

OBSERVATIONS

Tandem Investment Advisors | William “Billy” Little, Jr., CFA

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Financial Markets Review

In March, I made an analogy to what we were experiencing in the economy and financial markets to that of a hurricane. Upon further review, the hurricane analogy should be upgraded to that of a perfect storm. Webster’s Dictionary defines a perfect storm as “a critical or disastrous situation created by a powerful concurrence of factors.” What we are experiencing this year from a social, health, political, lifestyle, economic and financial aspect can only be referred to as the perfect storm of 2020. Any one of these factors alone will wreak havoc; however, when the forces collide, the intensity of the storm gets exponentially larger and the path of destruction is far and wide.

We find ourselves at the halfway marker for this year and I would surmise that we are firmly in the eye of the storm. The issues that have plagued the world through the first and second quarters of 2020 are still intensely circling around us and have not fully passed. From a financial markets’ perspective, a sense of relative calm and stability has set in, at least relative to what we witnessed in March. The S&P 500 rebounded 20% in Q2 and is now less than 5% away from getting back to even on the year; the Nasdaq soared over 30% in Q2 and sports a year-to-date return of nearly 14%; the U.S. 10-year Treasury yield has traded in a fairly tight range around 0.65% for several weeks now after falling as low as 0.38% in March; investment-grade corporate spreads have also been trading more consistently with an OAS (option-adjusted spread) of 160 basis points, which is down from a high of 400 basis points a few months back; and lastly, crude oil is back to trading on either side of \$40 a barrel after shortly trading on the wrong side of \$0. All in all, trading ranges across most asset classes have significantly narrowed over the past month leading many in the industry to debate the next move. Is the worst behind us or is this just the calm before the backside of the storm?

Preparation

“Hoping for the best, prepared for the worst, and unsurprised by anything in between” – Maya Angelou

Whether we are on the road to recovery and headed back to pre-COVID life, moving through the eye of the storm in anticipation for more of the same pain we have recently endured or something totally unexpected; there is no excuse not to take this time and prepare for what the future may hold. Everyone should use past experiences and mistakes to better themselves.

As an individual investor, this is the time to analyze your portfolio to make sure it matches your risk and return expectations. The time to make changes is when you can objectively analyze the matter at hand, which is inherently from a position of strength. When investment decisions are made from a position of weakness, they are typically done amidst an emotionally charged environment. With equity markets clawing back all losses from earlier in the year, you essentially have a do-over. If the volatility you experienced in Q1 was too much to bear, this is the perfect opportunity to assess your ability and willingness to take on risk. A disciplined and well thought-out plan will go a long way in helping you quell the emotional side of investing.

Every year the Federal Reserve runs a stress test on banks to determine if they have enough capital to withstand an economic crisis. The recent global shutdown was a live stress test for not only banks, but companies across all industries. Boards and executives have an opportunity to evaluate every facet of their businesses – revenue diversification, supply chain management, capital structure and employee welfare – to get their “house” in order. During a crisis, weak and mismanaged companies get exposed. For years now, we have highlighted the exponential rise of corporate debt and the misuse of those funds – namely, debt-fueled share buybacks. In many cases, companies have been paying out over 100% of cash flow to shareholders and making up for the cash they do not generate with the proceeds from issuing new debt. We are now seeing that this cash strategy has a finite life. At some point the amount of debt overwhelms a company’s balance sheet and they can barely service the debt, let alone pay back the principal. These are known as zombie companies.

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es. Recently, Deutsche Bank Securities estimated that nearly 20% of all U.S. corporations are in zombie status, a staggering statistic if you take the time to really think about it. Deutsche Bank is suggesting that one-fifth of all U.S. companies are theoretically bankrupt.

I will save the commentary regarding the moral hazard created and recently exacerbated by the Federal Reserve for another day. One could argue it is their decade long unconventional monetary policy that has gotten us to this point. However, there is no reason to cry over spilled milk. It is time for companies to identify what it will take to continue operating as a going concern for decades and centuries to come. If a company's balance sheet needs to be de-levered, it should use the recent bounce in the equity market to issue the shares it may have repurchased over the past few years to pay back the debt. It is time to put the ego aside, act responsibly and recapitalize the balance sheet. If only more companies could follow the lead of one of our long-time core holdings – Becton Dickinson (BDX), who recently issued \$3 billion of common and preferred equity to pay down their debt obligations – U.S. companies would be better prepared for whatever the future may hold.

Tandem Strategy Update

Over the back half of June, volatility picked up a bit as COVID-19 new-case growth and hospitalizations began to increase across the South and West. The S&P 500's 8% ascent over the first six trading days of June was hastily taken back over the course of a couple days. These quick moves in the market were a good reminder that volatility is still very much with us. As we have mentioned countless times before, opportunity can be found in the throes of volatility. And thus, we were able to increase our positions in a handful of core holdings across all our strategies – Comcast (CMCSA), Essential Utilities (WTRG), Euronet Worldwide (EFT), JM Smucker (SJM) and NV5 Global (NVEE). In addition, we finished the liquidation of TJX Companies (TJX) and Ross Stores (ROST).

As earnings season draws near and with almost 80% of S&P 500 companies having not provided guidance, it is likely that volatility will pick up. The summer months tend to be void of volatility while many traders enjoy the beach. However, with all the uncertainty surrounding the economy and coronavirus-induced travel restrictions, I suspect there will be more opportunities for portfolio positioning over the coming weeks and months.



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Billy Little is a shareholder, Vice President and the Lead Portfolio Manager for Tandem Investment Advisors, Inc. Mr. Little began his career in the investment industry in 2004, as a Financial Advisor with Ameriprise Financial in Baltimore, Maryland. Mr. Little joined Tandem in 2006 where he directs Tandem's quantitative research. He is a regular member of the CFA Institute and past President of the CFA Society South Carolina. Mr. Little graduated from the College of Charleston with a Bachelor of Arts in Business Administration with a concentration in Finance.

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