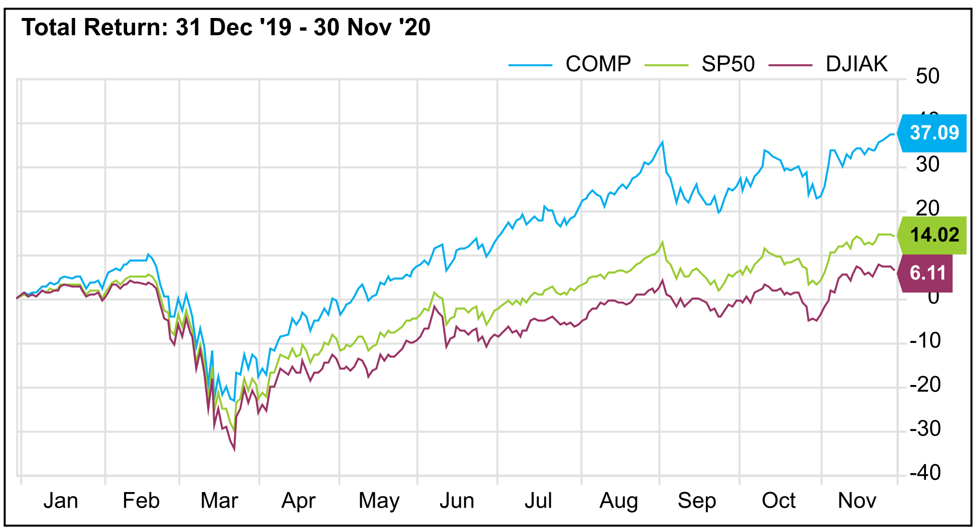
December 11th, 2020

MARKET COMMENTARY

Though it is already well in the rearview mirror, the third quarter saw a continuation of the market's dramatic recovery from the Covid-19 pandemic. Thus far, this trend has continued into the 4th quarter. Through the end of November, the S&P 500 is now up 64% from its March 23rd COVID Pandemic low. Over the same period, the Nasdaq, heavily comprised of emerging growth technology companies, is up 79%! The chart below depicts the S&P, Nasdaq, and Dow Jones Industrial Average performance for the year. It does an excellent job of pointing out what appears to be a disparity in outcomes between "old economy" companies represented by the Dow versus their "young economy" company NASDAQ peers. This disparity, of course, is sadly ironic given that the COVID-19 health crisis itself has cut along similar lines. It carries with it financial, social, and political consequences that we will be contending with for years to come.

Figure 1: Performance Comparison 2020 (11/30/2020)



Source: Factset

Surprisingly, the Dow fell further than the S&P and Nasdaq into the crisis and has also been slower to recover. This fall mirrors the pandemic itself, which has been much harder on the older segment of society than the young. Likewise, the market has been much harsher on more mature sectors of the economy while leaving the young, faster-growing technology companies, representative of the NASDAQ, relatively unscathed. This phenomenon runs counter to what investors have come to expect from the equity markets during periods of heightened volatility.

Typically, high flying, higher P/E growth companies are often the first to fall back to earth during corrections, as investors flee their names for the safer shores of traditionally defensive sectors of the market like Utilities. Until just recently, this has not been the case. Surprisingly, High dividend-paying stocks lagged dramatically through the recovery. Though perceived as an attractive alternative to low yielding bonds, the dramatic reduction in interest rates was not as advantageous as younger higher growth companies. High growth companies are rewarded in lower interest rate environments as that future growth is discounted back to a higher present value than when rates are higher. The low rate environment works to justify their higher stock prices. Making matters worse, the employees of "old economy" companies, and those employed in the service sector, have seen their lives dramatically impacted from both the risk of the virus as well as the government's response. For example, when job losses were at their recent peak, wage growth in the U.S. went up, not down, indicating that most jobs lost were lower paying.

On top of being extraordinarily unfair and tragic, this outcome has also likely been very frustrating for traditional value investors on the investment front. After lagging the growth crowd during the entirety of the great recession recovery, they were doubtless anxious to show their wares during an environment that typically would appear to be more favorable to them (Figure 2).

Figure 2: The Value vs. Growth Divide as of 11/30/2020

Strategy	Benchmark	Month To Date	Quarter To Date	Year To Date	Last 12 Months	Last 3 Years	Last 5 Years	Last 10 Years	12 Years
Large Cap Growth	Russell 1000 Growth	10.2%	6.5%	32.4%	36.4%	21.5%	19.6%	17.3%	18.5%
Large Cap Value	Rusell 1000 Value	13.5%	12.0%	-1.0%	1.7%	5.3%	8.5%	10.9%	11.4%
Mid Cap Growth	Russell Mid Cap Growth	13.4%	13.5%	28.6%	30.0%	17.9%	15.9%	14.1%	17.0%
Mid Cap Value	Russell Mid Cap Value	13.8%	14.8%	-1.8%	0.9%	1.8%	5.6%	8.3%	10.9%
Small Cap Growth	Russell 2000 Growth	17.6%	18.5%	23.1%	25.9%	12.9%	13.2%	13.3%	16.0%
Small Cap Value	Russell 2000 Value	19.3%	23.6%	-3.0%	0.3%	0.8%	6.8%	8.7%	10.7%

Source: Black Diamond

As you can see from the chart, growth has been handing it to value for some time. Perhaps, most notable is that value strategies of all stripes are still down on the year. Recently there have been some early signs that growth's market leadership may be changing. The scientific community has done a tremendous job with three drugmakers, Pfizer, Moderna, and AstraZeneca, successfully developing vaccines well ahead of schedule. Clinical trials have shown all carry very high efficacy rates and, so far, limited side effects. This development, which represents the beginning of the end of the COVID-19 pandemic, has given investors the comfort to return to the broader economy equity markets and result in a pivot in market leadership. As a result, value outperformed growth across the board in November and the 4th quarter. A promising sign for many reasons.

At Alamar, we believe a stock market where many companies find success much more favorable than a narrow market only rewarding a few. As we have stated several times in the past, we are wary of equity markets driven by just a few FAANG names, as they result in too many investors leaning on them for returns. In our experience, these types of crowded trades eventually end badly. An environment that rewards many economic sectors relative to a few is a sign of a healthier market and economy.

Additionally, the equity markets have reacted favorably to the end of the uncertainty associated with the recent election season. Perhaps most specifically, equities have responded favorably to the lack of materialization of a heavily predicted Democrat blue wave mandate for change. Because of this, there is a good chance that the Biden administration will face challenges to fulfill some of its more aggressive

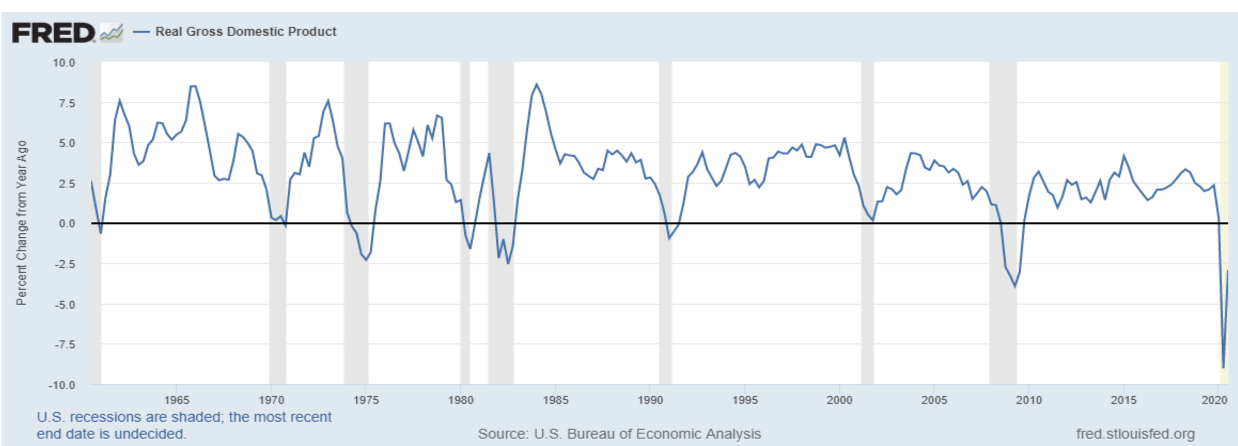
Campaign promises like selective tax hikes. These two outcomes, the recent arrival of a vaccine and the end of the elections, have combined to squeeze more uncertainty out of the stock market. It is also likely that they have helped to settle some frayed investor nerves. However, we are aware that many remain skeptical.

Their skeptical view brings us to another topic that we would like to discuss with the rest of this letter. In many of our recent conversations, we have noticed a recurring theme or a prevailing view that given how badly things have gone in 2020, it just seems irrational for the stock market to have done so well. Completely understandable, but we want to share some views on this, which might seem to be a bit counterintuitive at first, like the tech sector's big run this year.

WHERE'S THE PUCK

We should forgive investors for thinking the equity markets should still be down big this year. In our lifetimes, we cannot recall a period in which we were confronting so many simultaneous challenges and so much uncertainty. In just nine months, we have encountered a global health pandemic, the shuttering of the worldwide economy, the loss of more jobs than any period since the great depression, and the sharpest market decline in recent memory. In the U.S., we have experienced a less than stellar response to the crisis by our government leaders of all stripes, not to mention a genuinely uncivil election season. At present American citizens are openly questioning their safety at the police's hands, while others question the lunacy of a defunded police force. Lastly, we have watched these issues unfold while being locked into our homes. At times, this can feel like just too much. The chart below aptly summarizes this sentiment. It depicts Real GDP Growth dating back to 1960. A period of time that experienced eight separate recessions highlighted in grey, with the first seven do an outstanding job of putting the most recent 8th one into perspective.

Figure 3: Historical Real GDP 1960-2020

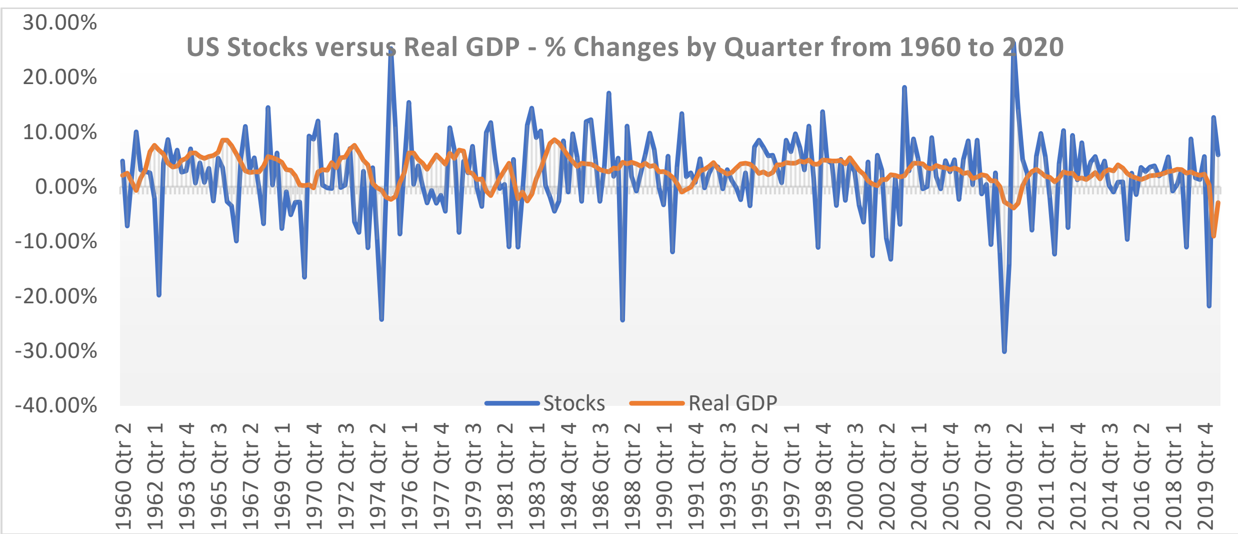


Source: BEA / St. Louis Fed

After stalling in the first quarter, GDP fell an unprecedented -9.2% in the second quarter and a further -2.9% in the third, in the first planned recession in U.S. history. The economic shutdown's orchestrated nature enabled an almost immediate response, with massive ensuing monetary and fiscal stimulus. This quick response was unusual in that historically; it is often difficult to determine precisely when the U.S. economy enters a recession, defined by two sequential negative quarters of GDP growth. Due to this, there is typically a delay in our federal response, making the recent recession unique. The sharp decrease in GDP was terrifying, though, no matter how you want to look at it. And it certainly does not look like an environment that equity markets would perform well. Interestingly, when you take the same GDP data as before and layer the U.S. Equity markets' performance over the top of it, this outcome grows more likely as we begin to see the forward-looking nature of markets.

As you can see from the graph, even though we are inclined to look for one, there does not appear to be a connection between stock returns and GDP. In the most recent correction, U.S. Stocks were up in the second quarter by 12.6%. In the same quarter that GDP was down -9.2%.

Figure 4: ALL US STOCKS vs. GDP 1960-2020



Source: St. Louis Federal Reserve

Looking back over prior years, this does not appear to be an anomaly. There is a statistical measure that we can use to test what our eyes are seeing, known as regression analysis. It allows us to attempt to measure the relationship between two independent variables., in this case, stocks and GDP. For example, regression analysis can be utilized to determine whether there is a correlation between GDP growth or contraction and stock prices and how strong that relationship is. A correlation of 1 conveys a strong positive relationship, or in other words, if GDP increases, so do stocks. While -1 indicates a strong inverse relationship, meaning that if GDP increases, it is likely that stocks go down. Lastly, a correlation of 0 indicates no real relationship at all. We conducted a regression analysis on GDP's connection to US Stock prices over the 60 years, and the results are displayed below.

Figure 5: Correlation of US Stocks VS GDP 1960-2020

Correlation of Stock Return with % Change in GDP	
Real GDP in Quarter	***Correlation***
Real GDP in the quarter	-0.0570
Real GDP - 1 Qtr. Lead	0.1211
Real GDP - 2 Qtr. Lead	0.2317
Real GDP - 3 Qtr. Lead	0.2618
Real GDP - 4 Qtr. Lead	0.2636

Source: St. Louis Fed./Alamar Capital

The data shows that the correlation between the current quarter for stocks and the same quarter for GDP is -0.05, which indicates no relationship between the two variables. The present quarter stock market return must be plotted against GDP one quarter in advance to achieve a small correlation (.12 on the chart). Plot the same stock return against GDP 2 quarters in advance, and the correlation increases further to .23, a still-fragile relationship, and so on. There are better predictive variables to compare stock returns against than GDP – we like earnings growth and free cash flow. However, the chart and regression analysis speak to the forward-looking nature of markets in its attempt to predict the future. All-time hockey great Wayne Gretzky once famously said, "I skate to where the puck is going, not where it has been." As investors, we would be wise to follow his lead because overly fixating on the present will likely result in missed opportunities.

SUMMARY

The market has staged a dramatic recovery in the latter part of 2020 thus far. With low-interest rates and a transition in the economy to a remote working environment, less capital intensive and higher growth technology businesses have thrived. Meanwhile, the relatively safe, slower growing, and lower P/E names that we think of in times of crisis have until just recently, have lagged their higher growth peers. This recent pivot towards value is a good sign as it reflects a healthier economy. It also shows investors looking forward beyond the recent elections and towards a world with a vaccine for the virus.

It is understandable to question the markets run given the economic environment, though instructive to understand the pockets that have experienced the lion's share of the appreciation and why. Additionally, the correlation between heavily scrutinized figures like GDP is a poor measure of near-term stock market performance. Like Gretzky, the market is much more focused on where the puck is going than where it has been. However, there is a current surge in the number of those sick with the coronavirus. The arrival of at least three highly effective vaccines, gives us much to be thankful for and a future in which to be optimistic! Something for all of us to reflect upon as we live in real-time through some challenging circumstances.

Lastly, we would like to share a quick update on Alamar. For those of you who are clients, we are very grateful to have you investing alongside us on this journey. Though we initially underestimated the impact of the COVID-19 crisis, we were nonetheless well-positioned and have had an excellent year. We have a propensity to identify and invest in companies in the earlier stages of their lifecycle, many in technology. As we have stated, this has been a real sweet spot for the market this year. Our flagship Alamar Equity strategy is up 30.6% net of fees through November, handsomely exceeding our expectations as well as our benchmarks on the year (Russell 3000 +15.7% / S&P 500 +14.0%). The considerable outperformance this year has added to our lead relative to the market since inception. Since our inception on January 1st, 2010, the Equity strategy is up 16.7% annualized net of fees, while the Russell and S&P are up 13.4% and 13.6%, respectively. Also, to share a bit more good news, we are delighted to report that our strategy was recently awarded a highly coveted 5-star rating by Morningstar, a database covering separate account managers such as ourselves. We would be happy to share this report with you upon your request. Much to be thankful for indeed.

Please continue to stay safe and healthy –

Best regards,

John Murphy, CFA

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