2Q 2020 Investment Strategy Letter - SMA

Madison INVESTMENTS

REVIEW – SECOND QUARTER 2020

Global economies experienced broad-based and historic declines as the impact of the COVID-19 coronavirus pandemic spread menacingly throughout the world. Conversely and remarkably, aided by unprecedented global monetary and fiscal stimulus, global equities rebounded sharply in the second quarter of 2020. For the quarter, U.S. stocks (Russell 3000) surged 22.0%, while foreign equities (MSCI ACWI-ex U.S.) jumped 16.1%; meanwhile, U.S. bonds (Barclays U.S. Aggregate) advanced 2.9%.

PERSPECTIVES

"Most human beings have an almost infinite capacity for taking things for granted."

-Aldous Huxley

"Injustice anywhere is a threat to justice everywhere."

-Martin Luther King Jr.

Our social fabric that holds us together is being seriously tested on many fronts. Our shared values are seemingly no longer being shared. Maybe we need a friendly reminder. What is it about our humanness that gives us current cause for hope? Maybe some 3-year-olds can help us.

Researchers at the Max Planck Institute in Germany found that children as young as three showed a natural inclination towards restorative justice – fed by a strong concern over the welfare of victims. The findings, based on experiments with 3-year-olds and 5-year-olds, provide insights into the roots of justice in humanity. The children were given the chance to take items away from a puppet that had "taken" them from another puppet. The researchers learned that the children preferred to return an item than to remove it – and when that was not possible would make the item inaccessible so it could not be taken by anyone other than the owner. In short, the children had natural empathy for victims and acted accordingly with a strong sense of justice. To emphasize the significance of this, just imagine if the counterfactual were true.

So perhaps humans do, in fact, have an innate sense of justice. If this is indeed the case, let's certainly not take this "gift" too lightly. In fact, let's value it, foster it and expand on it. As thoughtful investors, that can translate to focusing on those countries that promote and prioritize equal and efficient justice, open and accessible education and a fair and equitable rule of law. The World Bank Group publishes their highly valued and well-known Ease of Doing Business country rankings each year. This comprehensive report is designed to capture the vital significance of numerous qualitative type factors, like an effective justice system, in their relative assessment of 190 distinct countries in the global economy. Importantly, we note that countries like the United States (#6), Japan (#29) and China (#31) are ranked comparatively well. Conversely, Italy (#58), Mexico (#60), India (#63) and Brazil (#124) have less favorable rankings. It is no accident that our portfolios are well-aligned with these highly relevant findings.

PORTFOLIO ACTIVITY AND POSITIONING

Our portfolios were conservatively postured throughout the second quarter and remain cautiously positioned as we move into the second half of the year. Over the course of the quarter we further focused our allocations to align with our beliefs and outlook. Overall equity exposure remains below that of the neutral benchmark. While portfolios are underweight overall equity exposure, portfolios are overweight U.S. equity relative to international equity. Portfolios' fixed income exposure is equal weight to that of the neutral benchmarks.

Domestic equity markets persistently decoupled from economic fundamentals during the quarter as equity prices rose while earnings declined. This has forced valuation multiples above those seen in February, directly before the violent 35% decline in the S&P 500® Index. Within the portfolios, we continue to prefer high-quality large cap stocks that have consistently produced strong free cash flows. As such, the portfolios have minimal exposure to small cap stocks.

Within international equities, exposure to Europe was reduced in favor of the Asia Pacific region. The quarter saw some positive indicators coming out of Europe, however much of the region's growth is reliant on the growth of the Asia Pacific region while the underlying fundamental headwinds in Europe remain. We believe the Asia Pacific region will benefit from a weakening U.S. dollar and lower commodity prices moving forward. In addition, the region was the first to be impacted by COVID-19 and is leading the way for re-opening economies.

Our portfolios benefited from the unlocking and return to function of the corporate bond market. That said, we believe there is elevated risk within the credit market that is being masked by the immense support and unprecedented actions of the Federal Reserve. As such, we increased the overall credit quality of portfolios by reducing exposure to lower-quality securities. Portfolio duration remains in line with the neutral benchmark. Given the elevated risk within the credit market, the corporate bond exposure we have is focused on shorter dated paper while we prefer the quality of Treasuries further out the curve.

OUTLOOK

From a fundamental perspective, risk assets have rerated to historically unappetizing valuations. There is seemingly and traditionally little margin for error. Yet, paradoxically, investors are now increasingly relying on global central banks (most prominently our Federal Reserve) to fulfill their expanded and implied role as very soft, cushy, elevated and expansive safety nets, perched just under those performers formerly known as death-defying, high-flying trapeze artists. So, given this polarizing backdrop (circus), how should investors properly perceive both risk and opportunity? Jay Powell, for one, has made it clear that the safety net won't be coming down any time soon. The Fed Chair was recently asked about the possibility that the Fed was creating asset bubbles:

Powell was very clear in his response. The Fed has every intention of remaining highly accommodative for as long as the labor market is weak, and inflation is low. Elevated, even bubbly, asset prices won't be a determining factor for the Fed. As portfolio managers, we're focusing on the inflation side of this story. Once again, imagine the counterfactual, what if inflation was already rising? That would be a game-changer as it would force the Fed to tighten monetary policy. Thankfully, that is not the case. This gives the Fed the latitude to continue to radically support financial markets.

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Our portfolios are uniquely positioned for the brute reality that unattractive valuations and rising uncertainties are oddly coupled with the likelihood of massive and persistent fiscal and monetary stimulus. The focus of our portfolios remains centered on both quality and caution. The next six months carry a heavy agenda and many questions. Will vaccines and/or treatments be found to effectively stymie COVID-19? Will geopolitical tensions continue to escalate, or will cooler heads prevail? Will the U.S. see meaningful healing from poignant racial and social strife? Will there be a Democratic sweep in November? Buckle up. As always, we will do our best to take nothing for granted.

SUMMARY

We are confident our Multi-Asset managed portfolios remain well-positioned for a highly stressed global economy. We also understand and embrace our ongoing responsibility to insightfully differentiate between attractive and less attractive asset classes as we strive to deliver superior risk-adjusted returns. As we work through these difficult times as a nation, we truly appreciate your confidence in partnering with us.

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