WATERLOO CAPITAL

Letter to Investors

It's Been a Grizzly Month...

On March 12th we entered the first bear market since the Great Recession. All major stock indexes have fallen more than 25% or more from their peaks in February. The S&P 500 has now completely wiped out all 2019 gains and erased all gains under the current administration. The decline from the market peak to bear market levels was the fastest in history. Volatility has elevated to levels unseen before and has led to massive daily moves in major indexes around the globe as investors began indiscriminately selling positions in both stocks and bonds.

The economy is reacting to the virus like a person would. Right now, it's not looking great, but hope abounds for a cure. Global governments and central banks are trying to prescribe a solution to ease the pain, but fiscal policy responses have been slow and monetary policy responses are not designed to heal this particular type of demand slowdown. Bed rest, and some time on sick leave may be the only solution. The coronavirus will have to run its course through the economy.

As you know, our primary defense against market volatility is first and foremost your overall asset allocation and secondly, having the ability to tactically adjust that allocation. When we are thinking about asset allocation, we are not only thinking about what we own, but how we own it. What we own is defined by our asset class exposure, how we own it is defined by factors and strategies such as growth over value or tactical versus passive.

Heading into this year we were expecting market volatility to rise, given valuation and price levels. Based upon that expectation, we put an emphasis on being more tactical with our allocations by utilizing our Newton models developed by our team in Atlanta.
For example, our pricing models began flashing yellow in mid-February and we began to shift our allocations to more risk-off positions. We continued to reduce our risk-on allocations over the next few weeks as
our signals deteriorated, from yellow to red over each time period we track.

In the markets, you tend to make money walking up a flight of stairs, and lose it falling off a cliff. The equity markets are falling off that cliff right now, and we expect the path back to the top to look more like mountains and valleys than stairs. Going forward, we expect the unknowns surrounding the coronavirus will lead to more choppy and volatile days and weeks in the markets. Market breadth, the return disparity between the winners and losers within indexes and sectors, has been widening, and market fundamentals are still deteriorating. In an environment like this, holding
only passive positions becomes riskier. Fortunately, dislocations like these provide fantastic opportunities for our tactical equity strategies to take advantage of positive developments for individual companies and sectors. When we do begin to see stabilization in the markets, we will remain more tactically inclined to strategically work our way back into the equity markets and take advantage of attractive trading opportunities.

Overall, we do expect a healthy and full recovery, although the current timeline will remain unclear until we are able to review how the virus has impacted company earnings and economic data this month. We are now in a great position to capitalize on more attractive market valuations and opportunistic dislocations created by fallout from the virus. We have been strategically capturing losses and raising cash to take advantage of the market recovery. This is a great opportunity to consolidate or add idle cash to your investment accounts to take advantage of the upcoming recovery.

Our Short-Term Outlook:

There will most likely be continued volatility until the markets have clarity regarding the current economic environment. Typically, during an economic downturn companies will revise earnings guidance to reduce investor anxiety and provide a clear picture as to the health, or sickness, of their entity. Companies are now suspending forward guidance and the potential for influence from Washington has further clouded the outlook for many companies and industries. Markets have a great disdain for uncertainty, and until the first earnings reports begin rolling out in April, we believe the markets will whipsaw back and forth as they have for the last few weeks.

What would change the market behavior? Promising developments in testing, repositioning existing medicines that may be effective in treating coronavirus, and the development of new vaccines and treatments. Some of these existing medicines are currently in clinical trials. For now, it appears that to solve the economic crisis we must first solve the health crisis.

Our Long-Term Outlook:

Episodic events such as Covid-19 create opportunities. There will be a time to redeploy cash into the markets. As I mentioned earlier, we think tactical opportunistic investing will be far more successful that passive index buying in the future market environment. If you examine a multi-decade S&P 500 chart, market events like these have happened several times over the last 80 years for many different reasons. I believe in America and American ingenuity. We will overcome this, and the markets will once again move higher. In the meantime, we will be patient and look for opportunities. A mentor of mine many years ago taught me that, “we buy from the fearful and sell to the greedy.” The greatest time to buy something is when there has been a miscalculation of the risk priced into an asset. Our investment team has been developing a targeted list of companies we believe have been oversold and have seen investor sentiment fall deep into negative territory. We are constantly evaluating incoming data and are well prepared to manage through this crisis and the evolving market landscape.

We appreciate your confidence in these trying times. We will be reaching out to you to review how we were positioned heading into the downturn, the allocation changes we have made, and what opportunities we are seeing in the markets as the coronavirus threat continues. Please do not hesitate to reach out with any questions you may have.

John Chatmas, CEO