INVESTMENT CONCEPTS
JULY 2020

2nd Quarter 2020 in Review

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I hope this letter finds you safe and healthy.

Many of the emails I have either sent or received during the past quarter included this or some related sentiment as we have tried to maintain personal connections while at the same time reducing face to face contact. When something gets repeated this often, it tends to become trite, but please be assured of our genuine concern for your health and well-being.

Writing this around the Independence Day holiday naturally has me thinking about our country. America has faced its share of obstacles this year, such as: the physical toll of COVID 19, the economic and emotional tolls of the response, the ongoing journey toward racial equality, and the tensions of a politically divided citizenry in a Presidential election year, just to name a few. Add to that the anxiety that comes from the plethora of unanswerable questions like:

"Will I be able to keep/get a job?"

"Are my kids going to be able to go back to school?"

"Am I or someone I love going to get sick?"

"Will I get judged if I wear/don't wear a face mask?"

"What will a post-Covid world look like?"

and you get a culture whose collective nerve seems to continually reside on the edge. But here's the thing about America, while our history is littered with times we have failed to live up to our highest ideals, there are even more examples of when we have overcome challenges and dark days to become stronger, healthier, smarter, and a greater force for good in the world. Ours is a story of redemption. Of course, there are things that need fixing, changing, and improving, but there are also many things to love. Our office staff brainstormed a partial list of things that we find great about the USA:

- Freedom
- Apple Pie/Peach Cobbler
- Free Public Restrooms
- Interstate Highway System
- Amazon Prime
- Elvis
- Sweet Tea
- Diversity
- Museums
- Theaters
- Michael Jordan
- Baseball
- Restaurants
- Family Dinners
- Access to music/video everywhere
- The American Flag
- Roadside Attractions
- St. Patrick's Day
- Comedians/Artists/Entertainers
- National Parks
- Google
- Beaches

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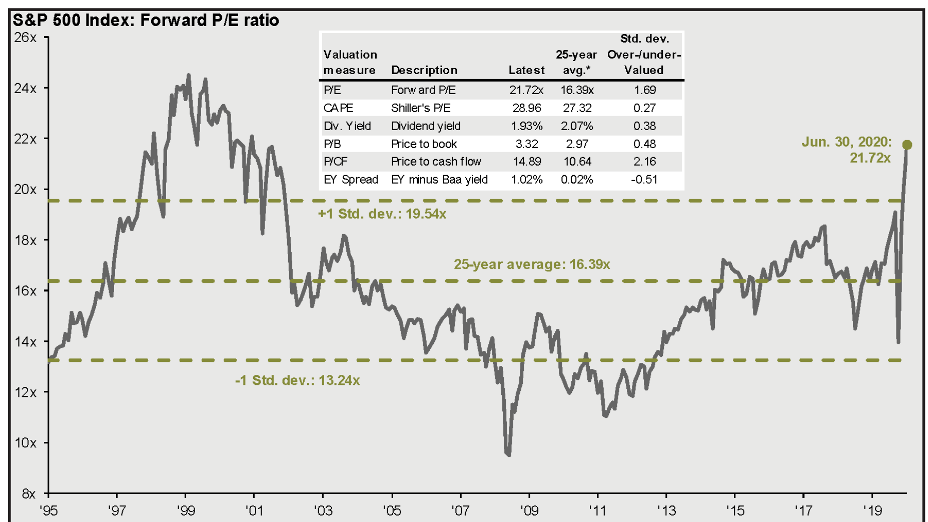
Speaking of great, the stock market had one of the greatest quarters in its history during the second quarter of 2020; particularly remarkable considering what the world was going through at the time.

Index	2nd Qtr 2020 Return	1 Year Return	3 Year Annualized Return	5 Year Annualized Return
S&P 500	20.5%	7.5%	10.7%	10.7%
Nasdaq Composite	30.9%	26.9%	19.1%	16.4%
Russell 2000 – Smaller Companies	25.4%	-6.6%	2%	4.3%
MSCI EAFE – International	14.9%	-5.1%	0.8%	2.1%
Barclays US Aggregate Bond	2.9%	8.7%	5.3%	4.3%

Many people have wondered how the stock market can rise so significantly when you have double digit unemployment, negative GDP, low consumer confidence, and general economic turmoil. Any answers to this question are overly simplistic out of necessity, but here are a few points:

- The economy and the stock market are not the same. While the market generally takes its cues from the economy, it is more forward looking and considers a host of structural factors that are not necessarily economic such as taxes, appetite for risk, government spending, psychology…
- Some companies and industries have done well during the pandemic – think tech and healthcare – and their stocks have been rewarded.
- The recovery, particularly in the area of consumer spending, is happening faster than most analysts were expecting.
- Aggressive actions taken by the Federal Reserve and Congress provided market participants confidence, fueling expectations that markets will continue to function properly and the Fed will serve as a backstop when appropriate in the future.
- A small but interesting component to the stock market this past quarter has been an influx of investors who have opened up trading accounts to scratch their competitive itch left by the lack of sports to care about (or wager on).

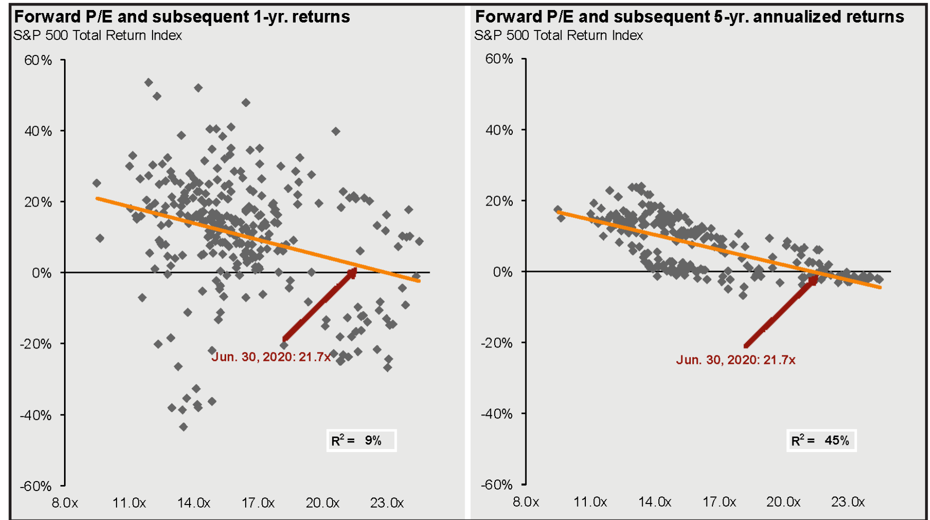
So where are we now? To the right is a chart that we have been monitoring closely in our investment committee meetings over the past few months. It shows the price to earnings ratio (P/E) of the S&P 500 over the past 25 years, as well as the current levels of some other market valuation measures compared to the 25-year average.



Source: J.P. Morgan Asset Management

If you are unfamiliar, this is showing that for every dollar expected to be earned by companies in the S&P 500 in the next 12 months, the market value is trading at 21.7 times that amount. For the past 25 years, that number has averaged closer to 16 (Slight rounding, but the S&P 500 ended the quarter at a value of 3100 and consensus estimates are for earnings of $143). As you can see, this indicates that

the stock market is trading at valuation levels that are considerably higher than average. While there is much more context here and investing decisions cannot be prudently made based on one data point, we think this is worth watching, particularly considering the following in the chart to the right:



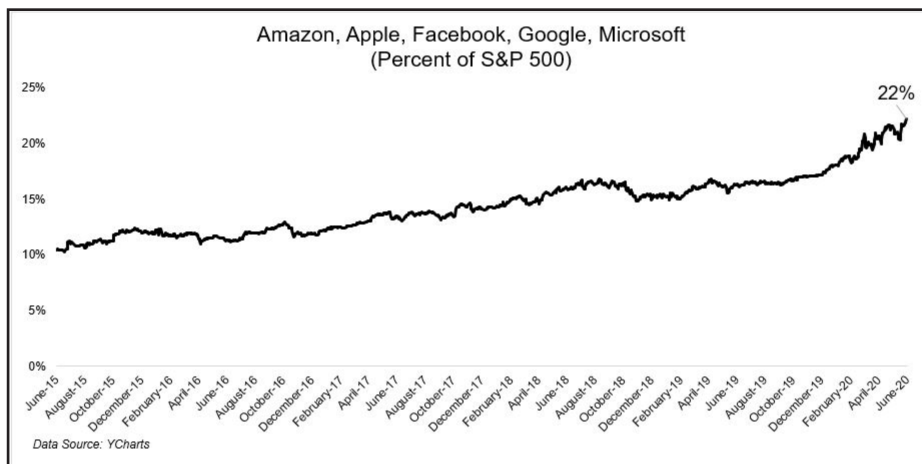
Source: J.P. Morgan Asset Management

I know this is a little "mathy," but bear with me. To read these charts, pick a P/E level anywhere on the horizontal line and assume that you invested in the stock market that had that P/E, then find a grey diamond directly above or below that point – that is what the market has historically returned in the 1 (left chart) or 5 (right chart) years that follow. The 1-year returns are all over the place, but the 5-year chart tells an interesting story. The higher the P/E is, the lower the returns over the next 5 years have been, and at the current levels, the subsequent returns have often been negative.

I cannot stress enough that this does not tell the whole story. When making portfolio allocation decisions we are analyzing much more than just P/E ratios; but if nothing else, it does indicate that market risks have elevated and potential returns have decreased.

This is why most of our clients at Castle have seen us recently reduce the amount of their portfolios devoted to equities. This is not a permanent shift, but one intended to take a little risk off the table until valuations again are in investors favor. What would make this happen? From a math perspective it is one of 2 things, either a lower P – the stock market drops, or a higher E – earnings grow.

Quiz time. Can you name the 5 biggest American stocks? How do they construct the S&P 500? Most people rightly connect that the S&P 500 is a combination of the 500 biggest stocks in America, but wrongly assume that the 500 companies are approximately equally represented within the index. The S&P 500 is a "cap-weighted index" which means larger companies impact its performance more than smaller companies. How much more might surprise you. The 5 biggest stocks are Microsoft, Apple, Amazon, Facebook, and Google (now called Alphabet). Together those 5 now comprise a stunning 22% of the S&P 500, a tribute to how powerfully they have grown relative to other companies. Consider that just 5 years ago their combined weight was 10% of the index.



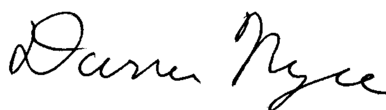
Source: https://theirrelevantinvestor.com/2020/06/22/a-giant-update/

One place this shows its significance is in performance comparison. Notice that these companies are all fast-growing technology companies. If you are a conservative investor, it is likely that your portfolio contains more of what are known as "value" stocks compared to "growth" stocks. These companies have historically been less volatile and have provided a smoother ride during down times. But in recent years, unless your portfolio contains a high concentration of the 5 biggest stocks, it is likely to have generated a return that is less than the S&P 500. This does not mean that your portfolio is sub-optimal, just that the investing world has favored different kinds of stocks as of late.

A few housekeeping items as we close this quarter's letter. In an attempt to improve the way we provide information and reports to our clients as well as enhance operational efficiency, we are in the midst of transitioning to a new software system. This will show up later this year as a new look to the reports used for investment review meetings and increased online access for clients to view their portfolios. We expect this to be a positive change, though we appreciate your patience if we experience some reporting hiccups during this transition. More information will be forthcoming as the new system comes online.

Additionally, those receiving the paper version of this letter will have noticed some official looking documents on top of the contents in this mailing. This is called Form CRS and is a new mandate from the SEC that investment advisors provide to existing and prospective clients. It is designed to spark questions that you might want to ask your advisor about their services, fees, conflicts of interests, etc. There is no action required by you, but if you have any questions, we would be glad to answer them. A copy of the form is also available on the investment page of our website at castle3.com.

Wishing you all the best during this wild year.



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