HIGHTOWER
VWG Wealth Management

VWG Wealth Management 3rd Quarter Review

Executive Summary

- Large U.S. stocks, as measured by the S&P 500 Index, rose 9.0% for the quarter, and have now increased 5.6% this year. U.S. small stock and international stock indices also gained but are still negative year-to-date.
- Despite equities positive tone, many concerns continue to weigh on investors. These include the continuing path of the global COVID-19 pandemic, its effects on economic growth and employment, apparent fiscal inaction on helping those impaired by the crisis, social unrest, and expectations for a very unsettling U.S. election season.
- The U.S. Federal Reserve added to the somber outlook, citing strong deflationary pressures, and revising monetary policy leading some experts to project near-zero interest rates for years to come.
- VWG recommends that when facing complex factors and uncertainties, investors should focus on a process of disciplines they can control. These include financial planning, portfolio diversification, matching the duration of their assets with the duration of their needs, and employing strategies relying on a core philosophy of a "margin of safety."
- Longer term we remain optimistic. Liquidity and monetary policy are extremely accommodative. Investor sentiment and asset-flows into equities are muted.

Review of the Markets

Equity markets continued their recovery in the third quarter. The S&P 500 Index rose relentlessly until September 2 when it hit an all-time high. From that point, the mood turned decidedly to "risk off." The S&P 500 receded -9.6% as investors took profits, COVID-19 pandemic fears re-emerged, and economic and presidential election concerns took hold. For the overall quarter, the S&P Index increased 9.0%. Year-to-date it has gained 5.6%. Small U.S. stocks also improved but are nowhere close to their 2020 high. The Russell 2000 index was up 5.0% in the quarter and has dropped -8.6% this year. This could imply that the economic damage inflicted by the pandemic is impacting smaller businesses more than larger businesses.

International stocks followed in a similar pattern to small U.S. stocks, increasing but remaining well below earlier year and all-time highs. The international equity benchmark MSCI EAFE Index, rose 4.6% in the quarter. Year-to-date it has lost -7.0%. The MSCI Emerging Markets Index was the best performing equity market in the 3rd quarter, supported by Asian technology and consumer sectors. It gained 10.2% for the quarter but has slipped -1.1% this year.

The U.S. Federal Reserve continued to offer sobering guidance on the economy and the bond markets. Chairman Jerome Powell said "we see a big shock to demand, and we see core inflation dropping to 1%. I do think for quite some time, we're going to be struggling against deflationary pressures." At their September meeting, the Federal Reserve clearly stated that monetary policy will remain loose for a prolonged period expecting to maintain near-zero interest rates until employment returns to normal and until inflation produces a long-term average of 2%. Noting that this level of inflation hadn't been achieved since the 2008-09 financial crisis, some well-regarded strategists took this to project that there will be no interest rate hikes until 2024 at the earliest!

In response to the Federal Reserve guidance, and with improved, but far from optimal levels of employment and economic output, bonds were sluggish. The 10-year U.S. Treasury note finished the quarter yielding 0.68%. The benchmark Barclays Aggregate Bond Index gained 0.40% this quarter and has increased 6.7% this year. Responding to improved confidence, high yield bonds performed better. The Bloomberg Barclays High Yield Bond Index rose 4.5% in the quarter. It has dropped -1.2% year-to-date. The S&P National Municipal Bond Index gained 1.0% for the quarter and has risen 3.3% this year.

Copper rose curiously in the quarter, with the NYMEX High Grade Copper continuous futures contract climbing 11.0% to levels not seen since mid-2018. This gave macro-strategists optimism for healing global growth, as the price of "Doctor Copper" is often considered a proxy for economic activity. Gold received a steady bid, hitting an all-time high in early August before backing off. Some of this strength was attributed to Federal Reserve near-zero interest rate guidance, and a decline in the value of the U.S. dollar relative to the currencies of most large foreign trading partners. The NYMEX Gold continuous futures rose 5.3%, bringing its year-to-date gain to 24.4%.

The Investment Outlook is Almost Always Uncertain

"Doubt is not a pleasant condition, but certainty is absurd."

- Voltaire

"The future is never clear; you pay a very high price … for a cheery consensus.
Uncertainty is actually the friend of the (long-term investor)."

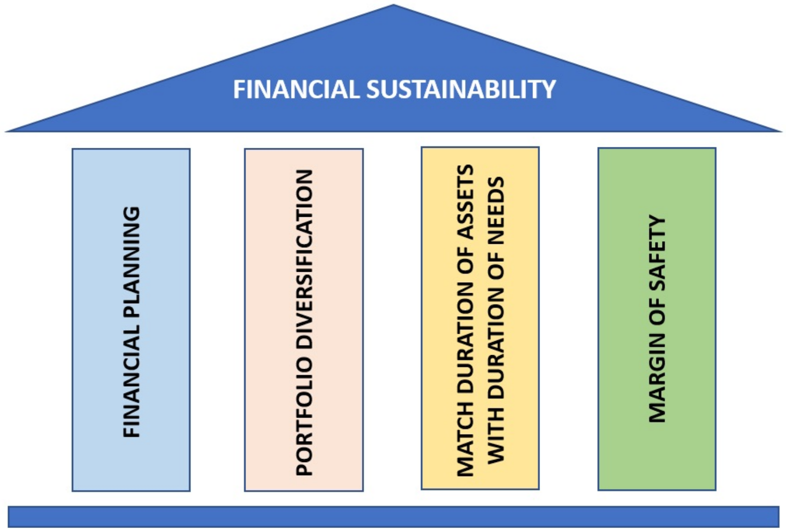
- Warren Buffett

2020 has been a crazy, often surreal ride. The year is far from over, and neither is the COVID-19 pandemic or its far reaching second- and third-order effects. VWG has fielded many client concerns over the summer months. Some of these include, "Should I sell my stocks before the U.S. Presidential election, and sit on the sidelines until things are calmer?" "Should I still own bonds when interest rates are this low?" "How can the stock market rise when so many Americans are out of work?" "Won't the Federal Reserve's massive expansion of their balance sheet lead to inflation, and if so, what should I do about it?"

Many risks abound, some that we have never experienced before. The U.S. and global economies have taken a swift and severe hit, from which many believe will take years to recover. The Federal Reserve has almost doubled the size of their balance sheet in a period of four short months. We have observed some frothy action in certain public and private market sectors. Facing this myriad of complexity and confusion, how should investors respond?

Acclaimed behavioral finance expert James Montier reminds us that "investing is always about making decisions under a cloud of uncertainty." Moving to cash, "sitting out" until perceived risks abate, is extremely difficult, and often amounts to "market timing." Such an act requires accuracy in making two separate decisions – when to divest, and when and how to re-invest. Increased volatility makes getting this 'timing' right challenging. For investors attempting to secure long-term needs and goals, missteps could lead to disastrous results. Getting an "all clear" signal in our complex world is unlikely. As Mr. Buffet cautions, if such a sign appeared, would come at a very dear price.

VWG's response, today as always, is to rely on a process of managing things we can control. The core of these are our four pillars of financial sustainability:



Financial Planning

Financial planning is the initial pillar of the financial sustainability and investment program. It needs to be updated and reviewed periodically throughout one's life. If you have concerns over your financial situation due the COVID-19 crisis, or if you are contemplating a significant portfolio change for any reasons, please work with us to review your financial plan. A review and update will provide some objectivity and will maintain focus on your long-term goals. If any significant life changes have occurred or if your objectives have changed, your plan should be updated. Seeing how the projected outcome of your plan is affected by changes in different assumptions and variable is extremely valuable in helping manage nearer-term uncertainty.

Portfolio Diversification

Nobel Prize laureate Harry Markowitz termed diversification as being an investor's "only free lunch." VWG seeks to create and manage an investment portfolio tailored to each client's specific needs, goals, tax sensitivity and temperament. We optimally group multiple asset types, strategies and liquidity profiles. Together, these will ideally provide a smoother return stream. Aiming to smooth overall portfolio returns serves to help keep our focus on the long-term and reduces the possibility of being dissuaded by short term noise and uncertainty. It is critical to maintain appropriate levels of cash and liquid high-quality bonds. These can be used for unexpected emergencies, and for future investment opportunities and tactical deployments.

Matching Investment and Needs Durations

VWG commonly segregates client needs, and identifies assets necessary to fund these needs, as being in one of four primary categories. This segregation is identified during the financial planning process, either conceptually or physically (placed in needs "buckets"). These four categories are: *emergency* (3-6 months of living expenses), *medium-term* (will be needed for living needs and specific purposes over the next 1-4 years), *long-term* (will be needed for living needs and specific purposes 5 and more years from now), and *legacy* (not expected to ever be needed for living needs, ultimately for generational gifts and charitable intentions).

The components of the investment portfolio should be selected and placed within this "duration of needs" framework. We want little long-duration assets, including stocks, private investments and long-maturity bonds, held in funds targeted for medium-term needs. Conversely, very little cash and short-term bonds should be held in funds targeted for legacy goals.

Matching asset duration with planned needs helps investors navigate through uncertain, choppy periods. The knowledge that one has allocated assets to provide for their medium-term needs can help them maintain proper focus in reviewing their assets allocated for the long-term.

Margin of Safety

Particularly during periods of great volatility and uncertainty, VWG favors investments directed by disciplined managers and entrepreneurs, operating within a narrowly defined asset class or niche strategy. Often these are asset constrained, meaning that only a limited amount of funds can be managed while maintaining this discipline. VWG seeks to avoid excessive exposure to momentum and large, money-flow driven strategies, which are more sensitive to the changing sentiments of the masses.

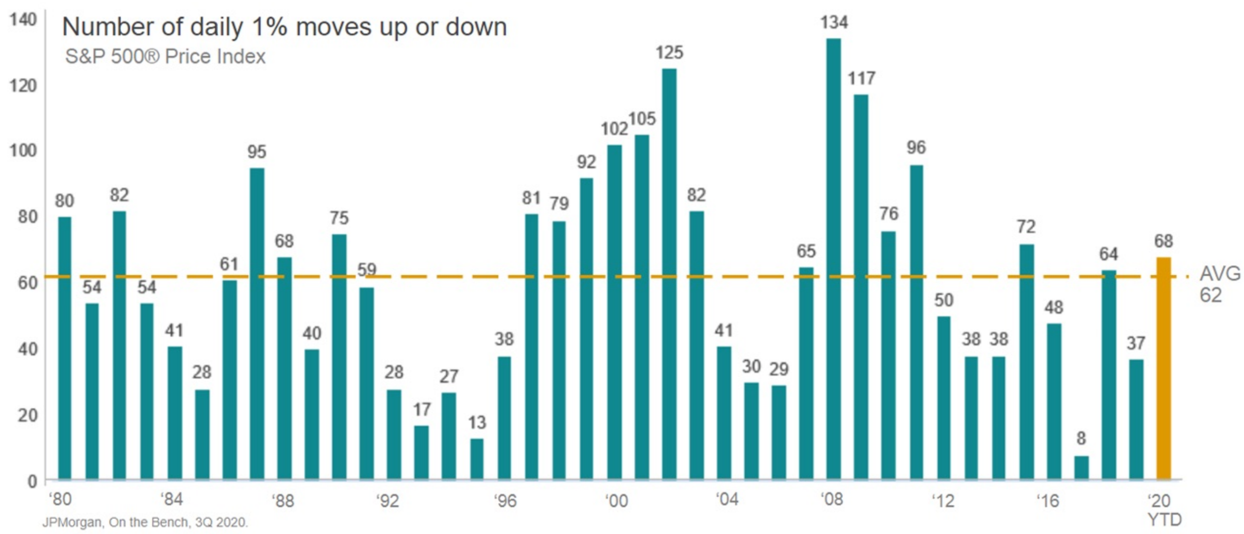
These managers and entrepreneurs should have the concept of a "margin of safety" deeply ingrained in their investment process. For different operators and strategies, their "margin of safety" can mean many different things. It can include holding adequate liquidity, maintaining flexibility, and limiting the use of leverage. "A margin of safety" can also in mean identifying and buying assets at perceived present discounts to their long-term values and their expected growth paths. Common to all, these operators should have proven records of creating investor value during varying time periods and conditions, and of protecting capital during difficult periods.

Portfolio Strategy and Asset Positioning

VWG acknowledges the continuing and uncertain path of the global COVID-19 pandemic, and the possible risks from the execution of fiscal and monetary policies, social inequality and the U.S. elections. We recommend that long-term portfolios remain balanced, holding adequate amounts of cash and quality short-term bonds.

Although we are not aggressively adding to stocks and other "risk on" assets, we have several reasons to be optimistic over the longer-term. Signs of U.S. economic activity are increasing, including manufacturing output, housing starts and purchases, and consumer confidence. M2 Money supply remains extremely high in the wake of unprecedented actions and tools implemented by the Federal Reserve. Similar positive signs are being seen globally, including Chinese manufacturing and industrial production.

The U.S. stock market is also showing counterintuitively encouraging signs. September's pullback in the S&P 500 has provided a well-needed breather, and yet market breadth has remained resilient. Sentiment has retreated. The week of September 21 witnessed the third-highest outflow from U.S. equities ever. Volatility has picked up, as marked by 1% daily moves in the S&P 500 in either direction. This can lead to opportunity. As we all know too well, 2020 has already seen above average volatility, and 25% of the year remains.



VWG continues our vigilance in attempting to assess risks and evaluate opportunities. We will notify you with anything requiring immediate attention. Over the coming months and quarters, we will continue performing due diligence on investments producing sustainable cash flows that are not excessively leveraged. Although we find some value in select bond sectors and strategies, these should not be over-weighted for those requiring income and capital preservation on an after-tax and an after-inflation basis.

As always, please contact us to discuss any of these topics, and any other questions and insights you have. We are honored to serve you and your families, and to be sharing this journey together.

Regards,

VWG Wealth Management
Suzanne, Ashley, Rashmi, Kay, Lynette, Ona, Michelle, Ryan, Ryan, Susan, Marnie, Justin, Elana, Patricia, John, Rick and Jeff
Who we are

** Index Data Sourced from FactSet Research, Morningstar, J.P. Morgan*

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