DANN ASSET ADVISORS, LLC

Third Quarter 2020 Update

October 12, 2020

3Q20 Highlights

- Stocks register a strong quarter despite a weak September
- Market gains continue to mask wide divergences among sectors
- Pace of economic recovery slows as Congress fails to agree on additional stimulus
- Fed commits to low rates into 2023 and raises its temporarily acceptable inflation target
- Election may spur near-term market volatility and impact longer term sector performances

The table below summarizes the performance of some key indices during the third quarter and year to date:

Market Performance		
Index	% Ch. 3Q20	% Ch. YTD
S&P 500	8.9	5.6
MSCI All Country World ex US	6.3	-5.4
MSCI Dev. Markets (ex US)	4.8	-7.1
MSCI Emerging Markets	9.6	-1.2
US Aggregate Bond	0.62	6.8
Liquid High Yield	4.3	-1.1

Source: Morningstar, iShares

Equities. Even with a 6.1% decline from its September 2 peak, the S&P 500 generated a strong 8.9% return for the third quarter and ended the period up 60.1% from the March 23 low. While technology continued to be among the market's leading sectors, there was a broadening to other, more economically sensitive groups during the quarter. For example, the industrial and materials sectors both did better than the broad market.

The market's strength in July and August (+12.9% in total) seemed to be driven by a combination of supportive Fed policy/low interest rates and sectors of the economy improving more rapidly than expected. The drop off in the mid-summer spike in Covid-19 cases also likely helped. Finally, while impossible to quantify, speculative trading in some of the largest and most popular technology stocks may have contributed to the market's unusually strong gain over the two-month period.

Despite volatility in September, most of the trends in place earlier in 2020 continued. As measured by the Russell 1000 indices, growth stocks returned 13.2% for the quarter compared with only 5.6% for value stocks. The difference between the two sectors for the year to date is an astonishing 35.9 percentage points, with the Growth index up 24.3% and the Value index down 11.6%. Smaller company stocks as measured by the Russell 2000 index generated a decent 4.9% return for the quarter but lagged the large-company S&P 500 by 14.3 percentage points for the year to date. As in prior periods, international stocks continue to trail the U.S.

Fixed income. Treasury markets were relatively quiet during the quarter despite a brief downtick in yields over the second half of July when Covid-19 cases were increasing. Ten-year treasuries ended the quarter yielding 0.68% compared with 0.65% at the end of June. Two-year treasury

yields declined from 0.15% to 0.13%. More speculative fixed income, as shown by the iShares Liquid High Yield index, had a better quarter as credit spreads continued to narrow.

Market sectors. The consumer discretionary sector was the best performer in the third quarter, rising nearly 20% and led by Tesla (the third largest stock), which roughly doubled. However, several big retailers that are migrating successfully to omni-channel models (in-store, internet, pick-up and faster delivery) also had strong quarters; partly this may have been due to pent up consumer demand and government aid programs. Technology was the second-best performer, closely followed by materials companies, the latter likely benefitting from industrial production ramping up following the second quarter's shutdowns.

Continuing the trend of the first half, energy and financial companies were among the three worst performing groups. Energy was the quarter's only down sector, falling nearly 20% as energy-related commodity prices remained weak. Financials, and banks in particular, continue to be constrained by low rates and fears of higher write-offs. Real estate also had a difficult quarter as occupancies and rents have been pressured by Covid-19.

Year-to-date, technology, and the two other sectors with heavy technology-related exposure – consumer discretionary (Amazon and Tesla combine for 30% of that sector) and communications (Alphabet and Facebook 40%) – were the best performers, gaining from 9% to 28%. Energy, financials and real estate were the worst, with losses from 13% to 49%. The first three sectors generally are considered growth sectors and the last three value – and the extreme difference in performance among these specific groups goes a long way toward explaining why growth strategies have trounced value thus far in 2020.

Portfolio Positioning

With respect to fixed income, for many clients we added back some of the short duration, noninvestment grade exposure that we had reduced during the first quarter. The addition was to an already-owned fund that had held up relatively well during the March downturn. We judge that the pick-up in yield is worth it given the fund's good long-term record and the Fed's seeming commitment to keeping fixed income markets functioning smoothly. Still, even with this modest change, most client's fixed income portfolios remain 90% or more investment grade and 70% or more short duration (which we define as three years and under).

On equities, for most clients our only significant move during the quarter was to sell the remainder of a mutual fund that we'd been reducing in size over the past year. Over the past several years this fund's performance had become more erratic, and with a disappointing third quarter developing we finally lost patience. Proceeds from the sale were put into a U.S. focused fund whose manager we're already familiar with through other funds that he manages.

General Comments

The S&P 500 advanced 12.9% in total in July and August before declining 4.7% during September. The moves in both directions were led by technology-related stocks, with some of the largest, most popular stocks making the biggest moves. In our opinion, July and August represented a temporary peak in speculation in some of the big tech names. We believe the stock splits of Apple and Tesla were good examples of this speculation.

In a stock split, shareholders are given more shares of stock but at a proportionately lower price, so that there's no change in the overall value of the holding. After announcing a stock split on July 30, Apple's stock – with no change that we could see in the company's business outlook – rose

34% to August 31, the date of the actual split. Tesla – perhaps with some modest improvement in its outlook – gained 82% during the period between its August 11 split announcement and August 31 split date. Articles in The Wall Street Journal (9/4/20), Barron's (9/14/20) and elsewhere attributed these seemingly irrational moves to options strategies and greatly increased trading by small, individual investors. Both stocks gave back some of their gains in September – also for no apparent reason.

As we mentioned in our second-quarter update, given their substantial weight in the market the stock price movements of the biggest technology companies currently have an unusually large impact on the overall market's direction. In our opinion, as exemplified by the Apple and Tesla splits, technology stocks in general have appeared overvalued at times in recent months.

Looking beyond technology, however, we believe that more economically sensitive sectors of the market offer decent upside potential – assuming a vaccine is widely available by summer 2021. If the pieces were to fall into place, we could envision a scenario where the overall market doesn't do much over the next six to 12 months – held back by technology appreciation temporarily being capped by high valuations – but with other sectors moving up with signs that the economy is improving. Of course, we're familiar with the "nifty fifty" stocks of the 1960s (a group of large, "must-own" growth stocks that dominated that bull market for roughly a decade), and understand that, especially in a Covid-19 environment, today's "nifty" tech stocks could continue to lead the market higher.

It seems to us that there's a wider than usual range of potential outcomes for the market near term. Among the key variables are:

- If and when a vaccine is widely available – we view this as a prerequisite to a broad-based economic recovery.
- Will there be a significant spike in Covid-19 cases during the fall/winter – leading to near-term pressure on the economy?
- Federal Reserve policies – likely to be favorable for the market given recent commitments on rates and inflation.
- Additional fiscal stimulus – will Congress provide additional aid for those most negatively impacted by Covid-19?
- November's election results – which party wins the presidency and the Senate, with the potential for significant change in fiscal, regulatory and tax policies should the Democrats sweep.

In our base case investing assumptions, we're assuming that a reasonably effective vaccine is available in 2021. We have no special insight into the development process but judge that with all the resources and presumably best minds working toward a solution something effective will be developed and available. We believe the market likely would rise in advance of this occurring, even though it will take time for a substantial part of the population to be vaccinated.

Given President Trump's comments about the election, we appreciate that there could be significant near-term market volatility if former Vice President Biden wins by what Trump views as a narrow margin. However, at this point, we'd be willing to look through that volatility, believing that a vaccine and continued economic recovery are far more important factors for the market.

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