Managing Portfolios Through the ‘Great COVID Crisis’
David Sowerby, CFA
Managing Director, Portfolio Manager

Three months have passed since the stock market peaked on February 19th. We can only attempt to describe what the past three months have been like with natural concern for family and friends, insatiable amounts of reading and listening to conference calls and podcasts, thoughtful discussions with peers to discuss views and, most importantly, pride in family and colleagues who, as expected, have risen to meet this challenge.

There are several items worth pointing out about the current market. The first is market breadth. The S&P 500 is off roughly 15% from its February 19th peak, which, to borrow from the legendary broadcaster Paul Harvey, does not tell “the rest of the story.” While the index has declined about 15%, the median company in the S&P 500 has fallen by 20%. As of early May, approximately one quarter of the market capital weighted S&P 500 return had been generated by five stocks. In other words, one percent of the 500 companies in the index had delivered one quarter of the index’s return. There are both good, and not so good, elements to that fact. The not so good is that the decline has been more pronounced than simply looking at the index headlines. The good, is that the breadth of potential opportunities is compelling for active managers.

The second item worth considering is reflection. Anytime you go through a stressful period in the market, it is good to reflect. This is now my ninth bear market working in the investment profession. Throughout the past three months, I’ve realized that some of my favorite time-tested rules have proven to be as relevant now as they were before the virus dominated our daily lives. Here are some that resonated once again with me during this period.

- As an investor, recognize what you know and, more importantly, what you do not know. This especially includes the unpredictable nature of economic forecasts during the economic shutdown.
- The effort to draw parallels to past bear markets, including the World Trade Center attacks, the Great Financial Crisis and the 1918...
Influenza Pandemic, are just as likely to be unhelpful as they are to hold any accurate insights as we look at our current crisis.

- Investment decisions need to be based more on what a company is likely to look like in 3-5 years, especially when near-term price volatility can overwhelm one’s analysis.
- Periods of uncertainty make investment decisions more uncomfortable. This is especially true when you take a non-consensus view. However, you tend to produce better long-term returns when you run against the herd.

The third topic is admitting that as a long-term investor there are going to be times where there are questions without immediate answers. Among the more frequently discussed current issues is the significant amount of stimulus, both monetary and fiscal, which has now totaled $9 trillion, or 38% of U.S. GDP. To be fair, this stimulus is less robust than a long-term tax reduction. Nevertheless, when combined with the Federal Reserve’s expansion of its balance sheet, the sheer size of the stimulus is significant. The stimulus is measured against an assessment of how the consumer will reenter the economy and the length of time labor markets take to recover. To be concise, this is what weighs most heavily on the stock market. There are simply too many unknowns to have a firm opinion. Candidly, those who believe they do know what’s to come may unfortunately fall into the category of “those who don’t know what they don’t know.” We are taught to invest in the ability of the U.S. economy to prevail over the long term, yet we recognize the unique nature of this crisis and its potential impact on consumer behavior. As a personal example, when do I choose to get on a plane, stay at a hotel or attend a research conference? While this crisis has its unique features, and short-term forecasts are extremely uncertain, investment opportunities do exist. The median large, mid and small cap stock (S&P 1500), remains 24% below its February 19th level. Wall Street has attempted to draw parallels between this crisis and past ones to extrapolate what the future may look like. While tempting, it is probably more prudent to acknowledge that each crisis and bear market have their own unique DNA.

In closing, the final item I’d like to discuss is resiliency. Time and again it has been wise to believe in the ability of the U.S. economy to pick itself up and return to growth. One of the market’s greatest virtues is its ability to reward investors for their patience and resiliency. Consider the investor who had the unfortunate timing of buying into the market right before the three most recent (pre-COVID-19) crises. Specifically, buying just before the peak of the 1987 crash, the 9/11 terrorist attacks and the September 2008 Lehman bankruptcy filing. Despite what would appear to be poor timing, their investments, if held for five years, would have yielded favorable returns. Each crisis had its own unique features, but what was common was the ability of the U.S. economy, its companies and citizens to prevail in a system of free markets and capitalism. Choosing a five-year time period to measure returns would seem appropriate as being neither too short, nor too long. Returns also exceeded buying a 5-year U.S. treasury as a substitute. The table below provides the specifics.

**5-Year Returns: S&P 500 Index Purchased Just Prior to Market Decline**

<table>
<thead>
<tr>
<th>Purchases Pre-Decline</th>
<th>Pre-1987 Crash</th>
<th>Pre-9/11 Attacks</th>
<th>Pre-Lehman Filing</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Purchased 10/16/1987</td>
<td>Purchased 9/7/2001</td>
<td>Purchased 9/12/2008</td>
</tr>
<tr>
<td>5-Year Compound Annualized Returns After Purchase</td>
<td>11.5%</td>
<td>5.4%</td>
<td>8.5%</td>
</tr>
</tbody>
</table>

Source: Bloomberg

The market sell-off during this COVID-19 crisis is in the category of “the risk you did not know,” as something that was simply not identifiable in advance. As such, it reinforces once again, that good, long-term investment planning involves focusing on how you are positioned, and what you own, before a potential decline.

**Should You be Concerned about Dividends?**

Sonia Mintun, CFA
Managing Director, Portfolio Manager

Dividends are taking on new importance as the social aversion towards share buybacks has increased and investors make
judgements about equity valuations in today’s environment. Recently, there have been several dividend reductions or suspensions as economic conditions have become more uncertain due to the COVID-19 pandemic. Some experts are projecting a 20-30% cut in dividends in 2020, which brings up the question if investing in dividend-paying stocks makes sense in this environment and how one can protect a dividend focused portfolio.

Dividends have long been a popular way to return earned profits to shareholders and have been powerful indicators of management’s confidence in the business as dividend levels are expected to be sustainable through a full business cycle. The Dutch East India Company was the first recorded public company to ever pay regular dividends, which amounted to roughly 18% of the share value for almost 200 years from 1602-1800.

These challenging economic times have put tremendous pressure on companies’ cash flow, which in turn forces companies to make tough decisions when evaluating how to preserve their financial liquidity. If the Financial Crisis of 2008 was a guide, it is feasible that we will see a decline in the S&P 500’s aggregate dividend for 2020 based upon today’s crisis. During the financial crisis in 2008-2009, the S&P 500 saw 62 companies cut or suspend their dividend in 2008 with an additional 78 following suit in 2009. However, 151 companies, or 30% of the index, increased their dividend in 2009 as the economy was climbing out of recession. There are other levers that management can utilize while cash flows are under pressure before a dividend cut is implemented, with a cut typically perceived as a last resort. Alongside the suspension of earnings guidance this year, we have seen a significant number of announcements around reductions in share buybacks, lower capital expenditures and operating expense rationalization programs to preserve financial flexibility. A majority of these occur before consideration of cutting the dividend.

A popular metric referring to dividend coverage is the payout ratio, which is simply the percentage of dividends per share divided by the earnings per share. A payout ratio greater than 100 means a company is paying more out in dividends than it is earning. While this is commonly used, it may be misleading to rely solely on the payout ratio as a measure of dividend health and sustainability. Earnings per share alone do not portray a company’s whole profile as they can be influenced by non-cash items and therefore may not reflect the true cash flow dynamics of a company. Although we study the payout ratio, we find that dividends as a percentage of free cash flow is a more valuable metric.

When investing for dividend income, an investor must be careful not to simply seek the highest yielding companies for yield alone. Often, they are paying out too much of their earnings and the payout is either not sustainable or the stock is depressed for good reason. Instead, our focus is on selecting companies that have a history of growing profits and cash flow steadily that can support a consistent and growing dividend. In addition, we seek healthy balance sheets with reasonable leverage and an effective history of capital allocation. During these economically challenging times, these traits will result in companies that are more resilient and have the capacity and liquidity to maintain or increase their dividend. In addition, they are characteristics that can potentially contribute to outperformance with lower volatility over the long-term.

In reviewing your portfolio for resiliency, you can stress test your holdings using various forecasts to cash flow to give you an indication of where risks of a dividend cut are highest. Using models that stress test different sales and free cash flow margin levels can be a valuable technique when looking for dividends at risk of being cut. In addition, looking back to the previous recessionary times as a gauge of how particular companies fared and management reacted then can be insightful.
The anticipation of a dividend cut can often be identified based upon a stock’s performance relative to its sector, even in advance of an eventual announcement. Underperforming companies with outsized dividend yields suffer from an increasing cash flow drain to support their high dividend level. In addition, combining a large dividend with excessive buybacks or leverage can overwhelm the free cash flow generation at the expense of reinvesting in the business for future growth. That’s when tough decisions must be made because an unsustainably high dividend is not in shareholder’s long-term best interest if it creates an inability to grow, particularly when leverage is used to pay the dividend. Furthermore, when assessing safety of dividends, it can be dangerous to assume that higher-yielding stocks are going to be safe if they are paid by a large, well-established company that has been paying it for decades. Size alone or prior dividends do not ensure a perpetual dividend. Things can change, even for big companies.

In this historically low interest rate environment, dividend growth stocks continue to make sense if you are selective in the process. It is essential to evaluate several dynamics including the company’s fundamentals, history of earnings growth and margin profile, the stability of their cash flow and earnings streams, the strength of their balance sheet as well as their capital allocation strategy. These stocks can be an effective core part of your portfolio, allowing you to increase your income stream and provide opportunities for capital appreciation with a high-quality tilt.

The ‘COVID Quarter’ & Things to Remember When the Market is Down
Jeffrey van Fossen, CFA
Managing Director, Portfolio Manager

Over three months have passed, a full quarter, since February 19th when stock markets peaked and began a dramatic slide in the face of evidence that the coronavirus was a serious global threat, having spread beyond China. According to columnist John Authers of Bloomberg, “These have been three of the most extraordinary months in financial history,” as evidenced by this chart, which shows how various asset classes have performed over the past twelve months. The chart is normalized so that all of the indexes were at 100 on the February 19th market peak.

The dispersion of returns is surprisingly wide, with global equity markets, commodities and REITs having all suffered serious declines. Gold and long treasuries are the exception.

The bullish-bearish-bullish volatility rotation has been breathtaking. It took the S&P 500 just 16 trading days to tumble 20% from the February record high, which was the quickest descent into a bear market since July 1933. It took just another seven trading days for the index to hit its March 23rd low, down 34% from the high. From March 23rd, it took just 19 trading days for the market to exit bear market territory, marking the shortest bear market since a similar 15-day stretch in November 1929. Since then, this new bull market has tacked on additional gains, leaving the S&P 500 down just 9% year-to-date, and taking it back to levels seen as recently as the third quarter of 2019.

Difficult as this time has been, it is not without precedent. Crisis markets are nothing new. In fact, bear markets born of surprise events are common. Since 1900 there have been 31 bear markets, or, on average, one about every three to four years. Bear markets, defined as a market decline of 20% or more, vary in duration and severity. Historically, the average bear market lasts approximately...
1.5 years with a 26% decline.

Here’s a sampling of some of the more notable bear markets that have occurred over the years. Note that the “Pain Index” shown in the table gives perspective on how bad the episodes of decline were, considering not only the magnitude of the decline but also how long the decline took to unfold and how long it took to recover.

**Largest Real Declines in U.S. Stock Market History**

<table>
<thead>
<tr>
<th>Rank</th>
<th>Peak</th>
<th>Trough</th>
<th>Recovery</th>
<th>Pain Rank</th>
<th>Pain Index (%)</th>
<th>Events</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Aug 1929</td>
<td>May 1932</td>
<td>Nov 1938</td>
<td>1</td>
<td>100.00</td>
<td>1929 Crash &amp; Great Depression</td>
</tr>
<tr>
<td>2</td>
<td>Aug 2000</td>
<td>Feb 2009</td>
<td>May 2013</td>
<td>3</td>
<td>85.51</td>
<td>Lost Decade (Dot-Com Bust &amp; Global Financial Crisis)</td>
</tr>
<tr>
<td>3</td>
<td>Dec 1972</td>
<td>Sep 1974</td>
<td>Jun 1983</td>
<td>4</td>
<td>80.41</td>
<td>Inflation, Vietnam, &amp; Watergate</td>
</tr>
<tr>
<td>4</td>
<td>Jun 1911</td>
<td>Dec 1920</td>
<td>Dec 1924</td>
<td>2</td>
<td>89.34</td>
<td>WWI &amp; Influenza</td>
</tr>
<tr>
<td>5</td>
<td>Feb 1937</td>
<td>Mar 1938</td>
<td>Feb 1945</td>
<td>5</td>
<td>59.57</td>
<td>Great Depression &amp; WWII</td>
</tr>
<tr>
<td>6</td>
<td>May 1946</td>
<td>Feb 1948</td>
<td>Oct 1950</td>
<td>6</td>
<td>29.06</td>
<td>Postwar Bear Market</td>
</tr>
<tr>
<td>8</td>
<td>Jan 1906</td>
<td>Oct 1907</td>
<td>Aug 1908</td>
<td>8</td>
<td>8.23</td>
<td>Panic of 1907</td>
</tr>
<tr>
<td>9</td>
<td>Jun 1900</td>
<td>Mar 1901</td>
<td>Mar 1901</td>
<td>9</td>
<td>8.18</td>
<td>Cornering of Northern Pacific Stock</td>
</tr>
<tr>
<td>12</td>
<td>Dec 1961</td>
<td>Jun 1962</td>
<td>Apr 1963</td>
<td>14</td>
<td>3.55</td>
<td>Height of Cold War &amp; Cuban Missile Crisis</td>
</tr>
<tr>
<td>13</td>
<td>Nov 1988</td>
<td>Mar 1898</td>
<td>May 1899</td>
<td>11</td>
<td>6.25</td>
<td>Depression &amp; Railroad Strikes</td>
</tr>
<tr>
<td>14</td>
<td>Apr 1903</td>
<td>Sep 1903</td>
<td>Nov 1904</td>
<td>12</td>
<td>5.00</td>
<td>Rich Man’s Panic</td>
</tr>
<tr>
<td>15</td>
<td>Aug 1897</td>
<td>Mar 1898</td>
<td>Aug 1898</td>
<td>15</td>
<td>3.20</td>
<td>Outbreak of Boer War</td>
</tr>
<tr>
<td>16</td>
<td>Sep 1909</td>
<td>Jul 1910</td>
<td>Feb 1911</td>
<td>17</td>
<td>3.11</td>
<td>Enforcement of Sherman Antitrust Act</td>
</tr>
<tr>
<td>17</td>
<td>May 1890</td>
<td>Jul 1891</td>
<td>Feb 1892</td>
<td>13</td>
<td>4.80</td>
<td>Baring Brothers Crisis</td>
</tr>
</tbody>
</table>


For many investors though, the ‘COVID Quarter’ market feels very different. In fact, every crisis market is different. However, one thing is certain: crisis markets come to an end and bear markets are generally followed by rallies. To date, there have been no exceptions. So, the message is this: We have been here before and we have always recovered and eventually enjoyed new periods of prosperity as the economy repairs, reshapes and rebuilds itself anew. The U.S. and world economies are nothing if not resilient, and this has not changed. Nevertheless, here are some things you can do to stay on track when volatility does strike.

**Don’t act impulsively.**

Impulse and emotion are enemies of the intelligent investor. As Benjamin Graham (Warren Buffett’s teacher and author of the 1949 investing classic, *The Intelligent Investor*) said “The investor’s chief problem– and even his worst enemy– is likely to be himself.” In bull and bear markets alike, it pays to resist making portfolio changes based on emotion.

**Follow your plan, not the herd.**

“Beware the crowd during extremes” is sage advice. Remember that your personal financial circumstances are likely to change only relatively slowly over years, and therefore remain relatively constant, whereas the only constant in the markets is change itself. Avoid being “whipsawed.” By sticking to your plan, you vastly reduce the likelihood of “buying high and selling low,” the antithesis of
successful investing.

**Keep your balance.**
A diversified investment portfolio (diversified both across and within asset classes) helps to mitigate losses and minimize concerns during crisis events and bear markets. Remain diversified. Resist the temptation to chase those stocks and market sectors that are doing well at the risk of being late to the party. Conversely, completely avoiding those areas of the market under significant but temporary duress may lead to lost opportunities in the future. It is often said that “one makes money in bear markets; you just don’t know it at the time.”

**Make any necessary portfolio changes gradually.**
Bear markets sometimes prompt clients to reconsider their risk tolerance. We find that over the years we have been very successful working closely with our clients to get their overall asset allocation correct. However, if you do find yourself consistently unable to sleep nights, call us to review your situation again in detail. If it becomes necessary to adjust, it is generally prudent to do so gradually. We counsel limiting asset allocation shifts to relatively small increments to avoid timing risk.

**Tune out the Noise.**
In both bull and bear markets, the overwhelming focus of investment information on television, radio, and the internet is on short-term events and forecasts. In bear markets, this “news” coverage tends to be overly depressing, and in bull markets overly manic. Much of what passes for news is often little more than sound bites, just a micro snapshot in time lacking full context, balance and perspective. Worse, some reporting is factually incorrect or even purposefully misleading. Successful investors tune out this noise, know the full story and maintain a long-term focus.

**Remember that many successful, long-term investors are scrupulously contrarian.**
As Sir John Templeton, a legendary value investor once said, “Superior returns are most often generated by buying stocks at times of extreme investor pessimism.” Similarly, at the May 2008 Berkshire Hathaway annual meeting, Warren Buffett said, “If a stock [I own] goes down 50%, I’d look forward to it. In fact, I would offer you a significant sum of money if you could give me the opportunity for all of my stocks to go down 50% over the next month.” Knowing he owned good long-term businesses, Mr. Buffett wanted prices to periodically go down, not straight up, so he can buy more shares more cheaply before they bounce back.

While this may be difficult to think of in times of market turmoil, it is precisely at times like these that long-term investment opportunities exist. If you have an investing time horizon of more than twelve months, the odds are very good that today is a far better buying opportunity than a time to sell.

“Stay the course” may sound cliché, but it is often the best advice in uncertain times. It is important to remember that no one can predict what the market will do over the short run. That is why a long-term focus is so important. Over time, ignoring the short-term and remaining focused on the long-term prospects for sound investments has proven to be a successful approach even considering the occasional, ugly bear market, which typically comes like clockwork every three or four years.

**Negative Interest Rates – Are They Possible Here?**
Kevin Gale
Managing Director, Head of Fixed Income

Europe and other parts of the world have seen negative interest rates since at least 2014. During that time period, areas of the world that have had negative interest rates (the Eurozone, Japan, Sweden, Denmark, Germany) have not experienced either widespread growth or inflation in response to this policy decision. This makes it unclear as to how much economic benefit negative interest rates deliver. In fact, some would argue that negative rates may do more harm than good as it signals an uncertainty about the future and can lead to capital flight.
With the recent turmoil in the U.S. caused by COVID-19, investors are contemplating if the Federal Reserve will take interest rates negative soon. The Federal Reserve, on the other hand, has said not so fast. In recent days, several members of the Federal Open Market Committee (FOMC), including Chairman Jay Powell, have said they have no expectations of taking rates negative. Of course, this assumes economic conditions do not significantly worsen.

Should the FOMC take rates negative, the implications in the U.S. are still unclear. If we use Europe as a guide to what happens when rates go negative, the implications appear to be minimal. In the U.S., the biggest concerns would be how banks and individuals react to negative interest rates. If individuals are being charged to have a savings account at a bank, would they withdraw their money resulting in a run on bank deposits? Would banks do the same thing and withdraw the deposits they have at the Fed? If we look to Europe, surprisingly neither one of these has happened, which makes it possible for rates to go negative in the U.S. without a severe impact on liquidity and the banking system.

While the FOMC has said it has no intentions of taking rates negative, it does not mean the market will not do it for them. Treasury bond yields are at or near all-time low yields with parts of the yield curve near 0%, meaning we potentially could see negative interest rates driven by the market itself.

Either way, low interest rates certainly appear to be here for the foreseeable future.

**During Periods of Market Stress, Planning is More Important than Ever**

Vanessa Mavec King
Vice President, Financial Planner

Over the past few months, COVID-19 has completely disrupted life as we knew it. The pandemic has brought an enormous amount of uncertainty, stress and fear with it. In times of crisis, it is important to stay focused and take action on what we can control.

A proactive and comprehensive financial plan sets the groundwork to be prepared for meeting challenges like COVID-19 without having to lose sight of your most important financial goals and values. Now is the perfect time to create or revisit your plan with a fresh set of eyes.

Here are some simple financial planning steps that can help provide peace of mind by evaluating where your finances stand today.

**Re-Evaluate Cash Flows – Income, Saving, Spending**

COVID-19 has caused the greatest unemployment rate since the Depression era. There have been unprecedented layoffs, furloughs and salary cuts. As companies continue to tighten budgets and decrease revenue projections, it’s a good time to consider if any short or long-term income projections for your family have changed.

With the disruption to daily life, our spending habits have also seen major changes. Taking time to introspectively put together a budget that accounts for your ‘new normal’ will help set expectations for spending.

Even if budgets have gotten tighter, one of the strongest weapons for uncertainty is savings. Funding and maintaining your emergency fund (cash reserves) and continuing to contribute to your retirement accounts remain incredibly important actions.

**Reset your Balance Sheet**

What assets do you own and what debt do you still carry? With recent market volatility, it is likely asset values have changed. Do those changes affect your ability to fund your financial goals? Additionally, with historically low interest rates in play, there may be strategies to refinance and reset your debt planning.
Revisit Risk Tolerance
The market has experienced its first bear market in more than a decade. There is no way to tell how long this will last. Is it time to have another discussion on how much risk you are willing, able or need to take in your investment portfolios? What asset allocation has the highest chance of success in funding your financial goals?

Update Scenarios
Given all the change occurring, there are likely new stress-tests or scenarios for which you would like to see projections. How do all of these recent changes affect your overall picture? Do any financial goals need to be reconsidered?

Right now, there are endless unknowns, but one thing is certain, there will always be change- priorities change, markets fluctuate, emergencies happen. Proper financial planning is critical to keeping you on track to achieving your financial goals and limiting stress, especially during unique and difficult times like these.

Ancora's planning team is here to help, please reach out to your Ancora representative to discuss creating or adjusting your financial plan at any time.

As always, don’t hesitate to contact your Ancora advisor or relationship team if you have any questions or would like to learn more about these topics. Visit our website at www.ancora.net to read past newsletters and find other news and insights from the investment professionals at Ancora.