

Taking the Long View

July 7, 2020

We certainly live in extraordinary times, and the realities of a pandemic have become an unexpected new normal. Yet, the US stock market posted one of its best quarters ever, with the S&P 500 rising 20.5% in the second quarter of 2020, reclaiming all of the ground lost in a terrible March. Americans are discovering the balance of economic openness and viral transmission. The stock market seems to understand this while also appreciating the high probability of ongoing economic support from policymakers.

We have always believed the best investment strategy is to own high-quality growth companies with enduring business models, rather than try to switch holdings based on an uncertain outlook or fear. To this end, we believe the Oak Funds are well positioned to weather the uncertainty. We have made changes at the margin to reflect a shift in the outlook for specific sectors, but as the economic picture becomes cloudier, our companies actually appear more attractive. Our concentrated, actively managed strategy also enables us to avoid those sectors and companies most at risk.

It is difficult to reconcile the stock market's behavior during this health crisis. Certainly, the massive stimulus and the Federal Reserve's (the "Fed's") willingness to unwaveringly aid the economy if needed have provided support for stock prices. Optimism that the strong economy entering the pandemic would rebound once the lockdown restrictions were lifted has also helped. Ultimately, the quantitative easing, bridge-lending to businesses, and direct consumer payments through the Paycheck Protection Program and Cares Act will likely flow into asset prices, thereby benefiting equities. Cash on the sideline has soared to record levels due to panic selling and the direct stimulus payments. Within the uncertainty of pandemic direction, tailwinds to equities do exist.

Long-term, stocks will remain focused on the economy and earnings. The coronavirus is a short-term problem that will eventually end. In this situation, it may be a vaccine, the development of a treatment for those affected, or successful social distancing practices. In reality, a solution to end Covid-19 (or any virus) already exists, but only if the citizenry is willing to endure the short-term pain of economic suppression, strict social distancing and hygiene practices that break the transmission chain. So, while cases may be surging in certain parts of the US, this might actually accelerate a shift in behavior that expedites the disease's demise.

Thus far, the stock market has absorbed coronavirus volatility well. While still early, the sharp rise in unemployment has yet to produce problems with mortgages, delinquencies, or consumer confidence. These remain areas to watch for deeper stress on the economy. Yet the stock market seems somewhat unconcerned because it takes the long view.

In our opinion, the best working example of the investment environment for this pandemic

economy remains the 2000 Dot-com recession. After a massive capital-expenditure cycle driven by Y2K and the birth of the internet, economic activity slowed, leading to a recession. When major tech companies reported flat earnings growth after years of double-digit increases, stocks corrected sharply in Q2 2000 but recovered over the next four months. Market participants were digesting whether the drop in growth was temporary or would produce a sustained recession. In hindsight, reality set in around October 2000, and the ensuing bear market lasted a total of 31 months. Summer 2020 is probably a similar limbo period as, either the economic rebound unfolds; or unemployment, bankruptcies, and contagion uncertainty persist to overwhelm the market. One notable difference, however, is the fact interest rates are already very low and policymakers understand the need to be as accommodative as required.

When taking a 30,000-foot view, equities tend to enjoy a low interest rate, slow growth environment with no inflation, which is what the Fed has engineered. The equity market's valuation remains attractive in the context of historically low Treasury interest rates. Finally, relative to other investment options including bonds, stocks offer higher earnings yields, growth potential, and benefit from the support of dividends or buybacks.

We continue to monitor the risk to the economy and our portfolio companies. Stay safe.

Thank you for reading.

Robert Stimpson, CFA, CMT
Co-Chief Investment Officer & Portfolio Manager

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