Market Update

April 2020

While the market remains very volatile, the market has continued its upward trend since bottoming out March 23. In fact, April turned out to be, historically, one of the market's best months.

I. The Recent Rally

While some commentators are concerned about this upward trend ("too soon", "too fast", "ignores reality"), things are not quite as they seem. The market's upward movement has been led by only a small percentage of companies.

First, Amazon, Facebook, Microsoft, Apple and Google now make up 20% of the entire US market (Market Insider). These companies' returns skew the index. While the vast majority of US stocks have not experienced the rebound, one would not know this looking at the index, which, by definition, has much heavier weights in these, the largest companies.

Second, the markets have also been pushed upwards by 'short covering'. Remember that a 'short' is when one sells a stock one does not own (one borrows it) with the plan of buying it back later at a lower price. This was done to record levels recently with companies that are financially week, uncompetitive and poorly managed. The expectation was that these companies, in particular, would keep falling. Instead these companies stopped falling and started to rise modestly. At that time those who shorted these companies began to buy back the shares they needed ("covering" their short, that is, replacing the shares they borrowed) driving the prices upward. The result was a large amount of buying in these inferior companies, driving their share prices higher and higher.

As a result, the market rally has been led by the large tech companies (we own some of these) and inferior companies (we never own these), leaving out the vast majority in the middle.

Entire assets classes have barely experienced the rebound. Preferred shares, Small Cap, Emerging Markets, Real Estate, and more, have only rebounded slightly.

Such a 'narrow' rally is not a healthy sign. We are still waiting for the broad based rebound that signifies a market recovery.

Third, it is important to remember how misleading percentages can be. If a market falls 50%, it must rise by 100% to return to its former level. For example, if $10 falls to half at $5, it must double to get back to $10. By March 23, markets had fallen almost 40% (in our example that would be a drop from $10 to $6) and so it must rise by 66% to fully recover ($6 to $10). Since March 26 the market index has risen by 33% ($6 to $8) which is impressive, but that leaves us only half way back.

In short, while a 33% increase is significant, it is in only a few companies and it still leaves us only half way back to fully recovering. The broad market still has a way to go.

My conclusion is that there remains many attractive long-term investments for those who are selective and patient. Our managers had done and do their research. The managers were prepared, knowing what price they wanted to pay for which companies. There have been many changes in the underlying portfolios (topic for a future email) as these opportunities have drawn the attention of our managers. They know the companies they are buying, they know their potential, and they see the opportunity. We look forward to the future returns on these investments.

II. Markets hate Uncertainty

In normal times companies face a great deal of uncertainty. Will new products sell? Will they be made profitably? Will management make the right decisions? Will the company be able to expand and so increase its revenue base? Will the company buy out a competitor, and if so, will they do it profitably? What can go wrong? If things go wrong how bad can it get? ... these are only a few of the many questions fundamental research addresses.

The research seeks clarity and a limit on uncertainty. Knowledge and understanding are the basis for true investing, and they are the basis for manager's reactions. For example, when a stock falls, do they buy more or sell. Without such due diligence and knowledge one is flying (at least half) blind.

But at times like today, many answers are either unobtainable or highly uncertain. Those companies with the most uncertainty are simply avoided. Investors await at least some clarity.

This explains certain sectors, such as real estate. This is one area which is dependent to a fair degree on the success of other people and/or companies. Rents are paid by those who are employed and by companies that are going concerns. Looking forward, will people and companies be able to pay their rents? Will they be looking for smaller spaces as more people work from home? Or will they need more space to provide more room per employee? Will malls be able to reopen if crowds are not permitted / avoided? In short, this is an area of great uncertainty and so some real estate companies are down 50%! I believe they will recover, but in sectors such as these, it will take more time.

Looking Forward

Simply put, either things get better from here – countries continue to open up and learn to do so safely, people go back to work and a new normal, one of the now 105 companies working on a vaccine succeeds (a few are in human trials) - or they get worse – opening up too early results in a second wave, vaccine trials all fail, we are forced back into our homes again. In truth, the market is always a constant battle between things getting better or worse – which explains the volatility – and in the end, the market's price is the balance between the two competing views. But this time there is a difference in that the upside and downside cases are further apart than we would normally see. Thus high levels of volatility should continue. No one knows what is going to happen and uncertainty is everywhere.

As for investing, we like the positions we hold and do not wish to sell. In fact we are continuing to buy, though selectively. Many stocks and bonds are inexpensive, and we remain convinced that superior companies and investments will rebound in time, providing attractive long-term returns. The temptation to sell in the hope of buying back at even cheaper levels is a constant topic in the media, but it is near impossible, and the damage done in such attempts outweighs the rare occurrence of success .

We remain focused, selective and patient.

Have a good month and let us know if there is anything we can do to help,

- Meir

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