Sentinel Trust
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Q1 2020 Market Update and Outlook

Executive Summary

- While we expected increased volatility this year, as discussed in prior letters, no one could have anticipated the fear that emerged in markets during the end of the first quarter.
- Although we remain overweight cash, Sentinel used recent market pullbacks to increase client exposure to US equities and high-yield bonds.
- We are utilizing the current opportunity set to reduce overall hedge fund exposure while also adding high performing, sought-after hedge fund and private equity managers.

Introduction

In our 2020 outlook published on February 3, we discussed our expectation of increased volatility and noted that we would use it to reduce our overweight to cash and add to risk when other investors are fearful. Although we noted the coronavirus as one potential risk, among many others, we did not expect anything approaching the level of fear and volatility seen in the first quarter. Markets experienced their worst quarter since 2008; meanwhile, we stuck to our plan and added risk from mid- to late-March while fear was extreme.

We expect to continue to be buyers during bouts of fear and volatility, but remain overweight cash and underweight risk for various reasons. We humbly accept that the coronavirus has created unprecedented uncertainty. Nobody knows exactly how long the virus will spread, keeping societies in lock down and economies in recession. Most forecasters expect the recession to be short-lived with 69% estimating the global recession will last just two quarters. We hope this is the case, but as one of our managers noted, "hope for the best, prepare for the worst." Since 1800, event driven bear markets – like this one – last an average of nine months and typically take an additional fifteen months to mend. While we will be adding to risk in the near term on weakness, we will also be prepared for a deeper and longer shock to the economy.

Cash and Bonds

Cash, held in US dollars, and US Treasury bonds were just about the only asset class delivering a positive return in the first quarter. While we have considered putting our excess cash in "enhanced cash" instruments for additional yield, we have continued to hold all cash in US government money market funds. Three-month US Treasury bills – a good approximation for these funds – started the quarter yielding 1.5%, briefly dipped into negative territory, but closed the quarter with a 0.06% yield.

High-grade municipal debt fell ~3% in Q1. After 52 weeks of inflows into municipals, outflows were dramatic as investors feared that declining revenues juxtaposed against flat to rising expenses would leave municipalities stretched and at higher risk of default. For example, New York City, the epicenter of the coronavirus crisis in the US, now has tax-free AAA-rated bonds maturing in 2044 yielding 3.25%. This is a full 2% above 30-year AAA US Treasury bonds, which are taxed at the federal level, and represents an all-time high in terms of spread. The Federal Reserve has started purchasing short-term, high-grade municipals and Congress is seeking to support municipalities in its fourth phase of fiscal stimulus. In short, we find high-grade municipal bonds to be worth the additional risk here.

Heading into Q1, we were underweight riskier, high-yield opportunistic debt and moved to neutral recently after the space fell ~10%. Like high-quality municipals, high-yield municipals also experienced significant outflows leaving us with historically cheap valuations. On the tax-exempt side, we are seeing 6-7% tax-

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free yields from value-added services like charter schools. On the taxable side, yield spreads – or the added yield investors demand for taking credit risk – reached 9% in March. Although this time may be different, in the last 25 examples when spreads reached these levels, investors earned a median return of 37% over the next 12 months and never once lost money. We are neutral in this asset class and are utilizing active managers here.

US Stocks

The Russell 3000 fell -20.9% in Q1 for its worst quarterly loss since 2008. We maintain an underweight position within US equities, but began slowly moving toward a more neutral stance and rebalancing portfolios in mid-to-late March. We have admittedly been slow to buy the dip as most companies are still struggling to forecast their own earnings in 2020. While the ultimate impact of the virus and the length of the corresponding shut down are still highly uncertain, we have focused on various valuation metrics like the cyclically adjusted price-to-earnings ratio, which considers earnings over the past ten years. On these metrics, US stocks look fairly priced but not nearly as cheap as the levels we saw in 2008, or even 2011. We are therefore wading into US stocks, but are keeping considerable dry powder for potentially cheaper valuations. As we reduce hedge fund exposure (see below), we expect to have even more capital to invest in US stocks should markets weaken further.

International Stocks

International stocks fell 24% during the quarter and are approaching historically cheap levels that are on par with what we saw in 2008 and 2011. We are, however, maintaining our neutral stance on international equities rather than going overweight as we see several good reasons why international stocks are cheap. First, international stocks tend to have higher allocations to the banking, energy and material sectors versus US markets. Second, although China appears to be navigating the coronavirus relatively well, many other emerging economies like Argentina and India are enacting stringent social distancing with stingy stimulus measures. We hope that the studies showing an inverse correlation between temperature and coronavirus cases prove valid, but we fear that weaker countries with inferior health systems may be particularly vulnerable. Finally, even in developed Europe we continue to see the more fiscally conservative northern countries balking at supporting their weaker southern peers. In sum, we are not adding to international equities, but have worked to reduce our exposure to weaker countries and firms.

Hedge Funds

We are still getting hedge fund estimates in, but we expect that equity hedge funds indexed by the HFRX Equity Hedge Fund Index (that monitors long/short hedge fund strategies) fell 13% on the quarter. While this protected against the long-only stock benchmarks referenced above, we believe that, as we noted last quarter, this once again proved that the group failed to deliver returns justifying their higher fees and reduced liquidity. We continue to believe that there are a handful of hedge fund managers that warrant an allocation and we have seen many managers we hold in high esteem recently re-open to new clients. In April, we accessed two biotech managers who both see historically cheap opportunities in their sectors. We were overweight the space heading into Q1, which should have had the net result of protecting capital, but we will use the current opportunity to reduce our allocation and upgrade our roster of managers.

Private Equity

Due to the nature of private equity and valuing private assets, we will not see private valuations come in until midway through Q2 (or later), but we suspect that private equity was not immune to the weakness experienced elsewhere. As we noted last quarter, we have been extremely selective in making commitments

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in private equity and have passed on many more opportunities than we have committed to. We now have plentiful capital to commit to the space at much cheaper valuations and are again reaching out to respected, hard-to-access managers. As examples, during Q1, we committed to an oversubscribed, historically first-quartile performing, lower-middle-market healthcare fund and an oversubscribed, top-quartile fund that specializes in taking control of lower-middle-market owner-operated businesses.

Real Assets

We have also been patient in committing capital to real estate, energy and commodities, and have run our real estate proxy fund at a small underweight with considerable hedges. Public real estate, indexed by the FTSE EPRA Nareit Developed Index, declined 28.5% in Q1 and the S&P 500 Energy Index fell 50.5%. Within private assets, we have generally avoided commitments to commercial office space, which we suspect will struggle in a post-covid world, but did commit to a last-mile industrial warehouse fund utilized by e-commerce firms like Amazon. On the public side, we continue to see good opportunities in non-traditional real estate like cell towers and data centers that sold off with malls and office towers. Finally, in the energy space, we are hoping for, but not betting on, an accord between Russia and Saudi Arabia, but even that may not cure the significant near-term demand destruction. We are working with our trusted managers to sort through the rubble to identify the handful of firms with management teams, assets and balance sheets in place to capitalize on the current opportunity set at current oil prices.

Conclusion

In conclusion, although we expected an uptick in volatility in 2020, we have been surprised at the level of volatility and fear in markets. We, like most investors, are focused first on the human impact of the virus and are doing our part by working remotely in a highly efficient manner. While we do not know when the coronavirus pandemic and corresponding lockdowns will end, we are hoping for the best and preparing for the worst. On the quarter, we have harvested substantial losses, waded into risk markets and are reaching out to our partners to identify new opportunities for the post-covid world. We will continue to be both patient and opportunistic with the capital you have entrusted us with. As always, we greatly appreciate this trust, take it very seriously and are always happy to discuss your portfolio, the markets or any other concern with you directly. We will also finish a more in-depth Q1 review, which we are happy to provide if you are interested.