THIRD QUARTER 2020 CLIENT LETTER

It has been a tumultuous year to say the least. As a society, we are dealing with a tremendous amount of stress. It has been one of the few times in history where we are faced with both physical and financial health risks. This is coupled with a struggling economy, natural disasters, the anxiety and uncertainty of an upcoming election and a lack of reliable information from the media and leadership. While we do not have a crystal ball, our goal is to provide our clients with as much accurate information as possible and address a number of prevalent myths as they relate to financial markets and our clients' portfolios.

Myth #1: The economy and the stock market have recovered

While it is tempting to view the euphoric stock market returns as a sign of an economic recovery, the actual data is telling a different story. The shutdown of the U.S. economy during the first quarter of this year led to an unprecedented 31.4% annualized plunge in GDP (gross domestic product) growth. Certain segments of the economy, such as housing and online retailers , have experienced a meaningful recovery, and third-quarter GDP growth is expected to have a reasonably strong rebound. However, other segments of the economy, such as restaurants, travel and hospitality, have struggled to regain footing, especially given changing consumer behavior. According to Yelp, over 60% of restaurants and 50% of retail stores that were open as of March 1 were permanently closed over the summer. The jobs market is also a poignant reminder of how far off the economy still is from pre-pandemic levels. About half of the 22 million jobs that were lost have been regained, but the pace of improvement has started to slow. With the initial rebound from the onset of the pandemic behind us, the outlook for growth is highly uncertain and very much dependent upon the path of the virus, the availability of a vaccine and our ability to reopen the country.

On the surface, global financial markets seem to be ignoring the weakness in the real economy as major indices have seen robust rallies since the March lows. The table below summarizes the third-quarter and year-to-date performance for selected indices.

Index	Q3 '20	YTD
Large U.S. Companies (S&P 500 Index)	+8.9%	+5.6%
Small U.S. Companies (Russell 2000 Index)	+4.9%	-8.7%
Developed Foreign Markets (MSCI EAFE Index)	+4.9%	-6.7%
Emerging Foreign Markets (MSCI EM Index)	+9.7%	-1.0%
Core U.S. Bonds (Barclays U.S. Aggregate Bond Index)	+0.6%	+6.8%
Catastrophe Bonds (Swiss Re Global Cat Bond Index)	+3.3%	+5.2%
Commodities (BBRG Commodity Index)	+9.0%	-12.4%
Gold Spot (USD/Ounce)	+5.9%	+24.3%

Source: Bloomberg. Please see important disclosures at the end of this commentary.

As illustrated above, the S&P 500 Index recovered all its losses and was up 5.6% by the end of the third quarter. The headline return, however, does not tell the whole story. Two main factors led to the sharp upswing since the March lows—the large cash infusion (via low interest rates, money printing and the stimulus package) and the strong outperformance of a few mega-cap technology companies. The large cash infusion caused a market sugar high, where prices kept pushing upwards without earnings keeping pace to justify the rise. Just imagine that your diet only consisted of Twix and cotton candy—that might sustain you for a time, but eventually your body would need actual sustenance to thrive. In the same way, we believe the market will eventually demand that companies showcase true strength (e.g., strong earnings) to justify their stock prices. If the earnings do not rise to justify the price, we believe the only way they will converge is with a painful sugar crash of stock prices.

The second factor contributing to the rebound is the outperformance of mega-cap technology stocks. To demonstrate the bifurcation between these stocks and the broad equity markets, we examined an equally weighted portfolio consisting of Amazon, Apple, Facebook, Google and Microsoft. This portfolio of five stocks was up 40.5% as of the end of the third quarter versus 5.6% for the S&P 500 Index.

Because the S&P 500 Index gives more weighting to larger companies, those five mega-cap stocks have grown to represent around 23% of the index's current holdings. As a result, the performance of just these few stocks is a huge driver of the S&P's performance. If, instead of weighting the 500 stocks in the index by size, they were equally weighted, that equal-weight portfolio would have actually been down 4.7% during the same period. These large-cap technology stocks are really driving the positive performance as many sectors are negative for the year, including energy, financials and consumer-related stocks.

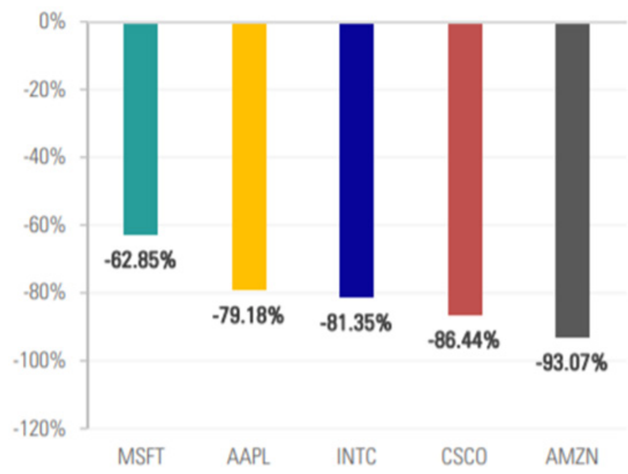
Myth #2: The stock market leaders (i.e., mega-cap tech stocks) will keep outperforming

Market concentration is not unique to the current environment. We had a similar situation during the dot-com bubble, and back in the 1960s and '70s, it was the "Nifty Fifty" must-own concept stocks. Everyone had to own a Polaroid camera back then, just as everyone must own the latest version of the iPhone today. But as firms become larger, rapid growth becomes more and more challenging. Historical data shows that once a company becomes a top-ten stock, its future performance becomes muted, underperforming the index over the subsequent five and ten years.

Mediocre future returns are one issue, but what about the downside? Do the largest companies protect investors from large losses when stock markets turn south? In fact, it is often the opposite, as market leaders have historically seen drawdowns meaningfully larger than broad stock indices during periods of volatility. The following charts illustrate the peak-to-trough drawdowns in some of the leading technology stocks, both during the dot-com bubble and the more recent Great Financial Crisis of 2008–9.

Drawdowns During Dot-Com Bubble Crash

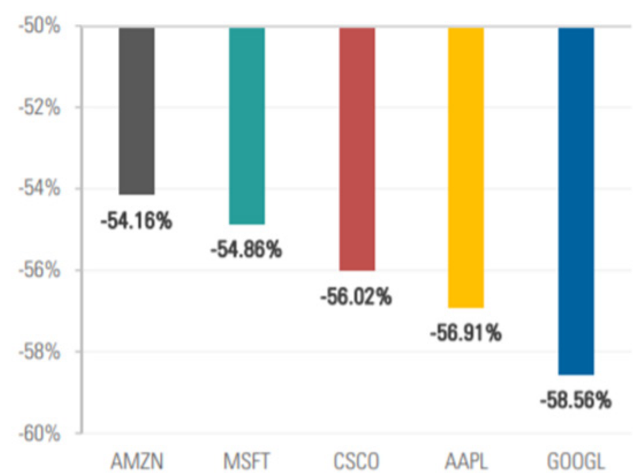
Worst drawdowns based on month return data from 1999-2003



Source: Catalyst Funds

Drawdowns During 2008 Financial Crisis

Worst drawdowns based on month return data from 2007-2009

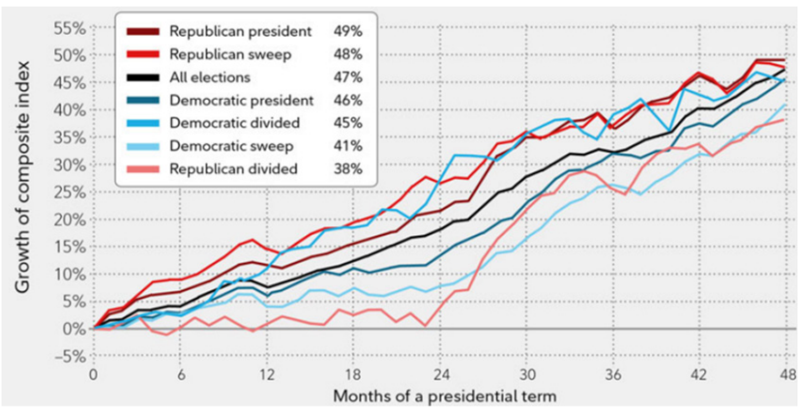


Source: Catalyst Funds

Investors piled into these stocks because they are great companies with great stories. But an attractive company does not always translate into an attractive stock, and once these companies were driven to sky-high valuations, they suffered disproportionately large corrections when the market reversed course. The broader market is also trading at or near all-time highs by most valuation measurements. This would feel precarious during "normal" times but seems especially risky considering that we are in the middle of a pandemic with an extremely contentious election quickly approaching.

Myth #3: If [insert Democrats or Republicans] win the election, the stock market is doomed

The upcoming election is front and center for most investors and the prevailing view is that if the Democrats take the White House and the Senate the stock market will suffer. If you can recall, the same was said about President Trump four years ago. History, however, does not indicate that Democrats or Republicans are necessarily bad (or especially good) for financial markets. The below chart looks at how the stock market has performed on average under different political parties going all the way back to the 1800s:



Source: FMRCo (Fidelity)

The data compares various scenarios where Republicans or Democrats are in the White House and either have a "sweep" of Congress (i.e., they control the House of Representatives and the Senate) or a "divided" Congress (i.e., one party controls each of the chambers). The range of average returns are very tight (38–49% over a four-year presidential cycle) and the Republicans claim the honor of both the best and the worst performance among the different categories. The main conclusion that can be drawn from the historical data is that which political party is in power is not necessarily a large driver of stock performance.

In fact, much of the market's performance and even the direction of the economy is outside of politicians' control. As an example, the path of the pandemic and the timing of an effective vaccine will likely have a much larger impact on the market than who is in the White House. Yes, the stock market may be volatile over the short term if the outcome of the election is contentious, leading to further rioting and social unrest. But over the long term, we believe that liquidity and interest rates will continue to be the dominant factors. Overwhelming all of the politics is the Federal Reserve and its prolific money printing and 0% interest rates. As mentioned above, we believe that much of the market's success over the past decade has been due to asset price inflation from all the liquidity that the Fed is pouring into the system. On the fiscal side, while there are distinct differences between the proposed policies of Trump and Biden, both presidential candidates are not shy when it comes to deficit spending and increased stimulus to support our fragile economy. So, if easy money is what gives investors confidence, then markets could have more to run.

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Myth #4: Stock and bonds are good diversifiers

As we have often discussed in our past communications, one of the three tenets of Morton Capital's investment philosophy is true diversification. By true diversification we mean designing investment portfolios that incorporate non-traditional asset classes that exhibit low or no correlation to stocks and bonds. We believe in diversifying this way to help produce the income or returns our clients need to support their lifestyles regardless of market performance. For many investors, traditional diversification between stocks and bonds has worked over the last few decades because bonds produced sufficient yields in recessions and tough stock market environments. However, this strategy will not work in the current environment, as the yield for the Barclays Aggregate Bond Index (a broad-based bond index) was just under 1% as of the end of the third quarter. With the current yield on the 10-year U.S. Treasury bond also below 1% at 0.7%, the main question facing traditional fixed income investors is whether income from bonds will be enough.

We believe the answer is no. Since the Great Financial Crisis, we have been reducing our exposure to traditional bonds in favor of alternative strategies that we believe will provide the cash flow our clients need. This approach has attempted to provide attractive risk-adjusted returns, stability and capital preservation. While our focus has mainly been on income-generating investments backed by real estate, we have also been conducting due diligence on asset-based lending and niche royalty income strategies. The goal of these newer asset classes will be to provide clients with cash flow and reduce exposure to the traditional stock and bond markets. While it is certainly possible that the traditional markets could rise, our preference is to allocate to investments where we have higher conviction in the fundamentals and likely range of returns.

Please do not hesitate to contact your Morton Capital wealth advisory team if you have any questions or would like to review your portfolio or financial plan in more detail. As always, we appreciate your continued confidence and trust.

Morton Capital Investment Team

Disclosures