NorthCoast
Asset Management

Quarterly Client Update

Q3 2020

September 30, 2020

Lighthouse in a Storm
Watercolor by Olga Beliaeva

"Lighthouses don't go running all over an island looking for boats to save; they just stand there shining."

~ Anne Lamott

I have always loved the lighthouse metaphor for what we do at NorthCoast. It's my belief that managing money requires guiding lights or foundational principles to help navigate the never-ending day-to-day financial crosswinds. This year the storms we've faced have been historically intense with unprecedented market, economic, and political action and reaction:

1. **The steepest and quickest bear market decline ever** - It took just 16 trading days for the Dow Jones to push into bear market territory and a 20% decline, with the S&P 500 and Nasdaq Composite Indexes one trading day behind. On an aggregate basis from peak to trough, the S&P 500 declined 34% in only 33 calendar days thanks to the Coronavirus panic. Compare that to the average bear market correction, which has historically taken at least 11 months to decline 30%.

2. **The highest volatility reading on record -** The CBOE Volatility Index, also known as the VIX, measures 30-day forward-looking volatility via options. In March, the VIX hit an all-time high of 85.47, eclipsing its previous record high of 80.86 set during the Great Recession.

3. **The first time crude oil futures contracts pushed into negative territory -** We also witnessed history on April 20, when front-running crude oil futures contracts for West Texas Intermediate (WTI) turned negative. It's not as if WTI futures dipped only a few cents into negative territory. Although the stay below $0 was relatively brief, WTI futures reached minus $40 per barrel before rebounding. Producers were effectively paying buyers to take the product off their hands.

4. **The fastest recovery from a bear market bottom to new highs -** Aside from enduring the steepest bear market drop in history, investors were also privy to the fastest recovery to new all-time highs. After bottoming on March 23, it took less than five months for the S&P 500 to rise to a fresh closing high. The Nasdaq Composite did even better, with the index recording more than three dozen record closing highs in 2020.

5. **The first-ever $2 trillion public company in the U.S. -** Lastly, we witnessed the first publicly traded company in the U.S. to hit a $2 trillion market cap: Apple. Apple was already doing well heading into late July. Its fiscal third-quarter earnings report showed surprising double-digit sales growth from the prior-year period, with services revenue leading the way during an especially difficult quarter for businesses. However, it was the company's announcement of a 4-for-1 stock split that appeared to create the euphoria that sent Apple to a market cap of $2.3 trillion before retreating**.**

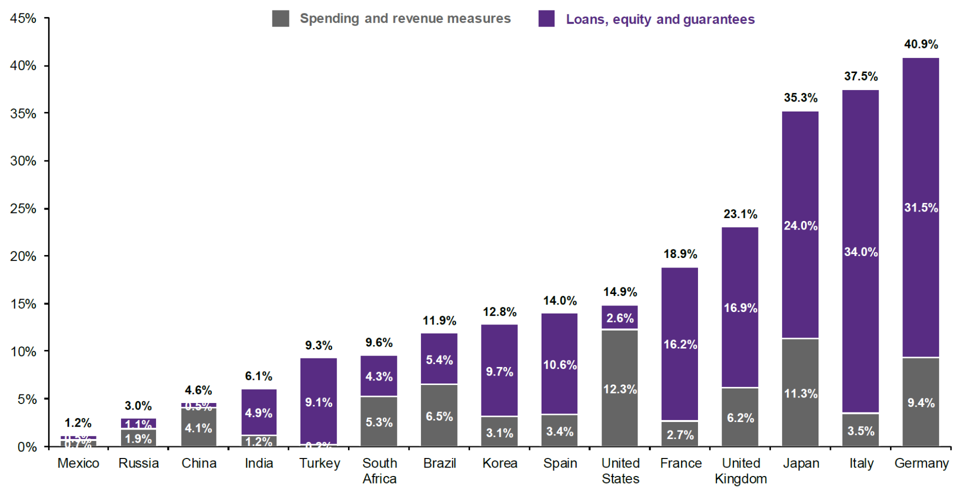
In a normal year, any of these market events could be the lead story. But they are dwarfed by the economic, political, and medical stories of 2020: the upcoming election, COVID vaccines, the Fed's declaration of war against a recession, and Congressional stimulus packages. Given all that's happening, I want to take time to highlight a few lighthouses that we use as these storms continue to roll in.

First, **Data and Discipline will Outperform Instinct and Intuition**. This is a cornerstone belief for us and has been on display every day since the storms rolled in during February. Markets move for four reasons: Macroeconomic (+/- change in economic activity and production), Sentiment (optimism/pessimism for future economic conditions), Technicals (+/- change in asset prices) and Valuation (what are people paying for future earnings). We measure over 40 signals from these four dimensions every day, then adjust portfolios based on whether these data points indicate future gains or potential losses. We discuss this exercise in the NorthCoast Navigator, distributed monthly to our clients.

However, as referenced above this market has many historical firsts. So if you use models built from 75 years of market history what do you do when you are seeing something for the first time? Well for us, we do not give up on data; we simply collect new and more relevant datasets to help us navigate. Below are some examples of data we've been using to complement our foundational thinking: Chart 1: How much global governmental support is at play? (A LOT!!); Chart 2: How is high frequency economic activity acting? (Improving still!); and Chart 3: Seven-day averages for COVID cases and deaths (better but not great).

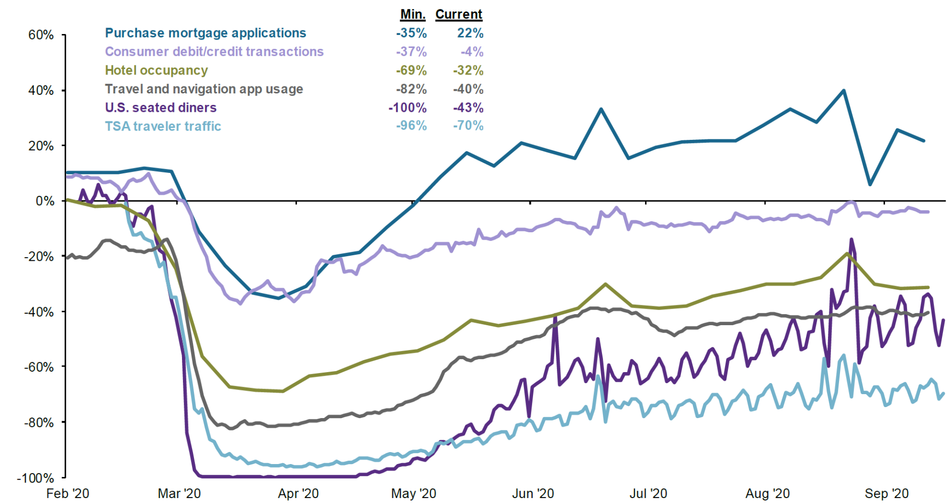
Considering all this, we are optimistic about the market over the next 6 months.

Chart 1: Fiscal Response to COVID-19 (% of GDP)



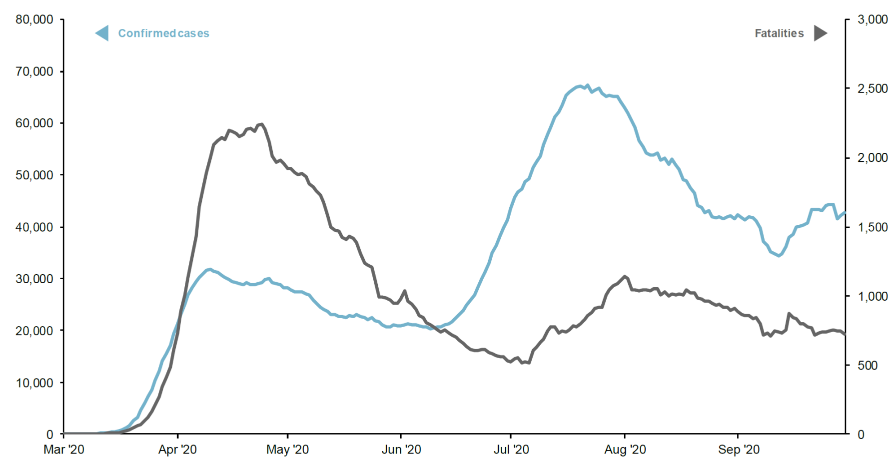
Source: IMF Fiscal Monitor, J.P. Morgan Asset Management.
Fiscal measures are estimates from the IMF's Fiscal Monitor Database from June 2020.

Chart 2: High-Frequency Data (Year-over-Year % Change)*



Source: App Annie, Chase, Mortgage Bankers Association (MBA), OpenTable, STR, Transportation Security Administration (TSA), J.P. Morgan Asset Management. *App Annie data is compared to 2019 average and includes over 600 travel and navigation apps globally, including Google Maps, Uber, Airbnb and Booking.com.

Chart 3: Change in Confirmed Cases and Fatalities in the U.S. (7-day moving average, as of 9/30/20)



Source: Johns Hopkins CSSE, J.P. Morgan Asset Management.

Second, **A Stock's Performance Over Time Will be a Reflection of its Underlying Factors.** We use 21 factors to measure whether a stock is a good investment or not - things like earnings growth, profit margin expansion, whether institutions are shorting the stock, is it cheap or expensive, is management buying or selling their stock, etc. This has been a very productive way to differentiate winners or losers over time.

This does not mean that it works all the time, however. I wish it did! *There is no easy money in the stock market*. It means instead you have to be patient and disciplined because it's not always going to work for you. And for about 18 months this has been quite a challenge. Why? Because only one factor has dominated performance – market cap, or, put more simply, size.

Would you put $226,000 of your $1 million into five stocks? Well if you want your portfolio to keep pace with the S&P 500, that's what you have to do right now because the top five largest stocks are currently 22.6% of the S&P 500. It is an idea that doesn't work out well historically and one of the reasons we are underweight these popular names. Can you believe that four out of the top five stocks in terms of market cap from 2000 are still below their prices from 20 years ago? (GE $58 vs $6, CSCO $77 vs $38, XOM $40 vs $34, PFE $48 vs $36). Incredible.

Weight of the Top 5 Largest Stocks in the S&P 500
(% of market capitalization of the S&P 500)

Source: FactSet, Standard & Poor's, J.P. Morgan Asset Management.
Information Technology sector's peak weight in the S&P 500 during the Tech bubble was in 8/31/2000, and peak EPS contribution to the S&P 500 was in 10/31/2000.

Another way of looking at this is to compare the performance of the cap-weighted S&P 500 (which is very influenced by size) to the exact same stocks equal-weighted:

S&P 500 YTD: +5.6%
S&P 500 Equal Weight YTD: -4.8%
Source: Bloomberg

That 10% difference is attributable to nothing else but size. Strikingly similar, small-cap stocks measured by Russell 2000 are even worse off at -9% year-to-date. This is exactly the run up we saw in 1999 when big stocks dominated and look what happened 5 years later – equal weight beat cap-weighted by +47%!

Total Returns as of 12/31/2004

	1 year	3 year	5 year
S&P 500 Index	10.88%	11.13%	-10.99%
S&P 500 Equal Weight	16.48%	28.76%	36.02%

Source: Bloomberg

Now is the time to be consistent and disciplined – we have seen this movie before. Mean reversion is a powerful market force. It's clear to me that investors who had significant losses from 2000-2003 are unfortunately doomed to repeat those mistakes in the current environment by chasing stocks that don't have the ingredients for long-term success.

The third and final lighthouse for this letter is **Election Outcomes Don't Mean That Much to the Stock Market**. Though the election will continue to compete with the Coronavirus for news dominance over the next four weeks (and probably longer if some states are contested), we all need to try to resist grand, linear (Linear = if Candidate X wins, this will then happen) arguments about what this means to the market. Why? Because the market doesn't really care (hats off to some spectacular visuals on this from Invesco in the Appendix below). The market cares about the dimensions I discussed above – the economy, the valuation, the technicals, and the sentiment of the participants. That is where we will continue to keep our attention.

To provide some historical context, I was in Portland, Oregon during our last election and remember watching Dow futures down 1000 points upon the announcement of President Trump's victory. It was so unnerving to clients that we put out a bulletin at the time.

To be sure, there will be anxious moments ahead. Volatility is rising and COVID cases remain stubbornly high, but remember the market will very quickly move past the news stories on to what matters to investors. We remain focused on the lighthouses which have provided the foundational guidance for our investment decisions throughout this turbulent year.

As always, thank you for entrusting us with your investments. I hope this letter finds you and yours healthy, safe and strong. 2021 is almost here.

Warm regards,

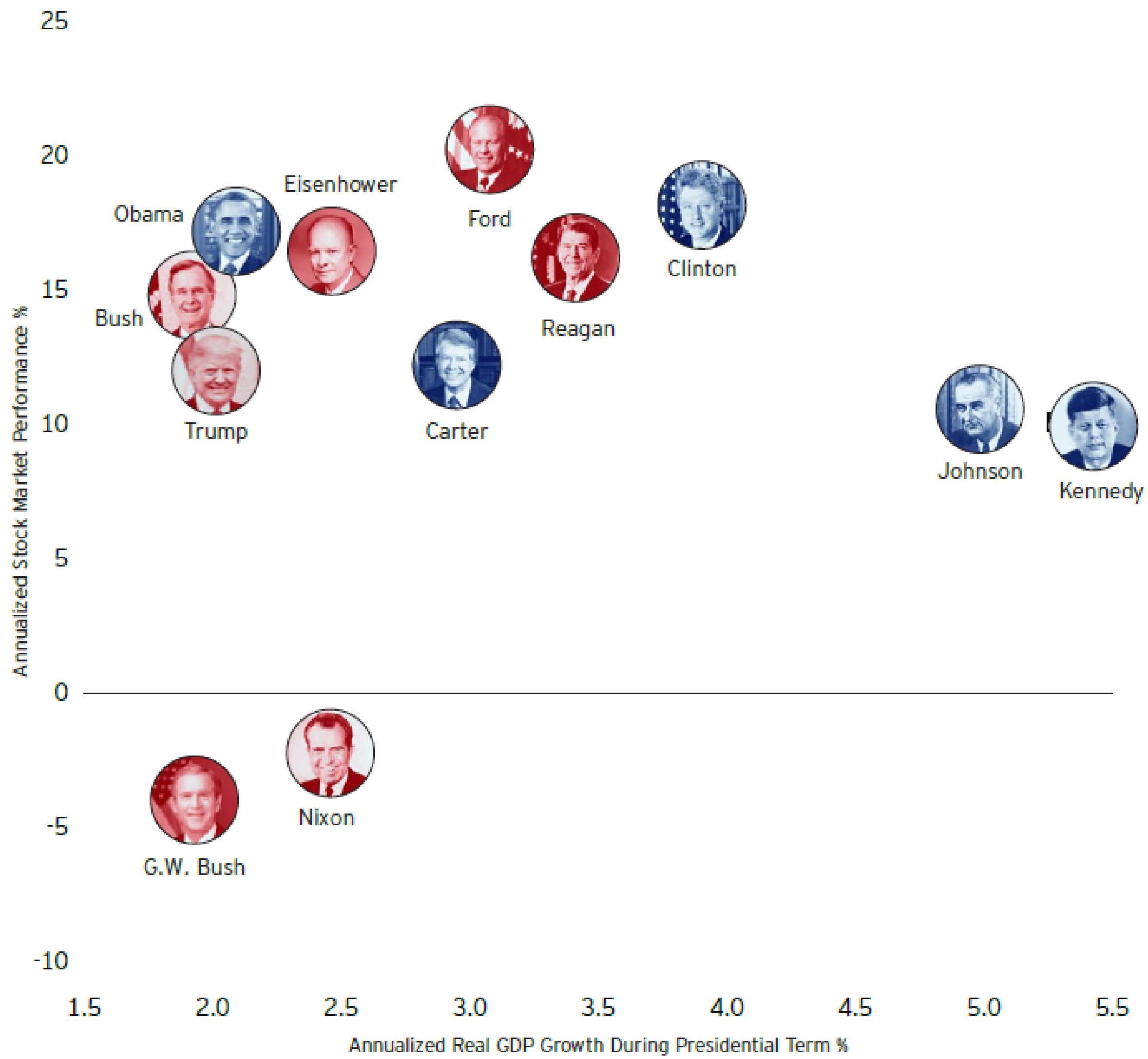
Dan Kraninger
President & CEO

NorthCoast Asset Management

Markets Have Performed Well Under Both Parties

- The S&P 500 Index delivered an average annual return of approximately 11% over the past 75 years, through both Democratic and Republican administrations.
- The US economy also expanded around 3.0% during that period.
- The stock market's return was negative for a presidential administration only when the country was in a financial crisis (2008) or experiencing a stagflationary spiral (1973).
- Neither party can lay claim to superior economic or financial market performance.

Presidential term stock market returns vs. economic growth (1957-present)



Sources: Haver, Invesco, 6/30/20. Note: President Trump stock market performance data from 1/20/17-6/30/20, real GDP data from 12/31/2016 to 3/31/2020 as GDP is reported with a lag. Stock market performance is defined by the total return of the S&P 500 Index. Index definitions can be found on page 13. **Past performance does not guarantee future results.**

The Historical Narrative Is Not Always as You Remember It

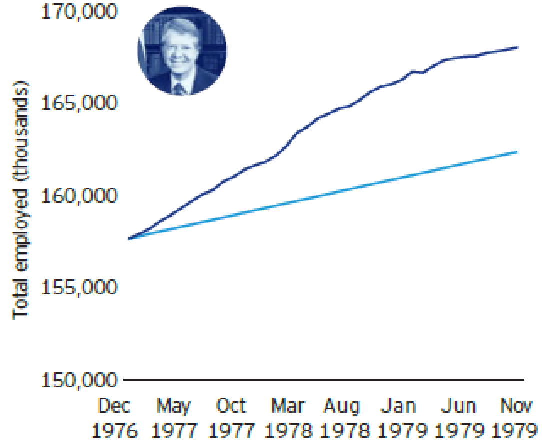
+ We may attempt to use historical narratives to inform the future, but do we get the history right? Who among us remembers that:
+ Jimmy Carter presided over significant job growth.
+ Under Reagan, income for those in the 50th percentile of the population, ranked by income, grew by almost 20%.
+ During Obama's presidency, despite concerns that his policies would be massively inflationary, the US had one of the longest disinflationary environments on record.
+ Under President Trump, capital expenditures have been below their historical growth rate, even in the aftermath of a large corporate tax cut.
+ The charts here show a metric for each president, in dark blue, compared with the long-term average growth rate for that metric since the end of World War II.
+ Clearly, history is often remembered differently than the actual data.

Sources: Bureau of Economic Analysis, Bureau of Labor Statistics and Haver Analytics, 3/31/20. Note: Long-term trends are all averages since the end of World War II in 1945 except for Median Weekly Earnings, which is an average of the change since 1971, when data collection began on that statistic. Capital expenditures are not yet available for 6/30/20.

President Jimmy Carter and jobs

Nonfarm payrolls

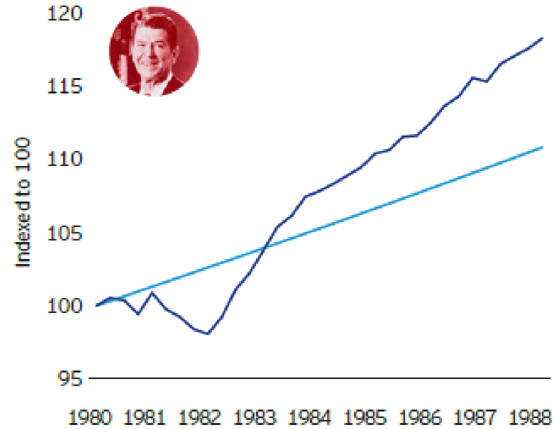
■ Actual job gains ■ Post-WWII Trend



President Reagan and income gains

Average weekly earnings growth

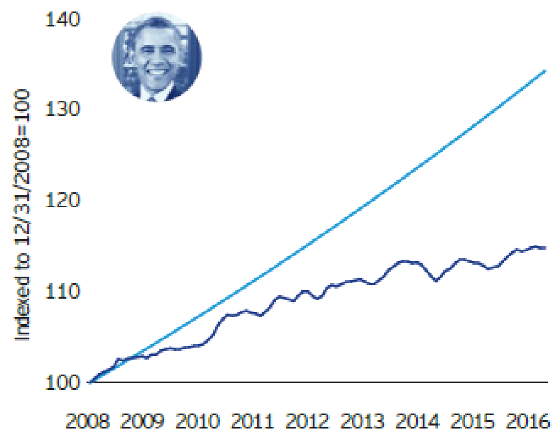
■ Median Weekly Earnings ■ Post-1971 Trend



President Barack Obama and inflation

CPI trend vs. actual

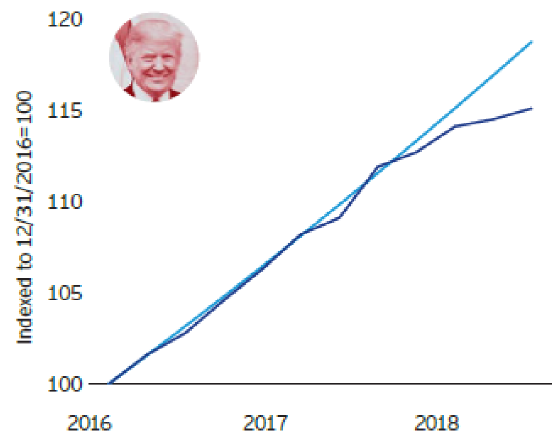
■ Actual CPI ■ Post-WWII Trend



President Trump and business investment

Capital expenditures

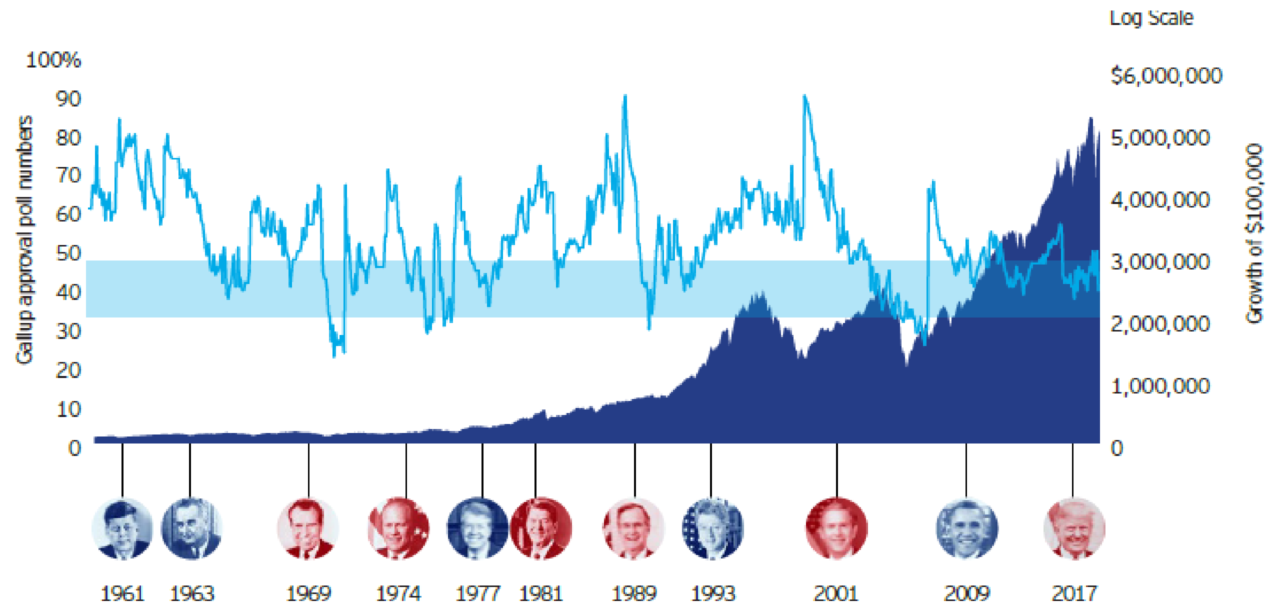
■ Actual ■ Post-WWII Trend



Markets Don't Care if You Don't Like Who's President

- Investors don't have to love what is going on in Washington, DC, to prosper in the markets.
- Some of the best returns in the market came when the presidential approval rating was in the low range of between 36% and 50%.
- That means the market had delivered some of its best returns during periods when half or more of the country didn't approve of the job the current administration was doing!
- Still, it's hard to discern any direct relationship between a president's popularity and the health of the US economy and the performance of financial markets.

Gallup poll presidential approval ratings and the growth of $100,000



Presidential Approval Rating	Gain/Annum	% of Time
>65	5.4%	13.9%
51-65	4.2%	38.4%
35-50	15.3%	41.1%
<35	-19.7%	6.6%

Source: Bloomberg, L.P., 6/30/20. See index definitions on page 13. An investment cannot be made in an index.
Past performance does not guarantee future results.

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NorthCoast Navigator

Q3 2020 | September 30, 2020

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 9/30/2020. Data provided by Bloomberg, NorthCoast Asset Management.

An Election and a Bullwhip

The first presidential debate occurred at the end of September and more officially kicked off what will be a contentious sprint to November. With debates scheduled for mid- and late October, campaign rhetoric and polling will only intensify. We are expecting spikes in market volatility as a result of this intensification and public attention, but hold steadfast in the statistical analysis of past elections. This analysis includes 23 past election years, 17 of which were positive years for U.S. equities. Furthermore, there is no strong correlation between market returns and which political party holds the executive office. While we are closely watching for significant events that may cause deviations from these conclusions or effects on sentiment, we are more intently focused on the progress of the medical crisis, the trajectory of the U.S. economy and market trends.

In mid-September, the Federal Reserve weighed in on the current economic outlook. They signaled that the near-term recovery from the reduction of mobility restrictions may mask some deeper and longer lasting issues with the economy. Jobless claims have held steady in recent weeks showing that employment gains may be stabilizing after recovering over half of the job losses in spring.

One particular near-term boost to the economy has been a “bullwhip effect.” Softening demand in the first half of the year caused manufacturers to reduce production and rely on existing inventory to meet the lower demand. This has a negative effect on GDP because demand is being met with previously produced supply and new supply is not being produced. As demand picks up, however, production needs to accelerate quickly to both meet the new, higher demand as well as make up for the shortage caused by the reduction in production. This is the bullwhip effect and while temporary it can provide a strong boost to the economy, increasing production throughout entire supply chains.

Emerging market countries are accounting for the majority of new COVID cases globally. However, some developed European countries are experiencing second waves including France, Spain and the UK. For now, no secondary lockdowns have been announced. Canada is also reporting an uptick in cases. U.S. new case numbers are still high at the moment but data points such as infection rate and death rate are ameliorated in most areas. Deaths in the developed countries remain low relative to the first wave of infections due in part to improved understanding and implementation of care as well as more young individuals getting infected relative to elderly, at-risk individuals. Regarding a vaccine, health officials communicated the difficulty of mass producing and distributing a vaccine to the general public, so there may be a long delay between final approval and public access.

The S&P 500 finished Q3 in the black with a quarterly return of approximately 8.8%, despite being down -3.8% in the month of September. We maintained a similar investment level as last month in both our tactical Domestic and International flagship programs. We are going to be watching for the latest economic data, any further notes from the Federal Reserve and signs of reversion from mega-cap tech stock gains.

Macroeconomic

The Bullwhip effect may have an outsized positive influence on upcoming GDP numbers. However, this effect is likely to be temporary. Despite gains in the job market in recent months, it appears to be stagnating as new weekly jobless claims have decreased only slightly.

Sentiment

The University of Michigan Consumer Sentiment Survey improved from last month to 78.9. For perspective, the average of the survey from July 2019 to February 2020 was 95.9. We are still seeing improvement, particularly in homebuilder sentiment and Manufacturing PMI.

Technical

Technical indicators did soften in September due to overall losses for U.S. equities. Longer-term trends are still looking strong, especially considering September was the first monthly loss since March. The S&P 500 sits even with its 50-day moving average (MA), but above its 100- and 200-day MA’s.

Valuation

After the negative price action in September, valuations improved slightly. However, they are still stretched with P/E ratios around 26.1. Low interest rates have allowed for some justification of these high valuations, but the coming earnings season will be insightful as to the pace of recovery.