WOODSTOCK

Quarterly Market Perspectives

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A quarterly newsletter offering our views on the market and economic topics of interest to investors.

A Perspective on Volatility, Complexity, and Other Asset Classes

William H. Darling, Chairman & CEO

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We feel we should be clear: there is volatility to be worried about. An article on "accounting for survivorship"[1] sought to explain the survivorship bias in looking at US international dominance when measuring "country-specific real equity market returns" from 1900 to 2019. As the Morningstar article points out, in 1900 the United Kingdom dominated the world equity market with a 25% share, while Germany, France and the United States held roughly 15% shares each. As we pointed out last quarter (see QMP Summer 2020), by 2020 the United States accounted for almost 55% of the world equity market itself. The authors of the article rightly point out that for equity markets in Germany, Russia and Japan, "being on the losing side of a world war or two, the overthrowing of capitalism or just prolonged poor market performance would have wiped out the capital investors." Certainly.

Not seeking to be flip, but standard investment advice is good only if a conflagration doesn't start in the South China Sea and expand from there. On their time scale, the authors point out that "lower volatility," as measured by the standard deviation of investment returns, seems to relate to higher "compound annual returns" by country. To state the obvious, the volatility of Germany was "extreme" and it negatively affected returns on capital.

Hard Versus Manufactured Volatility

We'd call this "hard" volatility. On the other hand, without some volatility, Wall Street can't make money trading financial instruments. Manufactured or incidental volatility is something that long-term investors can weather and survive. It is why we believe that volatility does not equal risk, most of the time. We'd differentiate between "hard" and "manufactured" volatility, however.

As one of our own portfolio managers has pointed out, if US equity investors can expect a long-term, inflation-adjusted return of 7-8% per year and the prior ten years yielded a 13% annualized return, a regression to the mean may require less than a 7-8% return for the next ten years to balance out. Investors may search for other investment vehicles to boost their return. We are familiar with other areas of investment focus such as private equity, frontier and emerging markets, inflation hedging with energy and metals investments, hedge funds and even investments in rare earths elements. (The trick to remember with the latter is that rare earths elements are not rare.) Someone will always be promoting an alternative to US stocks, so we keep watching and reading.

[1] *Morningstar, March 2020*

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One item that caught our eye was the news that Harvard University's endowment is undergoing a refocus from teams of in-house professionals[2] managing their different classes of investments to having most of them managed by outside professionals. The latest group to exit in-house status was the natural resources group, which includes timberland, vineyards with accompanying water rights, soybean plantations and olive oil pressing. These assets are typically very hard to value, so how accurate could an annual return calculation on these assets be? When Harvard's present endowment chief arrived in 2016, he took a few months and then "wrote down the natural resources portfolio's value by roughly $1 billion, the portfolio's biggest loss since its 1997 inception." The chief took a "more bearish view," probably accurately, but he didn't look up values in the Wall Street Journal.

He may have recognized what a letter writer to the WSJ realized. The writer listed the "keys to trading" in the agricultural markets as follows: 1. you must understand the fundamentals of your market; 2. your information flow must be equal to or better than the competition; 3. you must be able to recognize the underlying reasons for what is happening in the market; 4. it is very helpful to trade a large book, so that you can both hold a core position and then trade smaller amounts either offensively or defensively around the core position to defeat the algorithms; and 5. patience: algorithms are stubborn, and sometimes it takes several days or a week before a trade can be reversed "in the money." [3]

Currency Risks

For US investors in foreign and emerging markets, a major concern is currency risk. A recent WSJ article sought to explain why more risk didn't mean more return in emerging markets and found that "since most companies operating in a particular country have a good portion of their earnings coming to them in their local currency, this leaves any US dollar-based" investor in them "exposed to fluctuations in the local exchange rate,"[4] which affected returns negatively. The solution is not easy; perhaps purchasing currency to move with, or against "the US dollar's fluctuations against the currency in question."

Up until recently, protecting a portfolio from the "cruelest tax," inflation, meant purchasing exposure to energy and metals.[5] Bonds carry a special risk when emerging from a low interest rate environment: loss of capital if not held to maturity. However, the two sectors of energy and materials "now make up 5% of the S&P 500 – about half their share from five years ago" – for a variety of reasons. The downward pressure on these values may be alleviated by inflation, but when and how are very relevant here and not obvious.

What Next?

So here we sit, after ten very good years, surveying the alternatives. We prefer to spend our time understanding "complexity" by reviewing the approximately 100 companies we're interested in for their present situations, plans for the future, and their managements' ability. The complexities of valuation, currency effects and hedging for other assets classes seem to outweigh analyzing an individual company's attributes, perhaps not to the benefit of the investor.

We know that you are the most valuable business development tool that we have. Your referral of a friend, colleague or family member to us is the most important way that we grow.

We thank you for your support and want you to know that we are dedicated to serving your best interest.

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[2] *WSJ, 10/9/2020, p. B10*
[3] *WSJ Letter, 8/1-2/2020*
[4] *WSJ, 10/5/2020*
[5] *WSJ, 10/3-4/2020, p. B12*

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"The COVID-19 pandemic has also had an interesting effect on consumer behavior."

"Covid Stocks" and Pandemic Ripple Effects

Lawrence S. Foster, Vice President

US equity markets had a good third quarter (+8.9%) despite a rough (-3.8%) month of September. July and August were strong, driven primarily by the notion that much of our economy can function even with part of it disabled by a pandemic. Many of the same stocks that drove the market in April, May and June continued their strong performance, though the highest flyers suffered more in September. Volatility was up in September, with 17 of the 21 trading days showing a spread between the daily high and low of greater than 1%; two of those days had a spread in excess of 3 percent.

As the market roared back from the depths of fear in March, a new term entered the lexicon of our financial markets: "Covid stocks." These stocks are representative of companies that have benefitted from the COVID-19 pandemic. Clear examples include technology companies providing the hardware and software that enable remote work, remote meetings and remote learning. In addition, there are cloud-based services companies that have excelled as their offerings are by definition remote from their users. Furthermore, the Silicon Valley cadre of tech employees is as flexible as the open floor plans their companies have adopted. Working remotely for them is part of their culture and allowed this sector to keep the rest of us capably functioning away from our office settings. Other COVID-19 beneficiaries included retailers labelled as "essential." Those businesses that were prepared to handle customers in person or online with alternative shipping or pickup options have prospered. Manufacturers of essential products had to adapt to both changing markets and provide employees with a safe work environment.

New Consumer Choices

The COVID-19 pandemic has also had an interesting effect on consumer behavior. With a huge percentage of the US population stuck at home (and working from there), many discretionary purchases were deferred. Spending on travel and leisure activities was nil. Yet,

when the market showed some resiliency, consumers with adequate resources felt empowered to spend. Anchored at home, we found our home offices may have been inadequate, and we needed home exercise equipment or perhaps new furniture. When the weather improved, we turned our attention to the outdoors and more Americans took up gardening than ever before. Companies addressing these needs found themselves well positioned.

With COVID-19 making urban life more challenging, city dwellers (particularly millennials) began looking for suburban housing options. This trend accelerated when urban unrest turned violent in June and July. These new, young suburban families need two cars with at least one large enough for four, plus all the gear four people require for a weekend away. Furthermore, people who were accustomed to using ride-sharing services like Uber and Lyft have begun to opt for their own space and greater independence and are purchasing autos too.

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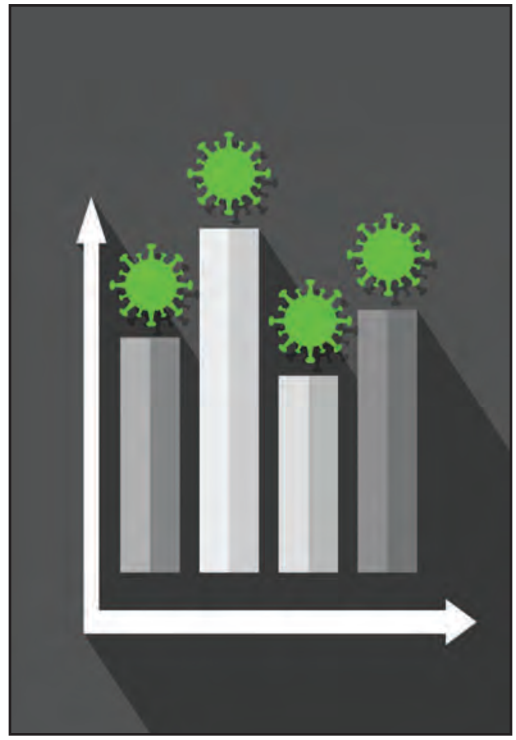
Changing Industry Fortunes

As Americans adapted to working remotely and life with social distancing, real estate well beyond suburbia heated up. Other factors influencing this could be an unwillingness to fly to vacation destinations and stay in hotels or other "publicly available options." Traditional summer communities and more remote mountain, lake and seaside vacation spots experienced strong demand. Inventories of condos and homes for sale dropped to lows of 2.9 months, where 6 months is considered "equilibrium." Real estate turnover begets home improvement spending. Strengths in housing and autos have typically been signs of a very healthy economy.

Despite the fact that the travel and leisure world is suffering like never before, it makes up only one small segment of our economy. Business travel has been replaced by Zoom video conference calls. Companies are saving on travel expenses, likely offsetting COVID-19-related expenses (sanitation, social distancing, employee physical separation measures) and those that can are offering employees the option to permanently work remotely. Restaurants are another service industry suffering greatly. Even operating at 25-50% of capacity is unlikely sufficient to provide ownership a decent return on their investment. Those who worry about restaurant failures should be reminded that restaurants have always come and gone. The industry is notorious for quick successes and equally fast flameouts. Once the pandemic ends and restaurants can open, new capital will fund the best opportunities and the entrepreneurs will return. It's what capitalists do in a free society. Meanwhile, the government will have to take care of the wait and kitchen staff who are out of work by providing ample unemployment benefits.

Look Long-term Amid Uncertainty

Investors have been inundated with quite of bit of noise on the health of the economy, the health of consumers, the likelihood and size of another stimulus package, predicting election results and the ongoing pandemic. All these factors impact corporate revenues and profits expectations. We always have conflicting in



formation or conflicting interpretations of various sources of data and other information. Election polls, for example, can vary significantly, and we learned in the 2016 presidential election the polls don't always predict the result accurately. Pollsters don't want to be incorrect and therefore adjust (presumably) their methodologies to try to better collect and analyze their data to provide a more accurate prediction. However, the uncertainty remains and both opinion and bias impact both the interpretation and the presentation of data.

September's market reflects this uncertainty. Since the election has apparently been settled, the market has reacted positively. The positive pricing action most likely reflects a hopefulness for more constructive behavior by the political class and the prospects for a balanced government which will be forced to compromise rather than force its economic philosophy on the electorate. Furthermore, we know that despite the current pandemic, the economy will likely come out the other side and be pretty healthy. Long-term investors should be prepared to take advantage of post-election volatility to invest idle cash.

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Tax Update

William H. Darling, CPA – Chairman & CEO

Jeanne M. FitzGerald, CPA – Tax Manager

Will the Tax Bite Ease?

The day-to-day quest to lower the bite of taxes continues. Examination rates for the IRS now defy logic. For all individual returns the examination rate for tax year 2018 was 0.15 percent.[1] For income over $100,000, progressing by categories to income over $10 million, the examination rate varied from 0.05% to 0.03% annually. This is where the money is. For incomes of zero, yes, that's right, zero, the examination rate was 0.31 percent. Fraud, particularly regarding the earned income tax credit (EITC), causes the focus. Using the tax code for social engineering rather than collecting money does skew the system. Some other things require attention, but don't get it.

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The taxability of social security benefits, meaning "the percentage of social security benefits received that were included in taxpayers' adjusted gross income," rose from 21% in 1992 to 48% in 2017.[2] When paid into the social security "trust fund," an individual's payments were not deductible. The income tax was calculated on income before social security payments, everyone's W-2, box 1. Now to tax that portion of the "benefits" again defies more logic. It's just an easy target.

Tax Season Surprises?

What will be the biggest surprise this tax season? According to the National Taxpayer Advocate Objectives Report to Congress for Fiscal Year 2021, key points for improvement are updating hardware and software, modernization of technology, use of digital communications, and electronic production of documents in a secure environment.[3] The IRS is now behind the times electronically. Coming into the train tunnel at the other end are stimulus checks received, which, as you may remember, are merely advance payments of a 2020 refund due to be paid, if earned, in 2021.[4] If not earned, what happens? Give it back! Adding to the potential mess are the executive order for payroll tax cuts and the confusion around teleworking both for employees ("domicile") and for companies ("nexus") (see QMP Summer 2020).

"The IRS is now behind the times electronically."

Qualified Charitable Distributions

Even though required minimum distributions have been suspended under the SECURE Act for IRA owners over 70½, a qualified charitable distribution (QCD) can still be made for 2020. Because of the larger standard deduction now available, "if clients are giving to charity anyway and they qualify for QCDs, then this is the way they should be giving."[5] Because a QCD from an IRA is not included in the income of the taxpayer, then adjusted gross income (AGI) is not inflated by the gift. Because AGI determines the "availability of tax deductions, tax credits and other benefits," such as the taxability of social security benefits and the surcharges for Medicare, this is an important benefit. These gifts must be made before year-end.

If you or any of your other advisors have questions about the issues raised here, please contact your investment manager or one of us.

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[1] *Journal of Accountancy, October 2020*

[2] *Journal of Accountancy, August 2020*

[3] *Journal of Accountancy October 2020 and https://taxpayeradvocate.irs.gov/reports/fy-2021-objectives-report-to-congress/full-report.*

[4] *WSJ, 9/29/20*

[5] *Financial Advisor Magazine, October 2020*

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All of us at Woodstock extend our best wishes to you for a joyful and healthy holiday season, as well as a happy and prosperous New Year!

Your ideas and questions are important to us. What would you like to see in our Quarterly Market Perspectives? Please contact your portfolio manager, or anyone from Woodstock's team of professionals and let us know.

We want to hear from you!

If you're new to Woodstock, you can reach us at **info@woodstockcorp.com.**

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