QUARTERLY COMMENTARIES

RISKS & REWARDS LEADING INTO THE ELECTION

Kurt Hoefer, CFA

Q3 2020 Quarterly Commentary – October 1, 2020

2020 continues to be a year for the record books. Following a first quarter that saw some of the most precipitous stock market declines in history, the U.S. markets finished the third quarter in the black. For the year, the Dow Jones Industrial Average is down by -2.4%, the S&P 500 is up by 5.6% and the Nasdaq Composite is up by 25.3%, including dividends. The last number was not a typo, but is rather a reflection of the fact that a disproportionate share of stock market gains in 2020 have been from a small selection of large technology stocks that dominate that index, including Alphabet, Amazon, Apple, Facebook and Microsoft, whose business models and financial strength have enabled them to weather the COVID-19 storm far better than most other industrial, financial and service businesses. Further, the flood of liquidity formed by the Federal Reserve interventions had to find a home, and large capitalization technology stocks were among the beneficiaries. As a group, domestic small capitalization stocks and most major foreign equity markets continued to underperform U.S. large capitalization issues. In fact, if the five largest stocks in the S&P 500 were excluded in the calculation of that index's return, the remaining 495 issues produced a year-to-date loss of -2.9%.

There is both bad news and good news in the above statement. On one hand, this large portion of the index, a few of which have been Summitry holdings, are no longer as cheap as they once were. As a result, we have been forced to sharpen our pencil when sizing our positions, a process that has led to the sale of Apple from client accounts, for example. This action is further discussed below. On the other hand, because so many stocks have not participated in the overall market's gains in 2020, we believe that the market still offers opportunities for us to find sensible investments for the portfolio. As always, we will deploy cash into these new opportunities only when they meet our investment criteria requiring an intrinsically good business offered in the market at a compelling price.

In fixed income markets, the U.S. Treasury yield curve remained relatively constant through the quarter, with the 2-year and 10-year Treasury notes yielding 0.13% and 0.66% respectively on September 30th. Investment grade corporate credit spreads (the additional return above Treasury rates required by investors to accept the higher risk of corporate bond defaults) is close to historical norms after spiking amid the acute phase of the Covid-19 financial crisis. This suggests to us that investors expect high-grade corporate issuers of bonds to stage a solid earnings recovery and face little risk of default. The Barclay's Aggregate Bond Index returned 6.8% for the year through September 30th, driven by Federal Reserve action and investor flight to quality, and 0.6% in the third quarter of 2020.

Most fixed-income securities today offer little return and present a challenge to investors who have historically relied on them for income. Higher-yielding securities have commensurately higher risks, and in our opinion, this tradeoff of accepting higher risk for additional return is not favorable in most circumstances. For example, credit spreads on junk bonds are too narrow, in our opinion, to justify the meaningfully higher default risk resulting from the economic shutdown. We will avoid the junk bond markets. We do not suggest that clients whose situations warrant a more conservative posture abandon the bond markets, as they provide an important buffer against equity volatility, however bond investors need to have realistic assumptions about what their holdings will generate over the foreseeable future. Higher income can be found through selected equities, and we have a vehicle designed to produce income from dividends, but using this strategy involves accepting the additional risk that comes from exposure to equity markets. We can help you determine if it is an appropriate solution for you, and we are always available to discuss bond strategies in the context of your long-term financial plan.

The Election

We have written about the election in a recent blog piece and hosted a conference call for clients to offer a D.C. insider's view of the election, but we understand that this is an event that has few parallels, in terms of the passions fueled by this race. There is a higher-than-normal probability of a contested outcome to this election, in part because the race is close in several key states, in part because of mail-in balloting made necessary by Covid-19, and in part because of the unusually vitriolic political atmosphere in which we find ourselves today. A contested election could delay the final determination of who (and which party) will control the executive branch and perhaps the Senate, and markets may react violently. Or perhaps they won't. We are often surprised by markets that go in the opposite direction of what our intuition suggests in reaction to well-publicized events.

If you know us well, you know that we don't like to make predictions that are tantamount to guesswork and act on them with your wealth. To us, that would be wholly inappropriate for any fiduciary, as well as unproductive. The outcome of the election will be known eventually, the world will keep turning on its axis, and wealth will be created by those businesses that adapt well to whatever changes come from the shifts in government power. We do pay attention to elections—and we certainly vote!—but we don't believe the outcome should be a major factor in our investment selection process. Our research time is spent understanding the businesses we own and making judgments about their growth opportunities on one hand, their resiliency in the face of adversity on the other, and determining a fair price to pay for this reward-versus-risk relationship. The portfolio, as it evolves, is a reflection of these judgments. To work, the process must be devoid of emotion and personal biases that are so easily surfaced at election time.

Should the markets turn volatile for whatever reason (not a prediction by any means), please know that we will be watching and working to position your wealth as best we can to produce attractive long-term results. Please note that in the depths of the crisis around Covid-19 during March, we were buyers more than we were sellers, taking advantage of an opportunity to improve the quality of the portfolio and purchase securities that we had eyed for months or years, and which the market suddenly offered to us at a deeply-discounted price. One can choose between two attitudes toward volatility: It can be the thing one dreads and therefore tries to avoid, or it can be viewed as a frequent and normal condition of healthy markets, and a condition that creates opportunity for disciplined investors. If one's attitude is the former, then one should adjust expectations of long-term returns downward. This can be perfectly acceptable if one's financial plan requires stability rather than growth. If one's attitude is the latter, then we have the conditions for the long-term compounding of one's wealth.

Q3 Portfolio Changes

*Please keep in mind, these commentaries should not be construed as a recommendation to buy or sell the securities discussed. Such decisions are made only within the context of the market environment as we perceive it at the time of the decisions and the structure of the diversified portfolio of which the securities are a component. ****

During the quarter we exited our position in Apple.

Apple

Apple needs no introduction. We first invested in the company eight years ago assuming that Apple was well positioned to benefit from growth in the smartphone industry. Over the course of our holding period, Apple has created a powerful ecosystem around its devices and pursued new areas of growth in wearables and services, which expanded its economic moat.

The future of Apple looks promising, but unfortunately the stock has become significantly overvalued, in our opinion. While we are always reluctant to sell a great business, we cannot justify holding a position when the stock price materially exceeds our fair value estimate, even in the best-case scenario. At the time of our sale, Apple stock traded at almost 40x earnings, a valuation that assumes nothing short of perfection. In this blog post we provide more details on our thinking behind this decision.

Additions to the Team

Despite our shift to remote operations, we have been active in our recruiting efforts and are pleased to announce some new additions to the team. We never imagined that we would be conducting our efforts virtually but have found that video conferencing has been an acceptable substitute to physical meetings for this purpose. Under the leadership of Tiffany Lessler, Talent Manager for Summitry, we have used technology to broaden our searches for the most talented people in our industry and fill a pipeline of candidates. Interviewing has been simplified for both the candidates and our team, and consequently we have been able to build a quick consensus around those we think are the best fit for the firm.

We welcomed William Lorne to Summitry in July as a member of our Business Operations team. Will is a 2018 graduate of UC Davis, with a Bachelor of Science degree in Managerial Economics. Following his graduation, he worked for State Street Bank where he processed over-the-counter derivative transactions, reconciled client trade ledgers and performed similar functions to ensure timely and accurate processes and meticulous risk management. This experience will be particularly useful to Summitry as he takes a role with our trading team, among his various duties to the firm. Will grew up in Stinson Beach, where he developed a love for the ocean and a passion for its conservation. Outside of work, Will can typically be found on a golf course or on an auto racetrack. This last avocation is fascinating to us. We are looking forward to getting to know the whole Will Lorne better once Covid-19 is in our rearview mirror. He’ll likely be looking at us through his.

Lisa Morabe made her debut in September in the role of Office Manager. There may not be much to manage with respect to our physical space today, given that we are currently working remotely, but Covid has provided a range of organizational challenges that will keep Lisa very busy for the period leading up to our return to our offices. Lisa graduated from UC Davis with a Bachelor of Science degree in Human Development in 2019. Her path after graduation led her to Kanagawa, Japan to teach English to children, but Covid-19 forced her to rethink these plans. Summitry is the beneficiary of this strange turn of events, and we look forward to giving Lisa a great platform for professional growth. Future visitors will certainly have a chance to meet Lisa as she will be stationed at our reception desk.

Two additional candidates accepted our offers of employment in September and are scheduled to begin with us in October. We welcome Winnie Butt, CFA, CFP® to Summitry as a Senior Financial Advisor. Winnie has served the wealth advisory needs of individuals and families since her graduation from Macquarie University in Sydney, Australia. In her native Australia, Winnie served with Mercer, Perpetual Limited and Mercury Private in advisory roles catering to the needs of high net worth and ultra-high net worth families. Upon her move to the United States, she joined Mill Valley-based investment advisory firm, Brouwer & Janachowski. Winnie comes to Summitry with great credentials as well as great experience. She has earned a Bachelor's degree in Economics with a focus on Finance from Macquarie in 2004, an Advanced Diploma in Financial Planning from Kaplan Professional, a Chartered Financial Analyst charter from the CFA Institute, and a Certified Financial Planner® designation. At Summitry, Winnie will closely align her practice among an advisory team that includes Mandy Pham, CFA, CFP® and David Langhals, CFP®. We look forward to having her here.

Alex Leitzes will also join Summitry in October in the role of Business Development Principal, reporting to the firm's Chief Growth Officer. Alex joins us from Fisher Investments, where he currently serves as Portfolio Counselor and is charged with introducing prospective clients to that firm's Private Client platform. Alex had great success at Fisher, having ranked among the highest in respect to the firm's key performance metrics for his role. Prior to Fisher, Alex served as a Private Banker in the wealth management division of JP Morgan Chase Bank. He is a graduate of Indiana University and earned a Bachelor of Science in Public Affairs in a program affiliated with the Kelley School of Business in 2011. At Summitry, Alex will build and maintain relationships with client-facing professionals at Charles Schwab, helping Summitry maintain its position as a preferred solution for clients of Schwab who would benefit from the comprehensive financial advice that we provide to families with significant wealth. For prospective clients of the firm, Alex will ensure that the right resources of Summitry are brought to bear, and that the solution crafted is tailored to meet the specific needs of that person or family.

***The securities identified do not represent all of the securities purchased, sold or recommended for client accounts. The reader should not assume that an investment in the securities identified was or will be profitable. All material of opinion reflects the judgement of Adviser at this time and are subject to change. This material is not intended as an offer or solicitation to buy, hold or sell any financial instrument or investment advisory services.