The Best Way Out is Always Through: Coronavirus Part 4

ABOUT THE AUTHOR

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"By good rights I ought not to have so much put on me, but there seems no other way. Len says one steady pull more ought do it. He says the best way out is always through. And I agree to that, or in so far as I can see no way out but through " -

A Servant to Servants by Robert Frost

Last week I started watching the Sony Productions series "Cobra Kai," which takes place 34 years after the 1984 hit, Karate Kid, starring Ralph Macchio, on which it is based. In the original movie, Macchio's character, Daniel LaRusso, is a new kid in a new town and is bullied by a group of karate students at the local Cobra Kai dojo. LaRusso befriends the maintenance man in his apartment building, Mr. Miyagi, who teaches him karate and encourages him to challenge the Cobra Kai bullies at the 1984 All Valley Karate Tournament. For those of you who have seen the movie, you know that Daniel makes it to the tournament finals where, injured, he beats Johnny Lawrence, the Cobra Kai star student, for the trophy. LaRusso knew that he would endure great pain and physical exhaustion even to have a chance to win the tournament, but he and Mr. Miyagi knew that the only way out of Daniel's problems with the bullies, and his own self-doubt, was to go through this tough test.

In his poem, A Servant to Servants, Robert Frost uses the phrase "the best way out is always through." Like Daniel LaRusso, it is not so much that we must endure and accept a situation as a finality. It means that to get some sort of healing for a situation, to get "out," we must embrace and go through our ordeal wholeheartedly, with inquiry and desire for self-awareness.

As we wrote in our last quarterly letter, we expect to see progress with monumental societal and geopolitical challenges as a result of the Coronavirus pandemic. However, for that to happen, we must continue to endure the fits and starts this unprecedented time will continue to throw at us. As Frost says, we must go through it all to get out. In July, we analyzed the major issues that we believe the pandemic has brought to the forefront and are now ripe for solutions. In that piece, we discussed the threat of China and the widening wealth gap in the

United States. We will now focus on the return of evidence-based dialogue in our political system and the removal of the barriers that will usher in the next great productivity revolution in our economy.

Bring Back the Experts

Skepticism around experts has been part of a growing global movement across the entire political and policy landscape, amplified by the election of President Donald Trump - a particularly visible critic of bringing in experts, in my view.

When did experts get such a bad rap? I know I still want a certified mechanic working on my car, a licensed doctor with a long, successful track record to perform my surgery, and a tenured professor to teach my child. Since 2008, when experts failed to predict the Great Financial Crisis or the virulence of the political fallout that followed, they lost their credibility rapidly.

The dominance of social media further deepened this decline. Instead of creating a new age of enlightenment, academics lament the rise of "narcissistic and misguided intellectual egalitarianism," stifling evidence-based policy debates.[1] American citizens today are bombarded by misinformation from self-proclaimed experts, fake facts, and false truths, only to become even more ill-informed, cynical, and angry. They reject elitism as undemocratic but happily consume the latest conspiracy theory on Twitter.[2]

Today, we see a most egregious trend of policymakers sidelining experts in favor of "their own facts" to push their political agendas. While it is admittedly harsh to criticize the early reactions of our political leaders on both sides of the aisle for their lack of urgency when faced with COVID-19, one cannot deny that leaders from both sides, at one point or another, have shunned expert advice in exchange for political opportunism. The most disappointing outcome of this pandemic, aside from the tragic death of so many across the world, is the unabated power-mongering by Democrats and Republicans even in the face of such life-threatening circumstances. There was a glimmer of hope that we might see a truce emerging between these warring factions when both parties passed a comprehensive Coronavirus relief bill, but unfortunately, that was just wishful thinking. A friend told me a story recently about a close friend of her daughter who was set up on a date with a young man whose family I knew. The couple went out a few times and liked each other; however, when the young lady found out that her new boyfriend was a Republican, she broke it off immediately, citing that with differing political views, there was no future for them. In much the same way, our political leaders will not even listen to ideas from their counterparts on the other side. They will not entertain a scenario where our country might be better off with representation from both parties sharing power within our governmental branches. No, it has become an "all or nothing" proposition. Both parties demand a mandate- full control of the legislative and executive branches, and they will do anything to get it. While many believe our politicians are less educated on issues and less competent in political chess than in prior decades, they have become experts in one thing: gaming the system. Never do I remember seeing such gamesmanship involved in policymaking: executive orders to circumvent votes;

threats of impeachment thrown around like Instagram "likes;" overuse of the filibuster; the threat to remove the filibuster; squashing a Supreme Court nominee before an election; rushing to confirm a Supreme Court nominee before an election.

What has been forgotten is that open debates, from which evidence-based decision making and policy arise, are one of the pillars that maintain democracy. Public policy decisions are best when produced by diverse teams with both focused experience and extensive knowledge. Diverging national and international assessments should be embraced as they enhance the data set upon which to make critical decisions. The current crisis provides a unique opportunity for us and our political leaders to rediscover the value of real expertise, trustworthy sources, and policy recommendations grounded in data and logical assumptions. Decisions centered on facts and expertise remain our best remedy not only to the current crisis or the next, but to uphold democracy and the values we hold dear.[3]

The Bright Side of Covid-19

Innovation relies upon the freedom to experiment and try new things, which requires reasonable regulation that is progressive, positive, and quick to render decisions. The surest way to rediscover rapid economic growth when the pandemic is over will be to study the regulatory delays and hurdles that have now been hastily swept aside to help innovators in medical devices, therapies, and vaccines; and to see whether such reforms could be applied to other parts of the economy too.[4] This recognition that speed and innovation require the removal of bureaucracy will also play a considerable role within American corporations as they exit the crisis and embark on even more ambitious strategic plans, many of which have been accelerated by the lessons learned during the pandemic.

The current pandemic has already led to numerous advances. "Dyson designed a new ventilator in 10 days. Alibaba built an unmanned store for essential items and disinfectant supplies. Chick-fil-A developed more than a dozen changes to its drive-through process to maximize both safety and efficiency in the face of skyrocketing demand for take-out food."[5]

Frankly, these examples do not surprise us. We have studied many companies with great businesses for over 20 years and have frequently seen how quickly a company can innovate when it sheds the constrictions of bureaucracy and adopts agile methods. One sign of today's agility is the rapid rise in many companies' "metabolic rate."[6] An executive with a major retailer told us, "we've gone from making five big decisions a month to sometimes making five a day now. And I'm not sure we've lost a lot in the quality of those decisions." While this is a clear sign of how companies can become corporate MacGyvers when the shackles of the establishment are removed, we must note that this spur-of-the-moment agility is fragile. Typically, when the emergency fades, people return to traditional command-and-control innovation until the next crisis arises. We are optimistic that many companies (and even our government) see permanent benefits of agility and plan to maintain it after the pandemic ends.

Business systems have a more significant impact on long-term performance than individual goals. In his book, Atomic Habits, James Clear says, "When all your hard work is focused on a particular goal, what is left to push you forward after you achieve it? This is why many find themselves reverting to their old habits after reaching a goal. The purpose of setting goals is to win the game. The purpose of building systems is to continue playing the game. True long-term thinking is goalless thinking. It's not about any single accomplishment; it's about the cycle of refinement and continual improvement."[7]

Simply stated, if businesses are more innovative and decisive during a crisis, why not design permanent systems to encourage that agility all the time? As Clear states, the reason is that most businesses are goal-oriented, not process-oriented. Thus, after an emergency, businesses revert to old habits, sluggishness, and bureaucracy. We believe, however, that many companies now realize that they must embrace an agile management system all the time to compete. The technologies employed during the pandemic are just one example of how businesses will have to adapt to stay relevant. Their best employees will demand these tools to achieve optimal productivity.

Take meetings, for example. Forbes wrote that before the pandemic, "people spent up to 23 hours per week in meetings, half of which are considered a failure or waste of time." [8] Today, we see that work can be done effectively and productively on a digital platform that allows meeting participants to be scattered all over the world. Further, without worrying about travel time, meetings start on time, are rarely canceled, and are typically shorter. This is just one instance where an old habit will be forever changed for the better in our view due to necessary innovation resulting from the pandemic. When you start to extrapolate this agile system to hiring (why does your next hire need to live in your state, or even in this country?), supply chain management (a desire to reshore or create redundant supply sources will speed automation and machine learning), and time management (reduced or eliminated commutes will give employees more headspace), it is easy to see the fantastic growth potential corporate America, and the American economy, will get able to "test drive" once life returns to a more normal status.

A final word on how this new-found and more lasting agility will impact our next economic revolution expands on this idea of more headspace. Far too often, we found our schedules overflowing with events and obligations prior to the economic shutdown. The relative quiet that accompanied the quarantine, while jarring, did allow for more time to think. Repeatedly, many found themselves working so hard in their businesses, that they rarely had time to work on their businesses. The ability to focus on strategy, long-term planning and processes, structure and future growth, rather than just living in the present, will be a key, in our view, and in addition to the other advancements discussed, in bringing forward new and exciting growth opportunities for American corporations and the American economy.

Merlin Wealth Management Market Commentary

Why are stocks at an all-time high?

We are equally as surprised as many of you that stocks have reached all-time highs so soon after the bear market triggered by the COVID-19 pandemic. A great deal of credit goes to the power of massive stimulus - both from the Federal Reserve and government spending and programs. Investor sentiment also improved more quickly than we expected, as Americans are banking on a vaccine and a quicker restoration of "normal" life.

Near-zero interest rates have boosted the valuation of mega-cap tech stocks to extraordinary levels. In fact, half of the market gains since the March 23rd low are attributable to 5 companies: Apple, Amazon, Facebook, Alphabet, and Microsoft. [9] This is a direct result, in our view, of the "K-shaped" recovery we are currently experiencing in the economy, as spending on restaurants, in-person entertainment, and physical retail is still at a near standstill. In contrast, spending has soared on things like technology, online shopping, and streaming entertainment.

As outlined in our last piece, we believe that the K-shaped recovery has legs and will continue to benefit companies in industries like technology, biotechnology, e-commerce, networking, and electronic payments. Further, Federal Reserve Chairman Jerome Powell assured markets that the FOMC would be keeping rates low for at least the next three years. Other accommodative stimulus measures coming from the federal government will also likely continue, as curtailing them would be politically unpalatable going into the November election. These measures continue to bode favorably for risk assets.

Debunking the myths of high-priced tech stocks

(Excerpt taken from The AB Blog on Investing, Debunking the Myths of" High Priced" Tech Stocks by Lei Qiu 8/31/2020)

"Technology stocks seem unstoppable. Titans like Apple and Microsoft, as well as technology-driven consumer firms like Amazon and Alibaba, continue to do well through the COVID-19 pandemic." Additionally, there are new technology and innovation leaders emerging in cloud-based services, fintech, and e-commerce whose substantial growth has been enhanced by the rapid business and consumer changes brought on by the pandemic. We are fortunate to own many of these established and emerging growth businesses within our Dynamic Growth and New Era strategies.[1]

The substantial gains in technology stocks have pushed up valuations and brought back fears of a repeat of the dot com bubble bursting in 2000. We believe that technology companies today are vastly different from the companies that drove the dot com bubble. Here are a few myths that explain why:

Myth #1: Tech is Overpriced

Technology is not a homogeneous industry group, and not all tech companies are overpriced. In fact,

[1] Past or targeted performance is not indicative of future results, and there can be no assurance that these strategies will achieve comparable results.

the sector's valuation premium is comparatively low versus its historical high. "At the market's peak in March 2000, the MSCI World Index's technology and communication services sectors combined accounted for 35% of market cap and less than 18% of the earnings. But today, the two sectors represent 30% of market cap yet almost 25% of all earnings."[10] The reason? The services provided by tech companies now permeate every industry in the economy. Whether it is cloud storage services, e-commerce, digital payments, or simply providing connectivity among workers and customers, the tech sector increasingly enjoys the positive benefit of this network effect, allowing these companies to take advantage of scale and produce higher incremental margins, earnings, and profits. In 2000, the tech companies that exemplified that era were conceptual, maybe even slightly ahead of their time. Today, companies like Apple, Amazon, Microsoft, Salesforce.com, ServiceNow, and others have stitched themselves into the fabric of Corporate America. They are robust businesses with scale, immense cash flow, and long growth runways.[11] Thus, one could argue that their valuation premiums are much more justifiable today than they were 20 years ago.

Myth #2: Paying Up Is Hard to Do

Is it riskier to pay more for a stock? Not necessarily. Historically, technology companies traded at much richer multiples than their slower growing, more cyclical counterparts. The reason behind the high valuations for the technology stocks was that earnings were hard to come by. In the late '90s and early '00s, the majority of tech revenues were plowed back into research and development, marketing, and business development. Cyclical names, which grew the top line slower, had more cash flow hitting the bottom line, or paid out as dividends, and were therefore seen as more defensive even though their businesses were more susceptible to economic downturns.

That dynamic has clearly changed. Technology companies are now the cash cows, with most of the larger companies sporting rock-solid balance sheets, billions of dollars of free cash, and little to no debt. Conversely, banks, energy, and industrial names are much higher leveraged, and their earnings are much choppier. In the 2nd quarter earnings season, information technology companies were among very few reporting year-over-year revenue growth and earnings growth. Tech companies also performed much better than expectations. Almost 74% of information technology companies in the MSCI World Index reporter higher revenue, and 78% reported upside earnings surprises, compared to just 51% and 56%, respectively, for the market overall. [12]Despite these superior financial results, technology companies are trading at similar valuations to consumer staples, while offering better growth characteristics.

Myth #3: More About Valuations, Less About Fundamentals

To piggyback on our thoughts regarding valuation, is there too much emphasis among investors on price and not enough emphasis on earnings growth consistency and future potential? We think so. Our Dynamic Growth portfolio is filled with familiar growth stories that have always been considered expensive. Apple and Amazon are the most cited examples.[2] I remember vividly in 2007 when Apple traded up to a lofty high of $18 per share, based on projections to sell 3 million iPhone units worldwide in the device's inaugural year. Compare that to the 200 million it sells annually today, and we would all have happily paid that $18 in hindsight.[13]

Innovative tech businesses may look expensive if viewed using only the consensus estimate at a fixed point in time. But true tech leaders have vision and tenacity—a successful innovative company is more than just a good new idea. Enduring growth businesses should offer sustainable revenue and profit growth potential. Currently, ample liquidity is chasing very few growth opportunities, many of which are smaller, newer companies. Not all will turn out to be the next Amazon, but some may have the right characteristics to become the next generation's leaders- products and services with transformational impact and the relentless, innovative DNA to reinvent themselves along their growth paths consistently.

Is Value Investing Dead?

The K-shaped backdrop has created an even more challenging environment for value investing. COVID-19 has wreaked havoc on the "old" economy while boosting demand for technology, social media, and online services. On a year-to-date basis, the Russell 3000 Growth Index has gained 29% through the end of August, while the Russell 3000 Value Index ended the period with a -10% loss. If you go back to the start of 2017- the growth index has generated a cumulative return of 122% vs. the value index's meager return of 18% in the same period.[14] This is one of the longest dry spells for value. It has resulted in frustrated investors pulling their money out of value funds, plowing the proceeds into growth and index funds dominated by the mega-cap growth stocks, which further widened this gap in performance and valuation.[15]

History, however, has shown these investment "styles" go in and out of favor. Believe it or not, since the inception of the Russell 3000 Growth and Value indices in mid-1995 to the end of 2019, they have generated a nearly identical annualized total return: 9.34% for growth and 9.48% for value.[16] That would make a data-focused investor believe that value is poised for a comeback. Conventional wisdom still favors growth stocks, however, due to the low-interest-rate environment seemingly staying with us for the next several years.[17] To many, this supports the higher valuations of today's growth businesses, although others caution that the recent surge in some of the market's favorite growth names brings about bad memories of the dot-com bubble in early 2000. As mentioned above, we do not believe the two periods are synonymous.

So, what will be the catalyst that finally jumpstarts a value outperformance cycle? In the short-term, we believe that the availability of a COVID-19 vaccine should lead to a gradual but sustainable cyclical recovery, an environment that has historically favored the "value" sectors. Such a recovery would

[2] **Past performance is not indicative of future results**, and there can be no assurance that these strategies will achieve comparable results. Actual performance may vary.

also likely broaden out market leadership to include some of the larger, cyclical companies currently trading far below their pre-COVID-19 ranges. Thus, it may be rational to practice a bit of "buy-low-sell-high" in the coming months. Over the long-term, we still wholeheartedly espouse one of the core tenants of Merlin Wealth Management's Investment Discipline:

Consistent earnings growth is the primary driver of intrinsic value and long-term stock appreciation. Investing in businesses with exceptional earnings growth, driven by a sustainable competitive advantage, superior financial strength, proven management teams, and powerful products and services is the key to long-term investment success. Further, we hold the view that such exceptional companies not only have the potential to achieve outsized returns but are also inherently less risky. Their superior earnings stability and financial strength serve as a "margin of safety" that typically results in less volatility in declining markets as well.

Where are the markets heading, and how are MWM Equity Strategies positioned?

Sting is one of the greatest musicians of our time. One of the things I admire most about Sting is his willingness to take risks throughout his career, for the sake of better music or sending a message. When talking about his life and career, Sting said, "The logical process will often be the safe one. I tend, when I'm given that choice, to go the way that's not safe."[18]

While we usually applaud that kind of risk-taking, especially when combined with the entrepreneurial spirit of many of our portfolio companies, in the current environment, I could not disagree more. At present, the logical process is the safer path, and the one we are pursuing. I reference, of course, the aggressive hedging we implemented in our 3 equity strategies during the month of September. As we mentioned in our email communication, when we added the hedges, the cost-benefit analysis considering the significant outperformance our strategies have produced is very compelling. Combining that attractive risk/reward balance with the many uncertainties we see in today's market, the decision to pump the brakes and play a bit of defense was not a difficult one to make, particularly since our proprietary valuation and risk models are pointing in the same direction. Sometimes, the safe choice is the <u>only</u> choice.

Forecasting and predicting economies and markets is a common conversation starter in the investment community, just as the weather is at the backyard barbeque. But practically speaking, we do not believe that we or others out there add much value when opining on these highly complex topics that typically involve a multitude of inter-related issues. However, looking in the face of a contentious U.S. presidential election, a still uncertain outcome for our economy as COVID-19 still hampers many American businesses, not to mention escalating hostilities with China, we feel that some caution is warranted.[19]

Consistently identifying the highest-quality businesses is where our focus lies and where we believe our experience and discipline can offer the most value. Time after time, our experience has proven to us that remaining invested over the long term is the best path forward for our clients. That is why we elected to hedge our portfolios rather than reduce positions to any significant degree (tax efficiency also played a role).[20] I hope we are wrong and will happily eat my words if our economy and our markets blow past the election and the first part of 2021 without any hiccup. But, even if we are wrong and markets continue their upward climb into year-end, we will only "outperform by less." If the safe path can also be exceedingly profitable, you will see us choose it every day and twice on Sunday.

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