

“Valor Views”
COVID-19 Thoughts & Model Adjustments

By: Lee R. Johnson, Jr., CFA | Chief Investment Officer | April 17, 2020

Think Clear Skies

As I write this from my home in Chester Springs, PA, I thought I would share a few thoughts unrelated to work, the stock market or the economy. There is plenty of that in the pages that follow.

First, I want to extend my warmest wishes to everyone out there and my hope that you are all safe and healthy. The top priority right now is your health and the well-being of you and your family. That is the most important thing.

Second, I urge you to stay positive because I firmly believe the human spirit always prevails. For me, I think back to a 100-mile bike ride I did last year to Ocean City, NJ. It was a beautiful day and the group I rode with went through Philadelphia and crossed the Benjamin Franklin Bridge. As I began my ascent up the bridge, I passed a few people and then the path opened up in front of me. The sky emerged and served as my view the whole way up. It was such an invigorating blue no matter where I looked. Even the sound of the passing cars went silent. At the top of the bridge, I stopped and looked around and could see for miles. There wasn't a cloud in the sky and the view was spectacular. I looked back at the city and thought “well I just rode through all that confusion and commotion and made it up here safe and sound and now it's so nice and calm”. There were no limits as I stood there. I compared it to what I do on a daily basis working in the stock market. Where there is constant uncertainty and constant commotion. I thought “this is just like the market...if you stay the course, think positive and stay focused, you will find yourself in a better place and much better off for it”. This is how I am thinking right now. I am simply riding my bike up that bridge and thinking of that clear blue sky in front of me because I know there will be clarity on the other side.

Finally, as we all stay at home, think of all the good that brings. Think about the extra time you get to spend with your family, your kids, your pet, your significant other and/or your extended family. Think how you've had extra down time in the house to relax and unwind. Think how you've been able to reconnect with friends and family in different ways - perhaps through a “Zoom” meeting. Now you may be feeling separation anxiety as you adjust from your normal routine. And you may be doing things outside of your comfort zone. Like working from home or home schooling your kids. But think of it this way: is it really that bad? Or would you rather be in a hospital bed with a ventilator as your only hope for survival? Not me that's for sure. And I'm sure not you either. So let's all be mindful of that and focus on the good and think positive here. Because it's my belief the rest will work itself out in time. Now, let's get on to the markets and the economy.

Coronavirus Thoughts

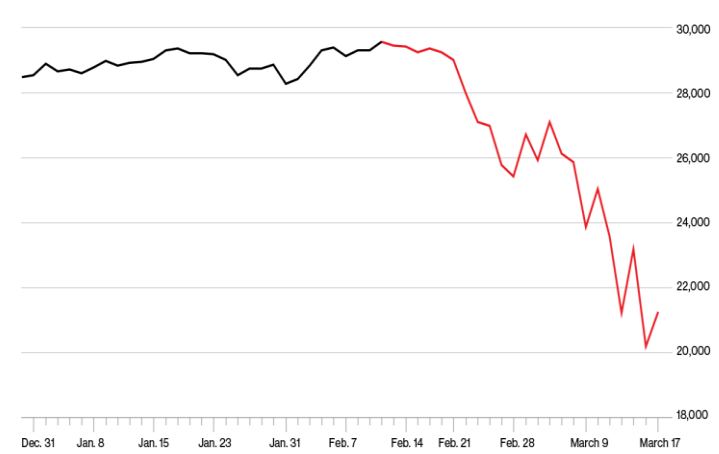
As we have ended the first quarter of 2020 and continue to experience the unknown with the virus, I have to say a big “WOW” and I think everyone would agree with me on that. I also think it’s fair to say that since the markets first dropped on February 21st, the entire world has literally been turned upside down. And caught off guard. We are certainly living in unprecedented times and are navigating uncharted territory. But that’s not to say investors weren’t expecting some form of a market correction before any of this happened. Because the market was trading at all-time highs to start the year and news had been circulating about COVID-19 since December. But the *degree and speed* in which all of this happened has been very unsettling to say the least. And more importantly: *historic*. If you look at the charts below (sourced from Yahoo Finance and Bloomberg) you can see the rapid decline we experienced in the market. It was the fastest decline in the history of the stock market; quicker than the crashes of 1929 and 1987. As a result, caution flags have risen all over and “risk off” has been taken to a new level. And for all the right reasons. But now the question becomes where do we go from here and how do we navigate the uncertainty ahead?

% Decline in the S&P 500 to bear market



Source: Yahoo Finance

Dow Jones Industrial Average 12/31/19 to 3/17/20



Source: Bloomberg

The Good and the Bad

When you shut a 22 Trillion economy down, we all know there will be consequences. The economic data is showing that as we speak with the latest jobs report coming in at 5.25 million people filing unemployment claims. Last week was no different at 6.6 million. The prior two weeks posted 6.8 and 3.3 million. That makes it an astounding 22 million Americans who have filed for unemployment since this crisis started. That’s because nearly 90% of the entire US population is under stay at home orders right now. Unfortunately, the majority of these people are at risk of losing their jobs. And since the consumer is roughly 70% of the economy, this will have a significant impact on future results and projections for our economic growth ahead. Such as GDP,

manufacturing and exports. It will also have an obvious effect on corporate projections for earnings and revenues. We will see this over the next several earnings seasons, the first of which is beginning now. And this will translate to lower valuations – most of which we’ve already seen with all the downside pressure lately. And unfortunately, I expect more volatility ahead, primarily driven by further declines in the jobs market. Even though we have four weeks of data, the bulk of the job losses will not be reported until May when the full month of April comes out. This is where I expect a peak. And it will probably cause further declines in the markets in the months ahead. I would not be surprised if we see the Dow dip below 20,000 and the S&P below 2,000. It’s unfortunate to be thinking this way but this is the reality if we consider the impact of lost jobs across the country. This is the reason why we have positioned ourselves more defensively across all Valer models (more on that below). So that’s the bad news.

But there is some good news too. As of April 9th, we now have **not ONE** but **TWO, \$2 trillion stimulus packages**:

1. The first, approved on March 26th, is called the “CARES Act” or the Coronavirus Aid, Relief and Economic Security Act. It is the most expensive piece of legislation ever passed and will provide much needed support to the economy through direct payments and incentives to individuals and families; expanded unemployment benefits; loans to small businesses; expanded healthcare funding and of course additional funding to support vaccine research. It will also provide up to \$58 billion to the airlines to help manage that industry amid the losses they are experiencing.
2. The second \$2 Trillion package is different. This package, announced on April 9th, is coming from **the Fed** who committed hundreds of billions of dollars in loans to mid-size businesses, along with the purchase of short-term municipal bonds directly from state and local counties. This is an unprecedented move by the Fed as it has never exercised its right to purchase municipal bonds. And this is on top of its prior commitment to buy corporate bonds too. Usually, the Fed just buys Treasury Bonds or mortgage backed securities. Or reduces interest rates. But this time is different.

“Put It On My Tab”

I thought I would break here and provide some insight on the concept of stimulus packages and what they mean in light of all this money magically entering the system. Because it may make you wonder where it’s all coming from and how it’s even possible. The first thing to understand here is this is all being done on a macro level with multiple layers of coordination between many authorities and institutions. And they all have one common goal: to keep our economy balanced and stable. And more importantly, to prevent a recession. The next thing to think about is basic economics – namely balancing supply and demand in an economy. In very simple terms, **the**

Government and the Fed work together to do this, by balancing the inflows (supply) and the outflows (demand) of our economy. In other words, money that's available (through the Fed, i.e. "the money supply") and money that's being spent (through the Government, i.e. "taxes"). Now that is a very broad statement but that's the general idea. Another way to look at it is while Government runs a "tax and spend" policy, the Fed – as the Central Bank – promotes borrowing and lending which in the most general terms is simply CREDIT. Then by working together, they balance the effect of the other. For example, when the Government "spends", money is distributed into the economy. Likewise, when the Fed raises/lowers interest rates or buys/sells Treasury bonds, it is adjusting the overall level of money in the economy which in turn is used to lend and borrow, i.e. available CREDIT. But too much money (CREDIT) is not a good thing, so a balance needs to be made. It's that balance that drives our economy. It's also the idea of money being readily available which also drives our economy. This gives people - and businesses - an opportunity to spend more which in turn drives productivity which in turn drives income and ultimately growth. It's a well-oiled machine that runs continuously on cruise control.

A good example is when you go to a bar and buy a beer. You can either pay with cash or open a tab. If you pay with cash, you've settled your purchase with the bar and your transaction is over. You've essentially done what the government does with "tax and spend". But if you open a tab, you are borrowing money from the bar with the intent to pay later. That allows the bar to drive more business because with more spending comes more productivity and growth. And in that way, *the bar* is essentially acting as *the Fed*. Now, assuming that all the bar tabs get paid by the credit card companies, it's a win-win for everyone involved. The patrons get their fill and the bar has a nice take for the night. Which in turn goes right back into the economy by way of the bar staff who eventually get paid and spend their own money. It's a cycle that gets repeated every day and it's that cycle that maintains equilibrium in the economy.

There is a very important point to make here. And that's the concept of CREDIT. Again, credit is the ability to borrow with the understanding you will pay later. It is the most important aspect of our economy because without it, an economy doesn't have a leg to stand on in order to grow. Credit also provides an additional (and immediate) source of money in the system. But what happens if something causes an unexpected disruption in the cycle? For example, what happens if people stop spending? What happens if businesses can't sustain their operations? What happens if the patrons at the bar don't pay their tabs or worse yet, they don't even show up? This is where a break in the economic cycle may cause a break in the credit cycle and ultimately an unanticipated slowdown in the economy. Which would require additional measures to be taken. And that's what is happening now where the Government and the Fed have stepped in to provide funding in the form of the two stimulus packages (and possibly more).

“Out of Thin Air”?

At this point you are probably asking where did all of this money come from? How can it appear out of thin air? That’s a very good question and it’s something that is commonly known as “printing money”. But that doesn’t necessarily mean someone is in a smoky back room somewhere printing money and handing it out like Santa Claus at Christmas time. It’s more controlled than that. But there is a common misnomer about this where the public tends to think the Fed “is acting irresponsibly” or the Fed is “endlessly printing money”. That’s not the case and again by *working together* to solve a problem in the financial system, the Fed and the *US Treasury* (the Government) establish a balance in the money supply which in turn promotes CREDIT that ultimately leads to more borrowing, more lending and ultimately sustainable growth.

The way “printing money” actually works is the Fed dictates an amount of currency to be circulated in the economy every year. This is authorized by the Board of Governors of the Fed. From there, the money is printed by the *US Treasury* and put into circulation. Under normal circumstances, the Fed regulates that money supply by adjusting interest rates and/or buying/selling bonds. But in extreme cases, like what we have now, the Fed goes on a buying spree for US Treasury bonds (or other types of bonds such as corporates or municipals like what is happening now). But the catch is where do the bonds come from? And that is where you can say “out of thin air”. Because essentially a bond is just a loan to another person, or an “IOU” obligation. Which can get created out of thin air as long as there are two parties willing to take the deal. And to take a bond, the person who is fronting the money has to be confident the bond will ultimately get repaid. Now classic bond fundamentals dictate a level of risk by which a bond will be sold in the open market. That risk is quantified in the form of price and yield, or the “coupon” that gets paid to the bond holder. And that is based on the credit worthiness of the lender or bond issuer. In this case, we are talking about the US Government issuing these bonds. And the US Government is essentially the most reliable entity to borrow from and therefore the least risky. This is because the US Government has authority to tax people and businesses. Therefore, any IOU coming from the US Government is “as good as gold” as some might say. So, when the US Treasury issues these bonds, it offers them to investors with the full faith and backing of the US Government as an obligation to pay back the debts it owes. Investors flock to these bonds in a time of crisis because they are considered a safe investment. These investors are entities like banks, companies, individuals and of course the Fed. For all but the Fed, they use their own funds from either their own cash reserves or by selling other securities. Like stocks or bonds. This is actually happening now where corporate bonds and municipal bonds have had a run on sales in recent weeks. Which has actually caused the Fed to step in to buy those too to help stabilize those markets.

Speaking of the Fed, the purchase of bonds and subsequent exchange of money is a little different. In a way, the Fed is simply acting as a *middleman* between the US Treasury and all the banks across the country. When it’s all said and done, banks are able to distribute money to its account holders – in this case in the form of a \$1,200 stimulus check or direct deposit. The banks can also lend on

that money to help spur growth. This helps with the ultimate goal: to keep money in circulation. But how is this done?

It may appear like the Fed is just handing out money blindly from a printing press in a back room somewhere, but it's really not. For one, it's taking all the bonds its purchases (Treasuries primarily; the Fed's *asset*) and converting them to "Federal Reserve Notes". That's nothing more than a *liability* on the Fed's balance sheet. And if you look at any dollar bill that's exactly what is printed on them: "Federal Reserve Note". Then it's passing that liability on to all of the banks in the country in the form of a deposit to their reserves, which in turn becomes an *asset* for each of those banks. So at the end of the day, the Fed is simply acting as a middleman but in the process converting bonds to actual money that can be put into circulation by the banks. Hence the term "Central Bank" which the Fed is also referred to. The point is the Fed is only distributing money it holds as *an asset* on its own balance sheet (the bonds) so it's not blindly printing money out of thin air. And even though the Fed is committing this money as a liability, the true obligation to pay all of that money rests on the *US Government*. Because that money is coming from the Treasury Bonds the Fed originally purchased. Second, as the bonds pay interest, the Fed collects it. And we are not talking about pennies here because the bond purchases are in the billions. So, the Fed is guaranteed to make money every time in this scenario. Which then helps strengthen its own balance sheet and its own liquidity. But at the end of the day all of this points right back to the US Government and its ultimate ability to repay its obligations - through taxation. The Government can take that risk because it has the ultimate authority to tax.

Another thing the Fed can do is regulate bank reserve requirements. This affects the US money supply in a similar way as when it "prints money" but the point is keeping reserve requirements in check helps with *foreign borrowing and lending* because it keeps the US Dollar stable. The dollar isn't just used in the United States; it's the most popular underlying currency in global trade. So, at the end of the day, the Fed is not only working to regulate the domestic money supply it is also focused on foreign cash flows as well.

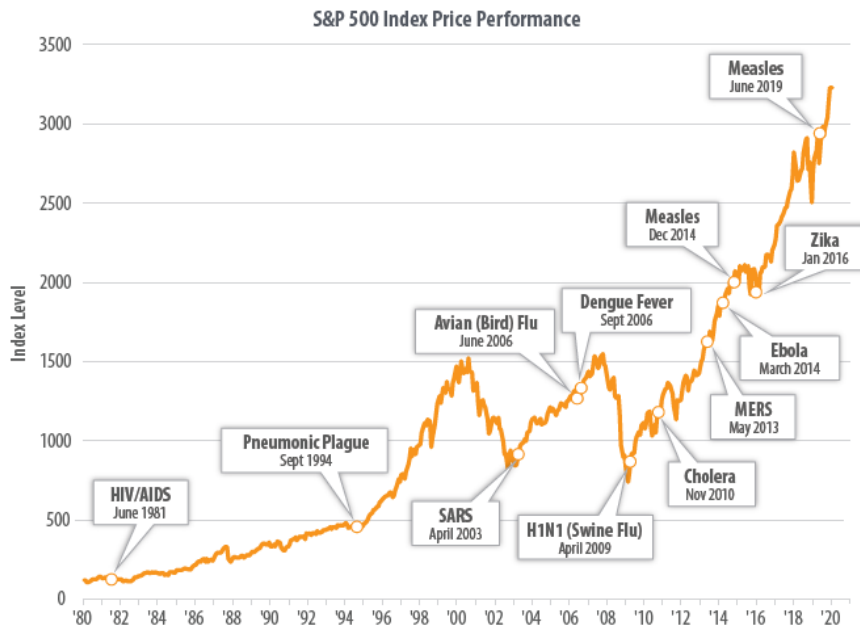
The big picture here is to keep money in circulation. As long as that is happening, the economy will sustain itself. That is not what happened during the Great Depression when people hoarded their money and did not spend. Which led to a collapse in the economy, record levels of unemployment and a run on the banks. This is what the Fed and the Government are trying to prevent now.

Will all of this work? Only time will tell but at least the powers to be are unified to help keep our economy in check using the stimulus process outlined above. I think you have to seriously weigh that in terms of the \$4+ trillion being made available to sustain our economy going forward. I also think you have to consider all the people working together on this between state, local and federal authorities, economic, banking and finance experts, and of course our medical and healthcare professionals. Especially the first responders and those working in hospitals and temporary care

facilities that make it feel like wartime conditions right now. It's a herculean effort involving all the right people doing all the right things to get us all out of this and better off for it in the end.

The Root Cause

We haven't even gotten into the root cause of this situation. The fact is we are dealing with a public health crisis that has nothing to do with a true fundamental collapse in our markets. Rather, it's an event driven reaction to a public health crisis. I think a lot of people - and investors - are losing sight of that. Now I am not downplaying the situation we are dealing with, quite the contrary. My point is this did not happen because of a disruption in the economy or the financial markets. Like what happened in 2008 when the economy spiraled into recession. That happened because of a legitimate break in the financial system caused by disregard of the true value of real estate. It led to systemic flaws in the modeling and assumptions used to build securities tied to real estate with inappropriate risk ratings and ultimately caused a bubble. Instead, what we are dealing with right now is a global health crisis that is causing unprecedented turmoil. So, from a pure *investing* standpoint, this did not happen because of anything that was wrong with the economy or Corporate America. Therefore, if we set the economy aside for a moment and consider past health epidemics and pandemics, history shows a favorable outcome for this. The chart below shows that very well (sourced from Bloomberg). Of course, this is a new virus and should not be taken lightly. And we do expect impacts to the business cycle. But we should not let that deter us from opportunities we see in the market for the long term.



Epidemic	Date	S&P 500 6-Month % Change	S&P 500 12-Month % Change
HIV/AIDS	June 1981	-6.6%	-16.5%
Pneumonic Plague	Sept 1994	8.2%	26.3%
SARS	April 2003	14.6%	20.8%
Avian (Bird) Flu	June 2006	11.7%	18.4%
Dengue Fever	Sept 2006	6.4%	14.3%
H1N1 (Swine Flu)	April 2009	18.7%	36.0%
Cholera	Nov 2010	13.9%	5.6%
MERS	May 2013	10.7%	18.0%
Ebola	March 2014	5.3%	10.4%
Measles	Dec 2014	0.2%	-0.7%
Zika	Jan 2016	12.0%	17.5%
Measles	June 2019	9.8%	N/A*
Average Price Return		8.8%	13.6%

Observations

- 6-month change of the S&P 500 Index following the start of the epidemic was positive in 11 of the 12 cases, with an average price return of 8.8%.
- 12-month change of the S&P 500 Index following the start of the epidemic was positive in 9 of the 11 cases*, with an average price return of 13.6%.

Source: Bloomberg

What Did We Do?

With all of this in mind, we here at Valor shifted our models and outlook over the next several months to a defensive position. But we were already in that mindset before any of this happened since we began 2020 with a more conservative approach based on the fact that markets were trading at all-time highs. For example, our most aggressive equity model (“Titan”) was only 78% equity when normally it’s 90%. Our thinking did not change all of a sudden because of what happened. We simply stuck to our process and shifted exposures accordingly based on the information we had at the time and our outlook for the future. Just like we always do. So, all else equal, our process has not changed. Now with that said, in this market you have to be tactical and you have to go back to basics and identify companies that will emerge from this stronger. Ideas that we are favoring at this time are:

- a. e-commerce as people and businesses order considerably more online,
- b. remote access as the country shifts to a work at home routine,
- c. cleaning supplies and disinfectants, and
- d. healthcare companies especially those in medical supply and vaccine discovery.

With that in mind, we added exposure to companies in the **All-Stock and Blend models** that operate in these specific lines of business and are expected to see an increase in in operations as a result of current conditions. And we continue to hold many core companies that we feel exhibit strong fundamentals, a clear competitive advantage and most importantly have a strong balance sheet to weather the storm in favor of the long term. In the **Mutual Fund models**, we added to more defensive holdings in the hedged equity space as well as multi-alternatives. Hedged equity is a strategy that invests in a combination of stocks, options and ETFs in either “long” or “short” positions. The role of “long” equity positions is to drive returns through dividends, capital gains from purchase prices that appreciate in value. The role of “short” positions is to achieve positive returns through declines in value. A multi-alternative strategy combines a variety of “alternative investments” into one model. In the broadest sense, an alternative investment encompass all of the possible investments not included in the traditional equity and bond allocations. Such as private equity, hedge funds, venture capital, real estate, precious metals, rare coins, wine and art. These assets usually perform with low correlation to stocks and bonds. In the **ETF models**, we added to conservative positions that pay dividends as well as hedged equity. We also **raised cash across the board to 5%** (our highest level) in keeping with our model limits to remain fully diversified. Finally, we reduced exposure to certain asset classes such as Emerging Markets Equity, Intermediate Term Bonds, Convertible Bonds, and Master Limited Partnerships and used that money to add exposure to domestic and international to maintain an 80/20 split between US domestic and international.

These changes were made to adjust our mindset for the current market conditions and future expectations but also stay true to our process and the model limits. We will continue to make adjustments to the models as necessary.

For more information on any of these changes please contact me or anyone on the Valor Asset Management team.

Finally, to show how our models fared in the first quarter, performance for the Blend, Yield and All-Stock models are shown on the next page. These trends show that each model performed as they were designed to. The diversified models did not go down as much as the overall market fell towards the end of March. This is a testament to the asset classes represented and shows the concept of diversifying risk on the downside.

Final Thoughts

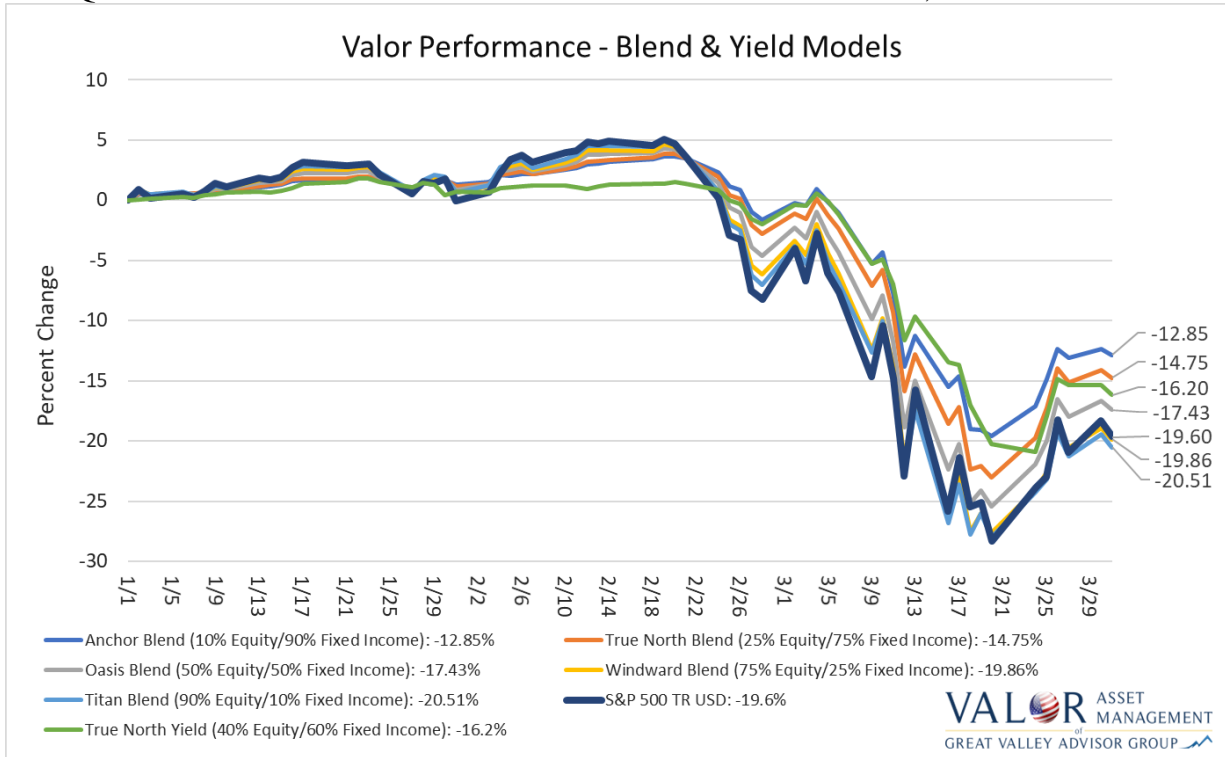
A lot has been written here and I hope you've found it informative. In conclusion, I will simply say that we are monitoring the markets very closely as we always do. And we are staying on top of trends and new ideas as information flows in daily. This is certainly a different market to invest in and it's certainly offering us plenty of opportunity where prices are these days. As I said earlier, I do expect a bumpy road ahead, but it is my belief that we will eventually emerge from this right back where we started. When that happens is anyone's guess but as long as progress is being made on the vaccine front and the economy opens back up then we should and will see a market that looks more normal. And don't lose sight of the \$4 trillion being injected into the economy and quite possibly more depending upon how things develop from here. That's a huge number and a huge boost to the economy. And finally don't forget the market typically trades ahead of the economy by about 6-9 months so if this market gets any inkling of a turnaround in economic activity you can rest assured the recovery will be quick and decisive with so much money on the sidelines.

I wish you the best during these times and as always if there is anything we can do to help serve you better please know that the Valor team is ready and willing to help you navigate the markets.

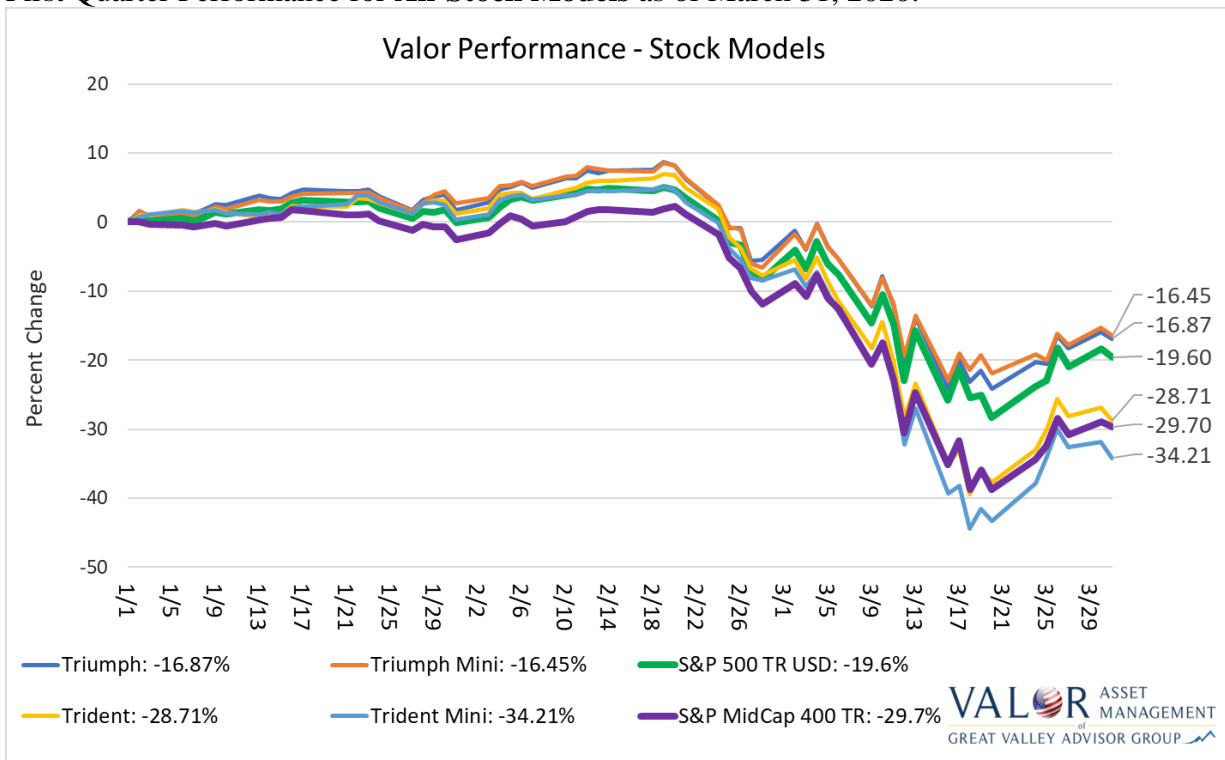
Sincerely,

Lee

First Quarter Performance for **Blend and Yield Models** as of March 31, 2020:*



First Quarter Performance for **All-Stock Models** as of March 31, 2020:*



*thank you to my colleague Rob Schmauk, Jr. for his assistance in creating these graphs.

Disclosures

1. Rebalancing a portfolio may cause investors to incur tax liabilities and/or transaction costs and does not assure a profit or protect against a loss.
2. The prices of small and mid-cap stocks are generally more volatile than large cap stocks.
3. International investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors. These risks are often heightened for investments in emerging markets.
4. Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and bonds are subject to availability and change in price. The market value of corporate bonds will fluctuate, and if the bond is sold prior to maturity, the investor's yield may differ from the advertised yield. Bond yields are subject to change. Certain call or special redemption features may exist which could impact yield. Investment grade bonds are those graded BBB and above. Preferred stocks are "hybrid" investments, sharing characteristics of both stocks and bonds. Like a stock they are generally paid after a bond, but like a bond they offer a fixed rate of payment and par value upon maturity/redemption. Risks can include interest rate risk, longer duration, lower credit ratings, and sector concentration, etc. Convertible bonds are a type of debt security that can be converted to a fixed number of shares of the issuer's common stock.
5. The fast price swings in commodities and currencies will result in significant volatility in an investor's holdings. Precious metal investing involves greater fluctuation and potential for losses.
6. The payment of dividends is not guaranteed. Companies may reduce or eliminate the payment of dividends at any given time.
7. Dividend yield refers to a stock's annual dividend payments to shareholders, expressed as a percentage of the stock's current price.
8. An investment in Exchange Traded Funds (ETF), structured as a mutual fund or unit investment trust, involves the risk of losing money and should be considered as part of an overall program, not a complete investment program. An investment in ETFs involves additional risks such as not diversified, price volatility, competitive industry pressure, international political and economic developments, possible trading halts, and index tracking errors.
9. ***Investors should consider the investment objectives, risks, charges and expenses of the investment company carefully before investing. The prospectus and, if available, the summary prospectus contain this and other important information about the investment company. You can obtain a prospectus and summary prospectus from your financial representative. Read carefully before investing.***
10. Content in this material is for general information only and not intended to provide specific advice or recommendations for any individual. All performance referenced is historical and is no guarantee of future results. Value will fluctuate with market conditions and investments/portfolios may not achieve its investment objective. No strategy assures success or protects against loss. Investing involves risk including loss of principal.
11. Consult your financial advisor prior to making any investment decision.
12. Because of their narrow focus, sector investing will be subject to greater volatility than investing more broadly across many sectors and companies.