Weekly 3

WHAT YOU NEED TO KNOW ABOUT THE MARKETS

May 6, 2020

ORION

New Highs by Year-End? | Future Investing Mindset | Buffett Speaks

By Rusty Vanneman, CFA, CMT
May 2020

- April was the best month for stocks since 1987.
  - Expect more extreme volatility, including the possibility of new all-time highs before year-end.
- How should long-term investors adjust their mindsets?
  - Expect lower financial market returns going forward. That means save more, invest more, and diversify more.
- Warren Buffett speaks:
  - Don't bet against 'American magic'.

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Market Performance

as of 05/01/2020

FIXED INCOME	10-YEAR	5-YEAR	3-YEAR	1-YEAR	YTD	QTD	APRIL
Cash Equivalent[1]	0.58	1.11	1.70	1.78	0.41	0.28	0.01
U.S. Investment Grade Bonds[2]	3.96	3.80	5.17	10.84	4.98	3.00	1.78
EQUITIES	**10-YEAR**	**5-YEAR**	**3-YEAR**	**1-YEAR**	**YTD**	**QTD**	**APRIL**
Global Equity Market[3]	7.05	4.33	4.34	-5.25	-13.26	-12.26	10.70
Total U.S. Market[4]	11.45	8.54	8.34	-0.56	-10.07	-10.10	13.21
Domestic Large-Cap Equity[5]	12.08	9.97	10.46	3.70	-7.23	-7.69	12.94
Domestic Small-Cap Equity[6]	7.84	2.31	-1.33	-17.50	-21.62	-19.50	14.60
International Equity[7]	3.18	0.06	-0.15	-11.36	-17.72	-15.47	7.82
Developed International Equity[8]	3.53	-0.01	-0.36	-11.15	-17.86	-16.21	7.22
Emerging Market Equity[9]	1.95	0.18	0.59	-12.04	-17.32	-13.31	9.55
DIVERSIFIERS	**10-YEAR**	**5-YEAR**	**3-YEAR**	**1-YEAR**	**YTD**	**QTD**	**APRIL**
Diversified Alternatives[10]	1.46	-1.00	-1.83	-6.21	-9.50	-9.15	5.01
Commodity[11]	-7.07	-9.07	-8.62	-23.18	-24.47	-18.48	-1.54

Source: Morningstar

[1]Morningstar Cash Index [2]Bloomberg Barclay's Capital U.S. Aggregate Bond Index [3]Morningstar Global Market Large-Mid Index [4]Morningstar U.S. Market Index [5]Morningstar U.S. Large Cap Index [6]Morningstar U.S. Small Cap Index [7]Morningstar Gbl ex U.S. Large-Mid Index [8]Morningstar DM ex U.S. Large-Mid Index [9]Morningstar EM Large-Mid Index [10]Morningstar Diversified Alternatives Index [11]Bloomberg Commodity Index.

The Weighing Machine podcast is on Google Play and iTunes.

On Orion Portfolio Solutions' The Weighing Machine podcast, Rusty Vanneman and Robyn Murray cut through the market clamor and focus on time-tested, proven principles that help financial advisors and investors reach their long-term financial goals.

Market Update Video

April Market Review and Outlook

Review

April was a "wow" month — in a good way. The rest of the year will likely add more wows. April was the best month for the U.S. stock market since 1987. It was almost the best since 1974, but the losses on the last day of the month held it back. This followed, of course, a bloody first quarter.

Over the last 20- and 50-year periods, April has been the best month of the year for generating the highest average monthly return. This year fortified that statistic.

Will April be the best month of the year? Given it was the best month in many years, it probably will be. But don't count on it yet. Considering the sharp volatility of the markets, combined with extraordinary factors that qualify as kindling for more volatility, such as economic and health data, anything is possible this year.

And it certainly has been volatile in the stock market. After the fastest 10% loss, the fastest 20% loss, and the fastest 30% loss from a record high ever, the market turned around and produced the shortest bear market on record at just 33 days (a bull market is defined as a rally of 20% off the lows after a 20%+ loss from record highs).

Later in this section, we will discuss some reasons the market may climb higher. But first, the numbers from last month, which are a lot more enjoyable to review than the last few months'.

In April, the U.S. stock market rose more than 13%. Investors made nearly $3 trillion last month and have now made a total of $6 trillion since the beginning of last year.

Small-cap companies were up nearly 15% in April. International markets lagged, up less than 8%, with emerging markets (+10%) outperforming developing markets (+7%). Among diversifying asset classes, bonds were up nearly 2% while commodities were down nearly 2%.

Outlook

It may seem hard to fathom that April's returns were so strong considering the many unknowns about COVID-19 and the extraordinary economic backdrop. There continue to be many concerning elements at play, such as:

1. **The possibility the bear market may retest its lows or hit new lows before a genuine, new bull market can begin**
2. **Exploding federal deficits**
3. **High valuations**
4. **Lower corporate earnings**
5. **Lower economic growth**
6. **Lack of a vaccine or effective treatment for COVID-19**

There is truth to each of these concerns, of course. But it's important for long-term investors to note that none are likely to stop the stock market from generating long-term positive returns or even, possibly, hitting new highs this year.

RUSTY VANNEMAN, CFA, CMT
Chief Investment Officer

Rusty Vanneman serves as Chief Investment Officer (CIO) for Orion Advisor Solutions, where he is responsible for overseeing the investment processes across Orion and its subsidiaries, including CLS Investments.

*Mr. Vanneman joined CLS in September 2012 as CIO. Previously, he served as CIO and Portfolio Manager at Kobren Insight Management (KIM) in the greater Boston area. His 11-year tenure at KIM included a 5-year span during which the firm was owned by E*TRADE Financial and he served as the Senior Market Strategist for E*TRADE Capital. Prior to working at KIM, he was a Senior Analyst at Fidelity Management and Research (FMR Co) in Boston. He was also a Managing Analyst at Thomson Financial. In 2018, Mr. Vanneman took on the role of President of CLS, in addition to his position as CIO. He became CIO of Orion in 2019.*

*Mr. Vanneman received a Bachelor of Science degree in Management from Babson College where he graduated with high distinction. He has held the Chartered Financial Analyst® designation since 1994, and is a member of the CFA Institute. He has also been a Chartered Market Technician® since 1999, and is a member of the Market Technician's Association (MTA). In addition, Mr. Vanneman authored the book "Higher Calling: A Guide to Helping Investors Achieve Their Goals." He was named one of the Top 10 Portfolio Managers to Watch by Money Management Executive in 2017.**

**Rusty Vanneman, CFA, CMT, was selected as a "Top 10 Fund Managers to Watch" in 2017 by Money Management Executive. Money Management Executive is an unbiased, third-party publication covering the asset management industry. Money Management Executive chose the list of managers to watch by screening Morningstar data from funds with a single manager, ranked as having the best three-year annualized returns in their respective categories. The list of managers was published March 27, 2017. Money Management Executive is not affiliated with CLS. Ratings and awards may not be representative of any one client's experience and are not indicative of CLS's future performance.*

New Highs by Year-End?

1

Bear Markets

Bear markets sometimes retest their initial price lows, if not extend them. Essentially, this has occurred 50% of the time in the stock market's history, depending on the time frame studied. The fact is anything can happen, so build diversified portfolios that are suitable for all market cycles.

Since the 1930s, the stock market has generated above-average returns after 'big months' in the following one-, three-, six-, and 12-month periods. In other words, April being a big month is not a reason to exit the market. If anything, it suggests more gains ahead.

Exploding Federal Deficits

The U.S.'s federal deficit is exploding. Economists disagree on this point, but many have argued for years that the deficit will be a problem for the economy and markets. So far, it really hasn't, but this time could be a bit different. Government spending relative to the economy just increased by 50%+. Short-term, this is a big plus for the markets and economy. There is a lot of juice in the system, not only boosting investor and consumer sentiment, but it's real money.

Longer-term, however, there could be a host of repercussions, such as higher inflation and weaker currency. These wouldn't necessarily be showstoppers for the stock market, but it could mean different economic sectors take over market leadership.

High Valuations

The stock market was very expensive at the beginning of the year. After losing nearly 40%, it was less so at the March lows. Now, with the April gains, it's back to being expensive, and arguably more so since fundamental metrics of value, such as revenues and earnings, have fallen.

Investors in an expensive market should expect below-average returns in the years ahead. While there is also a higher probability of a loss, the historical odds still overwhelmingly suggest a positive return. Even when a market is overvalued, it tends to produce positive returns over the following 1-, 3-, 5- and 10-years.

In addition, while the overall U.S. stock market is expensive, not all markets are extremely overvalued. International markets, especially emerging markets, have lower valuations. Within the U.S., smaller companies and more value-oriented economic sectors, such as financials, are also more attractively priced for better expected returns. In other words, a globally diversified equity portfolio should outperform the U.S. large-cap centric S&P 500 in the years ahead.

Lower Corporate Earnings and Economic Growth

There were some terrible economic and corporate earnings growth numbers in the first quarter. The second quarter's numbers will be worse — historically bad worse, all-time bad worse. It may take years for the U.S. economy to fully recover. However, the stock market typically bottoms 3-4 months before the economy does. Considering we just had the fastest 10%, 20%, and 30% drops, and the shortest bear market ever, wouldn't it be plausible for the economy to find a trough quicker, too? In fact, the absolute worst has probably already been seen given the initial claims for unemployment data. Let's all hope.

Curbing COVID-19

1

The most important signal, of course, is the COVID-19 data. The good news is U.S. and global growth rates have apparently peaked. When that has happened in the past, either around the world during the current pandemic or during past pandemics, it typically signals better economies and markets.

Now, while there may be a second wave (and perhaps more) and the coast is absolutely not clear, there are some other positives to keep in mind. The magnitude of global collaboration on COVID-19 from the health care and technology communities is unprecedented. Everything is moving faster now. It seems probable that treatments and vaccines will also be developed faster than they have historically. While public officials need to plan for the worst, the probabilities seem to suggest positive developments will occur quicker than the worst headlines indicate. Again, let's all hope.

It's illustrative to note market behavior around the two worst pandemics of at least the last century. The Spanish Flu had three prominent waves in 1918 and 1919. The second wave was indeed worse than the first. Two hundred thousand Americans died in October 1918 alone (when the U.S population was only 30% what is now)! The third wave occurred in the spring of 1919. However, the U.S. market generated strong, double-digit returns of approximately 20% in both 1918 and 1919 and then averaged 15% returns per year in the Roaring '20s that followed.

That said, I don't think the Spanish Flu is the best example as the market had other notable influences at that time, such as World War I. A better example is the Asian Flu in 1957. In this case, the market was coming off a seven-year bull market that snapped at the time the Asian Flu hit the U.S. in the summer of 1957. The Asian Flu was also a big, bad deal as the population-adjusted equivalent of 200,000 Americans died. The infection rate peaked in the late fall of 1957. The economy took a significant GDP hit in the fourth quarter of 1957, and then had its worst quarter of GDP growth since WWII (until the upcoming second quarter that we will likely soon witness) with a 10% loss. The stock market lost ground in 1957, but it generated a 40%+ gain in 1958 and then didn't have a losing year until 1962 (when it lost 2%).

Need more reasons for the possibility of new highs?

Investor sentiment was still very negative at the end of April. That's a bullish sign for future returns. The 'Wall of Worry' is still intact.

Also, while consumer confidence has taken a big hit, it's still near the 20-year average. "Don't fight the consumer."

And I haven't even mentioned "Don't fight the Fed." The Federal Reserve has short-term interest rates essentially pinned at zero for the foreseeable future and has flooded the system with money, acting as a backstop for the markets, including many segments of the fixed-income markets. Quite frankly, this might be the most important reason the market could still move, if not explode, to new highs (especially with a good news catalyst on the COVID-19 front).

Lastly, small-cap stocks are now showing some strength, even outperforming toward the end of April. This will be important to watch. A sign of a healthy market is when it has good "breadth" of participation, meaning market leadership isn't just in a handful of names. If that's the case, add "Don't fight the tape" to the list of positives.

Investing Mindset Future

2

News headlines like to stress "we have never seen this before." That is true for most of us individually, but the current crisis is not entirely new in terms of world history. The world has lived through pandemics before, and they haven't changed the fundamental nature of the markets. In the broadest terms, the markets will likely act as they always have, and will be cyclical. They will likely trend upward, not downward, especially over longer time horizons. Markets are driven by human beings. They are volatile and messy, but they have always bounced back — despite pandemics, wars, and economic recessions.

This said, I think there are important items to keep in mind for investing success in the years ahead.

- The U.S. stock market is likely priced for below-average returns, but these returns will still most likely be positive and better than bonds and cash.
- Investors invest to "beat the bank." In other words, the goal is not to beat the overall market, but to beat the return you could get by just putting your money in a savings account. The key is to figure out how much you can participate in the stock market. Whether it's 20% in the stock market, or 50%, or 100%, the "right" answer depends on your goals and capacity for risk.
- Bonds, especially with interest rates near 0%, will likely have below-average returns moving forward. While bonds will still be part of the toolkit to diversify equity risk, return expectations should be muted, and investors will need to be more creative diversifying portfolios.
- With lower returns on stocks and bonds expected, investors will need to try and save more.
- Because investors are living longer, and despite lower returns expected in the markets, many investors will likely need to raise, not lower, their exposure to the stock market, in addition to saving more.
- Although returns are expected to be lower for the overall U.S. market, there should be opportunities to enhance returns by diversifying into less expensive asset classes with higher expected returns. Small-caps, value stocks (such as financials), and emerging markets all have higher expected returns than the overall market.
- Volatility will likely remain high. This has always been the price of investing, but it will probably be more of an issue moving forward. Returns aren't likely to be as robust, but volatility will likely be more so. Risk-adjusted performance won't be as efficient as it was. There are a few ways to handle this.
    - Build broad portfolio diversification as this is even more crucial now to control portfolio risk.
    - Have a disciplined plan to regularly rebalance portfolios, which should enhance returns in addition to controlling risk.
    - If possible, view your portfolio less often. Investors who more frequently examine their portfolios tend to see and feel more volatility and, in turn, have lower allocations to equities, trade a lot more (more performance slippage due to transactions, costs, and timing costs), and ultimately lower returns.
    - Look at the bottom-line portfolio returns, not just the "underperforming" individual securities. In a diversified portfolio, there is always something "underperforming."

- “Expert” forecasts (including this one) should be treated with more than a grain of salt. For example, did you know Wall Street strategists had their most optimistic view on future stock market returns at the beginning of this year — just in time for the most epic sell-off in generations? Even more interesting is the Federal Reserve’s own forecasts. The Fed is arguably composed of the best, the brightest, and the most credentialed experts with the best training, resources, and, most importantly, the most current information. However, their forecasts are notoriously inaccurate.

What’s the best antidote to a world filled with opinion and forecasts? Yup, diversification. Diversified portfolios still participate in the upward slope of long-term growth, but they’re humble enough to survive various market cycles.

Warren Buffett Speaks

3

In Omaha, where Orion is based, one of our biggest events of the year is the annual Berkshire Hathaway (BRK) shareholders' meeting. This is where Warren Buffett and his partner, Charlie Munger, talk about the financial results and operations of BRK and, perhaps more importantly to most listening, share their words of wisdom when it comes to investing. Their experience, perspective, and track record warrant attention.

The meeting was held as usual this year, but this time Buffett addressed an empty auditorium. Instead of 40,000 people, there were about a dozen. Charlie Munger, still healthy at age 96, did not make the trip from California. Nonetheless, Buffett still presented, and the meeting lasted more than four hours, including Q&A. There was even a question from the actor Bill Murray.

In my biased opinion, Buffett did not disappoint. Here are my major takeaways.

- Buffett stressed the most important view and "bet" investors should make — maintain an optimistic mindset and remember the future of America remains very bright.

  > "I remain convinced. Nothing can stop America. The American miracle, the American magic has always prevailed, and it will do so again."

  Buffett opened the shareholders' meeting with numerous examples of American magic.

- Buffett is often considered a "cheerleader" for the markets, but I think this is misinterpreted. He is an investor, and he is practical. When investing, long-term optimism and patient investing has worked and will likely continue to work as progress is inevitable.

  He also tends to appear the most positive when most investors are the most fearful – which is often the best time to buy. That's not just being a cheerleader, but it's a proven way to build long-term wealth. It's also just good investment counseling advice.

- On net, BRK bought an underwhelming less than $2 billion in stocks last quarter and spent less than $2 billion buying back its own stock, despite having approximately $140 billion in cash (representing 30% of its portfolio), a balance which has grown this year.

  Some will see this as Buffett being very negative on the current situation. I have three comments on this:

  - Buffett acknowledges the wide range of possible economic outcomes in the months and quarters ahead. He will continue to be patient.
  - Buffett is, first and foremost, operating a business. And this he does well. The company made money in terms of operating business performance in the first quarter (excluding the temporary price losses in the publicly held stocks), and he's maintaining balance sheet strength, which is good practice for an insurance firm. And it keeps dry powder for a deal.
  - Most importantly, while BRK buys quality companies, Buffett is a value investor. He needs a good price to invest. He is also likely looking for an "elephant" deal that will move the needle on the overall investment portfolio. In other words, he needs a very large company to buy. And, as we have often written in this commentary, large-cap companies aren't cheap yet. (As Buffett acknowledged, they might have become cheaper if the Federal Reserve hadn't backstopped the market earlier).

- The topic of buybacks was interesting. Buybacks have been an important source of buying power for the U.S. stock market in recent years, especially so for certain industries and companies (notably tech). Buffett has spoken on this topic often. He has said many buybacks were silly since valuation needs to be considered. This year, he was a bit more positive on buybacks, even though he is still not buying back his own stock.

- One surprising news item was that Buffett sold his entire position in the airlines industry. BRK was a top three shareholder in the top four U.S. airlines, and he sold them all due to COVID-19 concerns and their uncertain future, especially so given the overcapacity in this sector. While his owning of this industry always felt a bit outside BRK's typical holdings and history, this still surprised me. Did he sell partly because the industry stopped its aggressive stock buybacks? If so, what might that mean for his largest-sector holding in financials, which are also curtailing buybacks? This will be something to watch.

In the end, I think you could still boil down this year's shareholders' meeting into a couple quotes, one from Buffett and one from his mentor:

> Over time, Charlie and I expect our equity holdings — as a group — to deliver major gains, albeit in an unpredictable and highly irregular manner."

And, quoting Benjamin Graham, Buffett's mentor:

> To be an investor, you must be a believer in a better tomorrow."

By no means did Buffett's message at this year's annual meeting suggest anything otherwise.

Thank You

Thank you for your time and trust.

If you have any questions or feedback, please let me know.

Stay balanced, stay the course, and please be well.

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