray of these crashing waves of bad news, can markets be doing well and investment firms like WCM be stepping further into equities and bonds when the instinctive response would be to run far and run fast?

Two words -- Liquidity and Innovation. Or looked at another way – The Fed and Tech. Lessons were learned in the Financial Crisis, not the least of which was the materiality of decisions on timeliness, amplitude and duration of policy responses to a crisis. It was the announcement of how, in the broadest terms, the TARP funds would be deployed in 2009 that put a bottom in the market. The insufficient size of the initial relief program and the drawn out and incremental process of subsequent policy decisions like quantitative easing (QE) left us with a slow and stuttering recovery that still did produce economic expansion and jobs, and most assuredly fueled the rise of asset prices as measured by the stock market and a lasting dependence on low policy rates. It was different in that the disintegration of markets in 2007 – 2009 was systemic and broke from the inside – the markets melted down and took the economy with them. But, in 2020, the previously healthy economy stalled and took down the markets from the outside. It was also different in how quickly and how massively coordinated policy and legislation were rolled out, shoving trillions of dollars into the US economy in a matter of weeks. Liquidity.

Money that went out in checks to taxpayers, through the CARES Act in programs like PPP, in enhanced unemployment benefits, was rapidly spent in the real economy paying bills and buying goods, services, and food, and ultimately filtered up into the markets along with the stimulative dollars from rescue funds for industries

like airlines. The Fed piled on top with various actions to make borrowing cheap and accessible (although not for small private businesses) and even stepped in as a buyer of last resort for corporate debt. As has been the case since 2009, a supportive Fed helps maintain or inflate asset prices, and thus those with access to the markets are relatively unscathed after a sharp and deep correction that sorted itself out as quickly as it appeared.

At the same time, moments of maximum stress and difficulty spawn moments of maximum innovation and creation. Suddenly, every desk job that didn't get eliminated became a telecommuter job. Every restaurant that stayed open became a take-out counter. Every meeting was held on a computer screen. Every retail purchase was made online. Every delivery service became a lifeline. TV shows are being produced in attics and concerts are assembled in pieces and performed on social media. In the midst of this, with the support of governments, academia, and private enterprise, there is a global coordinated moonshot-level effort to develop therapies and vaccines for COVID-19. New opportunities to apply technology are exploding around us at the same time businesses that were marginal pre-COVID are staring (or falling) into the abyss. The cycle accelerated and capital is starving out obsolete businesses and flowing to the new economy at a remarkable pace.

We see this creative/destructive process, raw capitalism in a nutshell, moving quickly, and the next generation of winners are being chosen now. Trends like de-officing, ex-urban migration of Millennials, the death of brick-and-mortar shopping, even the decarbonization of energy and transportation, are speeding up and destroying value in hard assets and commodities like real estate and oil, but the capital and resources pulled away from those areas are having an even larger catalytic effect in the businesses that benefit from these trends, like telecommunications, logistics, and distributed power generation.

Our view remains that the greatest long-term opportunities reside in the United States, and the trillions of dollars being thrown at the economy and markets are evidence the government believes in that trade. Europe still faces challenges that we have discussed elsewhere that held back economic growth and market performance, and pre-COVID we were of the opinion that, while not the best opportunity, Europe still represented a good opportunity because its economic engine and markets were undervalued as compared to their potential. The deadly outbreaks in Italy, Spain, and France put that on 'pause', but with their pandemic houses now in order and a commitment of more than 700 million Euro in coordinated stimulus across the 27 nation bloc (far less per capita than the US, but still encouraging), we again see an avenue to participate in the realization of that value.

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