NorthCoast
Asset Management

Quarterly Client Update

Q2 2020

June 30, 2020

"The rules of navigation never navigated a ship." -Thomas Reid

There is a pocket guide on my shelf I picked up twenty years ago called The Worst-Case Scenario Survival Handbook. It details the necessary action steps to take when confronted with unlikely yet life-threatening situations. . . imagine things like stuck in quick sand or fending off a shark or what to do if your parachute fails to open. All of the information in the book comes from experts in the situation at hand. Their advice seems reasonable given they survived and there is a large enough sample size of others who have successfully dealt with the same scenario.

But what do you do when dealing with a new threat without a playbook? One where there is no previous experience – like a zombie approaching? Do you run, offer a beer, or pull out the kitchen knife? No one knows. All you can do is build a framework using knowledge, experience and new data as it becomes available.

Similarly, Wall Street offers scores of playbooks – what to do during times of rising inflation or economic recessions or liquidity crunches. We have worked through or studied those markets at length to better prepare ourselves as asset managers. What do we do then when dealing with a new threat? One where there is no previous experience – say like a medical crisis, an economic cessation and a liquidity emergency happening simultaneously globally? The answer is the focus of this quarter's letter – to share with you our framework and our plan going forward.

As a backdrop, the first half of 2020 contained an all-time high for stocks, the deepest recession since the 1930s and the sharpest bear market drop on record, followed by a market rally that included the fifth-strongest quarterly gain since 1950. In total, the S&P 500 finished the second quarter up 515 points, or +20%, to 3100 – its biggest percentage gain since the last three months of 1998. The Dow Jones Industrial Average added 3895 points, or +18% – its best quarter since 1987. The rally has cut the indexes' losses for the year to 4% and 10%, respectively. Further:

- The economic picture remains bleak. Nearly 20 million jobs have been lost since February. Unemployment went from a 50-year low (3.5%) in February to the highest level since the Great Depression (14.7%) in April, reflecting the abrupt and widespread economic shutdown. Retail sales are far below pre-pandemic levels and manufacturing activity in the U.S. also contracted, albeit at a more gradual rate.
- The Federal Reserve announced a policy of quantitative easing forever and became a massive backstop for the financial markets and the economy with truckloads full of cash. The Fed actually started its campaign on March 15, when it announced a lowering of federal funds rate by 100bps to zero. Since then, the Fed's security purchasing programs have pushed its balance sheet by $2.5 trillion to a record $7.1 trillion. Its holdings of Treasury securities increased $1.6 trillion over the same period to a record $4.1 trillion.
- Congress authorized three pieces of legislation to address the outbreak, bringing the total amount of already-passed economic support to $3.6 trillion – much of it aimed at getting cash into people's hands immediately to help them pay their bills and buy groceries. So far, the biggest aid package approved by Congress was the CARES Act which accounted for approximately $2.7 trillion of the spending. It called for sending direct payments to most Americans, expanded unemployment benefits, and included emergency grant and loan programs for small businesses.
- Finally, the medical crisis has evolved but not necessarily improved. Active cases and new diagnosed cases hit records in the United States on June 30 even as some would argue that increased testing and lower death rates prove better management. Further, 23 companies have stepped forward with plans to develop vaccines or treatments but clinical trials are still in process with unknown outcomes.

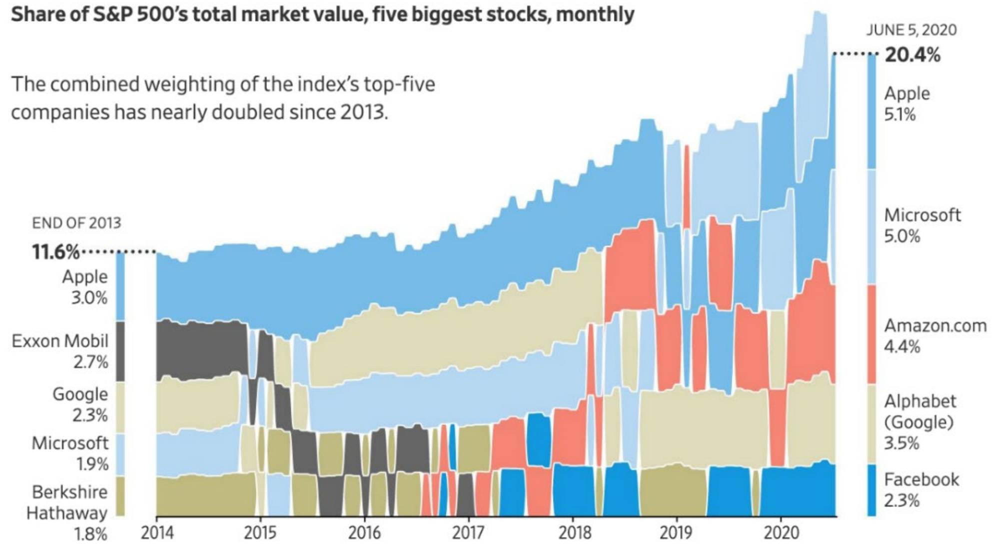
So how do we manage market exposure and stock selection models during this time? We rely on knowledge, experience and data as it comes available. At the time of this writing, our US tactical models are 68% invested and 32% in cash. Our analytics suggest we will sit in the market channel between S&P 500 3,200 and 2,800 as bouts of hope and fear consume investors week to week. Our position is guided by over 13 new data sources we have added to our core models. We have purchased or accumulated data sets covering real-world metrics like infection rates, restaurant bookings, bankruptcy filings, public transit and credit card usage as well as mobility and lockdown data. The latter two data sets I've highlighted in the appendix below.

Given our approach, we are optimistic that better investment opportunities lie ahead. This framework kept us adding equity positions in early April when we were 75% invested and then subsequently reducing exposure during some of the advance in May when we hit our exposure low of 61% on 5/13. We were and continue to actively balance risk and reward along the way given the best set of inputs and signals we can uncover and I'm proud of our effort here.

Stock selection, however, continues to amaze me. Even with great market exposure analytics in order to keep up with the market we would need to place over 23% of our clients' capital into the five stocks (MSFT, AAPL, AMZN, GOOGL, and FB) that have dominated all of the investment gains this year. If you stripped them out, the market would be down closer to -10%. Diversification, according to Nobel prize winning economist Harry Markowitz, is an investor's best friend over long periods of time – a risk reducer and an investment tailwind. However in the recent past, like many things right now in the world, this is upside down and reminds me of the market in 2000 when investors similarly could not own enough of Enron, GE, and CSCO.

Thomas Fuller once said "Vows made in storms are forgotten in calm" and nothing better captures this saying than the "stay at home" stocks in the current "storm". People seem to have forgotten the 2000-2002 market and that the price you pay for something matters. . . paying 502 times earnings to own a stock like Zoom is a fantasy but price momentum is all the market cares about right now. Zoom has echoes of Etoys.com or Pets.com during the late 90's.

We continue to conduct additional research and will share with you more about this subject this quarter. Understanding this phenomenon is an important topic and a preview is below … the table and chart are worth the time to read and consider. The biggest stocks in the market are also the best performers. While the median stock is -11% YTD, the top 10 are +9.6%.



Note: Individual shares do not add to combined figures due to rounding.
Source: Dow Jones Market Data
Peter Santilli/THE WALL STREET JOURNAL

S&P 500 Median Results Through July 3, 2020

Company Size	Market Cap	P/E	P/S	P/FCF	P/B	YTD Returns
Top 10	$848.5 billion	31.4	6.3	33.2	6.3	9.6%
Top 50	$198.7 billion	28.7	4.6	23.3	5.5	2.4%
51-100	$77.6 billion	26.0	3.8	25.0	5.3	-5.7%
101-150	$49.5 billion	22.9	3.9	23.6	4.1	-1.9%
151-200	$30.5 billion	26.4	3.0	23.5	4.1	-6.7%
201-250	$24.6 billion	24.4	2.6	20.0	3.2	-9.3%
251-300	$20.2 billion	23.2	2.6	21.8	3.3	-5.5%
301-350	$14.9 billion	23.9	2.8	22.8	2.5	-8.5%
351-400	$11.8 billion	22.1	1.8	18.4	3.0	-17.6%
401-450	$8.9 billion	13.3	1.4	12.8	1.9	-22.6%
451-505	$5.1 billion	13.9	0.8	10.0	1.2	-38.5%
S&P 500	$21.8 billion	22.8	2.4	20.4	3.0	-11.0%

Souce: Ycharts

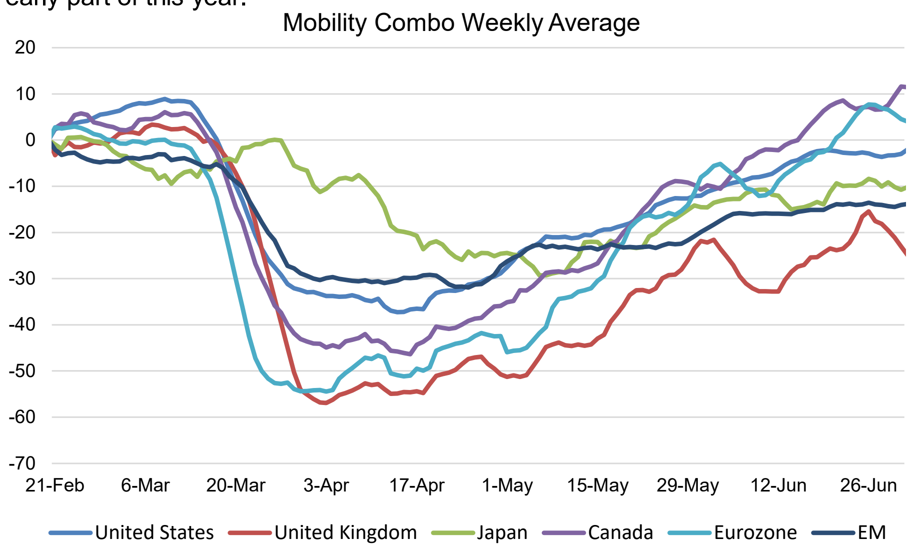
While I've included a lot of information here, it's important to convey that especially in these complex times we operate strategically on a myriad of fronts. As always, thank you for your business. We have worked hard as a team – from investment and advisory to trading and operations – to deliver top advice and uninterrupted service during these challenging times. My thanks go to my amazing colleagues here at NorthCoast and my hope is that this letter finds you and yours healthy, safe, and doing the best you can. Things will get better. Bumpy but better.

Warm Regards,

Dan Kraninger
President & CEO

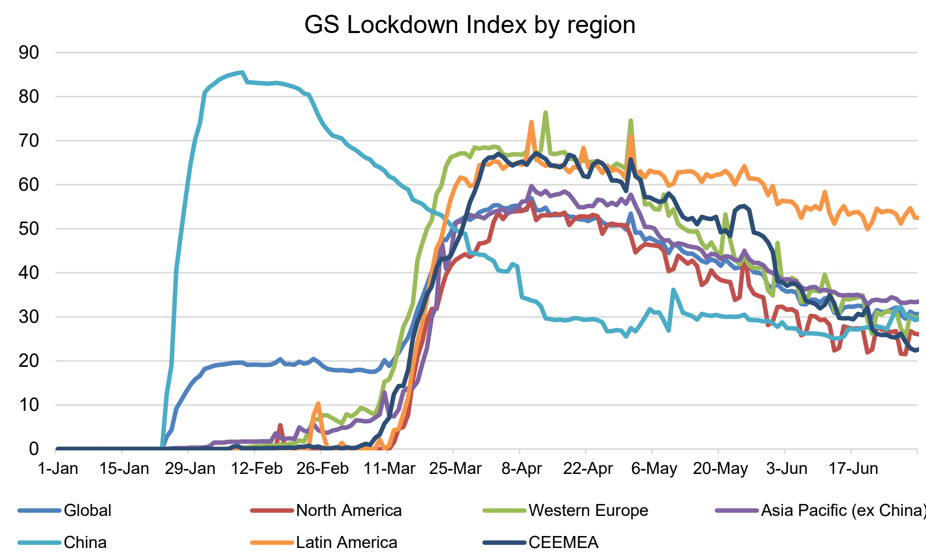
APPENDIX

Global Mobility Signals
We believe that as mobility increases, economic activity will increase. Thus we have added a global mobility signal as a complement to the economic factors in our model. Each line below represents a region of the world and shows movement trends across different categories baselined to the 5-week period of 1/3/20 to 2/6/20. Anonymous aggregated GPS data can show how many people made trips to non-essential places such as national parks, campgrounds, taxi stands, highway rest stops, airports, etc. Though influenced certainly by weather, Canada (yellow, below) has surpassed their average mobility from the early part of this year.



Source: Google Analytics

Lockdown Data
The lockdown index influences our sentiment signals. The index assesses the impact of virus control policies and attempts an objective measure of their "tightness" both across economies and over time. It combines seven policy measures: 1) school closings, 2) workplace closings, 3) public event cancellations, 4) closure of public transportation, 5) public information campaigns, 6) internal movement restrictions, and 7) international travel controls for over 73 countries. The daily index ranges in value from 0 to 100, with higher values indicating more stringent policies. In the graph below, it's very easy to see how quickly and stringently China implemented lockdown measures in early January.



Source: Goldman Sachs

Important Disclosures

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NorthCoast Navigator

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The NorthCoast Navigator is a market barometer displaying current equity outlook. The aggregate metric is determined by multiple data points across four broad dimensions including macroeconomic, sentiment, technical and valuation indicators. The daily result determines equity exposure in our tactical strategies. As of 6/30/2020. Data provided by Bloomberg, NorthCoast Asset Management.

An Uneasy and Uneven Recovery

An anemic gain in June capped off the S&P 500's best quarter in over 20 years, rising roughly 20% over the 3 month period. Much of this past quarter's gains were logged in April and May when federal stimulus packages were announced and the Federal Reserve pledged to provide liquidity to credit markets and other asset classes. June's gains were stymied by a recent increase in Coronavirus cases, specifically in the Southern and Western U.S., which has caused delays in economic reopening plans. Additionally, it has become clearer that both manufacturing and consumer spending are recovering at a slow pace.

The recent spike in cases across parts of the U.S. has led to some hesitation in economic reopening plans and increased uncertainty regarding the recovery timeline. Similar to the beginning of this health crisis, the focus is again on infection data. The difference at this stage is that the state-level data has become more important, making it more apparent that the reopening will vary by region as opposed to sweeping across the country as a whole. The likely effect on the U.S. economy will be an increasingly uneven recovery. For equities, the high level of uncertainty regarding the Coronavirus and economic stability can both be expected to contribute to elevated volatility. While we anticipate the U.S. election to gain attention during the 3rd quarter, the reopening of the economy will be the overwhelming focus in the near-term.

Two interesting phenomenon became more pronounced throughout the second quarter. The first was the reluctance by companies and analysts to provide guidance. In fact, roughly 40% of companies in the S&P 500 have withdrawn their guidance due to the uncertainties surrounding the Coronavirus crisis. The second was the increase of individual investors in the market who continue to fiscally support companies most affected by the health emergency. The stock prices of cruise lines and other tourism or travel-driven companies have benefited from a flow of investor funds.

We increased our U.S. equity exposure during the month of June as we saw an improvement in both technical and sentiment indicators. However, we remain cautious due to pauses in reopening and the concerns and uncertainty they raise. We anticipate some short-term volatility resulting from Q2 earnings announcements and increased volatility in the longer-term until some of these uncertainties are resolved.

Macroeconomic

Consumer spending increased marginally during May according to data released in late June. Despite the increase, spending remains down roughly 12% from February. Unemployment is still at a record high and it remains to be seen how much of the job loss will be permanent.

Sentiment

Though still low, our measures of sentiment moved slightly higher during June. The University of Michigan sentiment survey ticked up to 78 from 72, and mutual fund outflows slowed slightly. However, investor sentiment remained low.

Technical

With only a small overall gain in the month of June, technicals remained in line with last month. Volatility, as measured by the VIX, is still high and we did see some large intra-month daily moves. We expect volatility to continue well into the third quarter.

Valuation

There was little change in valuation indicators during the month of June. Some sectors are becoming more stretched than others even as guidance is being pulled, specifically technology. P/E ratios sit at 22.0 as of 6/30.