REYNDERS, MCVEIGH CAPITAL MANAGEMENT, LLC
*Invest in better.*

# The Long Run

INVESTMENT LETTER | OCTOBER 2020

***"The breakthrough innovations come when the tension is greatest and the resources are most limited. That's when people are actually a lot more open to rethinking the fundamental way they do business."***
- Clayton Christensen

The question that seems to be on most people's minds these days goes something like this: "How can the market possibly be trading near all-time highs when we find ourselves pinned by a deadly global pandemic, struggling against a deep economic recession, challenged by a societal reckoning illuminated by the Black Lives Matter movement, witnessing wildfires relentlessly devouring millions of acres across the American West, and immediately facing both an accelerated Supreme Court confirmation process and a Presidential election in an historically polarized political environment with the President and many others in the White House and Washington D.C. diagnosed with COVID-19?"

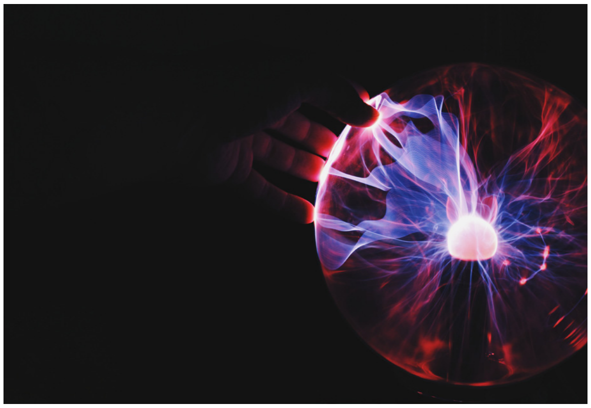
Our immediate challenges are significant – and they are fueled by enormous economic and societal currents that have the potential to derail many industries and to change the priorities that shape our communities and the nation. There is more to the current picture, however, than the fear-stoking headlines that blare at us unremittingly in our captive state. It's imperative, therefore, that we look beyond these headlines to keep our balance. Periods of dislocation – like the one we are enduring now – reveal the deepest weaknesses and strengths embedded in our existing economic structures. And, they open the door to the new technologies and innovations that will drive growth in the future.

Let's start with "the Market." As our clients know, we don't invest in markets. We invest in individual companies trading at discounts to their long-term earnings prospects. It is true that the S&P 500 – buoyed by strong performance in extremely large tech companies – is currently trading within 6% of all-time highs. A closer look at the individual constituents that make up the S&P 500, however, tells a more nuanced and instructive story. As of this writing, 59% of the individual company components of the S&P 500 are down for the year. Currently, 43% of these individual company stocks in the S&P 500 are down more than 10%, and 32% of these component stocks are down more than 20% for the year. With nearly one third of large capitalization stocks in the S&P 500 trading at significant, bear market discounts from highs, there are certainly opportunities available for disciplined investors. Similar prospects exist today in foreign markets and in smaller capitalization stocks.


Investors also need to recognize just how powerful the Federal Reserve's policy response has been and continues to be. The Federal Reserve moved precisely and decisively in March to support money markets, municipalities, and indebted companies through lending programs and by becoming the buyer of last resort for a huge range of debt instruments. These dramatic moves assured liquidity in markets – avoiding the freezing of capital flows that choked markets at the beginning of the Global Financial Crisis. To give you a sense of the scale of current programs, the Fed authorized $2.3 trillion in emergency lending programs in March – more than four times the size of the lending programs authorized during the Global Financial Crisis. The Fed also authorized $700 billion in asset purchases in March (and soon after agreed to remove the explicit limitations on potential purchases). By mid-April, purchases in a range of fixed-income instruments had already expanded the Federal Reserve's balance sheet by more than $2 trillion. All of this support is, of course, beyond the Cares Act and whatever additional stimulus that may come from the White House and Congress. We can argue about the long-term impacts of such stimulus, but the immediate result has been to install a formidable economic backstop.

Importantly, the Federal Reserve is committed to keeping interest rates at currently low levels for years to come. Low interest rates reduce friction in the economy and provide inexpensive capital to support businesses. Potentially longer periods of low rates have more impact on equity and other growth investments than investors might think. Most financial analysts utilize discount cash flow models to establish long term valuation potential for stocks, real estate and other growth investments. When interest rates are low, long-term valuations go up in these models as discount rates shrink. Equities, therefore, are not just attractive today because they offer better potential returns than low-yielding bonds, but also because research organizations around the globe are raising equity price targets as rates drop. This is a potent one-two punch.

To us, however, the most critical factor driving markets is the reality that we are living through a powerful innovation boom that is changing our economy dramatically across a wide range of industries. ARK Invest projects that – over the next ten years – about 50% of S&P 500 companies will be replaced by fast-growing innovators. Economic and health pressures are only accelerating the adoption of new innovations today. Clayton Christensen was a Harvard Business School professor who famously championed the concept of disruptive innovation. A disruptive innovator allows a whole new population of consumers access to a product or service that was once only available to consumers with significant capital, or specific skills. Disruptive innovators also might emerge simply because they deliver better solutions than those that currently exist in the market. A necessary part of understanding innovation, therefore, is to recognize that for every powerful innovation that wins new customers there are old businesses losing share.



Just as we watched personal computers replace mainframe machines, cellular phones replace fixed-line telephony, and discount retailers replace full-service department stores in years past, we now see electric cars challenging the internal combustion engine, alternative energy replacing carbon-based fuels, digital transactions replacing paper, online shopping replacing brick and mortar stores, telemedicine replacing direct office visits, digital conferences replacing short haul business flights, genomics redefining how we manage health and disease, and much more.

Our focus on innovation – and our avoidance of vulnerable "old-line" businesses – has resulted in one of our strongest years of outperformance in 2020. Through the third quarter of this year, the equities in our Balanced Moderate Composite were up 18.94% for the year after fees compared to the MSCI World Index, which provided total returns of 1.70%, and the S&P 500, which had a total return of 5.57%. We believe that an economic recovery will take longer than most expect as many legacy businesses and indebted companies will not survive through this dark valley. We remain on the highest ground, investing in companies with powerful balance sheets that can weather through the darkest potential storms ahead. We also have been rebalancing portfolios, by taking some of our significant gains in innovative winners and moving those proceeds into new innovators. The pressures of the pandemic have uncovered significant market issues – and opportunities – in food infrastructure, air quality and filtration systems, health measurement, and digital infrastructure. We are excited to see new innovators in these critical areas selling at significant discounts.

We wish everyone in the Reynders, McVeigh orbit good health and safe passage through our current challenges. Please be sure to call us if we can be helpful in any way.



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