Investment Update

April 7, 2020

It's hard to know where to start. The suddenness of what's transpired over the past six weeks revealed a vulnerability to our way of living previously only appreciated by those of the scientific community. Ten million people have filed for unemployment over the past two months, following historically high employment levels and erasing five years of new job creation. This is one of many non sequiturs that define a starting point of where we go from here.

As we take account of what's ahead, we reflect on how the market's assessment of risk has evolved since the first documented cases of COVID-19 were reported on January 7th (after being originally reported as pneumonia on December 31st). The initial take was that this was a China supply chain disruption story, thought to possibly reduce U.S. GDP by ½ of 1%.

The subsequent spreading of infections outside of China and eventually inside U.S. borders transformed risk to include direct hits on U.S. corporations. By the time the CDC said there would be a possible disruption to U.S. life on February 26th, stocks were in broad retreat from market highs the week before. Compounded by the untimely collapse of oil prices, stocks experienced their fastest 20% decline in history from all-time highs over 22 days.

On March 11th, World Health Organization (WHO) officially declared the coronavirus a pandemic. Many thought the most sobering message that day in March was actually delivered by the NBA. Their decision to suspend the rest of the basketball season served as a wake-up call, not just for organized sport, but to any group related activity. Market risk shifted to an extreme level as the health care crisis became an economic crisis, and raised fears of a financial crisis.

The implications of a massive economic shutdown for an indeterminable time and the daunting challenge of restarting an economy triggered panic selling in multiple asset classes. Over the next 12 days, the S&P 500's decline topped 34% from the February high, with other segments of the market faring worse.

Over the course of this collapse, several unprecedented interventions from the Federal Reserve and Congress cushioned the free fall, culminating in the $2 Trillion CARES Act. This lifeline to businesses, workers, and others helped calm credit markets and prompted a spirited rally at quarter-end, mitigating S&P's decline for the year at 20%.

SO, ARE WE GETTING CLOSE TO A BOTTOM?

Most, if not all our conversations include this question. With uncertainties at so many levels, it's hard to have much conviction in either direction, but at the margin, we think downside risks will weigh on the market as we learn more about the broad ramifications of a shuttered economy. This does not discount the possibility of periodic counter-rallies as the news on infection rates improves, but we are still inclined to hold some additional cash in deference to a more challenging economic recovery ahead.

With respect to market bottoms, we think more in terms of a bottoming process rather than a single point. We also expect stocks will follow history and move off the bottom in advance of the general news flow turning positive, regardless of the shape of the recovery one subscribes to (V, W, U, L, or anything in-between). This is primarily why an investor's comfort level is a poor gauge to use as the criteria for getting back into the markets.

The stock market bottom of March 23rd reflected the initial shock that COVID-19 would ravage the global economy and that a quick recovery was no longer an option. This bottom in stock prices may hold if existing known uncertainties have been fully priced in. Or, the markets may make new lows if things we don't know paint a more challenging picture. Either way, we have moved beyond the stage of being shocked.

Predictions of when a sustainable market recovery will begin range from when the growth rate of infections crests, to when stay at home orders are relaxed, to when the virus is under control, which essentially means that hospital and medical treatment is accessible and a vaccine has been developed. It's difficult to see the economy move toward firmer footing without this last condition being in place.

The magnitude of the economic disruption in this crisis has no precedent in modern history. The natural instincts of this country to bounce back from adversity have been temporarily disabled. The longer the nationwide lockdown lasts, the more complex it will be to restore an economy that we recognize. The logistics will be demanding to re-engage a workforce, access supply chains, manage finances, and deal with tepid demand from consumers who may be reluctant to abandon their social distancing habits.

There will also be changed patterns of consumer and lifestyle preferences. Each industry will have companies that are in a better position to thrive in this post-virus world and others who will need to change to stay relevant. Obvious areas of flux include travel, dining, entertainment, business meetings and workspace, public transportation, doctor visits, biotech research, among many others, all with investment implications. We will discuss these issues in future correspondence.

Over the next several weeks, we will hear corporate CEOs report on the damage they know and collectively acknowledge they have little visibility on the impact to future quarters. We will be watching the credit markets closely for signs of additional stress and potential systemic risks. The accumulation of leverage by corporations and non-traditional lenders during this era of historically low interest rates will have consequences to more speculative investors, not yet recognized. Calmer credits markets are usually a necessary condition for stocks to recover and there is a way to go here.

It is uncertain whether sheltering at home guidelines will be extended through May, but it would not surprise us as peak infection cycles move through different metropolitan areas. More federal stimulus bills are in the works to keep targeted groups from falling between the cracks. While these measures will be well received, the risk becomes greater that politics may get in the way. The historically high volatility readings have moderated some, though we expect markets will continue to experience wider swings than normal in both directions.

PERSPECTIVE

In our 2019 year-end note, we made what we thought was a cynical observation that conditions and expectations were so benign, seasoned investors would have reason enough to maintain a measure of caution. This was not meant to be prescient. It was not complacency but rather a biologic pathogen that brought the economy to its knees. It could have happened any time.

The coverage of this event is omnipresent, and justifiably so. It will mark a generation as deeply as 9/11 and the Financial Crisis, combined. Much of the focus has and will be on missed opportunities, startling levels of unpreparedness, and conflicting messages from our leaders in government, healthcare, and business. Equally visible have been profound acts of courage, inspired leadership, intelligence, and generosity inside each of these same groups. When we see the pictures of those serving on the front line helping others, it puts into perspective what we think of as a bad day.

When the best and brightest develop an effective treatment and vaccine that can truncate this cycle in its tracks, we will have suffered enough. God speed to these efforts and continued safety to you and your families.

Data as of March 31, 2020

Meritage Value Equity Fund

Top 10 Holdings	% of assets		% of assets
Utilities Select Sector SPDR	4.0	Roche Hldg Ltd Sponsored ADR	2.2
Vanguard Consumer Staples ETF	3.5	Globe Life Inc.	2.1
Consumer Disc. Select Sector SPDR	3.3	Idacorp Inc.	2.1
Wal-Mart Stores Inc.	2.3	Verizon Communications	2.1
Duke Realty Corp	2.2	Ericsson L M Tel Co ADR	2.0

Meritage Growth Equity Fund

Top 10 Holdings	% of assets		% of assets
Microsoft Corporation	8.5	Micron Technology	3.2
Apple Inc.	7.7	Fiserv Inc.	3.0
Amazon Inc.	6.1	Generac Holdings Inc.	2.8
Alphabet Inc. Cl A	5.6	Adobe Inc.	2.4
Zebra Technologies Corp.	3.4	Ametek Inc.	2.4

Meritage Yield-Focus Equity Fund

Top 10 Holdings	% of assets		% of assets
Verizon Communications	2.8	CVS Health Corp	2.5
National Grid Plc ADR	2.7	National Health Investors	2.5
PPL Corp	2.6	Gilead Sciences Inc	2.3
British American Tobacco PLC ADR	2.6	United Parcel Service Cl B	2.2
Centerpoint Energy Inc. 7.0% Conv PFD 9/1/2021	2.6	Lamar Advertising Co	2.1

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