The Water Valley Review

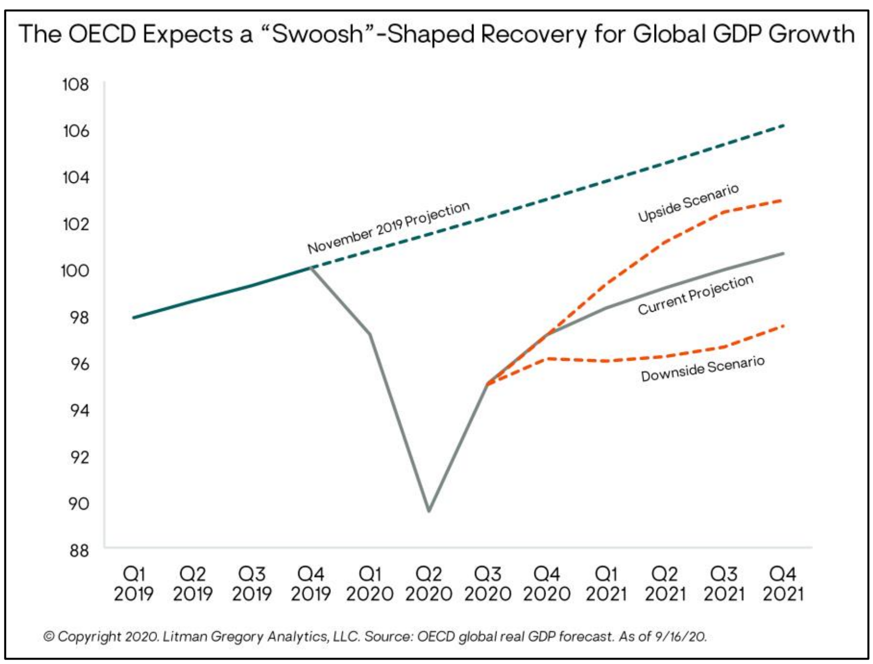
Water Valley Investment Advisors, Inc. **Third Quarter 2020**

Investment Commentary - Despite some choppiness in September, equity investors were treated to solid gains during the third quarter. The broader stock market rose 8.9% in the quarter and has recovered most of its losses for the year. Developed international stocks gained 6.0% this quarter and emerging-market stocks returned 10.2%. Both groups still trail U.S. stocks year to date and have not fully recovered their losses for the year. Bond markets were calm throughout the summer, thanks in large part to the Federal Reserve's extremely accommodative monetary policy. Treasury yields were unchanged, and investment-grade bonds gained 0.6% in the third quarter.

Underneath the surface, mega-cap growth names continue to lead the U.S. market. **Without the outsized returns of the six so-called FANMAG stocks (Facebook, Amazon.com, Netflix, Microsoft, Apple, and Google/Alphabet), the broader domestic stock market would still be negative for the year.** The outperformance of these top names means they now dominate the market index, with the ten largest stocks making up an extreme 28% of the index.

Outlook - Going into the final quarter of 2020, multiple crosscurrents and uncertainties are presenting both investment opportunities and risks. A unique U.S. election approaches in November. The market doesn't like uncertainty, so the weeks leading up to the election and afterward may be volatile. **But history shows any election-year declines are usually short-lived and the political party in power is not a significant driver of investment returns.** Our philosophy has been to not attempt to predict the short-term market reaction to elections (or any short-term event). There are simply too many *other* factors that impact markets over time. Instead, we stick to our longer-term analytical framework in which we consider and weigh multiple scenarios and assess the potential risks and returns for numerous asset classes and investments in each scenario. **The fundamentals are what really drive long-term market performance.**

Looking through the election, there are reasons to be cautiously optimistic about the investment prospects for global equities and corporate bonds. An economic recovery *is* underway, as economic data and forecasts are improving, as noted in the included chart. All else equal, rebounding economic growth here and abroad should support equity and corporate bond markets. **Also, the speed of progress in vaccine development is promising. An effective and widely distributed vaccine would allow economic activity to return to its full pre-pandemic potential.** Finally, this year's extraordinarily supportive



monetary policy and huge fiscal stimulus, were key drivers of the speedy recovery in markets and the programs are in place that could step in to help again. Fed officials have signaled that they do not expect to raise rates at least through the end of 2023. Since inflation has not topped the Fed's 2% target in a decade, many market participants expect low rates and supportive policy to continue for a long time. **A reason for caution is that it remains to be seen how strong the actual economic recovery is and how much of it is already discounted in current prices.** Also, the potential remains for a large resurgence of COVID-19 in the fall and winter months. In addition, further fiscal stimulus from Congress may not happen in a timely manner and be a hit to fourth quarter economic growth and impact markets. Finally, there is always the potential for a negative geopolitical shock (i.e. – strained China relations, drawn out election results court battle, etc.).

Portfolio Positioning - We are very comfortable with how our portfolios are constructed, with the watch words of our current positioning being *balance* and *resilience*. Our portfolios are balanced across multiple dimensions: domestic vs foreign, growth vs values, interest rate vs credit risk, traditional vs alternative investments. We have designed our portfolios with the goal of generating solid long-term returns in positive economic scenarios, while maintaining resilience in a more challenging scenario. **On the equity side of our portfolios, during the March downturn we added to U.S. equity exposure at attractive prices. Since that time, U.S. stocks have appreciated strongly and valuations are getting stretched. Nothing prevents valuations from rising even further near term, but overvaluation tends to not matter … until it does.** However, stocks look cheap relative to bonds. Bond yields are extremely low, which forces investors to allocate more to stocks, pushing stock valuations even higher or keeping them higher for longer. **That said, a durable economic recovery taking hold could be the catalyst for investors to turn away from these highflyers and favor undervalued stocks in out-of-favor industries and overseas markets.** On the international side, we are overweight emerging-market stocks and a full strategic weight to developed international stocks. **We don't want to reduce our global diversification right now as stock valuations are cheaper in non-U.S. stock markets and we continue to see superior expected returns over the next several years.** In addition, stocks being cheap compared to bonds is even more true in international markets and with Fed-repressed U.S. interest rates, the odds are that foreign currencies will appreciate against the U.S. dollar and further enhance overseas returns.

On the fixed-income side, core bonds are an important shock absorber in a negative economic or geopolitical shock. However, yields are very low and to protect against an even modest increase in interest rates, we have invested in actively managed flexible bond strategies with higher expected returns and lower interest rate risk. **Our positions in alternative investments further diversify equity and bond market risk and are intended to generate solid returns.** In a strong market, alternative strategies will likely trail stocks. But in a weak market, we expect them to provide protection and offset stock losses.

Closing Thoughts - History shows markets are consistently unpredictable. Adding to the uncertainty are the unprecedented circumstances, challenges, and structural changes the global economy is currently facing. **Having a high degree of conviction in any single outcome strikes us as imprudent. Instead of trying to continuously predict the future, we are focused on building resilient portfolios across multiple plausible scenarios, accounting for a range of shorter-term risks but keeping our primary focus on the medium- to longer-term fundamentals that ultimately drive investment returns.** This is the best approach we've found to achieve long-term investment goals. As always, we appreciate your continued confidence and trust, and we do our best to continue to earn it.

The Water Valley Investment Team