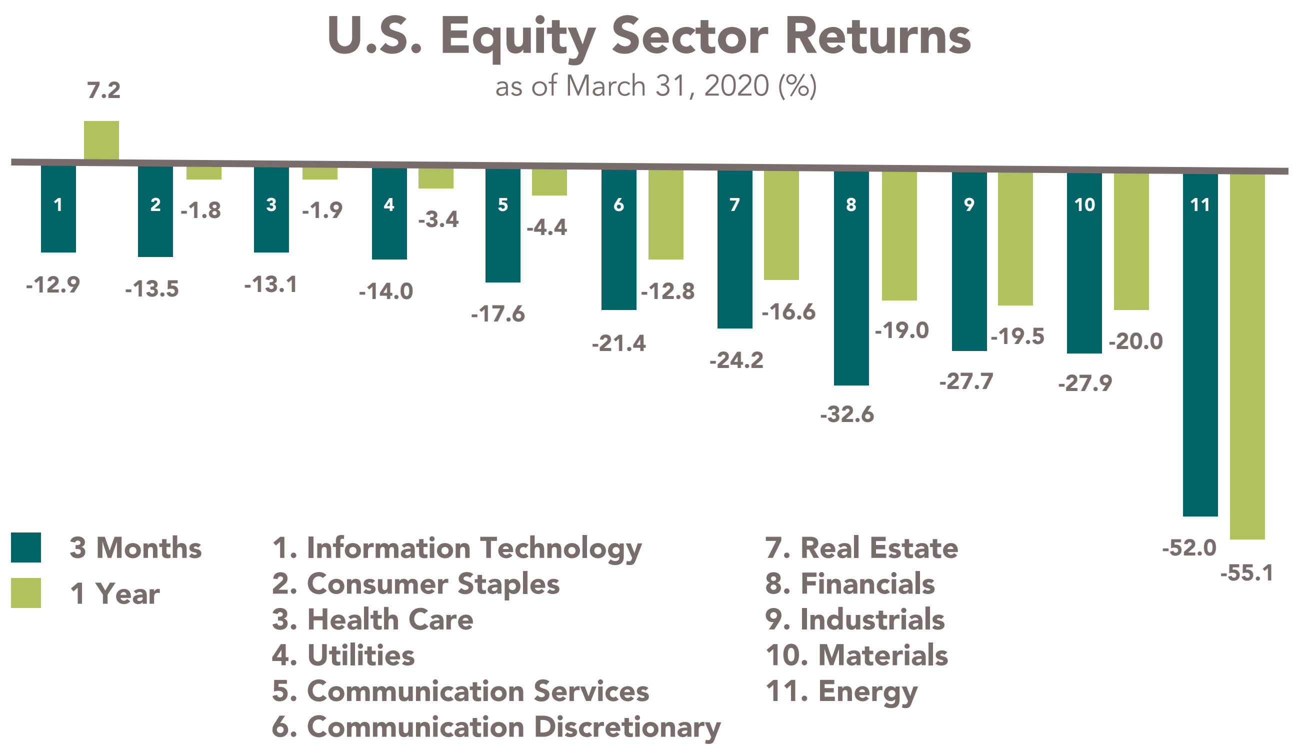
Spring 2020

Dazed and Confused: The World According to COVID-19

Since mid-February, the global response to the COVID-19 outbreak has had an unprecedented impact on our personal lives, our jobs, and the global stock markets and economy. After a 34% decline in the value of the 500 largest U.S. companies (the S&P 500) between February 19th and March 23rd, values rebounded nearly 30% as of early May. The stock market comprises many industries and sectors that have been impacted differently. While airlines, hotels and energy companies were hardest hit, as of early May large tech and healthcare companies recovered most of their losses.

The recent market rout and subsequent rebound shows how stock and bond markets — in the short-term — can leave us dazed and confused and exhausted. Markets confound and frustrate observers who believe they have it all figured out. To most, a resurgent stock market seems strange against the backdrop of unprecedented unemployment, "shelter in place" rules, worsening economic statistics and company earnings, and daily reporting of national death rates from COVID-19. No one knows for sure what kind of economy we will have once we begin to open up and emerge from this crisis. No one knows if the markets will "re-test their lows."



However, early catalysts have relaxed investors and elevated prices, including massive government stimulus, better news on the virus in the form of "flattened curves" in New York City and Italy, hopes for vaccines and treatments, and in early May, prospects of reopening the economy.

To help with this confusion it is important to remember that the stock market always looks forward. Warren Buffett's mentor, Professor Benjamin Graham said that "in the short run, the market is a voting machine…", implying emotional considerations such as popularity drive its trajectory. He follows with "but in the long run, the market is a weighing machine," meaning that actual results and substance ultimately drive stock valuations.

When investors began to comprehend the massive implications of closing down the global economy, the future looked bleak and investors panicked. Suddenly, the short term (the next five trading days) became vastly more important than the next five years. Saving lives required extreme measures, such as sheltering in place, to prevent an overwhelming spike in cases, hospitalizations, and fatalities.

Investors had never witnessed an engineered economic "full stop" and had no way to comprehend and measure the magnitude and duration of this severe response. But both the Federal Reserve Bank and federal government began offering financial "backstops" such as loans to small businesses and other stimulus measures. Health statistics in COVID-19 epicenters began to improve and broke the cycle of fear. In regard to the value of all the world's publicly traded businesses and their bonds, investors could think beyond five days and reassessed their value.

It may seem redundant to once again emphasize the importance of thinking long term. However, COVID-19 demonstrates how critical a long-term approach is to investment success. You don't have to try and make sense of emotionally driven and confusing short-term stock market moves when you're investing for the long haul.

An Alternative Way to Think

Imagine for a moment that in 2010, after much research, you purchased a 10- unit apartment building in your town for $500,000. It is well-located and near many employers and you believe there will never be a problem keeping it full of tenants. Within a year, after all expenses, you net $40,000 — an 8% return. By 2019, through rent increases, you net $48,000. You couldn't feel more secure with your investment.

Several years ago, you got to know Sam, a local real estate investor who also owns apartment buildings. Sam has a peculiar habit. Every day, he emails you an all-cash offer to buy your building. Depending upon how he "feels," some days he offers more than the building is worth and other days, much less. You like your building as a long-term investment and pay little attention to his offers.

Recently, however, the COVID-19 pandemic has had an impact on your collections. Two tenants ask to defer their rents for a year and another two might lose their jobs. You might collect less in rents this year but you have cash reserves and aren't that concerned. In his email on March 23rd Sam offers you $250,000 for your building. You laugh and never feel you "lost" money because he was there to buy it. You plan to continue collecting rents, get through today's situation, and wait until the situation normalizes. The fact that you could sell it every day is only a nice convenience but does not define the quality of your investment.

We propose to you that, as an owner of stocks, the correct long-term investment strategy should be no different than our apartment building analogy. Owning funds containing thousands of stocks, among them Google, Netflix, Procter and Gamble, Verizon, Apple, Exxon, Southwest Airlines and Boeing, is your ownership of small pieces of businesses representing a broad cross-section of the U.S. economy.

These businesses generate quarterly dividends just like rents from an apartment building. And, if history is a guide, the value of your investments will appreciate over the years.

As a result of the COVID-19 pandemic this year investors are more emotional than usual, and like Sam, offer less money for your shares than they did on January 1, 2020. While your energy and transportation (airline) stocks are down 30% to 40%, your technology and healthcare stocks have not declined much. You are protected because you own a wide array of companies, industries, and sectors of the economy. But, like the peculiar real estate broker, just because five days a week the "stock market" offers you a price for your ownership positions, should you be tempted to sell if you don't have to? Not to us. Just because millions of buyers congregate daily in a market and offer exaggerated prices when they get emotional does not mean that emotion has to impact your investments.

America has lived through plenty of financial crises. Among them are depressions, recessions, world wars, and 9/11. There is good evidence to suggest that the marketplace eventually will look past COVID-19, and start to offer you more for your ownership stakes of these companies.

This is why we consistently stress long-term thinking and will continue to do so in the future. Our team is very sensitive to the pain and uncertainty that everyone feels during times like these. However, at Rebalance we are trained to remove our emotions from decision making and to remain disciplined. In fact, our firm often looks for opportunities in such disarray, such as rebalancing client portfolios (as we did in late April).

Looking forward

Sticking with a long-term investment plan clearly is made more challenging given the situation at hand. So much patience is required on so many levels. It is very difficult to know what will happen with the virus, plans to reopen the country for business, and the trajectory of markets. What our firm does know is that as time passes there will be more clarity on the shutdown's effect on businesses and what the plan is to gradually and safely reopen the economy. While Rebalance continues to monitor the situation, our investment focus is on the long-term "weighing machine" and not emotions.

We are happy to report that, so far, nearly all Rebalance clients have "stayed the course" with their investment and financial plans and have been able to emotionally weather this difficult investment landscape.

Please stay safe and healthy. Do not hesitate to call us with any questions or concerns, we will be standing by and we look forward to speaking with you.

World Markets Review – First Quarter 2020

Index Returns

	US Stock Market	International Developed Stocks	Emerging Markets Stocks	Global Real Estate	US Bond Market	Global Bond Market ex US
Q1 2020	**Stocks**				**Bonds**	
	-20.90%	-23.26%	-23.60%	-29.02%	3.15%	0.51%
Since Jan 2001						
Avg. Quarterly Return	1.8%	1.2%	2.5%	2.2%	1.2%	1.1%
Best Quarter	16.8% Q2 2009	25.9% Q2 2009	34.7% Q2 2009	32.3% Q3 2009	4.6% Q3 2001	4.6% Q4 2008
Worst Quarter	-22.8% Q4 2008	-23.3% Q4 2008	-27.6% Q4 2008	-36.1% Q4 2008	-3.0% Q4 2016	-2.7% Q2 2015

Past performance is not a guarantee of future results. Indices are not available for direct investment. Index performance does not reflect the expenses associated with the management of an actual portfolio. Market segment (index representation) as follows: US Stock Market (Russell 3000 Index), International Developed Stocks (MSCI World ex USA Index [net div.]), Emerging Markets (MSCI Emerging Markets Index [net div.]), Global Real Estate (S&P Global REIT Index [net div.]), US Bond Market (Bloomberg Barclays US Aggregate Bond Index), and Global Bond Market ex US (Bloomberg Barclays Global Aggregate ex-USD Bond Index [hedged to USD]).

The **Rebalance Investment Committee** works with two broad asset classes as the basic building blocks of our client portfolios: Growth and Income. During the first quarter of 2020 these asset classes performed as follows:

Growth Asset Classes

Large U.S. Stocks. Stocks fell sharply in reaction to the ongoing COVID-19 crisis and the related shutdowns of economies in the U.S. and abroad. U.S. shares fell with record-breaking speed, down in weeks by percentages typically seen over months in past bear markets. Volatility measures spiked to an all-time high in mid-March while recorded volatility rivaled only Black Monday in 1987. The Federal Reserve and Congress immediately stepped into the breach with an interest rate drop, asset purchases, and direct financial aid to businesses and individuals, but the full impact will remain unclear until well after companies fully report first- and second-quarter earnings.

Small Cap Stocks. Investors sold off small-cap stocks more aggressively than their large-cap brethren, likely on fears that small-firm business models would be more challenged by the incipient economic shutdown than large firms with more resources and, in some cases, cash-heavy balance sheets. The typical "flight to quality" response was in play as investors sought to avoid short-term pain by moving money into bonds and blue-chip equities. Volatility is part of the package with small-cap investing.

International Developed Stocks. Given that the COVID-19 crisis unfolded across parts of Europe ahead of its major impact in the United States the impact of the shutdowns were felt among large foreign stocks more keenly in the first quarter. Business activity indices showed record declines as both the consumer and industry froze up over uncertainty; supply chains halted and demand fell. The European Central Bank and the Bank of England have promised relief is on the way. Already in a funk, Tokyo delayed its long-planned summer Olympic Games for a year. The games had been projected to boost the economy.

Emerging Market Stocks. The pullback from risk assets naturally extended more deeply into the relatively riskier developing-country equities markets. Brazil slashed its interest rate, as did Mexico, in response to the COVID-19 slowdown. Russian shares fell sharply as oil prices collapsed. An ongoing price war between Russia and Saudi Arabia had pushed down oil to punish their competition, then global demand cratered and supply flooded into container ships at sea.

Real Estate. Low interest rates should be a boon to the debt-dependent real estate business, but nothing really fixes the problem of rent strikes and empty commercial and retail space. When the economy is stressed lenders tend to walk away from property development, then problems compound as lease defaults pile up. Small business, office space, and malls were negatively affected by the general business malaise; even healthcare real estate faced stress as elective care was delayed to offset the impact of emergency response needs.

Income Asset Classes

U.S. Government Bonds and TIPS. It should come as no surprise that as investors fled the relative risk of equities the beneficiary was the relative safety of U.S. government debt. The Federal Reserve slashed the interbank borrowing rate to zero in response to the pandemic but that didn't stop fearful investors from flooding into bonds and even cash as refuge from howling market winds. The 10-year Treasury ended the quarter at a yield of 0.70%.

U.S. Corporate Bonds. While corporate bonds are usually viewed as a relatively safe place to park cash, they do represent risk compared to government bonds. Investor fear took over the market and public company bonds fell on concerns that flagging profits and declining debt quality would introduce unwelcome risk into the market. Liquidity also played a role as bond fund managers were forced to sell in order to fulfill redemptions as investors exited those funds. The Fed stepped in to support the corporate bond market as it tanked.

High Yield Corporate Bonds. The Fed announced plans to purchase high-yield bonds if necessary. Lower-quality bonds saw the worst of the flight to higher quality debt, Treasury bonds and cash. Recession fear overcame investor interest in the better returns often found in the junk bond market. Hardest-hit were companies related to travel and retail, as well as energy as the price of oil crashed to zero. The great unknown for investors remains upcoming corporate earnings statements.

Emerging Market Bonds. Local currency debt is highly sensitive to the direction of the U.S. dollar. While we purchase debt denominated in dollars, if the local currency weakens against the greenback, that increases the cost of the debt to the sovereign issuer. The declining oil price hurt economies dependent on oil exports most, but all economic growth has been put into question by the pandemic, causing investors to pull back on emerging market debt as a result. The rapidity of the decline makes comparisons to 2008 difficult but, all things being equal, a market in freefall should find buyers at some point.

Preferred Stocks. Preferred stocks got through the first couple of weeks of the broader stock market decline unscathed, though they eventually suffered sharp moves in both directions amid rising doubt about what exposure financial institutions have to bank loans likely to default if COVID-19 continues well into the future. The sharp drop in bank preferred-share prices suggests that investors believed that those loans represented a systemic threat to the financial system. Nevertheless, shares eventually recovered much of their losses and, while still down for the year, they are an essential part of an income portfolio and offer a high dividend rate that compensates investors for volatility.

The Rebalance Investment Committee

The **Rebalance** Investment Committee meets several times a year to review our client portfolio options, asset class selections, and overall economic factors. The Committee's goal is to curate client portfolios that generate the most investment return for the least amount of risk.

During the **Rebalance** April 2020 meeting, the Investment Committee evaluated two longer term risks as a result of COVID-19 and addressed them in the most recent rebalancing late April.

- In a world with near zero percent interest rates, the Investment Committee felt it important to seek alternative sources of income for our clients. In most portfolios, a high-yielding ETF was added with nearly 400 high-dividend paying stocks, including AT&T, Procter & Gamble, Intel, and JPMorgan Chase.

Due to unprecedented amounts of monetary stimulus, renewed inflation is now a rising risk. As a result, in two of the growth portfolios Treasury Inflation-Protected Securities (TIPS) have been added. This addition protects against rising inflation via an ETF collection of specialized U.S. Treasury bonds.

The Rebalance Investment Committee meeting in New York, April, 2019 (left to right: Scott Puritz, Charley Ellis, Jay Vivian, Burt Malkiel and Mitch Tuchman)

Burton Malkiel, Charles Ellis, and Jay Vivian comprise the core of the Rebalance Investment Committee. They are renowned for creating and implementing sophisticated investment methods used today by elite pensions and endowments.

Rebalance and its clients are fortunate to have such respected and savvy financial experts guiding key investment decisions.

Professor Malkiel is an Emeritus Princeton University economics professor, a former board member of The Vanguard Group, and author of the investment classic, "A Random Walk Down Wall Street."

Dr. Ellis was for three decades the managing partner of Greenwich Associates, the leading strategic advisor and consultant to large institutional investors around the world. He was Chairman of the Investment Committee of the famed Yale Endowment; and he has served on the governing boards of The Vanguard Group, Yale, Harvard, NYU Stern, Exeter, the Whitehead Institute and the Robert Wood Johnson Foundation.

Jay Vivian is the former managing director of the IBM Retirement Funds, responsible for more than $100 billion in IBM investment funds for more than 400,000 employees worldwide.

We thank them for their input and wisdom.
Very truly yours,

Your **Rebalance** Team