MARKET LETTER

PACIFIC PORTFOLIO CONSULTING, LLC

Third Quarter 2020

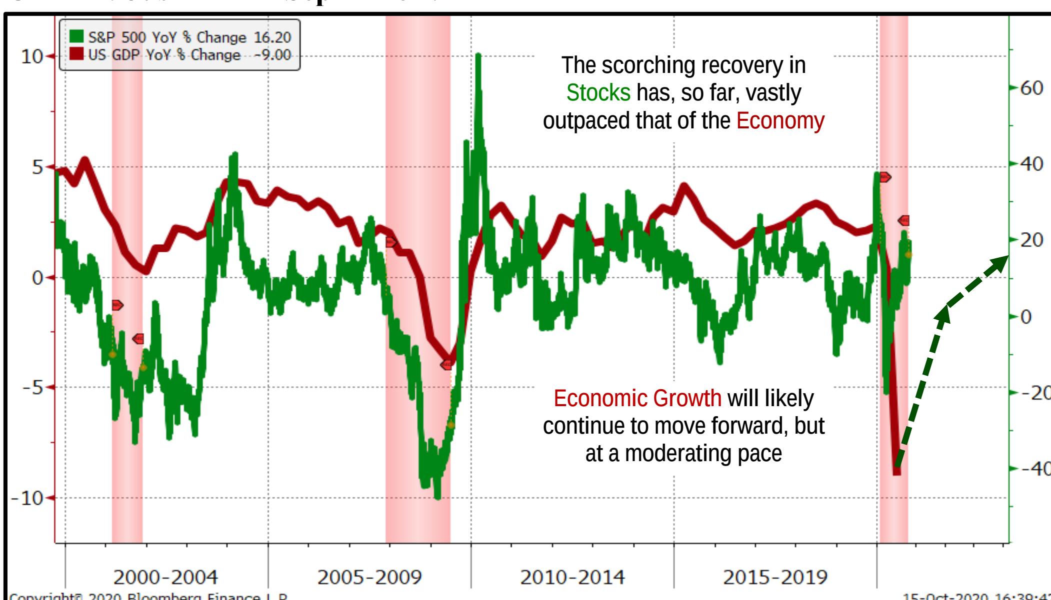
HISTORY IN THE MAKING

It's not very often you can use a headline like that comfortably, without feeling as though you need to second-guess yourself; quite frankly, in light of everything we've had to go through to get to this point, that's just fine with us! We feel quite confident, however, applying this particular lens to our current global circumstances, given just how many tensions, uncertainties, and potential pivot points we're facing right now on any number of different (but often interrelated) fronts for so many different (but often interrelated) reasons and for many of which the outcomes are entirely up in the air at this point!

From an investment perspective, the result is an extreme example of a fairly common problem we very often face as investors: even though our financial and investment planning and the steps we have taken around these have supplied us with a relatively well-defined long-term view, the scale of the "map" we're following can't possibly tell us exactly what we face over the next ten feet in front of us. As a result, some "surprises" – to put it nicely – are likely, even inevitable, along the way and, thus, the long-term plan must be sufficiently robust in construction to be able to withstand and adapt to whatever markets may throw our way.

Much like the Chinese word for "Crisis" (Weiji), however, which was famously – if inaccurately – broken down by John F. Kennedy to be a combination of the words "danger" and "opportunity" (more accurately, "change point"), we now find ourselves in a period where significant near-term change has become extraordinarily likely within key aspects of our economic, financial, political, and/or personal lives, creating the potential for tremendous disruptions and volatility in the short-run. Nonetheless, we believe any such crises actually will end up bearing opportunities for disciplined investors, those able to stay the course and ride out interim periods of turbulence, uncertainty, and even pain in order to reap the benefits of a longer-term outlook that, we believe, remains reasonably favorable.

Chart 1: Just a Trial Separation?

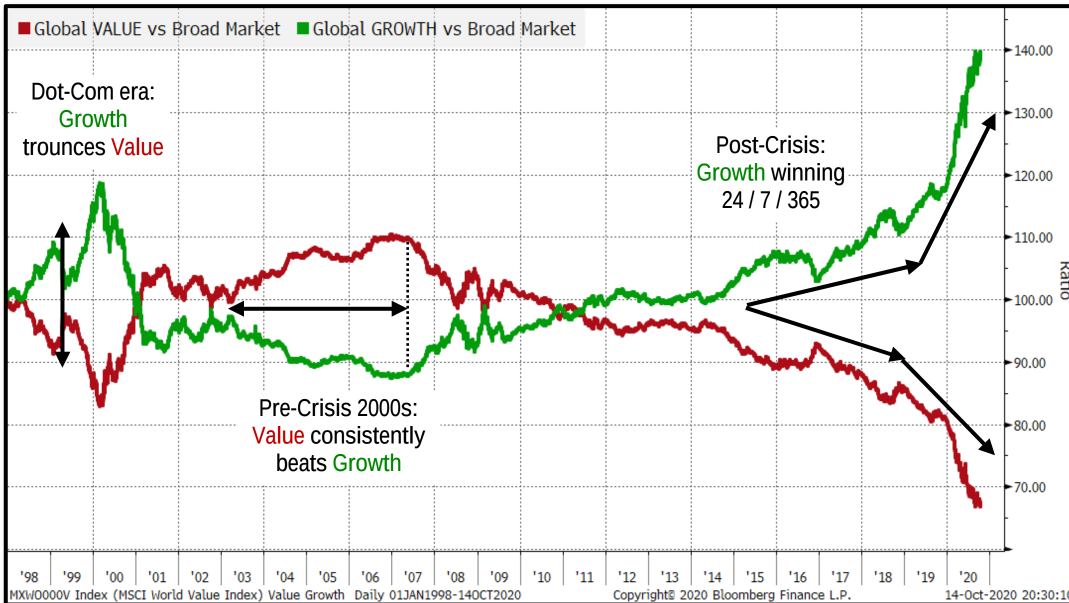


The graph above highlights the sheer depth of the (officially, still ongoing) recession; while brief, the contraction cut much deeper into the economy than anything since the Great Depression. What also becomes clear, however, is the stark parting of ways between the stock market – whose dramatic recovery took it to new all-time highs just prior to a September pullback – and the US economy. Since economic growth drives broad corporate profits and these, in theory, should drive stock prices, we would expect this separation to be short-lived. While this could potentially be resolved by stocks coming back down, that would probably require a double-dip recession from a renewed shutdown; more likely is that the stock market is looking ahead – as it's meant to – and already discounting continued improvement in the economic data. We believe we will continue to see the U.S. and global economies move further into positive territory, albeit at a more gradual pace than the initial V-shaped "pop" we saw off the bottom.

A HOUSE DIVIDED

A house? More like the whole neighborhood! Wherever we turn, we find division, disparity, and divergence as far as the eye can see. In 2020, there is no longer any such thing as a "gray area"; everything must be either very starkly black or white. On the political front, Republicans and Democrats have rarely seemed to have less common ground to stand on. Within the global economy, the ongoing COVID pandemic has largely spared – or, in some cases, even benefitted – sectors like Tech, Health Care, and Communications, even as it continues to wreak havoc on literally anything to do with, say, travel, leisure, or hospitality. Meanwhile, the same tune is playing out in the stock market, where the sustained outperformance of growthier, less economically sensitive stocks over their more cyclical value counterparts has now become stretched to historic proportions. It may not come as much of a surprise, therefore, to learn that a similar dichotomy of extreme winners and losers is also unfolding beneath the surface of the stock market itself, where the top 5 holdings in the S&P 500 – all growth stocks and currently at their highest concentration ever at roughly 22% of the index – have gained an average of +42% year-to-date, while the remaining 495 stocks were – on average – actually down roughly -2%!

Chart 2: Once More Unto the Breach…And Then What?



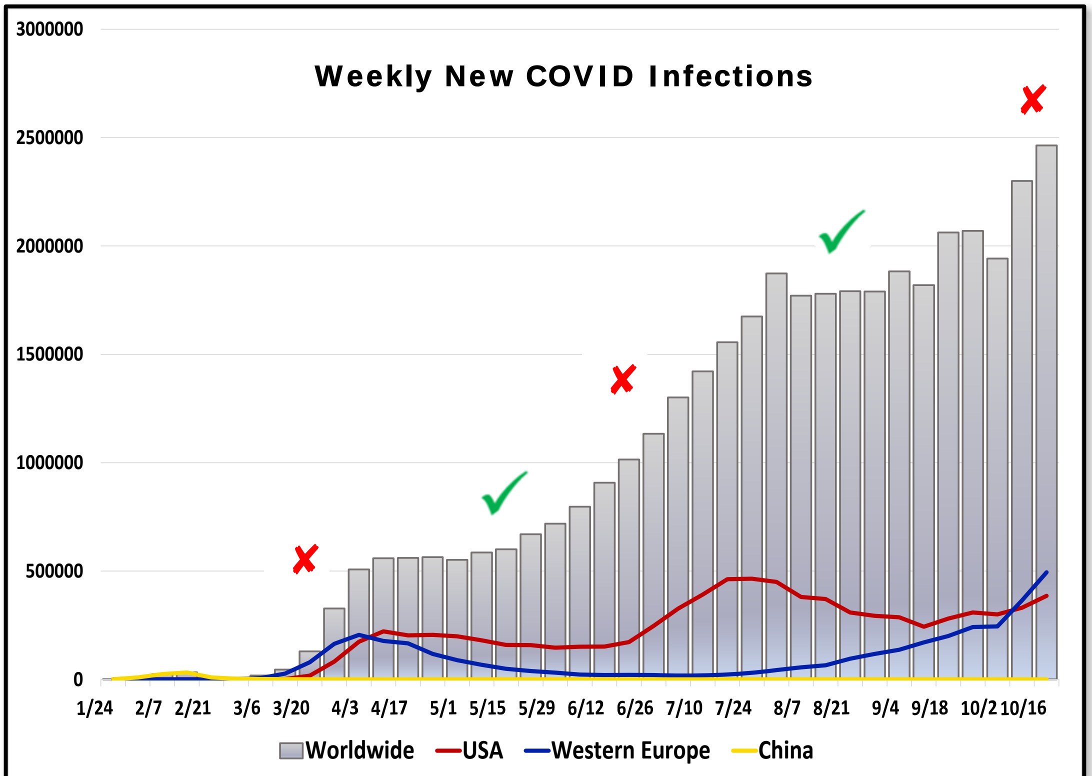
A fixture of the investment landscape since the end of the 2008-2009 crisis, Growth's dominance over Value has been taken to an extreme of late. Historically strong performers coming off of a recession or financial market bottom, value stocks have experienced their worst relative recovery ever at the same time that the stocks of growth companies have seen their biggest relative outperformance in decades. There is no question that a return to value will come at some point and the massive "breach" between the two styles will begin to narrow. We have reason to believe, however, that now is not that time. Given expectations for a return to modestly positive economic growth following the snap-back off the recession trough, as well as for interest rates and inflation to remain low for an extended period, conditions appear ripe for growthier, less economically-sensitive companies to retain the upper hand – barring an occasional cyclical rip – for some time to come yet. Meanwhile, although the gap between value and growth is quite a bit wider than it was even during the dot-com era, valuations are nowhere near those extremes and the earnings of the market leaders are robust (as opposed to non-existent). Finally, given the unpredictability of any rotation towards the more neglected segments of the market, it's critical to remain diversified, leaning towards areas expected to do better – like US growth stocks – but mitigating risk by holding diversifying exposures to other areas.

Even the broad economy and the stock market as a whole look as though they may have had a falling out of sorts these days. While they clearly don't move in lockstep, these two series do have a very intuitive tendency to spend much of their time at least heading in the same general direction. After all, the economy drives corporate profits and profits drive stock prices, right? Isn't that the way it works? Well, over the long run, at least, but from what we can see in Chart 1 (prior page), they certainly aren't reading off the same teleprompter at this point! The longest economic expansion on record had barely breathed its final breath and risky asset markets were already starting to roar back to life. From a whiplash-inducing reversal off the late-March lows, stocks began an impressive advance that took them – nearly-uninterrupted – to new all-time highs by mid-Q3. This clearly took quite a few investors, who apparently were expecting a much more extended period of gloom and doom, by surprise; not only those retail investors who had panicked out of their positions as part of the largest-ever stampede into money market funds (which is only now slowly starting to resolve), but even professional investors, with Wall Street's year-end 2020 consensus target of 3,300 on the S&P 500 (set in January) left far behind (granted, with a couple of months still to go). Even with a full-blown bear market wedged into the middle, however, 2020 currently remains on pace to deliver slightly better returns for many segments of the stock market than most had predicted even prior to the onset of COVID!

Ich Bin Ein Diversifier!

It would not be much of a stretch to think that this kind of market action could easily lead an investor to make some pretty rash portfolio decisions with, say, "Put it all on 'Growth'" at one end of the spectrum versus "Sell everything!" at the other. To put it mildly, it should not come as a surprise to any of you who know us to hear that we continue to **counsel strongly against** these sorts of maneuvers. We are, indeed, diversifiers, global asset allocators, as we believe

Chart 3: Rome Is Burning; So Is Paris, and Berlin, and Madrid, and…



There's no sugarcoating these numbers: the trajectory of the virus is headed squarely in the wrong direction across the developed and emerging world. Most startling has been the surge of new infections in Europe, where a robust initial response appeared to have squashed the curve. While this *had* caused some to wonder if this might mark an inflection point for European economies and markets to assume a leadership role as U.S. containment efforts continued to struggle to gain traction, optimism has been short-lived, as new COVID cases in Europe have now not only surpassed the rate in the U.S. but are over double what they were back in March and April at what was previously thought/hoped to be the peak. One potential saving grace is that the demographics of new infections have shifted lower in age, reducing the fatality rate and the need for hospitalization, keeping this new wave from completely overwhelming the health systems of the most heavily-affected countries. If true, this could reduce the likelihood of a renewed shutdown on a scale similar to that experienced earlier this year; clearly, however, the current trend remains sufficiently worrying to anticipate a continuation of the current social distancing measures and will continue to bear close monitoring for any signs that its impact on the economy is greater than currently anticipated.

all investors should be, and – while we will tilt modestly towards those areas our Investment Committee believes will outperform, we view maintaining a disciplined process of diversification and risk management as paramount over the long-term. As we often remind our clients, the context in which these investment strategies have been constructed incorporates the impact of all the short-term panics and euphorias, the melt-ups and the crashes that markets have experienced throughout their history.

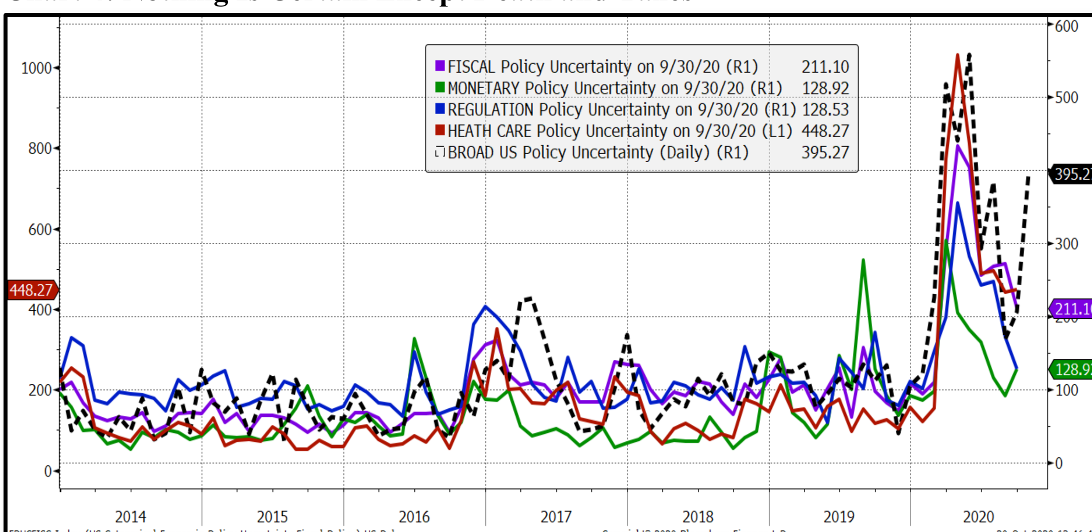
As a result, our strategies have fared reasonably well thus far in 2020, one of the more challenging years of any of our investing careers (which is really saying something!). On the equity front, they currently retain their bias towards the larger-capitalization, U.S. growth companies that have been leading the charge; they do, however, also still hold exposure to mid- and small-cap U.S. stocks, both of which have shown sporadic attempts to move to the forefront over the past couple of quarters, none of which has yet proven sustainable. Slightly greater success has been seen within the foreign equity space, which – bolstered by the recent fall in the value of the US Dollar – has shown better returns lately, though these have been concentrated in the foreign small-cap and emerging markets sub-classes. The broader foreign space has continued to languish somewhat, particularly in Europe, where equity markets continue to show double-digit losses over the year-to-date window, in sharp contrast with the stronger recoveries seen in Asia and the Americas. Although markets had been experiencing a rare bout of optimism regarding European economies and markets following their impressive initial success in containing the coronavirus – which raised the possibility that they would emerge from the recent economic downturn far sooner than the U.S. economy – such hopes appear to have been largely dashed by the recent surge in infections across the Continent and U.K., leading us to conclude the U.S. – despite its own COVID problems – is likely to retain the advantage near-term.

On the fixed income front, meanwhile, things remain remarkably quiet, as the massive monetary policy response – a key driver of the strong equity market performance noted above – drove extremely strong gains for bond markets earlier in the year but, in the process, took interest rates about as low as they can go. Similarly, the Federal Reserve's pledge to backstop the more credit-sensitive segments of the market caused spreads to compress drastically, even if not quite all the way back to their pre-COVID levels. In high yield, for example, what was an 11% yield premium over Treasuries in late-March has compressed down to around +4.5% relative to the roughly 4% prior to the market downturn. This has driven outperformance in these riskier segments of the bond market over the past couple of quarters, though some impact from the extraordinarily ugly decline in March remains evident in their year-to-date record. As for the more plain-vanilla, core investment-grade portion of the bond space, we currently anticipate a continuation of the recently more boring behavior that – once upon a time – was actually typical of the bond market. It seems clear to us that the Federal Reserve is in no mood to raise interest rates any time soon. Although they continue to emphasize the inability of monetary policy alone to sustain the nascent economic expansion, they do view it as a necessary piece of the puzzle. In conjunction with the recently much more explicit talk around taking on a symmetrical view of inflation – whereby the Fed would formally look for inflation to exceed their 2% target for a period in order to make up for the many, many, many years in which it has fallen well short of that objective – the stage appears set, in our minds, for the Fed to keep policy rates at or near zero for at least the next few years. Intermediate-term interest rates (i.e., market-set rates, as opposed to policy rates), meanwhile, appear poised to continue to climb very gradually alongside, further steepening the yield curve, alongside the return to modestly positive economic growth. Overall, this would seem to set the stage for a relatively benign bond environment for some time to come, within which core intermediate-term bond exposures would be expected to earn a modest but positive return – mostly the coupon – while at the same time contributing to overall portfolio stability and providing a broad-based hedge against equity market risk. Of course, it's worth incorporating into one's expectations the propensity for turnabouts and head-fakes that financial markets have exhibited over the past decade; in this regard, we would note the growing talk of the possibility of a "Blue Wave" election outcome (i.e., one where the Democrats take control not only the White House but Congress as well) unleashing massive fiscal spending (we should say "more massive", as our budget deficits under COVID have already well surpassed the merely "massive" threshold). Were such a scenario to play out, it would likely accelerate the timeline for the rise in interest rates and inflation (and, thus, of the next Fed tightening).

Those Who Do Not Learn From History

OK, fine, that's Churchill, not a president! My working title for this section – in an attempt to stick with a presidential theme – was Roosevelt's "Nothing to Fear but Fear Itself", acknowledging the truly unprecedented (the one and only use of this word that I am allowing myself this quarter!) uncertainties that currently confront us and how easily the resulting emotions – including fear – can short-circuit our investment thinking. Volumes upon volumes have been written on the subject of decision-making under uncertainty; no, I have not read them all, but I do know how they all end: we're really bad at it! Not only do we struggle to process the large amounts of information critical to making such decisions, but humans are also notoriously bad at assessing the true probability associated with a given outcome or estimating its expected impact. Emotions can easily take hold in investing, leading to decisions politely referred to as "sub-optimal" – in other words, they are reactive, contrary to the long-term plan, and

Chart 4: Nothing Is Certain Except Death and Taxes

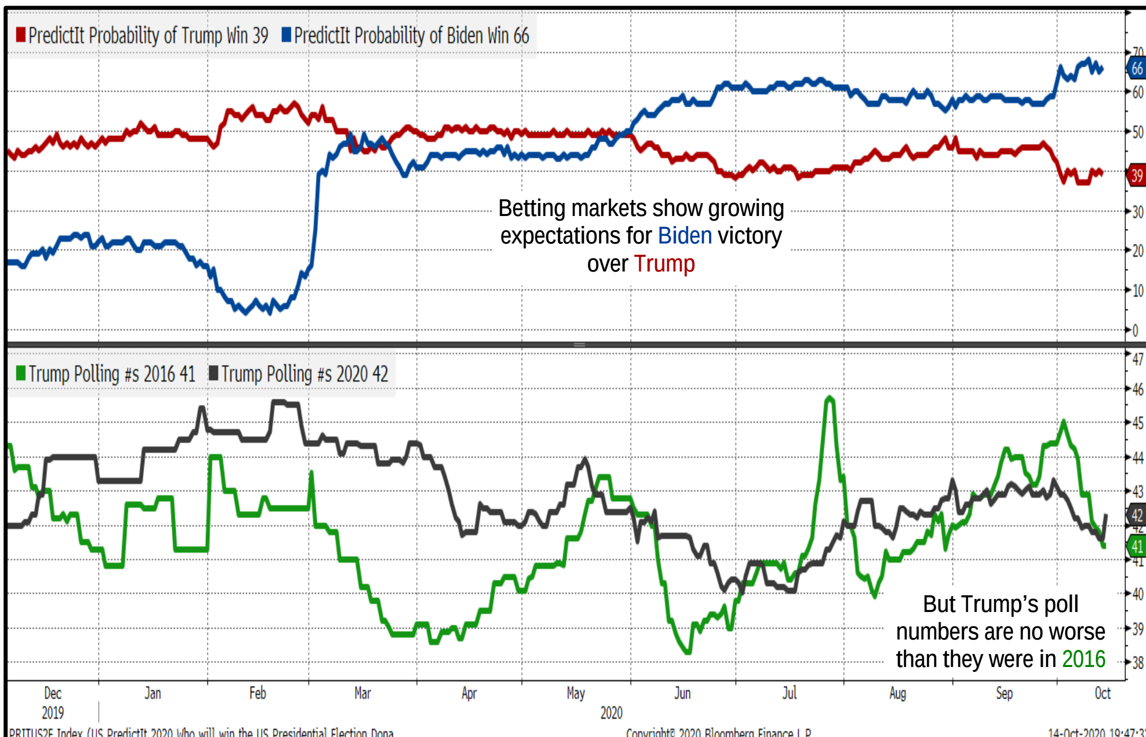


At no point over the last four years has there ever been any doubt that the upcoming election was going to fuel political uncertainty; the stakes are too high, the parties divided, the people divided, and civility and tolerance largely out the window. Now, add to the mix a resurgent global pandemic as flu season approaches and the aftermath of a deep global recession being met with literally the policy equivalent of the kitchen sink. Now it's a party! Although off their peaks reached in late-Q1, several of these appear to be moving higher once again, as markets ponder when and how much additional fiscal stimulus will be forthcoming or how much further the Fed will – or even can – take their bond buying program. While the election should be resolved fairly soon – if not on Election Night, then hopefully not long thereafter (now THAT is a tail risk!) – the rest may be with us for some time, likely pending the discovery of an effective vaccine for COVID, something not widely expected until at least the 1st quarter of 2021.

– most of the time – harmful to an investor’s long-term wealth! Meanwhile, sheer information overload can also lead investors to latch on to whatever decision seems within reach – something quick and easy, such as “Do nothing” or “Do something – literally anything!” – yielding to the near-term relief of having “made a decision” regardless of what the long-term effects on their investment efforts might be.

In the current climate, the Presidential and Congressional elections taking place in a couple of weeks are – if not the most critical (and some would argue that they are) – certainly the most immediate issues fueling the market concerns bubbling just below the surface. Regardless of party affiliation, speculation is rampant about who will win and how this or that market will react. Frankly, we continue to have less concern than many around this specific aspect of the election, as we remain convinced that – regardless of who is occupying 1600 Penn or wandering the halls of Congress – policy “Job #1” will remain one of helping the economy continue to heal and grow – in other words, policies we would expect to be largely business-, job-, and even relatively investor-friendly. Further, we would caution against becoming too wed to any anticipated market reaction, as 2016 showed investors quite vividly that not only outcomes but also the market’s reaction to such outcomes can be night and day different than what they expect. Just one more among many examples of why we discourage market timing.

Chart 5: The Dice Are Dancing



We will soon know the outcome of what some would argue is the most important election of our lifetime, with both sides seeing the very future of the country at stake. At this stage, both the polls and the betting markets are showing an increasing probability that Biden – with a growing lead over Trump – will be the one to steer the ship for the next four years (along with a smaller probability that Democrats sweep Congress as well). In spite of this, **make no mistake**: this election remains a coin toss. Trump’s polling numbers are just slightly above where they were at this time back in 2016, a level from which he went on to win the election. All politics aside, however, there are a couple of important things to keep in mind as investors. First of all, we know from experience that both the polls and the betting markets are capable of being spectacularly wrong, having predicted a decisive victory for Clinton in 2016. Another important consideration, however, is that markets’ reaction to a specific election outcome can be very different than what investors expect or fear: while many thought a Trump victory in 2016 would disrupt the market – which it did, for a matter of a few hours – stocks turned positive on a dime and embarked upon an impressive – if bumpy – multi-year bull run. The lesson for investors is to have a diversified strategy appropriate to their risk tolerance – one able to not only withstand but even flourish under either outcome – and to stick with it!

The fact that we believe the market will be OK with either candidate winning is not, however, to imply that the election is without risk; in fact, far from it. While not our base case, more concerning to us is the possibility of a contested election. While there appears to be a growing acceptance that, due to the increase in mail-in ballots, we may not have a definitive answer at the close of November 3rd, we would expect markets to remind us in vivid technicolor just how much they hate uncertainty in the event we find ourselves with a drawn out scenario where the losing candidate contests a close outcome, leading to recounts, challenged ballots, and eventually one of the several “alternative mechanisms” for selecting the President.

Unfortunately, it seems only reasonable to expect that while the sea of risk and uncertainty we face will ebb and flow, some portions resolving even as others escalate, we are unlikely to have meaningful respite from this new state of affairs any time soon. In fact, it's almost certain – ironically – that new and completely unforeseeable sources of uncertainty will flare up as we move forward. This is something we simply need to be willing and able to tolerate as investors, to acknowledge as part of the investing landscape in order to avoid letting it sway or derail our long-term investment plan.

Meanwhile, taking a step back to look at the map from more of a 30,000 ft view, in light of the source of the recent economic crisis – i.e., an event-triggered recession imposed upon an otherwise relatively healthy global economy – as well as the overwhelming level of ongoing policy response from both fiscal and monetary authorities around the world, we continue to think that the broad macro backdrop remains relatively favorable and conducive to moderately favorable outcomes for diversified portfolios of stocks and bonds. Returns may not be on par with investors' recent experience – certainly not the first time we (or thousands of other investment professionals) have said that, but let's face it: bonds are not really meant to return +6% a year, nor are stocks supposed to return +15% – but the continued growth of the global economy and earnings recovery this should engender, coupled with perma-depressed interest rates that help support higher equity market valuations, appear to make for a relatively asset-friendly environment (just look at what it did for the last 10 years!) We've no doubt there will be volatility – always has been, always will be – and (at some point!) even rotation to cyclicals and (eventually) even value stocks, though for the time being we remain comfortable with a bias towards quality and stability via larger, domestic stocks of companies capable of making their own growth – and, therefore, less reliant on any particularly favorable outcome to any or all of the uncertainties discussed herein – but with the healthy exposures to other, less-correlated classes and sub-classes, as dictated by the tenets of sound risk management that guide our investment process.

We realize the current environment can be both frightening and frustrating on many levels and we cannot emphasize enough the importance of having a game plan and sticking with it for the long-term as the best means of investing while still being able to sleep at night . As always, we invite you to reach out to your advisor or myself to discuss any questions or concerns you may have or simply to talk about the economy and markets.

-Jim Ayres, CIO

3RD QUARTER 2020 CAPITAL MARKET PERFORMANCE

Index (as of 9/30/2020)[1]	**1 Qtr**	**YTD**	**1 Year**	**3 Year**	**5 Year**	**10 Years**
FTSE 3-month T-Bills	0.03%	0.56%	1.02%	1.65%	1.16%	0.61%
Bloomberg Barclays Gov't/Credit Int.	0.61%	5.92%	6.32%	4.43%	3.39%	2.91%
ICE BofAML US High Yield	4.72%	-0.23%	2.35%	3.84%	6.61%	6.26%
Bloomberg Barclays Multiverse	2.71%	5.31%	5.99%	4.00%	4.08%	2.50%
S&P 500	8.93%	5.57%	15.15%	12.28%	14.15%	13.74%
Russell 1000 Value	5.59%	-11.58%	-5.03%	2.63%	7.66%	9.95%
Russell 1000 Growth	13.22%	24.33%	37.53%	21.67%	20.10%	17.25%
Russell Mid Cap	7.46%	-2.35%	4.55%	7.13%	10.13%	11.76%
Russell 2000	4.93%	-8.69%	0.39%	1.77%	8.00%	9.85%
Russell 2000 Value	2.56%	-21.54%	-14.88%	-5.13%	4.11%	7.09%
Russell 2000 Growth	7.16%	3.88%	15.71%	8.18%	11.42%	12.34%
MSCI EAFE	4.88%	-6.73%	0.93%	1.11%	5.77%	5.11%
MSCI EAFE Small Cap	10.34%	-3.90%	7.21%	1.78%	7.77%	7.71%
MSCI Emerging Markets	9.70%	-0.91%	10.91%	2.79%	9.37%	2.87%
MSCI Frontier Markets	8.42%	-8.61%	-2.54%	-1.45%	4.09%	3.32%
Wilshire US REIT	1.25%	-16.74%	-17.69%	0.45%	3.65%	8.00%
DJ Global Select RESI	2.09%	-21.24%	-20.08%	-1.85%	1.64%	5.66%
Bloomberg Commodity Index	9.07%	-12.08%	-8.20%	-4.18%	-3.09%	-6.03%
Credit Suisse Liquid Alts	2.81%	1.77%	3.92%	2.21%	2.99%	3.02%
60-40 Balanced EQ/FI – US Only	5.63%	6.33%	12.21%	9.49%	10.03%	9.53%
60-40 Balanced EQ/FI – Global	5.21%	3.99%	9.74%	6.74%	8.12%	6.85%

[1] The Bloomberg Barclays U.S. Government Credit Intermediate and Multiverse indices are registered service marks of Bloomberg Finance LP. Barclays is a service mark of Barclays Bank Plc, used under license; the ICE BofAML US High Yield index is a registered service mark of Intercontinental Exchange; BofAML is a service mark of BofA Merrill Lynch, used under license; the S&P 500 Index is a registered trademark of the McGraw-Hill Companies, Inc.; the Russell 1000, Russell 1000 Value, Russell 1000 Growth, Russell Mid Cap, Russell 2000, Russell 2000 Value, and Russell 2000 Growth indices are registered trademarks of the Frank Russell Company; the MSCI EAFE and MSCI Emerging Markets indices are registered trademarks of MSCI or its subsidiaries; the Wilshire REIT index is a registered trademark of Wilshire Associates Incorporated; the DJ global Select RESI index is a registered trademark of Dow Jones Trademark Holdings LLC; the Bloomberg Commodity Index is a service mark of Bloomberg Finance L.P.; the Credit Suisse Liquid Alternative index is a trademark of Credit Suisse Group AG.