Lebed
Asset Management LLC

Investment Commentary—April 2020

Six Beacon Street
Suite 925
Boston, MA 02108
Ph: 617.722.8322
Fx: 617.249.2020

Clients and Friends,

I hope this commentary finds you and your loved ones safe and healthy. I happily report that as of now, I, my family, and my colleagues Brad and Katherine are all healthy. As I work from the comfort of my home, I'm very cognizant of the tremendous devastation wreaked by COVID-19. The damage goes well beyond the economic and financial consequences discussed below. I hope the impact on each of you has been and continues to be as limited as possible.

--Jay

***

I was recently introduced to VUCA, an acronym apparently in wide use in strategic leadership circles. It stands for volatility, uncertainty, complexity and ambiguity—all of which seem apropos to the challenges confronting public health officials, political leaders and CEOs. The course of stock and bond markets in the months ahead will be determined by the complex interaction of various dynamics, each of which is almost impossible to predict and difficult to measure. Chief among these is the timing and manner in which social distancing is relaxed and the economy allowed to thaw. Focusing on just one aspect of this, consider when and how those with COVID-19 immunity are allowed to return to work: Can antibody tests determine immunity with some level of certainty? How quickly can those tests be created, disseminated and administered? What percentage of the population will be determined to have immunity? What impact will their freedom of movement have on both supply and demand in various industries? The extent of the economic and financial fallout could vary dramatically depending on the answers to these and dozens of other questions. And no one has more than a hazy idea of what the answers are and how they will interact.

As corporate earnings season unfolds this month, we may get some limited insight into the impact of COVID-19 on large public companies. But most Americans are employed by small and medium sized businesses. Sadly, a tremendous number of those businesses will not survive. Limiting the casualties will depend on the flow of credit, which is why the recently passed CARES Act (a/k/a the "fiscal stimulus bill") is so important. The legislation devotes $450 billion to support Federal Reserve lending

which could amount to over $4 trillion[1]. That lending—even if haphazard and inefficient as it surely will be—should help a wide range of businesses, as well as states and municipalities, to survive the crushing declines in revenue now underway. It's almost impossible though to estimate now the impact these efforts will have.

U.S. banks, which were highly leveraged going into the 2008/9 financial crisis, entered 2020 with vastly more capital. That capital would be more than sufficient to weather the storm in all but the most pessimistic economic scenarios now circulating. But if the lockdown drags on, or if there is a series of false starts, some of the more dire scenarios might become plausible and capital levels could be tested. To make matters worse, European banks are not nearly as well capitalized as U.S. banks and may need to be bailed out by European governments. If bailouts are needed in Europe and that process becomes disorderly, the impact will be felt in financial markets everywhere.

Uncertainty around the reopening of the economy, the extent to which previously healthy businesses can be kept afloat in the meantime, the health and stability of the global financial system, and countless other unknowns make the course of the economy and markets especially difficult to predict. Best case scenarios aren't very good and worst case scenarios are awful. In managing your portfolios, and our own, we're guided by the following:

- For several years now high valuations have suggested long-term U.S. stock market returns going forward will be below historical averages. That has now changed. We would expect long-term returns from March 31st levels to be much closer to historical averages of around 9% per year.
- Interest rates are at historical lows and are likely to remain low for many years to come. While stock market returns should be in line with historical averages, bond returns, which tend to correlate to current yields, are almost certain to be subpar. Low prospective bond returns make stocks relatively more attractive.
- That said, the decline on the S&P 500 from the February high to the late March low was significantly less than the average decline in post-World War II bear markets. This suggests that there could be substantial further declines before a bottom is reached.
- Most companies will experience a dramatic revenue decline of unknown length. This puts a premium on strong balance sheets. We are favoring companies with strong balance sheets, less than average exposure to revenue declines during the lockdown, and share prices that don't reflect these advantages.
- Companies with weaker balance sheets have seen share price drops far in excess of the overall market (at least prior to this week's rally). We are holding onto these positions and even selectively adding ***if*** (a) we have a reasonable level of confidence that the business

---

[1] The appropriations will cover losses incurred by the Federal Reserve. If the Fed assumes losses of 10% with a small buffer, then $450 billion of appropriations would support $4 trillion of lending. The legislation separately provides for $350 billion in loans specifically targeted to small businesses.

will survive without a major recapitalization and (b) the returns in that case would be extraordinary.

- Volatility, either up or down, will likely provide additional trading opportunities. We plan to take advantage of this when we believe the odds are clearly in your favor. In recent days, with stock markets rallying sharply, we trimmed several positions. We believe there will opportunities in the weeks to come to deploy that cash to your advantage.
- In light of VUCA, we are, as always, avoiding dramatic changes to your portfolio, favoring incremental changes and challenging the assumptions behind any trades.

We are also keeping in mind, and urge you to do so as well, that at some point in the next 18 months we will have a COVID-19 vaccine or "herd immunity." The world will look a lot different, but life will have returned to something approaching normal. We'll be on the other side, and the economy and the stock market, if not quite back to where they were, will be well on their way.

To close on a cheery note: if you are lucky enough to be fifteen years or more from retirement and not drawing on your portfolio, or if you are ten to fifteen years from retirement and adding to your portfolio, any near-term stock market declines will be of great benefit. By the time you begin drawing on your assets in retirement, most of your investments will consist of purchases made after March 2020, either due to cash additions to your portfolio, reinvestment of dividends within the portfolio, or company share buybacks[2]. New purchases made now are taking place at relatively attractive share prices. That will be even more true if there are significant near-term declines from here. While painful to watch, deep bear markets can have a very positive effect on long-term returns.

April 10, 2020
Boston, MA

---

[2] Company share buybacks have the same effect as reinvested dividends. In both cases existing shareholders end up owning a higher percentage of the company. Buybacks tend to shrink during the worst of a bear market as firms are forced to preserve cash. Nevertheless a material level of buybacks will persist and, because companies will be buying shares at a lower price, shareholders will benefit just as if they had received the cash directly and immediately reinvested.