CANVAS™

An investment service of O'Shaughnessy Asset Management, LLC

Q2 2020 Performance Comments

The second quarter marked a decisive comeback from the depths of the COVID crisis bottom. It has been a challenging road fraught with geopolitical battles, cascading virus updates, unprecedented Central Bank intervention, negative oil prices, a social media advertising onslaught, and lots of disappointed investors on both sides of the Bull/Bear debate. Yet despite all of this, the MSCI All Country World Index was up 19% on the back of its -21% decline in Q1. The S&P 500 and NASDAQ 100 Indexes finished up 20% and 30%, respectively. As we think about performance so far this year, we believe it's instructive to think about three different chapters in the story—pre-crisis from Jan 1 to Feb 19, crisis from Feb 20 to Mar 23, and recovery from Mar 24 to Jun 30.

Key Points:

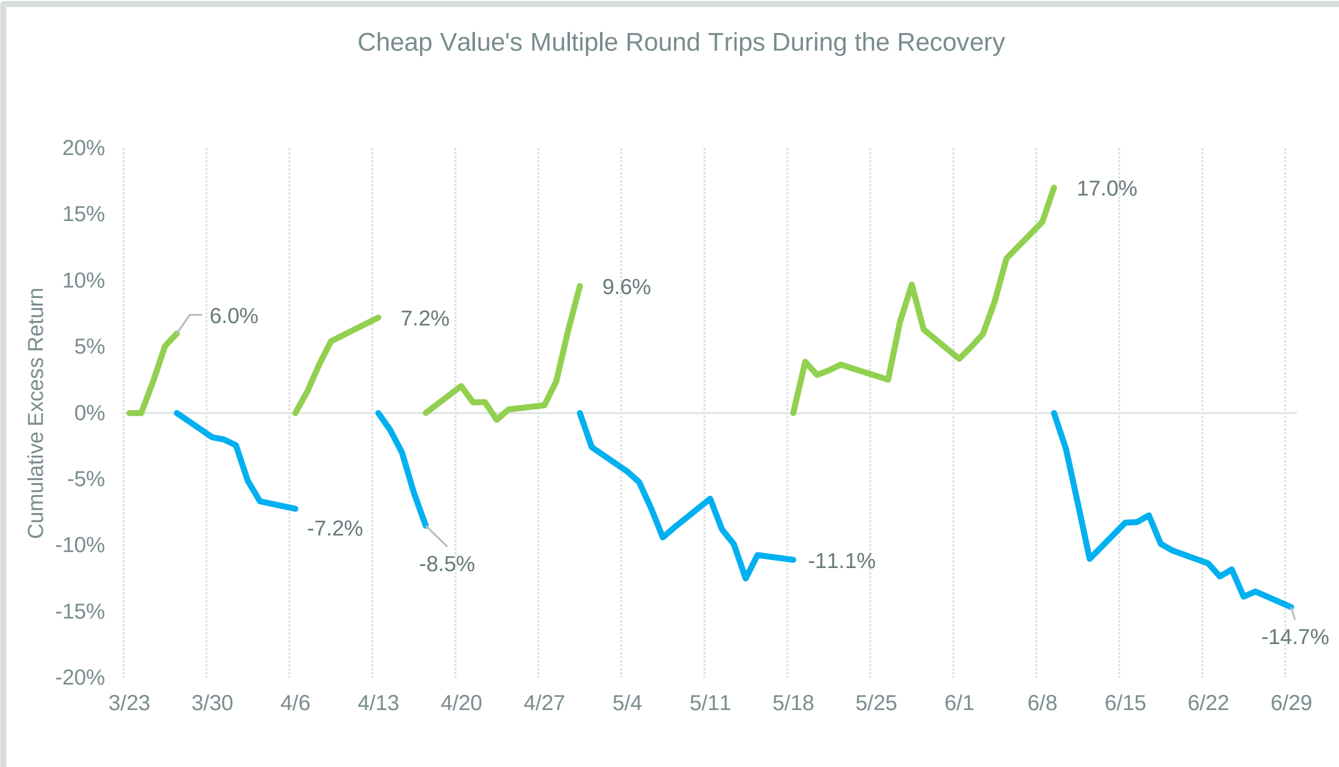
- Our key selection factors of Shareholder Yield, Momentum, and Value underperformed across all universes YTD.
- Lower market cap stocks outperformed during the recovery. This was a key tailwind for factor allocations relative to cap-weighted indexes.
- Poor quality stocks that do not meet our criteria for Value, Momentum, Earnings Quality, Earnings Growth, and Financial Strength are excluded from factor allocations and were a drag on returns.
- **Regardless of what the equity market holds in store, we will focus on adding value through tax management (where applicable), trade execution, and mitigating real world costs. For portfolios with factor exposures, we will attempt to position them with strong characteristic advantages versus their benchmark across our Quality, Value, Momentum, and Yield factor themes.**

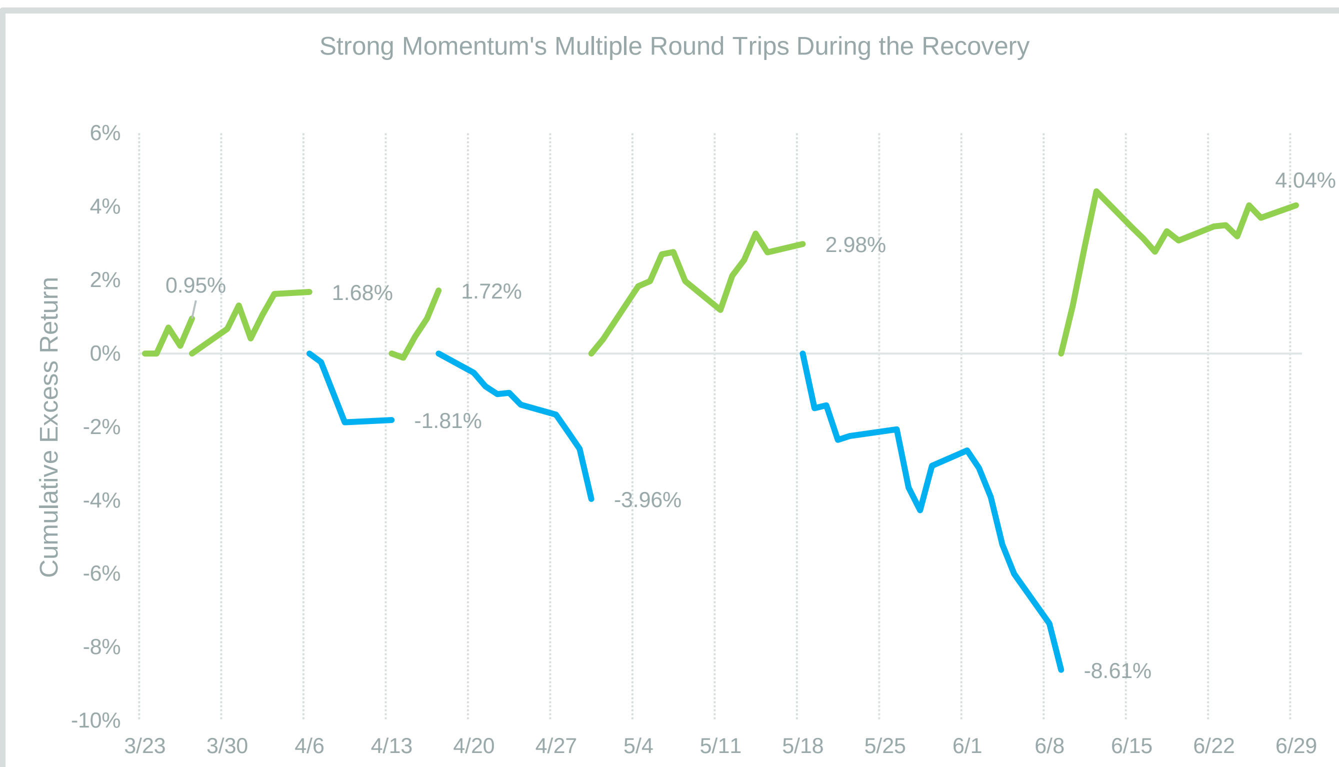
During the **pre-crisis** period, we saw a broad extension of the performance themes that developed in 2019. Mega cap growth was solidly in favor. Momentum outperformed. Value and Shareholder Yield continued to struggle, and quality was largely ignored, except for low volatility, which did well.

During the **crisis** period, Value and Shareholder Yield continued to be out of favor, while Momentum continued its win streak. Mega cap growth again reigned king as investors sought safety in the seemingly untouchable tech firms whose revenues seemed impervious to the lockdown environment. As could be expected, we saw quality rise in importance during the crisis period; over levered firms and those with declining earnings struggled.

We detailed much of the pre-crisis and crisis performance in our Q1 commentary, so we will focus on the subsequent recovery. The **recovery** period can also be divided into a few sub periods - see below for value's multiple round trips - but can broadly be defined as a junk rally.

Interestingly, Momentum's performance during these periods is almost a perfect mirror image by direction, though Value's moves tended to be of greater magnitude. In the technical analysis world, these shapes are broadening patterns and tend to be indicative of indecision.





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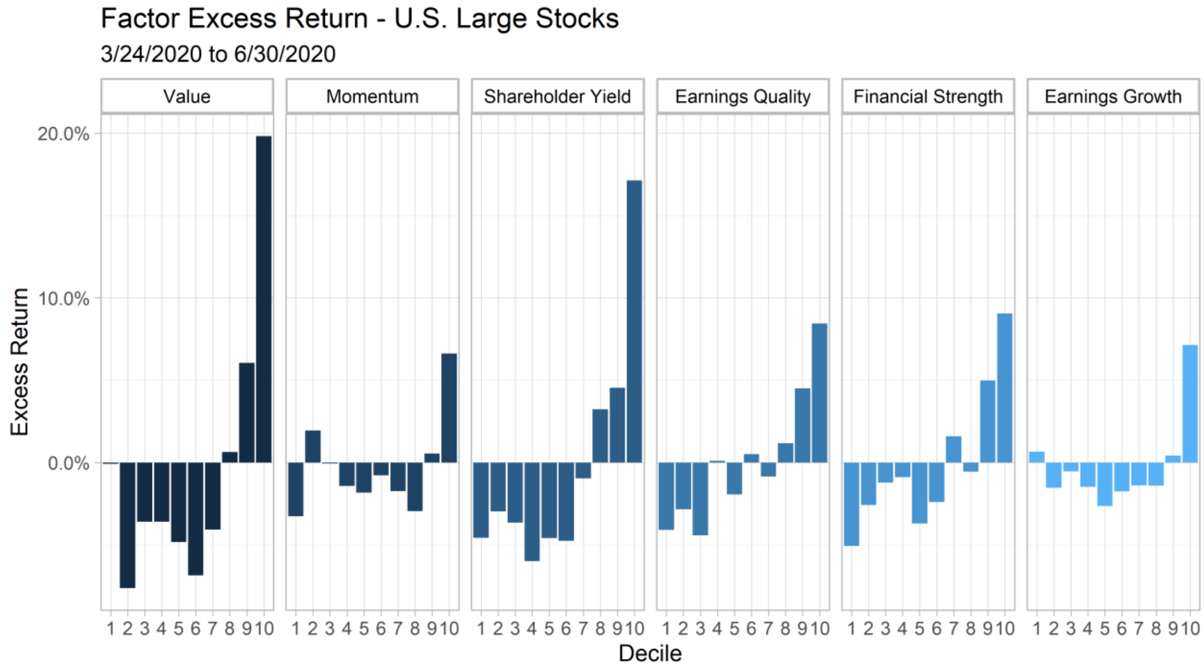
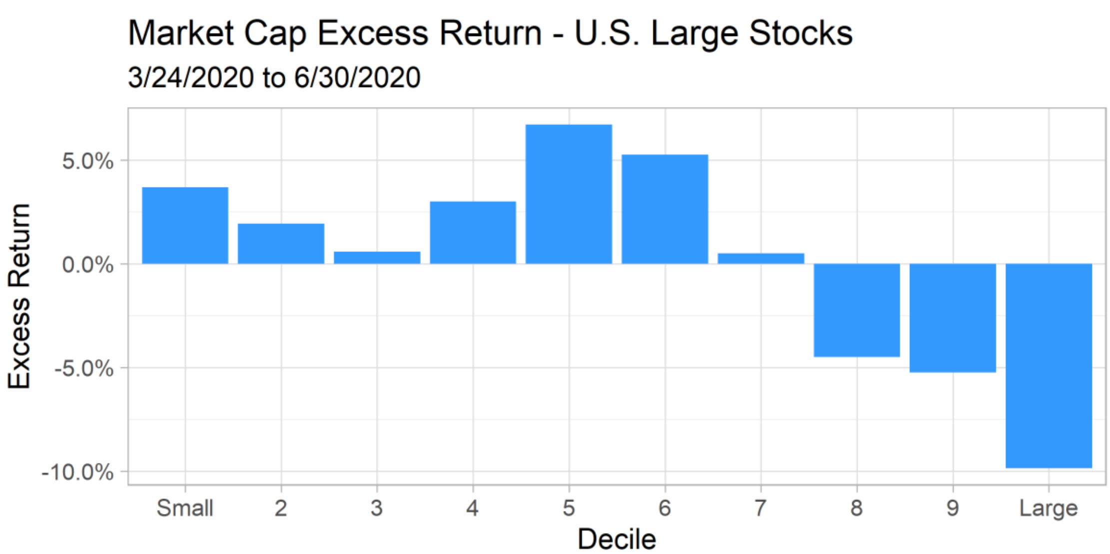
From a factor perspective, every major factor theme we track inverted, as can be seen below.



The broadening patterns and factor inversions all seem to point to short-term sentiment that is agnostic to current fundamentals. If you had a strategy that invested in expensive, weak momentum diluters, that are unprofitable, goose their books through accounting shenanigans, and take on excess debt, you probably did exceptionally well in Q2. Further, lower in market cap generally outperformed. All of this is consistent with bounces following drawdowns historically.



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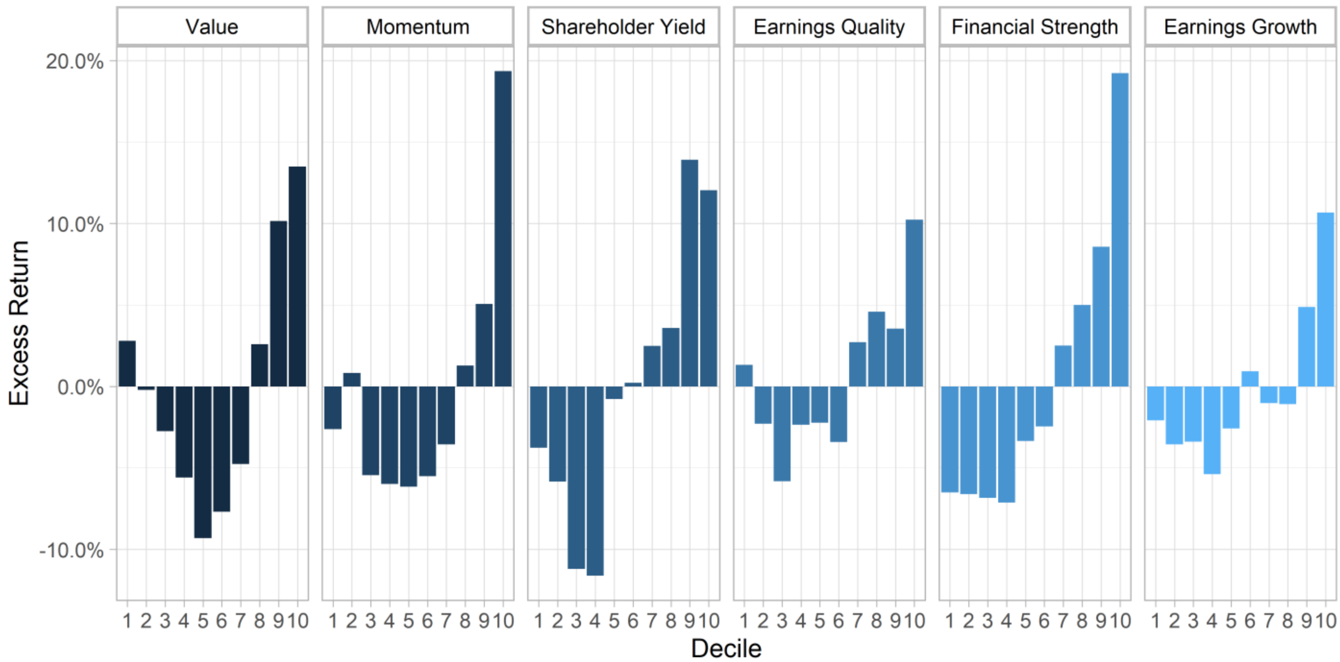
We saw a similar phenomenon in Small-Mid cap and non-U.S. stocks, though the trend in non-U.S. was not quite as clean.

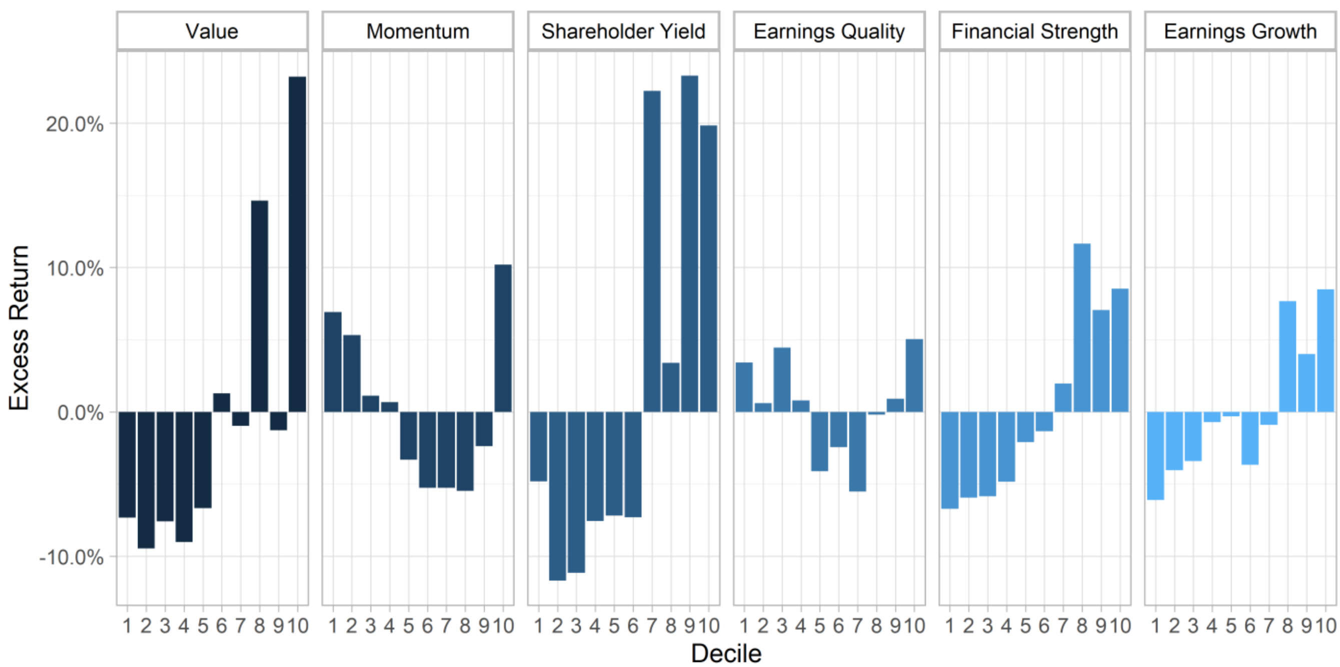
Factor Excess Return - U.S. Small-mid Stocks

3/24/2020 to 6/30/2020



Factor Excess Return - ADR All Stocks

3/24/2020 to 6/30/2020



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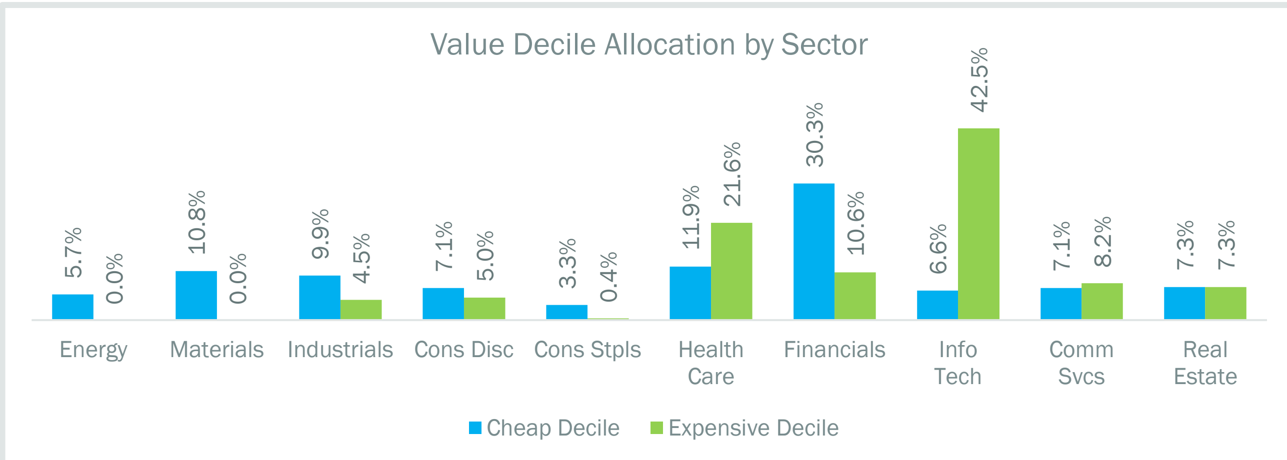
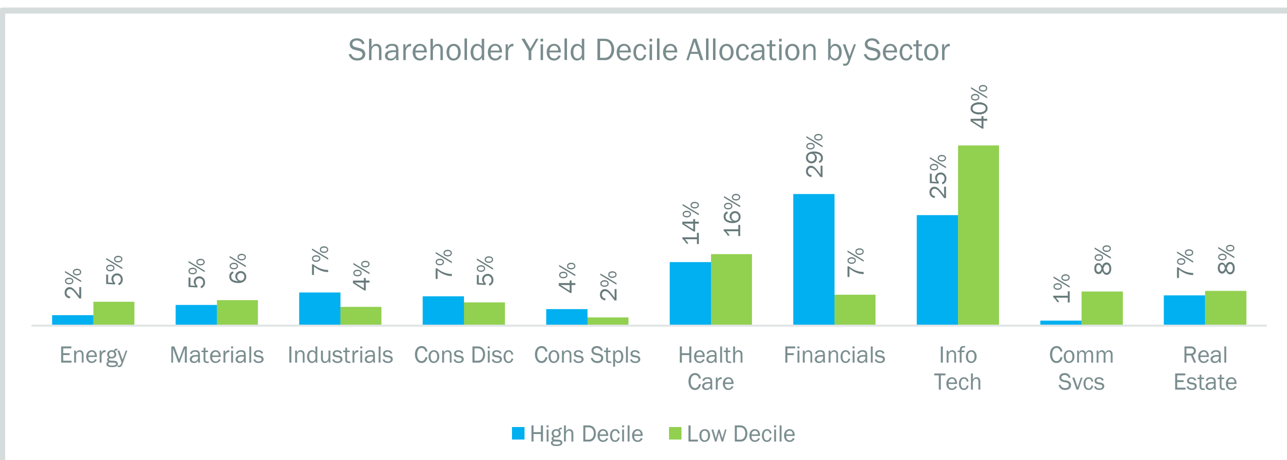
We saw four value impulses that have given value investors a breath of fresh air, if only for a short period. On June 8, we received the largest unexpected surprise of any economic statistic ever, a 10 million (!) job beat versus expectations for May Employment. This marked the peak of the recovery from an absolute perspective and for value's recovery. Soon thereafter growth came strongly back in favor as equity markets have struggled since then.

Value's woes are readily apparent when considering its sector makeup. The most expensive decile of Value, i.e. growth, is allocated 42.5% to Tech and 30.3% to Health Care. Meanwhile, the cheapest decile was overweight to Financials, Energy, Materials, and Industrials.



The sector allocations above are not too dissimilar for Shareholder Yield. Shareholder Yield fared a bit better than pure value. Historically, it does tend to act like a value factor, but more left of center on the style box. Key for the factor was a greater exposure to Tech and more moderate exposures to cyclical sectors.

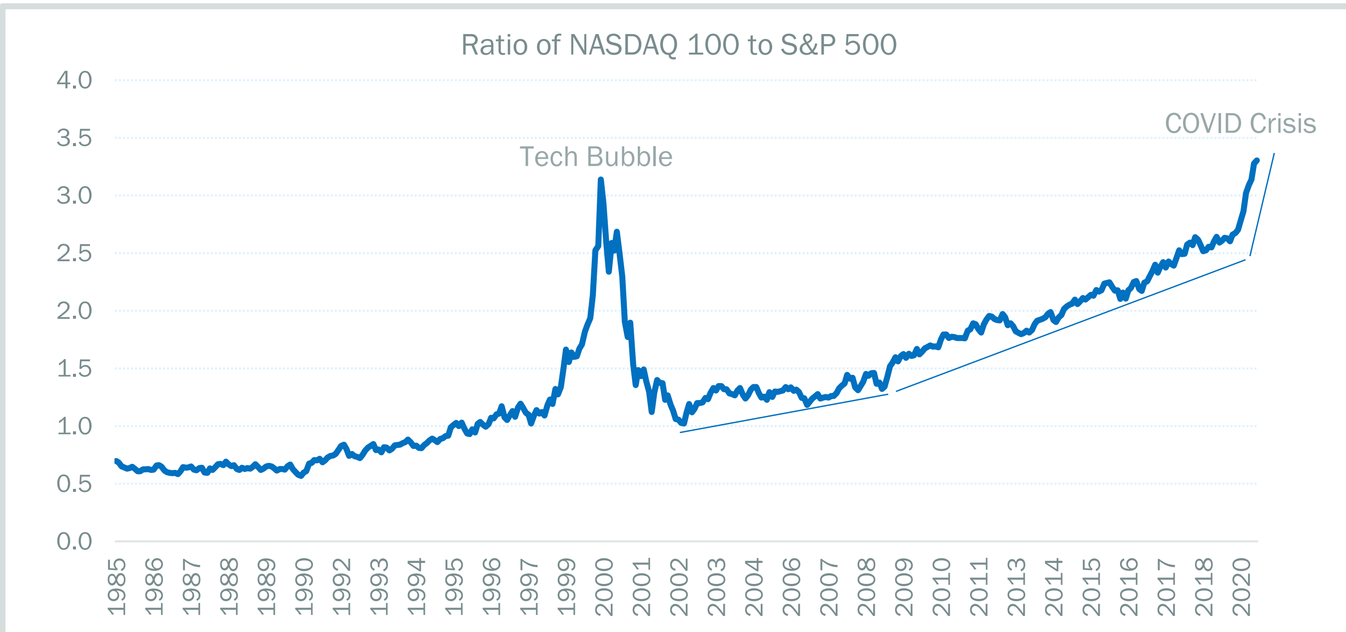


Current Positioning and Outlook

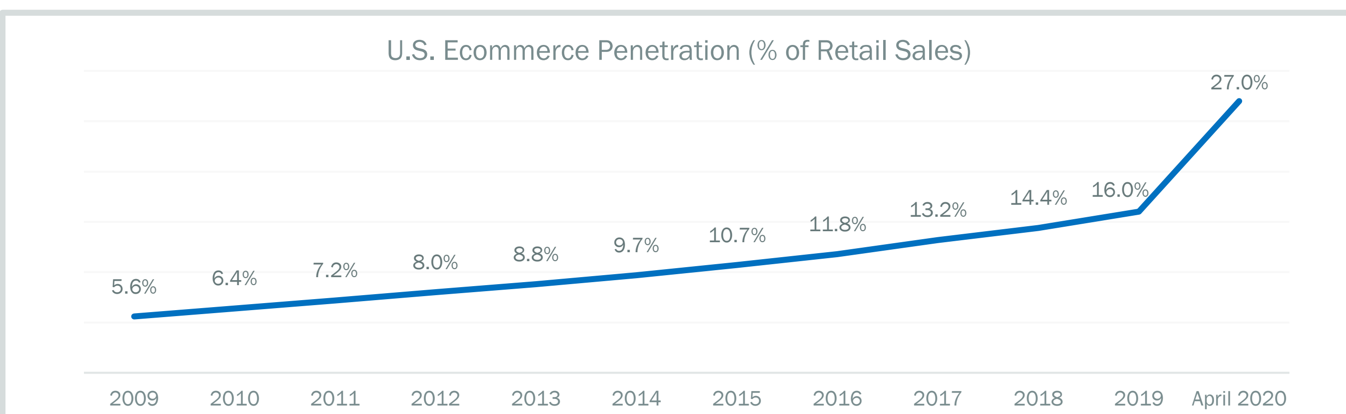
Stocks deliver returns to shareholders over time based on three drivers—their ability to grow their business, expansion of their price multiple, and prudent capital allocation practices that include returning capital to shareholders. Each of these drivers are fundamentally based. Whether due to fundamental uncertainty or the overarching impact of monetary liquidity and fiscal stimulus, the current environment is clearly not fundamentally based.

One really must wonder if the pace of mega cap growth leadership is primed to continue. Whether you look at price, valuation, or sentiment, support appears to be thinning.

Regarding price, we are at Tech Bubble levels in terms of relative pricing. The chart below shows the NASDAQ price level relative to the S&P 500 Index. Note that after the bubble burst in 2000, the two were at parity in 2002, a one to one relationship. The NASDAQ has outperformed 3.3-to-1 since then and since late 2019 has gone semi-parabolic. The challenge as we look at this comparison to the Tech Bubble is that we have not yet hit the true parabolic phase. The rise has been steady over the last 18 years, and certainly taking a turn up in 2019, but not at the velocity we saw in the latter stages of the Tech Bubble. If the analog were to play out, mega cap growth may have a couple more innings left.



The key driver of this levitation are the FANMAG stocks, which represent about 40% of the NASDAQ 100. Within the broader Russell 1000 Index, these stocks represent 17.5% of the index. Year-to-date, they have appreciated 26.0% while the rest of the Russell 1000 has declined -8.9% on a weighted average basis. Reliance on the group is heavy with each component, except Google, at all-time highs. Amazon is up roughly 65% on the year. Any sort of underperformance for FANMAG would at the least signify a change in leadership, and at worst a challenge to the equity market's recovery.



The valuation spreads, which we interpret as expectations for future growth, are staggering. As of 6/30, the FANMAG stocks have a weighted average PE ratio of 38x on a trailing 12-month basis. Compare that to the remainder of the Russell 1000 Index, which is priced at 20.8x.[1] Still not cheap, but 45% cheaper nonetheless. Valuation is (unfortunately) a poor timing metric, so it's unclear when this disparity will be resolved. One reason is the crisis we find ourselves in. The COVID crisis has done more to spur the proliferation of technology throughout the economy than any event in the last decade. The chart above shows the massive increase in E-commerce penetration YTD. As a percentage of Retail sales, more was converted to e-commerce in eight weeks than the prior eight years. It may very well be the case that the FANMAG's deserve their lofty valuations, but that is probabilistically low over the long term.

Regardless of where you look, as long as you look at financial market metrics as opposed to Main Street, sentiment is ostensibly strong. The VIX index is down. NYSE put/call ratios are euphoric. USD has weakened from its crisis highs—a positive for developed and emerging non-U.S. stocks. The Fed is trying to prove without a shadow of doubt that its foot is firmly on the gas pedal. Congress is negotiating the next stimulus package and COVID treatments seem to be more effective now than even a week ago. The Milken Institute is tracking 261 treatments and 179 vaccines in development.[2]

Ultimately, fundamentals matter; we just don't know whether sentiment or fundamentals will take the lead. Many market participants are "looking through" the recovery to 2021 earnings. This look through seems to be how a company like Facebook can publicly lose a not so small cadre of its corporate advertising customers and march on to near all-time highs.

In an ironic twist, CEO's are bearish as can be.[3] And it is that bearishness that has driven them to raise record amounts of cash via debt and equity offerings during the crisis.[4] That cash may very well be the fuel that allows them to 1) weather a downturn if lockdowns return, or 2) invest in growth initiatives, like M&A, inventory restocking, or CapEx should a vaccine be discovered tomorrow.

[1] For companies with positive earnings.
[2] https://covid-19tracker.milkeninstitute.org/
[3] Business Roundtable CEO Survey, Outlook Index
[4] $675 billion from March 17 to May 19, S&P Global; $113 billion raise in 2Q20 across 400 offerings, Bloomberg.

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- **Composite Performance Summary**

7/13/20

For the full composite performance summary of this strategy. please follow this link: http://www.osam.com

O'SHAUGHNESSY ASSET MANAGEMENT, L.L.C.

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