Financial Markets

Building on the recovery that began the last week of March, stocks recorded their best calendar quarter in over twenty years. As measured by the S&P 500 Index, stocks gained 20.5% during the three months ended June 30. From the market bottom of March 23, the Index is now up 39.3%. Other equity indices, both domestic and international, also registered gains well into the double digits. US smaller capitalization stocks, as tracked by the Russell 2000®, outpaced their larger cap counterparts by almost five percentage points dur the quarter. For the yearbl7 (e) (.)-6.3( )]T1.7 (,)1Trae. 62o 494.(,)1Tre56 .TJ 0.8.6 (h)-9.7 (e)-2 d t bg d5.i0w -17..8l3 -1.36 Td [(a)-4.

It isn't difficult to understand the extraordinary stock performance of these mega capitalization companies. For instance, Microsoft's prospects might actually have improved during the pandemic as businesses seek to enhance the interconnectedness of global customers and ease the barriers to working from dispersed locations. Similarly, Apple has benefited from ever greater reliance on their easy-to-use devices and access to a growing suite of service offerings. Amazon's rapid growth has only accelerated as shoppers avoid traditional brick and mortar stores. Moreover, these businesses generate prodigious free cash flow. Nonetheless, the stocks of all these companies entail appreciable risk. Valuations of several have risen to multi-year highs as investors seek to participate in these trends. Meanwhile, global regulators are troubled by the concentration of market power they have accumulated. And, of course, the rules of competition, which have trimmed the prospects of previous dominant companies, have not been repealed.

Besides this handful of dominant companies, several newer companies—frequently referred to as COVID-19 beneficiaries—have seen their stocks rise dramatically in 2020. These are companies we have become newly dependent upon, whether for communication, entertainment, e-commerce, or our health. With perhaps lasting secular changes in the economy (e.g., more working from home), some of these companies may indeed demonstrate their business models can be sustained. The success of many, however, we suspect will prove fleeting. Regardless, most of these market darlings now carry valuations that imply long-term growth projections we view as highly speculative.

Though portfolios we manage participated in this quarter's market recovery, the character of the market's performance led to disappointing results relative to equity indices. While portfolios maintain substantial positions in several of the large companies we judge to have both strong business models and reasonable valuations, we have avoided investments in companies whose valuations we believe entail too much risk. Portfolios also have little exposure to those newer companies with unproven business models and largely uncertain growth prospects. Despite the recent challenges, we remain committed to broadly diversified portfolios comprised of reasonably valued companies with strong financial underpinnings and well-conceived business models.

What's Driving the Market?

Any way you slice them, stocks have recovered much ground since the depths of late March. And although the pandemic rages on, there are logical if debatable