Market and Portfolio Update

The first half of 2020 was unprecedented. On March 11, our world changed dramatically as the World Health Organization officially characterized the COVID-19 virus as a pandemic. This declaration set forth a series of events resulting in a complete shutdown of the global economy, the likes of which we have never seen before. Markets reacted violently, and volatility was at extreme levels, with the stock market losing almost a third of its value in just 22 trading days between February 19 and March 23. Fixed income markets, even U.S. Treasuries for a time, also declined as a substantial number of liquidations by levered investment funds put massive pressure on bond prices. The Federal Reserve stepped in quickly, cutting interest rates in early and mid-March and providing massive stimulus to address liquidity concerns in fixed income markets. In addition, on March 27, President Trump signed the Coronavirus Aid, Relief, and Economic Security Act (CARES Act), which provided much-needed support to individuals and businesses that had no way of making money in an economy that was completely locked down. We didn't know it at the time, but March 23 was a turning point in investor sentiment that began a string of positive returns. Notably, the second quarter of 2020 generated the second-best return in the past two decades. It's almost unfathomable that amid a pandemic, the S&P 500 had two of its 25 largest daily gains since 1928 (9.3% and 9.7% on March 13 and March 24, respectively). What a period it was!

Investment Returns as of June 30, 2020

Asset Class	3 Months	YTD	1 Year	3 Years*	5 Years*	10 Years*
Fixed Income						
1-3 Year Treasury Bonds	0.2%	3.0%	4.1%	2.7%	1.9%	1.3%
U.S. Aggregate Bonds	2.9%	6.1%	8.7%	5.3%	4.3%	3.8%
Global Aggregate Bonds (USD – Unhedged)	3.2%	3.5%	4.6%	4.0%	3.7%	2.9%
U.S. Municipal Bonds	2.7%	2.1%	4.4%	4.2%	3.9%	4.2%
U.S. High-Yield Bonds	9.6%	-4.7%	-1.0%	3.0%	4.6%	6.5%
U.S. Leveraged Loans	9.7%	-4.6%	-2.0%	2.1%	2.9%	4.2%
U.S. Inflation-Linked Bonds	4.4%	6.4%	8.7%	5.3%	3.9%	3.7%
Equity						
Global Equity (ACWI)	19.4%	-6.0%	2.6%	6.7%	7.0%	9.7%
U.S. Large-Cap Equity	20.5%	-3.1%	7.5%	10.7%	10.7%	14.0%
U.S. Small-Cap Equity	25.4%	-13.0%	-6.7%	2.0%	4.3%	10.5%
Non-U.S. Developed Equity (USD)	15.1%	-11.1%	-4.7%	1.3%	2.5%	6.2%
Emerging Markets Equity (USD)	18.2%	-9.7%	-3.0%	2.3%	3.2%	3.6%
Non-U.S. Developed Equity (Local)	12.8%	-10.3%	-3.8%	1.7%	3.1%	7.4%
Emerging Markets Equity (Local)	16.8%	-5.4%	1.7%	4.9%	5.5%	6.4%
Long/Short Equity Hedge Funds	13.3%	-3.2%	0.8%	3.0%	3.1%	4.6%
REITs	11.7%	-18.4%	-12.8%	0.1%	4.1%	9.1%
Commodities						
Gold	12.9%	17.4%	26.3%	12.8%	8.7%	3.7%
Silver	30.3%	2.0%	18.9%	3.1%	3.0%	-0.2%
Crude Oil	91.7%	-35.7%	-32.8%	-5.2%	-8.0%	-6.3%

**Annualized return figures.*
Past returns do not guarantee future results.
An investment cannot be made directly in any index.

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As markets recovered in the second quarter while the number of COVID-19 cases increased across the globe, questions abounded as to whether the markets had gotten ahead of themselves and why there was a rebound when so much remained unclear. We cannot say for sure what drove the recovery and whether or not it will last, but we do know that equity markets are discounting mechanisms, and stock prices are likely responding to (perhaps overly optimistic) expectations of what economic and financial conditions will be like in 12 to 18 months, not what is happening today. We also believe that the markets may be reacting to the Federal Reserve's aggressive actions, which are typically supportive of equity markets. We have all heard the admonition "Don't fight the Fed" and witnessed the run-up in risk assets resulting from monetary stimulus over the past decade. Whatever the reasons, by the end of the six-month period, fixed income returns were in positive territory, and equities recovered much of their losses.

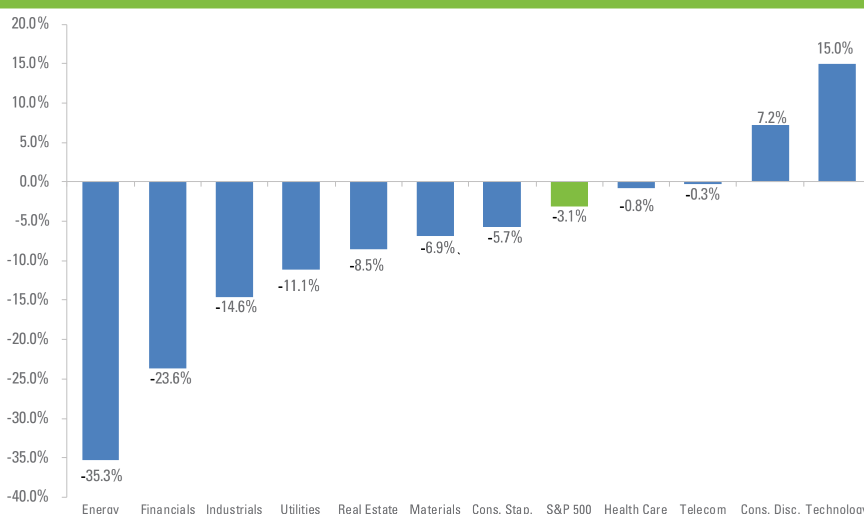
During this volatile period, our managers did what we expected of them. Many entered the year with significant cash allocations, which helped them protect capital on the downside. Several portfolios had been building cash toward the end of 2019, as managers saw valuations above their estimates of fair value, leading them to opportunistically sell or trim exposures. As the sell-off began and subsequently deepened, our managers started to deploy those cash balances at what they believed to be attractive entry points, buying the stocks of high-quality businesses whose prices had become dislocated from their underlying values. All in all, we are pleased with how our portfolios performed during this period.

Equity Markets

All major equity indices ended up in negative territory for the six months ending June 30, 2020, although once again, U.S. large-cap equities were the best performers. Remarkably, the S&P 500, which was down 30.4% at its trough on March 23, recovered to end the period with a modest loss of 3.1%. It's interesting to look at the returns by sector, as there was great dispersion during the period. For example, the nearby chart shows that energy and financials generated the lowest returns (-35.3% and -23.6%, respectively) as historically low oil prices put pressure on energy stocks and zero rates hurt financials, particularly banks. Meanwhile, technology had a positive return as the new normal of remote work created a tailwind for many of these businesses. Amazon had the highest contribution to the S&P 500's return – the stock's 49.3% for the six-month period contributed 1.6% to the index – as consumers turned to online orders in droves in the wake of COVID-19 lockdowns.

Small-cap equities suffered relative to their large-cap peers, returning -13.0%. However, we continue to believe that small-cap equities have a place in portfolios, and in another article in this issue, Jeff Hakala and Jerry Hakala of Clarkston Capital Partners, one of our third-party investment managers, walk us through their value proposition.

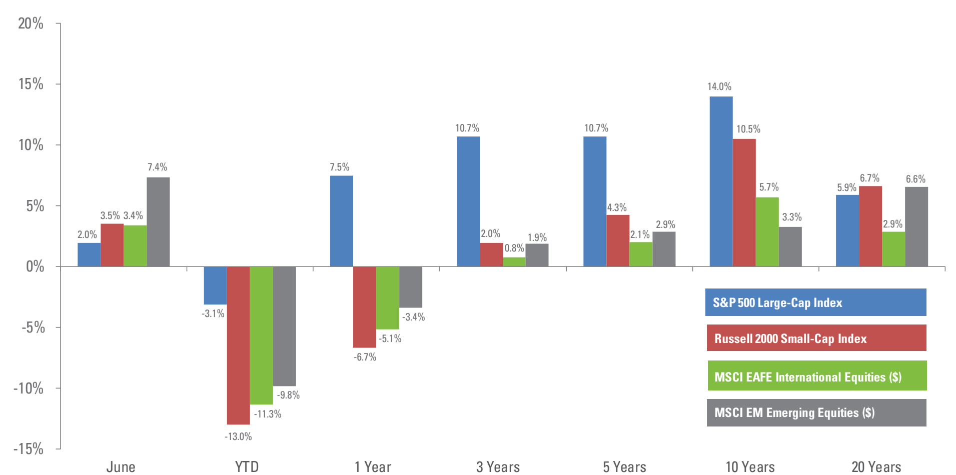
2020 Year-to-Date S&P 500 Sector Performance (As of June 30, 2020)



Source: Standard & Poor's.
Past performance is not a guarantee of future results.

International developed and emerging markets equities, despite recovering substantially beginning on March 23, delivered negative year-to-date returns of -11.3% and -9.8%, respectively. But the story was different depending on the country in which you were invested. For example, the U.K. returned -23.3% for the six-month period, while Japan had a more modest loss of 7.1%. The U.K. suffered from issues surrounding Brexit and COVID-19, and the pound weakened against the U.S. dollar, creating an additional headwind (approximately 550 basis points[1] [bps]) for U.S. investors. Similarly, there was a dispersion of returns across emerging markets countries, with China delivering a positive return of 3.1% and Latin America returning -35.2%. Interestingly, China, where the virus began, did not decline as much as other countries. Perhaps China's quick response to the COVID-19 virus made investors comfortable that the impact would not be as severe to the Chinese economy. On the other hand, returns in Latin America, particularly Brazil, declined substantially in the wake of COVID-19, as governments there have been less successful in containing the virus.

Equity Performance (Through June 30, 2020)



Source: Bloomberg and BBH Analysis.
Past performance is not a guarantee of future results.
Data as of June 30, 2020.

Looking at longer-term returns in the nearby chart, U.S. large-cap equities have been the place to invest over the past decade, as they have outperformed small-cap, international developed and emerging markets equities consistently. This track record might lead investors to conclude that they shouldn't invest in anything but U.S. large-cap stocks. However, we believe that conclusion would be ill-advised. For example, for the 20 years ending June 30, 2020, emerging markets and small-cap equities both generated higher returns than U.S. large-cap equities.

We can also point to the "quilt" chart nearby, which shows that there is no consistent pattern of outperformance across asset classes. For example, emerging markets equities had the highest returns for four years straight from 2003 through 2007, while municipal bonds outperformed all other asset classes in the equity downturns of 2011 and 2018. Though it is easy to be influenced by recent results, investors should be mindful of recency bias and recognize that we don't know which asset classes will be the winners in the future. Therefore, it is prudent to diversify portfolios to ensure that there

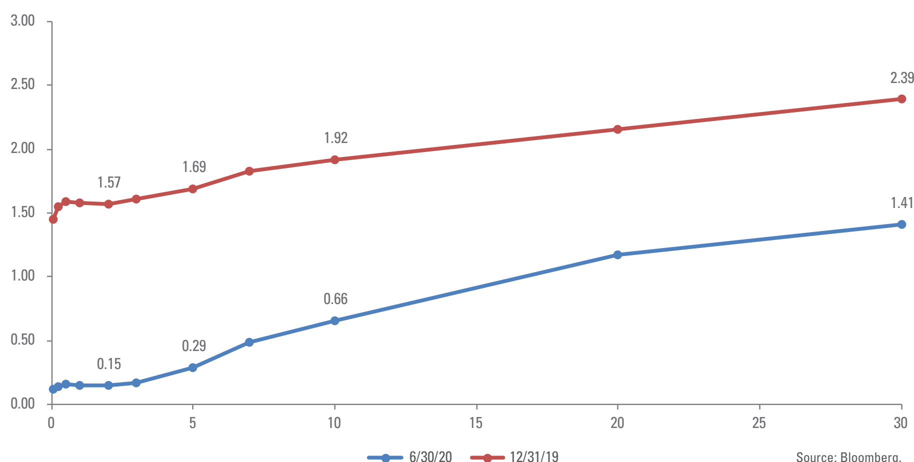
2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020 YTD (6/30)
11.7% Munis	8.4% Agg Bonds	10.3% Agg Bonds	55.8% EM	25.6% EM	34.0% EM	32.1% EM	39.4% EM	5.2% Agg Bonds	78.5% EM	26.9% U.S. Small Cap	10.7% Munis	18.2% EM	38.8% U.S. Small Cap	13.7% U.S. Large Cap	3.3% Munis	21.3% U.S. Small Cap	37.3% EM	1.3% Munis	31.5% U.S. Large Cap	6.1% Agg Bonds
11.6% Agg Bonds	5.3% High Yield	9.6% Munis	47.3% U.S. Small Cap	20.2% EAFE	13.5% EAFE	26.3% EAFE	11.2% EAFE	-2.5% Munis	58.2% High Yield	18.9% EM	7.8% Agg Bonds	17.3% EAFE	32.4% U.S. Large Cap	9.1% Munis	1.4% U.S. Large Cap	17.1% High Yield	25.0% EAFE	0.0% Agg Bonds	25.5% U.S. Small Cap	2.1% Munis
-3.0% U.S. Small Cap	5.1% Munis	-1.4% High Yield	38.6% EAFE	18.3% U.S. Small Cap	4.9% U.S. Large Cap	18.4% U.S. Small Cap	7.0% Agg Bonds	-26.2% High Yield	31.8% EAFE	15.1% U.S. Large Cap	5.0% High Yield	16.3% U.S. Small Cap	22.8% EAFE	6.0% Agg Bonds	0.5% Agg Bonds	12.0% U.S. Large Cap	21.8% U.S. Large Cap	-2.1% High Yield	22.0% EAFE	-3.8% High Yield
-5.7% High Yield	2.5% U.S. Small Cap	-6.2% EM	29.0% High Yield	11.1% High Yield	4.6% U.S. Small Cap	15.8% U.S. Large Cap	5.5% U.S. Large Cap	-33.8% U.S. Small Cap	27.2% U.S. Small Cap	15.1% High Yield	2.1% U.S. Large Cap	16.0% U.S. Large Cap	7.4% High Yield	4.9% U.S. Small Cap	-0.8% EAFE	11.2% EM	14.6% U.S. Small Cap	-4.4% U.S. Large Cap	18.4% EM	-3.1% U.S. Large Cap
-9.1% U.S. Large Cap	-2.6% EM	-15.9% EAFE	28.7% U.S. Large Cap	10.9% U.S. Large Cap	3.5% Munis	11.8% High Yield	3.4% Munis	-37.0% U.S. Large Cap	26.5% U.S. Large Cap	7.8% EAFE	-4.2% U.S. Small Cap	15.8% High Yield	-2.0% Agg Bonds	2.5% High Yield	-4.4% U.S. Small Cap	2.6% Agg Bonds	7.5% High Yield	-11.0% U.S. Small Cap	14.3% High Yield	-9.8% EM
-14.2% EAFE	-11.9% U.S. Large Cap	-20.5% U.S. Small Cap	5.3% Munis	4.5% Munis	2.7% High Yield	4.8% Munis	1.9% High Yield	-43.4% EAFE	12.9% Munis	6.5% Agg Bonds	-12.1% EAFE	6.8% Munis	-2.6% EM	-2.2% EM	-4.5% High Yield	1.0% EAFE	5.4% Munis	-13.8% EAFE	8.7% Agg Bonds	-11.3% EAFE
-30.7% EM	-21.4% EAFE	-22.1% U.S. Large Cap	4.1% Agg Bonds	4.3% Agg Bonds	2.4% Agg Bonds	4.3% Agg Bonds	-1.6% U.S. Small Cap	-53.3% EM	5.9% Agg Bonds	2.4% Munis	-18.4% EM	4.2% Agg Bonds	-2.6% Munis	-4.9% EAFE	-14.9% EM	0.2% Munis	3.5% Agg Bonds	-14.6% EM	7.5% Munis	-13.0% U.S. Small Cap

S&P 500 | Russell 2000 | MSCI EAFE | MSCI EM | Bloomberg Barclays U.S. Aggregate Bond | Bloomberg Barclays Municipal | Bloomberg Barclays High-Yield Corporate

Source: Bloomberg.
Past performance is not a guarantee of future results.
Data as of June 30, 2020.

[1]*Basis point: one hundredth of one percent.*

U.S. Treasury Yield Curve



is consistent exposure to the stocks and bonds of the best companies no matter their size or where they are domiciled.

Fixed Income Markets

Fixed income markets demonstrated historically high volatility levels in the first half of the year. As COVID-19 began to spread uncontrollably in February and into March, the Federal Reserve cut the federal funds rate by 50 bps on March 3, and then by another 1% in an emergency meeting on March 15, bringing rates back near zero, where they were previously held for seven years from December 2008 through December 2015. Accordingly, 10-year Treasury yields, which began the year at 1.92%, fell to new lows and ended June at 0.66%. As of June 30, the Treasury yield curve is below 20 bps out to three years and below 50 bps out past seven years. This precipitous fall in yields drove outperformance in high-quality and rate-sensitive areas of fixed income and served as a reminder of fixed income's role as a source of stability and downside protection for portfolios.

Focusing specifically on March, however, credit markets seized up, and a rush for liquidity caused an abrupt sell-off, the pace of which has never before been witnessed. Fixed income prices are set just like any other by the interaction of supply and demand among buyers and sellers, and there were many more bond sellers than buyers in March. Even high-quality, AAA-rated securities in many cases sold off in mid-March as investors were desperate for liquidity. Anecdotally, there were stories of "leveraged unwinds" as leveraged fixed income funds were forced to liquidate to meet margin calls, and even ordinary investors simply needed large amounts of liquidity from their fixed income portfolios.

In mid-March, the situation got so bad that even 10-year Treasury returns were negative for a period. In the midst of a historical decline in interest rates, the 10-year Treasury note due February 15, 2030, had a total return of -5.8% from March 9 to March 18, as yields briefly spiked from 0.54% to 1.19%.

Moreover, investors that owned high-quality, short-duration bonds as a source of portfolio stability were surprised not only to see credit sell off as hard as it did, but also to see shorter-duration bonds trade at wider spreads than similar long-duration bonds. As one example, BBB-rated 1-5 year corporate bonds, which usually trade at a credit spread (above comparable maturity U.S. Treasuries) 50 bps narrower than BBB-rated 5-10 year bonds, traded 70 bps wider on March 23, which makes little sense from a pure credit perspective.

The Federal Reserve took note of this lack of liquidity in fixed income markets and from March 17 through March 23 stepped in with several unprecedented measures, including programs focused on purchasing securities such as money markets, corporate, municipal and high-yield bonds and asset-backed securities. To date, little capital has been deployed in these programs, but their announcement immediately affected markets.

While we cannot say for sure whether there will be another credit sell-off in the latter half of the year, we can say that yields in fixed income markets are at historical lows and that defaults will likely be higher in 2020 (and likely 2021) than they have been in past years. It is impossible, once again, to earn positive real yields in high-quality fixed income without taking significant interest rate risk. For example, investors could buy 15-year-plus AA-rated corporate bonds and earn a yield of 2.5%; however, if interest rates rose by 1% (which is not hard to fathom

Fixed Income Index	Peak-to-Trough Drawdown	Date Range
High-Yield Bonds	-20.8%	2/19/2020-3/23/2020
Leveraged Loans	-20.7%	2/23/2020-3/23/2020
1-10 Year Municipal Bonds	-8.7%	3/9/2020-3/20/2020
U.S. Aggregate Bonds	-6.3%	3/9/2020-3/19/2020
1-3 Year Corporate Bonds	-4.2%	3/8/2020-3/20/2020
1-5 Year AAA-Rated ABS	-4.1%	3/8/2020-3/25/2020

Source: Bloomberg.

[I]t is prudent to diversify portfolios to ensure that there is consistent exposure to the stocks and bonds of the best companies no matter their size or where they are domiciled."

with rates this low), they would suffer a loss of 17%. Instead, our advice is to go back to basics and focus on why investors hold fixed income in the first place, which is liquidity and stability, before yield. In times when interest rates are more attractive, all three of those can be obtained with relatively low risk. Today, investors would be wise to prioritize liquidity and stability through holding high-quality fixed income instruments and to seek yield in other asset classes as part of a total return approach to investing. While investors will no longer earn attractive yields for the portion of their portfolios that provide them liquidity and downside protection, in our opinion, compromising on credit quality is not an option for this part of the portfolio.

Looking Ahead

There remains great uncertainty as we enter the second half of 2020. Markets will have to handicap the likelihood of a surge in the virus in the fall, the status of China-U.S. relations and a U.S. election. We will be sharing our thoughts on the election in more detail in future publications, but a Democratic win could bring meaningful changes in taxes and regulations. Of course, control of the Senate is also an important factor in determining the likelihood of such policy changes, and we will be watching all these developments carefully as they unfold over the next few months.

We cannot predict how markets will react to these uncertainties, but it is not out of the realm of possibilities that we may have another decline in the equity markets as the markets sort them out. When looking at the three most recent crises that occurred over the past 20 years – the 2000 dot-com bubble, the 2008 global financial crisis and the 2020 COVID-19 crisis – a common theme is that each was set off by an unpredictable catalyst at the time. However, there are certain tenets that we abide by that have enabled us to weather past crises, come out stronger on the other side and generate attractive long-term returns for our investors. They are as follows:

- **Don't try to predict the cause of the next downturn:** As former Federal Reserve Governor Kevin Warsh recently said: "If you've seen one financial crisis, you've seen one financial crisis." Therefore, resist the urge to "reverse optimize" your portfolio based on what would have done well in the past.

- **Be judicious with the use of leverage:** High leverage limits a company's flexibility and is a recurring theme in instances of permanent capital impairment. Leverage works well in up markets, but it can put you out of business in downturns.

- **Prioritize quality in investing:** High-quality companies backed by real cash flow are resilient through unpredictable and inevitable downturns. Companies that have strong balance sheets have financial flexibility enabling them to weather a downturn better than their lower-quality peers and emerge stronger on the other side.

- **Think about liquidity:** Liquidity ensures staying power to weather a downturn. Having liquidity enables investors to purchase assets at discounted prices, providing attractive forward-looking returns.

- **Respect your asset allocation and rebalance back to it:** In selecting a clients' asset allocation, we seek to balance our clients' desire for return with their ability to accept risk. To meet the return objective, we include growth- or equity-oriented investments in the portfolio, while risk is largely managed by investing in high-quality fixed income investments or cash. Different circumstances require different asset class mixes, and an individual's asset allocation must align with his or her unique circumstances and objectives. Once you have set your asset allocation, take opportunities to rebalance, especially through low-cost methods, such as reallocating new inflows, dividends or interest income. Rebalancing is a prudent exercise in risk management that is key to generating strong long-term returns. ■

Opinions, forecasts, and discussions about investment strategies represent the authors' views as of the date of this commentary and are subject to change without notice. References to specific asset classes and financial markets are for illustrative purposes only and are not intended to be and should not be interpreted as recommendations.

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