Exencial
Wealth Advisors™

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Market Update

Even though stock markets took a breather in September, the 3rd quarter was positive for all broad asset classes. Debt and equity markets continued to heal from the month long slide in late February to late March. 3rd quarter earnings will be closely watched as the first full quarter of recovery. While earnings in the 2nd quarter were expected to be very low (and they were), operating earnings for the third quarter are estimated to be about 25% higher with only energy and real estate sector earnings expected to fall. These two sectors combined now make up less than 5% of the S&P 500 Index though. Residential homes had strong price gains as a result of increased demand and ultra low interest rates which remained flat for the quarter. Large numbers of refinancings continued and have helped consumers lower monthly debt expenses.

Investors are interested to see how consumers are feeling about their situations after an annualized GDP decline of 33% in the second quarter. Consumer confidence surveys have been slowly improving over the last few months. Consumer spending has also continued to rise and there is evidence that delinquencies are falling. Still, claims for unemployment remain quite high and there are increasing signs the government will move forward with another round of fiscal stimulus to households.

What households do with that stimulus though remains to be seen. Much of the first round of stimulus went into savings and to pay down debt (probably smart), and households may do the same with the next round. Still, the improving household balance sheets will lay the groundwork for higher spending and growth over the next several quarters. Stock market prices continue to forecast a recovery, and clearly we are in an early stage of a recovery from the 2nd quarter lockdowns. Monthly employment gains are reversing earlier huge job losses, though at a slower pace. We maintain our view that the economic recovery will be uneven and that it will be several quarters before the broad market matches the level of growth and earnings achieved in 2019.

Expected market volatility, which has greatly fallen from March highs, is still elevated and we believe it will remain so into next year. The election is keeping volatility high and we may see large repositionings of assets towards year end if investors believe we will soon be operating under a new tax policy. We encourage clients to talk to their advisors and determine how potential tax law changes may affect their portfolios.

As we move into year end, market signals are mixed. Stocks are priced for a healthy recovery, bond prices suggest weakness and low inflation/deflation, gold is forecasting volatility and inflation, residential real estate shows strong consumer demand, and office/retail real estate expectations continue to erode. In this environment we want to remain well diversified in our portfolios and hold higher quality names in our individual stock strategies.

Performance Summary

For the quarter, broad asset classes were all higher. even after a September pullback. Stocks had a strong quarter globally, led by Emerging Markets (+9.7%) and the US (8.9%), but Int'l Developed Markets were also higher (+4.9%). Growth stocks and higher quality companies continued to outperform smaller companies and value stocks.

The US dollar fell against all developed market currencies, and this especially helped Commodities (+9.1%) and Gold (+3.6%). The Bond Market was slightly positive at 0.6%, and US Real Estate Investment Trusts were positive (+0.8%) but continued to underperform from concerns about falling demand for office, retail, and hotel properties.

Fixed Income Strategy

U.S. Treasury rates across the yield curve ended the third quarter little changed from the second quarter, with the 10-year Treasury closing at 0.68%. The Federal Reserve's expectation that its short-term funds rate will remain near 0% for the next few years, along with quantitative easing asset purchases, have acted to hold rates in a relatively low, narrow range.

Corporate spreads continued to tighten, with investment grade modestly tightening to 136 bps and high yield more sizably to 517 bps. Improving economic fundamentals and monetary stimulus have both been supportive of the corporate market.

Our preference is to defensively position portfolios in high-quality bonds with an average duration of 5 years and shorter or structured bonds with coupons that will step up if rates rise.

Equity Income Strategy

The Equity Income strategy's primary goal is to provide reasonable income while also offering the potential for capital appreciation. In February we determined that we could not achieve our 5% income target without taking an unacceptable level of risk. Accordingly, we prioritized capital preservation by liquidating the riskiest exposure in the strategy.

The simultaneous sell-off in equities combined with the widening credit spreads weighed on performance earlier this year. Since then, we have been looking to deploy some of our cash reserves and take advantage of the market volatility by adding good quality companies that pay above average dividend yield. For the remainder of the year, we will continue to look for areas where we can capture yield with an acceptable level of risk.

Defensive Equity Strategy

The Defensive Equity strategy remains focused on identifying companies with more stable operating results and stock price volatility than the broader market.

While we continue to be defensively positioned, we have been nimble enough to incrementally improve the quality of the portfolio. As the economy continues to heal, we will look for opportunities to deploy some of the cash reserves. As mentioned before, we consider our cash position as a source of opportunity in these volatile markets.

Core Equity Strategy

The Core Equity Strategy has been strengthened with the addition of Portfolio Manager Randy Farina. Mr. Farina brings over 20 years of investment experience to Exencial having spent nearly two decades as an analyst and Portfolio Manager at Putnam Investments in Boston.

The strategy was defensively positioned ahead of the market drawdown with historically high levels of cash, a material allocation to gold, and a generally defensive mix of businesses. This positioning allowed us to hold in better than the broader market. As the US continues with an uneven economic recovery, the team is evaluating opportunities to add to its technology holdings and reduce the underweight. Technology companies for the most part have proven to be resilient in the face of the economic slowdown or pause created by Covid-19. Although some pockets of valuation excess exist in technology, we still can find compelling high-quality businesses that are positioned to succeed whether the economy rebounds in 2021 or beyond.

During the quarter we did take advantage of some opportunities to add a few high-quality semiconductor capital equipment companies. The drivers of cloud, digitization and data analytics present a solid runway of growth for the semiconductor industry. We will continue to look for value in semis, technology and all industries and sectors. While we cannot predict near term risk factors, we can control the companies we invest in. Our disciplined approach of owning high quality, financially viable and intrinsically cheap companies form the Core Equity portfolio.

SELECT Equity Strategy

This strategy invests in companies we determine to have leading and innovative corporate strategies, while operating in a positive manner with regards to environment, social, and governance factors.

The portfolio contains about 45 stocks and is diversified. Our investment timeframe is 3-5 years, so turnover is relatively low. This year we made significant changes in the first half of the year eliminating fossil fuel energy companies and reducing our exposure to more economically sensitive consumer cyclical stocks. We retained all but one of our positions in this past quarter.

International Equity Strategy

The portfolio is now being managed by Randy Farina. Mr. Farina spent nearly 20 years as an analyst and Portfolio Manager at Putnam Investments in Boston. The International Equity strategy valuation philosophy will not change. Our belief is that value is created over the long term by the compounding of a company's the cash flows. The market's short-term focus routinely underestimates characteristics like durability and sustainability and consequently the intrinsic value of these businesses. The team has found that paying a reasonable price for a business with the above characteristics will lead to above average stock price performance over time. The team will have a long horizon as it believes this to be its key competitive advantage.

The portfolio is currently reducing its positions in cash and gold as it finds compelling valuation in some world class business. The approach is to have a portfolio of high-quality businesses with competitive advantages that can withstand changes in economic conditions and thrive through a business cycle. Companies with established moats often expand market share and strengthen their business during a downturn. These are the companies that we continue to evaluate for purchase in the International Equity strategy.

In the quarter we did take the opportunity to add to a few technology and health care companies. The outlook for the companies purchased during the quarter remains attractive regardless of the economic backdrop. These are companies that have proven their business resiliency and ability to adapt to challenges faced during economic stress.

Opportunity Equity Strategy

The Opportunity Strategy made three changes during the third quarter. The Strategy added Akamai Technologies (AKAM), a leading technology platform company that benefits from increases in internet usage and cyber security, two trends that are accelerating during COVID-19. Another change was the addition of Aquabounty Technologies (AQB), a pioneer in the more efficient and sustainable production of seafood using on-land facilities. We believe the company is about to reach a critical point in revenues with the commercialization of its Atlantic Salmon. Finally, our team added Farfetch (FTCH), the only online luxury retailer we see benefiting from luxury brands transitioning out of retail stores to online channels.

Currently, the Opportunity Strategy is invested in 24 companies. Our goal is to add a few more names in the next couple of quarters in order to reach the 25 to 35 name range level. By adding more names, it would allow this strategy to participate in a wider array of future trends while increasing the diversification of the overall portfolio.

Thematic Equity Strategy

The Thematic Equity strategy was unable to overcome the broader drawdown in global equities, even with a sizeable cash buffer. This is to be expected as the Thematic strategy is our most aggressive equity strategy and thus its optimal phase of the cycle should be after markets have fully bottomed.

Over the past quarter, we used some of the cash "dry-powder" and invested in themes that offered an attractive risk/reward proposition. While the economy has been healing since the shutdown in early Spring, the healing process has been for the most part uneven across industries and sectors. We believe that there is value in these areas that may have not received as much attention by investors over the past months.

Covered Call Strategy

The primary goal of the Covered Call strategy is to obtain exposure to equities, with greater income potential at the cost of reduced upside participation. The high level of market volatility in 2020 has created challenges for us but also opportunities. Options premia remain higher than long-term median levels, so the income potential from covered call sales is higher. In addition, support from global central banks and fiscal stimulus have provided significant protection for equity investors thus far. High valuations at the broad market level, top heaviness in a few megacap stocks, resurgence in the number of Covid-19 cases, the upcoming elections and relationships with our trading partners remain risks in the near-term. Options markets imply above-normal levels of volatility through early 2021, so investors should beware complacency and adhere to long-term investment plans in a disciplined fashion. Should the broad US equity market become range-bound in the near-term, constrained by high valuations and the slow pace of economic recovery on the upside but buoyed by fiscal and monetary stimulus on the downside, this may be a fruitful period for the Covered Call strategy.

As market conditions evolve, we will continue to monitor our exposure to the tech-heavy Nasdaq 100 index, which we pared from ~30% to ~20% down to ~14% this quarter. In Q2 we added the capability to purchase protective puts or replace equity exposure with purchases of in-the-money calls and we are monitoring options prices ahead of the election and looking for the opportunity to add some downside protection. However prices for puts covering the Nov-Jan period are high so it's more likely that we will slightly increase our cash position and lean our options strike prices lower than the benchmark to provide a slightly increased buffer, at the cost of potential income and upside exposure. As we look ahead to 2021, if we begin to see signs of a sustained pickup in global economic growth it's likely that we will begin to raise the strike prices of our calls relative to the benchmark and leave a higher proportion of shares uncovered in order to obtain greater upside exposure.

Disclosure

There is a risk of loss from an investment in securities, including the risk of total loss of principal, which an investor will need to be prepared to bear. Different types of investments involve varying degrees of risk, and there can be no assurance that any specific investment will be profitable or suitable for a particular investor's financial situation or risk tolerance.

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