ICR® 2nd Quarter Newsletter – July 2020

The second quarter saw stock indexes record a huge reversal from their first quarter drop. The S&P 500 rose almost 20% during the quarter, nearly erasing the losses from the beginning of the year. Consumer discretionary, energy, and technology stocks led the way, each posting gains of greater than 30%. Despite that quarterly performance, the energy sector still sat at -35% for the year, owing to its 50% first quarter loss. Small cap stocks rebounded, but are still down over 14% for the year, while growth stocks handily outperformed value stocks – a topic we'll discuss in more detail later.

Foreign stocks also rallied, but in a more subdued fashion. The MSCI EAFE index, which tracks developed foreign markets, gained 14.2% leaving its year-to-date performance at -12.6%. Emerging markets fared a little better, rising 17.3% to reduce the losses for the year to 10.7%.

Yields mostly held steady throughout the quarter. Though the 10-year Treasury yield briefly rose above 0.9%, it fell back to 0.65%, which is around the level it was at the end of March. The Federal Reserve attempted to shore up credit markets by purchasing large swaths of corporate debt and later including municipal debt in its bond-buying program. In light of massive injections of money into the financial system, investors have flocked to gold as a safe haven asset. The price of the metal rose almost 13% during the second quarter and, as of this writing, is within about 5% of its all-time high.

Is the Rally Justified?

There has been a lot of discussion lately about how the market can be recovering so quickly and robustly in the face of a steep economic downturn and continued uncertainty surrounding the Covid-19 pandemic. It's important to remember that the stock market is inherently forward-looking. A stock's value is based on the future stream of earnings and dividends expected to be generated by the company. So, while earnings may be low for a company during a pandemic-induced recession, if investors expect the fortunes of that company to quickly turn around, its stock price might rightfully rise. That is, the next ten years' worth of earnings and dividends – even discounted to present value – are more important to a stock's current price than the next six months' of earnings and dividends.

This might explain why the market has recovered as investors look ahead to a post-Covid world. What's remarkable, however, is that while the market indexes rose nicely in the second quarter, it was a handful of stocks that powered most of that rally. The five largest companies in the S&P 500 (Microsoft, Apple, Amazon, Facebook, and Google) now comprise almost 25% of the index. The average performance of those five companies year-to-date through June 30th was +24%. With the entire index down about 4%, that means the other 495 companies as whole (with some notable exceptions), have significantly underperformed the big five.

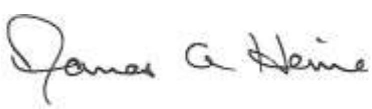
While it makes sense that large technology companies would stand to benefit in a world of reduced social interaction, the degree of outperformance is astonishing. Indeed, we haven't seen a disparity this large between growth and value stocks since the dot-com bubble. Through June 30th, the Morningstar U.S. Growth Index had out-gained the Morningstar U.S. Value Index by a staggering 33.5%, which, if it holds, would be the largest annual disparity since 1999 – at the height of the dot-com bubble.

To be sure, there are differences between this period and 1999. For starters, most of the companies leading the way this time are actually profitable, so price-to-earnings ratios – while quite high – are not in the stratospheric realm like they were in the late 1990s. And some of these companies have become so ubiquitous in the daily lives of ordinary people, that it is difficult to imagine them going the way of Pets.com or Worldcom. But, even in the dot-com bubble, good companies became wildly overvalued and lost heavily in the subsequent years. Amazon, for example, lost over 90% of its value and didn't reach its peak-bubble price again for another nine years. Whether a similar scenario plays out now remains to be seen, but it is alarming to see an almost blind euphoria among a handful of stocks, with Tesla standing out as the prime example.

So what is an investor to do? A sound process combined with a patient approach has historically led to good outcomes. The optimistic scenario currently being priced in to markets is that a vaccine will come sooner rather than later and in the meantime we'll get unlimited fiscal and monetary support to keep the economy going. That's certainly possible, but when risk management is the goal, it is important to beware of the potential for less-rosy scenarios to play out. The good news is that there are still high-quality companies selling for reasonable valuations. While it's tempting to chase the latest and greatest stock that your nephew claims to have made a killing on, the more sustainable approach is to own good companies at reasonable prices and to systematically accept risks that offer commensurate levels of reward. That is always what we are striving to do, though this type of market environment is a true test of patience.

We hope that you are making it through this trying time. It's been a difficult year in so many ways, but we remain optimistic for the future and truly appreciate the friendship and support of our clients. Thank you and please let us know if you have any questions.

Sincerely,



James A. Heine

James L. Cobb

Market Report (as of 6/30/20)

Index	2020 (%)	3-Year Annualized (%)	5-Year Annualized (%)
S&P 500	-4.0	8.6	8.5
Dow Jones Industrial Average	-9.6	6.5	7.9
U.S. Aggregate Bond Index	7.4	5.3	4.3
MSCI EAFE (Foreign Index)	-12.6	-1.9	-0.7