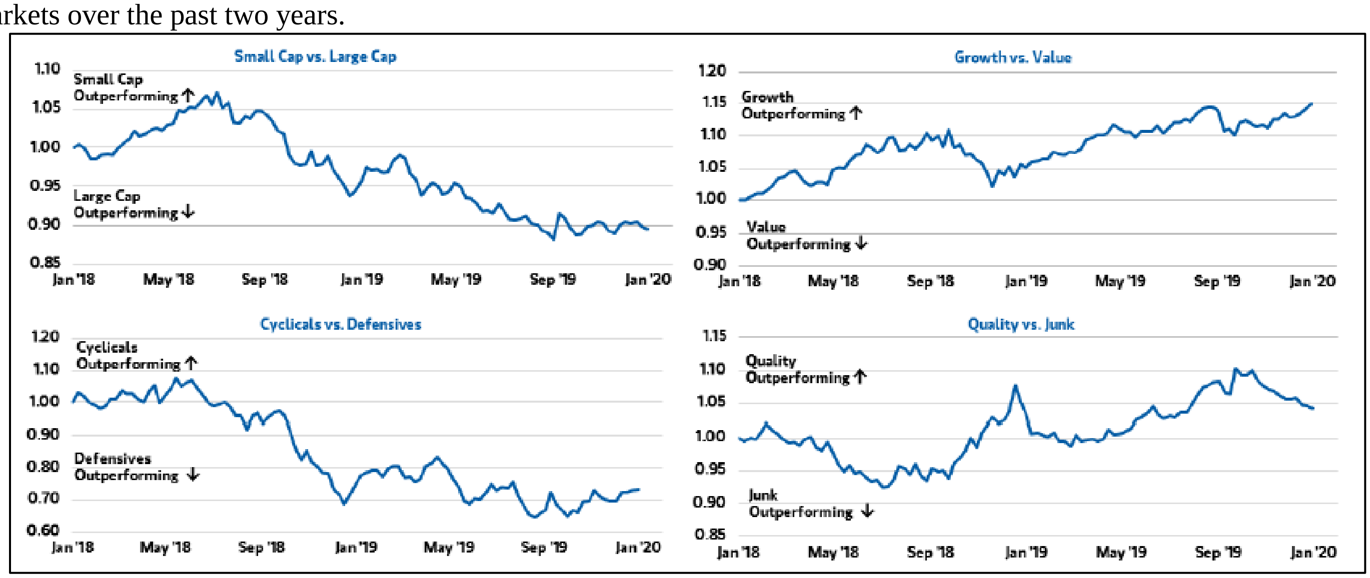
January 2020

INVESTMENT PERSPECTIVES

Upside-Down World

Investors typically buy stocks to participate in the engine of economic growth and purchase bonds for the stability of coupon income with the security of the return of principal, but 2019 was anything but a typical year. For most of our clients, we build portfolios that blend different assets based on their expected returns and tolerance for risk. Advances in technology are enabling broader access to information and increasing the availability of sophisticated investing tools to participate in a more extensive array of products, which is great news for investors and clients. Despite the introduction of more ways to participate in various corners of the economy, certain central tenets remain critical to successfully navigating different types of market conditions. In this *Investment Perspectives*, we will discuss some of the challenges we face in managing portfolios under never-before-seen market conditions. Market distortions have turned some traditional risk-return relationships upside-down, as many investors have been forced to seek yield through equities, while trading bonds for capital gains. This has prompted us to re-examine our perspectives on risk and expected return. We will explore the concept of '*Risk-Adjusted Returns*'[1] to shed light on how we allocate capital to different assets based on our view of the current risk-reward tradeoffs. We think this will shed greater understanding of our decision to target shorter duration bonds, and the caution we have applied to cash deployment within equities.

As hundreds of billions of dollars have flowed into fixed-income funds and ETFs, the resulting price explosion has lured even more return-chasing investors into securities they may deem safer than they are. Over the last ten years, the average annual return for investment-grade corporate bonds was under 6%, but in 2019 they returned over 17%[2]. Equities were not left out, by any means, with the S&P 500 nearly matching 2013 as the most significant gain since 1997. It was the best year in a decade for the Nasdaq 100, as Large-Cap Technology stocks rose 38%. But equity market returns have been uneven, leaving pockets of opportunity for those willing to look. 20% of stocks in the S&P 500 remain at least 20% below their highs of the last two years; amid small-caps, fully half of the S&P 600 stocks are still 20% below their highs. Just as investors chase returns in fixed income, perhaps unaware of the underlying risks, so too may equity buyers be unaware of the narrow group of stocks driving the indexes higher. The panel of four charts below depicts the tone and style of equity markets over the past two years.



[1] Calculating returns on a risk-adjusted basis is an attempt to normalize investment results so that returns between different assets or managers can be compared on a uniform basis. We want to know how much risk was taken in pursuit of returns.

[2] We used the iShares IG Corporate Bond ETF (LQD) as a proxy for investment-grade corporate bonds.

Source: Morgan Stanley & Co.

Always Asking 'Why'

Vital to us is not just the magnitude and direction of changes in asset prices, but also how and why prices move relative to each other. In short, the '*why*' is as important as the '*how much*.' Short-term price movements are often random, but over more extended periods, prices always move for a reason. Because money never actually leaves the financial system, the way it shifts between asset classes reveals clues about future investor behavior.

When investors get nervous about the future, they seek stability and security. This may mean shifting assets away from stocks and into bonds and cash; some will also buy gold. We mentioned earlier that asset prices behaved strangely in 2019, and we seek to understand why. Central banks pushed money into the financial system, which successfully promoted risk-taking. But how does that increase in risk appetite reconcile with other behavior?

- Why did gold have its best year since 2010, rallying 18% to surpass $1,500/oz?
- Why did investors pull money out of equities and pour hundreds of billions of dollars into bonds?

When markets are stable and rising, it's easy to take favorable returns for granted and lose sight of the risks. It's common to overestimate risk tolerance when things have gone well for a while. We are in such a situation now after concluding a decade of easy money made possible by easy money. It's not that we're looking for clouds inside of silver linings, nor are we bearish on the markets in general, but some of the inconsistencies in behavior among asset classes have made us more attentive to potential pitfalls.

Risk-Adjusted Returns

Risk and return have a friendly, symbiotic relationship. We can't have one without the other, but we always try to maintain a desired ratio between the two. The risk/return trade-off is stable, but it's not static; the relationship can become skewed at times when asset prices move in unconventional ways, for instance. If not managed through a proper framework, an investor's mood can influence the ratio in unintended ways. Complacency can allow risk to creep in, while fear can create missed opportunities. The net effects of investor risk appetite coursing through markets will shape our opportunity set because significant price moves can alter the risk-return ratio. We want to answer questions like:

- How did corporate bonds generate mid-teens returns in 2019 with current yields below 3%?
- What does this price behavior mean for the conventional risk/return relationship between stocks and bonds?
- Investors are pouring hundreds of billions of dollars into bonds; do they clearly understand the drivers behind the stated returns they are chasing?
- How did the S&P 500 return 31.5% in 2019 even as investors shifted money out of equities?

At a high level, looking at returns on a risk-adjusted basis is a way of putting returns from different sources onto an equal footing based on their riskiness. This widely-used concept can be applied when comparing individual securities, different portfolios, or asset classes. Each investor defines risk in their own unique way, but the most commonly-used metric is price volatility. Essentially, we want to know how much price uncertainty was endured on the path to generating returns. Generally speaking, smoother and more predictable returns on a portfolio are considered more desirable. Certain assets naturally bounce around more than others. For example, cash carries a volatility of 0%; comparing two equity portfolios with similar returns, but one of those portfolios has 10% cash/90% stocks vs. 100% equities, the portfolio with 10% cash will have higher risk-adjusted returns. Under most conditions, investors demand higher returns for enduring more price uncertainty. The overall volatility of a portfolio will vary depending on the mix of assets.

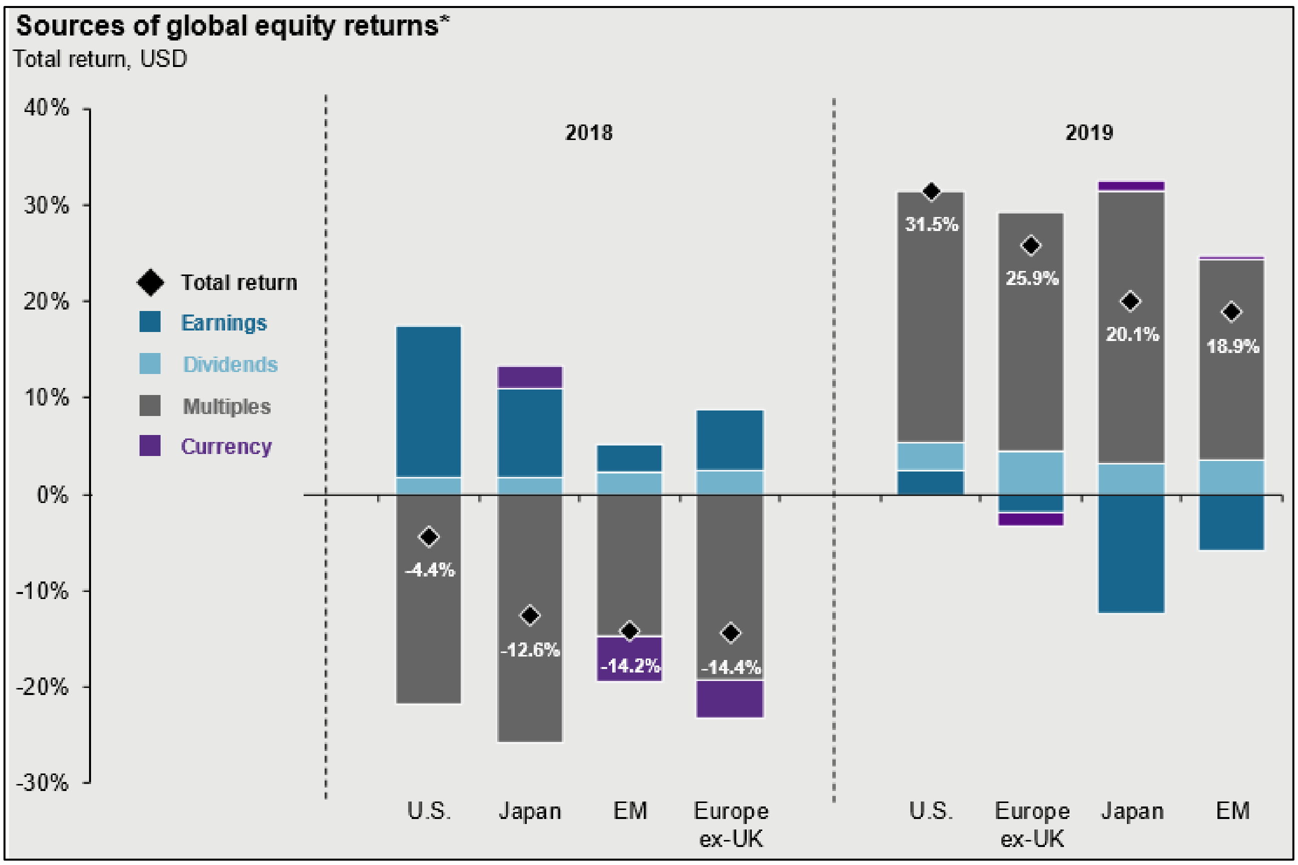
The risk tolerances among individuals vary. Imagine two skiers standing at the top of a mountain. They both want to get down to the lodge at the base of the mountain. Ultimately, their destination is the same, but there are two distinct paths to get there. One is direct, a steep run fraught with bumpy moguls. The other is a more gradual, smooth track which winds its way down the mountain. Both skiers get to the same destination, but each chooses the path best suited to their individual tolerance for risk. Investors make similar choices when evaluating risk/return trade-offs.

- Those who can tolerate more volatility may opt for a higher mix of equities in their portfolio. Historically, stocks have provided higher absolute returns than bonds and cash, but at the cost of higher price volatility
- Looked at over the past ten years, a hypothetical balanced portfolio of stocks, investment-grade corporate bonds, and cash (60% / 30% / 10%), generated lower absolute returns than the 100% equity portfolio but provided more return per unit of volatility

Risk Appetite

What do we mean when we say investors are increasing their appetite for risk, and how do we measure it? Embedded in any asset price is some amount of investor emotion. After determining an asset's intrinsic value, we can compare that to what other investors are paying in the open market. When market prices exceed intrinsic value, that difference can reflect investor enthusiasm. This means we can put dollar values around investor emotion for both stocks and bonds.

- For stocks, when investors feel more confident about the future, they pay higher prices for stocks, even if the fundamentals don't yet support such optimism. When prices rise, without a corresponding increase in earnings per share (EPS), that translates into a rising price-to-earnings ratio (P/E). When equities get more expensive through a rising P/E multiple, this is what we call '*Multiple Expansion*'
- For bonds, a similar risk expression can be measured; in this case, it's a credit spread, or the premium investors demand above the rate available on a risk-free asset. While P/E ratios increase with rising investor risk appetite, credit spreads narrow. The higher the prices that bond investors are willing to pay, the lower is the credit spread demanded to compensate them for risk



Source: JP Morgan

In 2018, the S&P 500 declined by 4.4% even though earnings grew by 22% and dividends added 2%. Strangely, the P/E multiple contracted by 28%. The 31.5% total return for the S&P in 2019 was a mirror image of 2018; the price change of 29% comprised only 2% earnings growth and 26.5% multiple expansion. Adding in dividends gets us to 31.5%[3]. The major difference between 2018 and 2019 was Fed policy; in 2018, the Fed was still raising rates, while in 2019, it pivoted toward easing. The important take-away is the extent to which investor sentiment plays a role in returns. In 2018, the strong earnings performance was overwhelmed by investor fears. In 2019, the Federal Reserve reignited risk appetite, which was transmitted through the 26.5% contribution from multiple expansion.

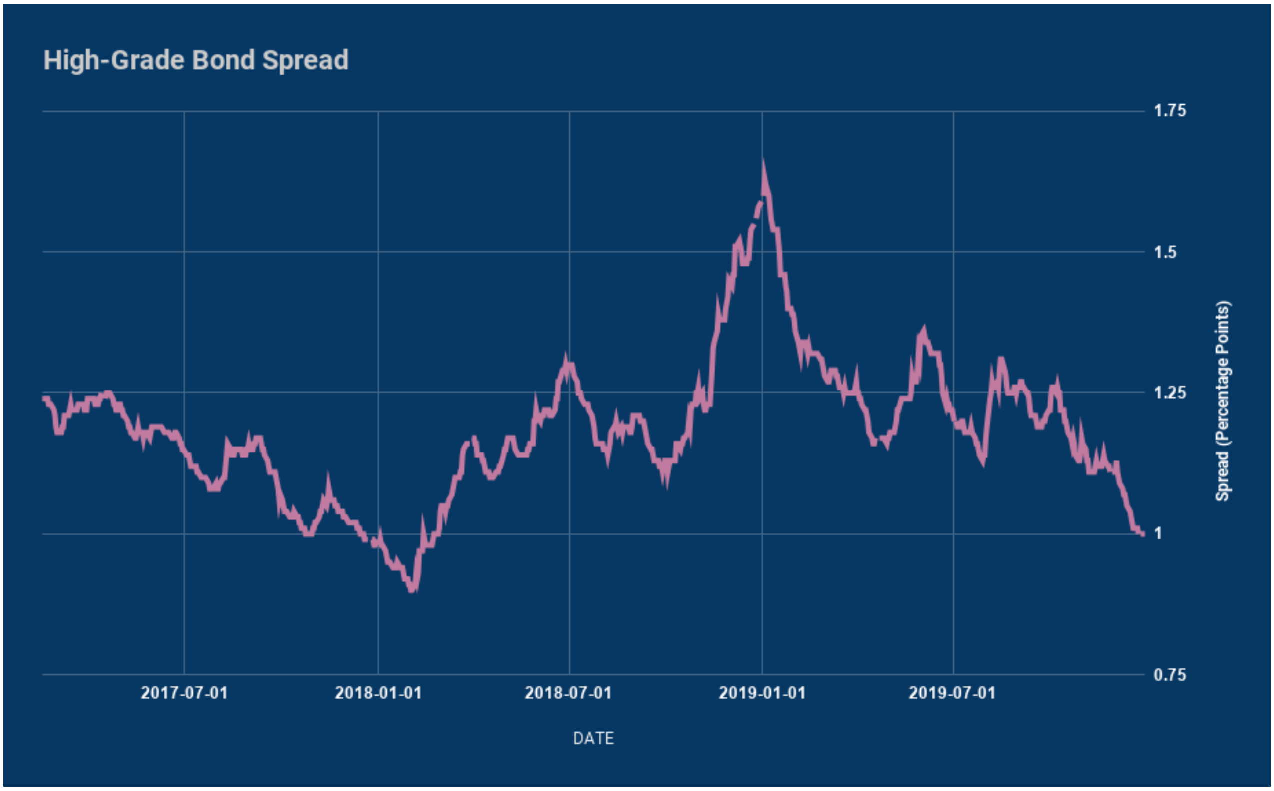
Owners of bonds can get returns from both coupon income and capital gains. If bonds are purchased at a discount (below par value) and held to maturity, the yield-to-maturity embeds the price appreciation (e.g., the YTM will be higher than the stated coupon). If a bond is purchased at a premium (above par) and held to maturity, the YTM will be lower than the

[3] Here's how the math works: 12/31/2018 the S&P 500 closed at 2,507 with EPS of $162, means the market P/E multiple was 15.5x; 12/31/2019 the S&P 500 closed at 3,231 with $165 of EPS, equating to a P/E multiple of 19.6x. S&P price change of 28.8% (2,507 to 3,231) comprised of EPS gain of 1.9% ($162 to $165), leaving the remaining 26.5% growth attributable to P/E multiple expansion (15.5x to 19.6x). Adding in the dividends of ~2.5% gets us to the 31.5% total return. Results subject to rounding.

stated coupon. A bond purchased in the open market and subsequently sold at a higher price, generates a capital gain in addition to any coupon income earned while the bond was held. A bond's price will rise when interest rates decline after that purchase. There are two ways that interest rates can decrease, thus driving a bond's price higher:

1. A decline in the yield curve whereby market rates or the benchmark government bond yields drop
2. A tightening of credit spreads, or a reduction in an issuer's yield relative to the benchmark rate

At the beginning of 2019, the credit spread on high-grade corporate credit was 160 basis points or 1.6%. This means if the 10-year US government treasury bond yielded 2.0%, 10-year corporate bonds, issued by investment-grade companies, would be expected to yield 3.60%. However, by the end of the year, this spread had declined (or tightened) by 60%, to a mere 1.0%, as depicted in the chart below. Tightening credit spreads for bonds is akin to expanding P/E multiples for stocks.



Source: Goldman Sachs & Co.

With the global central banks re-entering the markets with massive quantitative easing in 2019, and the commensurate rally across asset classes, we must adjust our perspectives on expected returns and future risk. When asset prices rise through increased risk appetite, we are pulling forward future returns into the present. We've seen these conditions throughout the past decade.

The performance of financial assets in 2019 came as a surprise to many, ourselves included. Financial markets incorporate new information quickly, and significant price moves come when markets are surprised. The Fed telegraphs its moves very clearly, so what was it that stunned markets in 2019? We believe that it was the decision to expand its balance sheet by $400 billion, on top of lowering rates, that proved a shocker. Our economy may not be robust, but it's growing faster than in Europe and Japan. That's why the Fed's $400 billion in money printing, three times greater than the ECB and four times more than Japan, came as such a surprise to markets. The Fed is adding $60 billion per month until April, at which time they think they'll be done. Our view is that the easy financial conditions today are likely to remain in place through the election. Absent a deterioration in economic conditions, the state of policy should be supportive of equity valuations.

Source: www.visualcapitalist.com

Optics & Perception

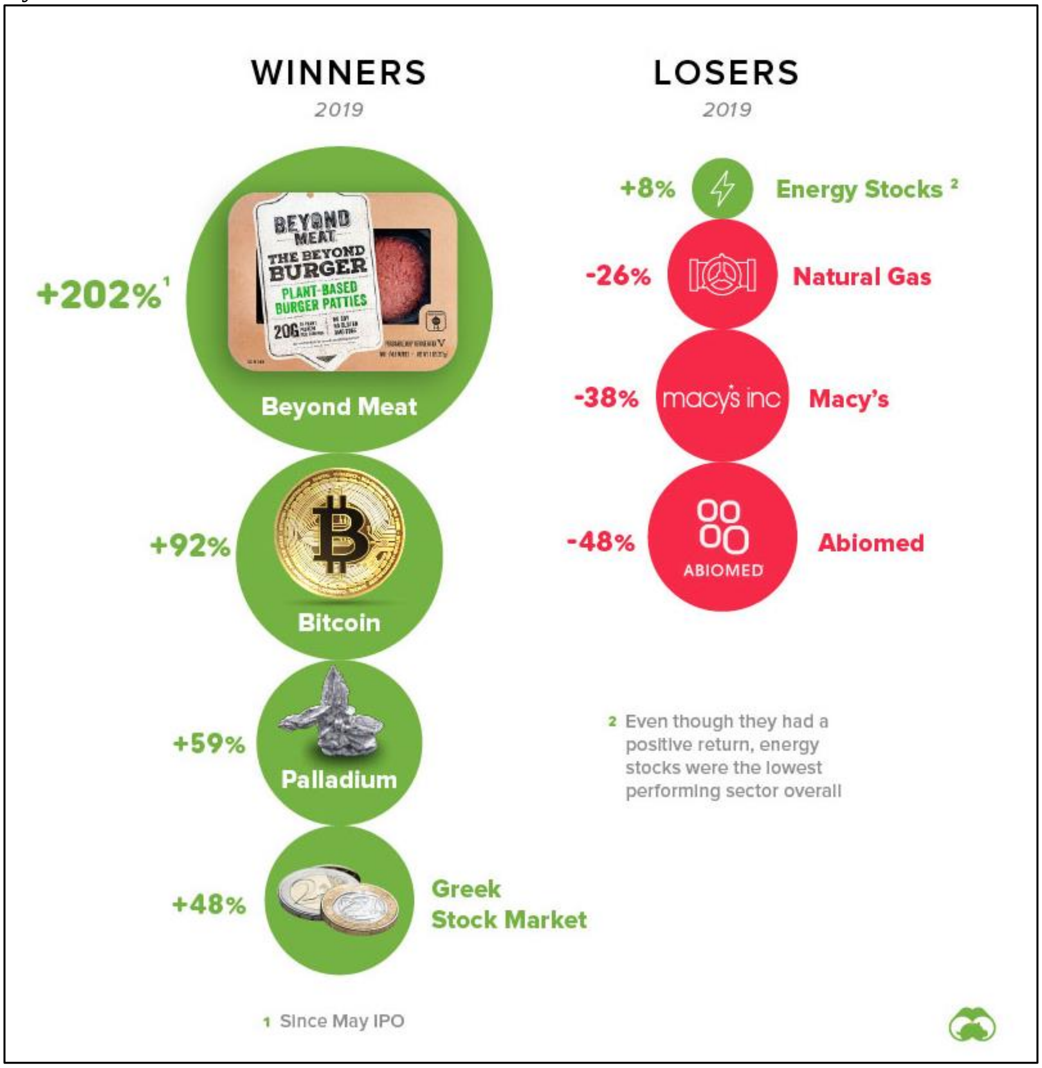
Human beings love round numbers and clean dates. While the tax collectors and the actuaries who calculate our returns take our measure from December 31 to December 31 each year, the stock market works on a continuum. The optimist might look at 2019's 31% gain and say, "*Wow, next year, it'll be up even more*," while the pessimist decries that it's sure to crash. Well, what if we were to look at it less like humans and more like computers? Hint, computers don't think about time the same way that we humans do. It could be argued that a big part of the success we saw from markets in 2019 resulted from a dismal fourth quarter of 2018. So, let's think about the 2019 return as if 2018 ended on September 30th rather than December 31st, thus removing the 14.5% fourth-quarter decline. In this case, the return looks a lot more like an average year at 10.4%. And if we extend our continuum back to 12/31/2017, the annual price change over the two years is a very reasonable 9.5%.

Supply & Demand

Back in 2011, Marc Andreesen famously said, "*Software is eating the world*." Eight years later, Software continues to gobble up the tech world, while humans are apparently eating a lot of fake meat. Even though it was publicly-traded for only half of 2019, Beyond Meat (BYND) was beyond belief, with its stock up over 200%. We have no particular view on BYND, and single it out only because it's a new company with a limited history but was quickly embraced by a market that is easily captivated by stories and visions of future growth.

Typically, when the products that companies sell go up in price, it's good for their business and good for their stocks. But in the upside-down world, it's best not to take traditional relationships for granted. In 2019, crude oil was the best performing asset class, while Energy stocks were the worst-performing sector. Supply and demand dynamics have been the key for speculators profiting in financial markets in recent years. With interest rates now able to go below 0%, traditionally conservative investors are trading bonds like speculators in Bitcoin. Bitcoin has no intrinsic value that we are aware of, trading on the emotion of supply vs. demand. Bonds trading with negative yields have indeterminate value with buyers today hoping that new buyers come along tomorrow and pay more.

Throughout 2019, investors worried about global growth. These fears emanated primarily from US/China trade tensions. In response, they sold cyclical stocks, such as automobile manufacturers. Palladium is a mineral used by automobile manufacturers to improve emission control systems. Granted, the mineral is in short supply, but 85% of it is used by auto manufacturers. So, while one group of investors was selling auto stocks thinking production was about to collapse, another group was driving Palladium to all-time highs as global automakers continue manufacturing over 70 million internal combustion-powered automobiles every year. We highlight these points because the relative movement of asset prices can provide insight into the state of markets, the degree of speculation, and hints to future investor behavior. Beyond Meat issued stock to the public on May 1, 2019, at $25 per share. By late July, it had skyrocketed to nearly $235 per share (↑ 840%), giving it a market capitalization exceeding $14 billion. By early November, it fetched under $80 per share (↓ 66%). Again, this is not a commentary or criticism of Beyond Meat, but rather an illustration of the connection between volatility and speculation. When we see signs of excessive speculation, we start looking around for the next pockets of volatility.



Source: www.visualcapitalist.com

Conclusion

In 2018, the Fed was draining liquidity from the financial system, performing the normalization we had long expected. Our belief that asset prices have grown dependent, if not addicted to money printing, was sadly borne out as nearly every asset class corrected by 20% at some point over the course of the year. The power of central bank-liquidity to lift asset prices in 2019, in the absence of strong fundamentals, sets the stage for a very interesting 2020. As 2020 is an election year, it is unlikely that we can count on money printing from either the Fed or the US Treasury. Shifts in policy are shunned during election years to avoid the appearance of manipulation. In 2020, we can expect broad market behavior in the US to be driven by fundamentals rather than by changes in system liquidity.

Even though many asset prices are at all-time highs, there's good news for investors like us who still choose to be choosy. At the end of 2017, we started to see cheap stocks get cheaper, while expensive stocks got even more expensive. Granted, there are a lot of stocks that are cheap for a reason, but there remain genuine bargains to be found in this market for those investors willing to do the necessary work to separate the wheat from the chaff. Garnering the highest returns in financial markets over the past ten years required a consistent willingness to take more risk. Within fixed income this was done by extending duration or accepting lower credit quality. For equities, it meant being fully invested all the time and buying the largest, highest growth, highest P/E stocks. We believe that generating superior returns over the next ten years will surely require higher selectivity and a more contrarian viewpoint.

As of December 31, 2019, the following were the ten largest holdings of HCM:

Name of Issuer	% of Equity Portoflio	12/31/2019 Closing Price
CVS CAREMARK CORPORATION	4.76%	74.29
WELLS FARGO & CO	4.67%	53.80
INTEL CORPORATION	4.65%	59.85
CABLE ONE	4.47%	1488.47
MARKEL CORP COM	4.43%	1143.17
CARNIVAL CORP	4.05%	50.83
MERCK & CO. INC.	3.99%	90.95
APPLE INC	3.86%	293.65
ROBERT HALF INTERNATIONAL INC	3.82%	63.15
JACOBS ENGINEERING GROUP INC	3.71%	89.83

At 12/31/2019, neither HCM nor any of its clients owned shares of Beyond Meat (BYND).

For a complete list of holdings, please see our most recent 13F filing on the following SEC website:
http://www.sec.gov/edgar/searchedgar/companysearch.html

HCM's investment decision making process involves a number of different factors, not just those discussed in this document. The views expressed in this material are subject to ongoing evaluation and could change at any time.

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