Information through 3/31/2021

ASB Investment Management
Institutional Portfolio Management Quarterly Review

EQUITY MARKET REVIEW

As the calendar turned to 2021 there were ample reasons to be concerned about equity markets. Market valuations were looking stretched after the powerful rebound from pandemic lows in March back to all time highs by the end of the year. COVID-19 cases were surging as new infection rates in the US were at the highest levels since the pandemic began.

Yet the momentum of the equity markets didn't falter. The S&P 500 tacked on another 6.17% gain in the first quarter. Optimism prevailed for several reasons, the most prominent of which were anticipation of significant new fiscal stimulus and the aggressive roll-out of vaccines across the country.

While momentum in the equity markets continued, the composition of winners and losers changed. The year 2020 saw the largest divergence in history between growth and value stocks. Growth stocks outperformed value stocks by more than 32% driven by a tech sector that was seen as a beneficiary of accelerated technology adoption in the wake of shut-downs, remote work, and remote schooling.

In the first quarter of 2021 the market broadened out to include value stocks and cyclical stocks in anticipation of a surge of economic activity as we move toward herd immunity and a gradual reopening of the economy.

EQUITY STRATEGY

Our equity strategy is driven by three broad fundamental factors: profitability, balance sheet strength, and valuation. We consider this an evergreen strategy. In other words, we do not waver from the discipline of this approach regardless of changes to market regime or macroeconomic backdrop.

While strategies that emphasize fundamentals are often contrasted with quantitative strategies, we think this is a false dichotomy. All of the fundamental factors we use can be quantified and thus we employ quantitative tools to help us identify attractive assets.

In the following paragraphs we take a closer look at each of the three fundamental factors and how we incorporate them into our investment process.

Profitability

The core function of (most) businesses is to generate profits. How efficiently a company does this can be measured many ways. For example, we look at return on equity, return on invested capital, operating margins and free-cash-flow margins. We are seeking companies that consistently produce higher profitability ratios than their peers in a given industry. We then try to identify why the company has been able to do this and if this excess profitability is likely to be sustainable going

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forward. Reasons for sustained excess profitability can include technological superiority, intellectual property, brand strength, industry structure, and scale advantages.

Balance Sheet Strength

We are strongly biased toward companies with minimal debt burdens and ample cash. Such companies can run their businesses from cash generated from operations and if that cash exceeds the operating needs of the business the excess can be returned to shareholders. Moreover, if the need arises to take advantage of a large expansion opportunity, the company will likely be able to borrow at preferential rates given the health of the balance sheet.

Valuation

The first two factors help us to identify highly profitable, high quality companies. The final factor helps us determine whether the company's shares trade at a price that is reasonable vis-à-vis the strength of the business. Importantly, valuation is always the final factor, never the first. In other words, we don't seek out cheap stocks (which often are cheap for good reason) and then try to identify the best of the worst. Rather, we try to identify high quality companies using our first two factors and then use valuation measurements to determine if a company is investable at current prices. We are agnostic to style (growth vs. value) but as core managers we are conscious of not allowing the overall portfolio to drift too far to either end of the growth/value continuum.

FIXED INCOME REVIEW

During the first quarter bond investors were treated like wallflowers at the high school dance, on the outside looking in as everyone else enjoyed the party. Equity and commodity prices rose to new highs and residential real estate surged, but bond prices sank with a velocity not seen in decades. Interest rates rose and inflation fears drove bond prices lower as the Aggregate Bond Index fell -3.4% to begin the year. The negative total return represented the index's worst quarterly return since ten year treasury yields rose to an all time high of 15.8% in the third quarter of 1981, when Paul Volker was hiking short term interest rates to stem double digit inflation.

Looking ahead to the rest of 2021, strategists expect real GDP to increase 9% and nominal GDP 11.7%. Over the past two years, house prices have increased 25% and bank deposits 33%. Gains in employment are likely to total one million new jobs in both April and May, including revisions to previous months.

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With the economy doing well by these metrics, stimulus spent to speed the recovery may be acting like fuel spilled onto a roaring fire. The economy has not absorbed $600 billion from last year's stimulus package, and yet immediately after passing the most recent $1.9 trillion stimulus package the Biden administration announced plans for $2 trillion of infrastructure spending. Moreover, this fiscal stimulus occurs with the tailwind of an accommodative Fed, determined to keep short term interest rates at zero likely until 2023.

A year ago Detroit auto plants were shut down so hospitals would not be overwhelmed with Covid patients. Today, factories fight to meet increased demand as suppliers struggle to fulfill the need for materials. U.S. manufacturing expanded in March at the fastest pace since 1983. U.S. order backlogs lengthened in March to the strongest reading since 1993, as a measure of supplier delivery times reached a near fifty year high. Widespread material shortages, rising commodity prices, and product transportation difficulties are affecting all segments of the manufacturing economy.

The rebound is global. Factory activity in Taiwan has led Asia's rebound after the Lunar New Year, Euro-area manufacturing was reported as strong, and the Global Purchasing Managers Index advanced to a decade high.

Not only is the economy taking off, but the rate of economic growth may be accelerating. The JP Morgan Forecast Revision Index, a measure of the magnitude of change of economic releases, recently experienced its single biggest upward move since the index's 2002 inception. Amid the signs of economic growth, investors worry about the onset of inflation.

FIXED INCOME OUTLOOK

With regard to interest rate risk, we have positioned most portfolios near benchmark index durations as the quarter comes to a close. Markets are a discounting mechanism, constantly pricing available information and expectations into current prices. Fundamentally, interest rates seem poised to increase. Pent up demand is increasing as vaccinated consumers spend accumulated savings. Trillions in government fiscal spending and a Federal Reserve committed to accommodative monetary policy are forces driving rates higher. Inflation expectations have increased. We expect to position most portfolios short of benchmark durations for most of the year. Extreme sentiment and the velocity of the recent advance of rates have, over the near term, kept us from positioning portfolios shorter.

Not only did interest rates rise, but the yield curve continued to steepen during the quarter. The difference

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between two year Treasury notes and thirty year Treasury bonds widened from about 1.50% to 2.25%. The shape of the yield curve represents a strong indicator of where the economy is positioned within the economic cycle. A steeper curve indicates additional growth ahead, as well as investor fear of future inflation.

We believe the treasury curve will continue to steepen. Two bond portfolios with identical weighted average maturities but different maturity bucket exposures perform differently when the slope of the curve changes. In a steepening environment the portfolio with bonds concentrated into fewer maturities close to the average life of the portfolio will outperform the evenly laddered maturity bucket portfolio. This trading tactic represents one way active managers add value to fixed income portfolios, and we position portfolios whenever possible to benefit.

Even though credit spreads are within basis points of February, 2018 post Financial Crisis tight levels, we remain overweight spread assets, including corporate, asset-backed, mortgage-backed, and taxable municipal securities. The strong fundamental factors pushing rates higher underlie strong credit fundamentals. In a low interest rate environment, the same incremental yield pickup of spread assets over treasuries represents a higher percentage of the base treasury rate than in a higher rate environment. We also remember the prolonged period of most of the 1990's of tight and stable credit spreads, from 1992 after the 1990-91 RTC-commercial real estate recession, through the tech-telecom-internet boom that peaked in early 2000.

The increased volatility of interest rates and tight credit spreads place a premium on relative value security selection and prudent investment policy that helps investors meet long term objectives through multiple market cycles. The harsh circumstances of the pandemic have impacted all of us. We are hopeful that the economy will continue its forward momentum and look forward to sunnier days ahead.

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