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At the beginning of this year, knowing it was an election year, I used the term 'festive chicanery' to anticipate the level of discourse and behavior that seems to take place every election season. I may have to come up with a different adjective. There are a lot of narratives being highlighted in the press, and the level of discourse is motivating us to defend capitalism, which we will do later in this letter.

Market Review

Markets continued improving during the third quarter of 2020, and the global equity market managed to creep back into positive territory for the year, with the Vanguard Total Global Stock Market ETF improving to a 0.95% year-to-date return. While Intermediate Term Bonds have helped overall this year, they were the one sector that did not contribute much during the third quarter. They added 0.4% to their annual total, bringing their YTD total to 6.7%. This strong return through the first six months of the year was a result of interest rates (yield) collapsing toward zero. The 0.4% third quarter return is likely indicative of what is to come for this sector, since returns resulting from addition yield declines are unlikely.

International and small cap's improved this quarter, but continue to lag for the year. The iShares MSCI EAFE ETF is down 7% and the iShares Russell 2000 ETF is down 8.6% for the year. These sectors lack the large cap US Technology exposure that helps the large indices. The large cap technology sector, and large cap growth in general, helped drive the global index to the 0.95% return (VT), and helped the US Large Cap market lead the way, with a 5.47% return from the Vanguard Total Stock Market (US) EFT.

The disparity of returns within the S&P500 continues. The best sector (out of 11) was Technology, with a 28% YTD return. The worst, Energy, posted a 48.1% decline. Even the difference between the third best sector (Consumer Services) and the third worst (Real Estate) was over 15%.

Earnings Review

It is safe to say that the market continues to anticipate a strong earnings recovery. The price/earnings multiple is still quite high and ended the quarter 30% above its 25-year average. This premium can be explained by three factors. First, interest rates are low, and low rates make future earnings worth more today, therefore you can value them more. Second, earnings are expected to improve materially. Third, expansive monetary conditions are allowing a bit of speculation. The combined result is an environment where continued volatility is likely. The election results could very well be the catalyst for volatility. It is possible that we may not know who the President-elect is for some time. Markets tend to dislike uncertainty, so if this scenario comes to pass, the market may fall.

Diversification assumes that there will be short-term sources of uncertainty. We never know the specific source, just that phases of uncertainty will exist. To a large extent, then, the diversification that we have already implemented in your portfolio addresses this specific risk. The good news is that consensus earnings expectations for the S&P500 have been improving for both this year and next. Analysts are now expecting an 18% decline this year followed by a 25.7% increase next year. This result would be historic, because it suggests that 2021 earnings will be higher than in 2019. Earnings surpassing the prior high after a recession has always happened three years after the prior peak. The current expectation is that it would happen the second year.

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In Defense of Capitalism

The critics of any system seem to focus on the worst 5% and try to use this to define and discredit an entire system. The relevant things to consider are the cost of the 5% failures, the benefits of the 95% of successes, and the cost to fix the 5% of failures. If you ignore the benefits of a system while destroying it, you will be far worse off. But the 5% is what gets people's attention. People who want power or want to gain your attention to convert your time into advertising revenue will focus on and hype the 5%.

Capital, both human and financial, is valuable. It takes effort to develop, and the way that it is spent or invested should be thoughtful and measured to make sure that is remains possible to continue its investment going forward. We should want capital to be available in a sustainable way.

Human capital or talent is widely dispersed throughout our country and world. There is no way a centralized group of "managers" can come close to identifying who is good at what. A system that has financial capital dispersed, and has a financial incentive to find, fund and support a country's dispersed human capital will flourish far more than a country that attempts to control everything from the top.

Every human system is flawed because it is made up of humans. We need checks and balances. Companies have both shareholders and boards of directors that can hold company managements accountable. Government also plays a critical role in creating regulations that reflect the priorities of a society and provides another source of accountability. Getting this balance right is difficult. The best we can hope for is to oscillate around the perfect amount, without going too far one way or another. Going to either extreme will greatly reduce the benefits to society and rejecting the system outright would be just as damaging, if not worse.

That is a synopsis created to fit in this space. If you would like to discuss this more, we would be happy to do so.

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