Sentinel Trust
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Market Update

Executive Summary

- When we wrote you last week, we remained overweight cash and hedge funds and underweight equities, high yield debt, and real estate even after US stock markets had fallen significantly from their recent highs.
- Since then, US stock losses have accelerated with the S&P 500 down 17% since our last note and 26% year-to-date on investor uncertainty over the ultimate economic impact of the coronavirus.
- Beginning on Monday of this week, we used cash in client accounts to purchase US equities despite the natural discomfort in buying assets as they are sharply selling off.
- In the chaos of extraordinary one-day declines, especially Monday's sell off of 12%, we recognized the fear in the market as an opportunity to buy cheap businesses and participate in their long-term cash flows.

Coronavirus

It is hard not to panic and sell investments with coronavirus news in the headlines and the anguish of affected communities and families dominating social media, news outlets, and conversations. The latest virus updates, coupled with wild daily stock market swings and constant talk of an impending recession, make it hard to want to buy stocks. As one of our managers recently noted, however, "all great investments begin in discomfort."

While we are concerned about those among us who are more vulnerable (seniors and people with existing medical conditions) as well as the impact to our overall healthcare systems, we believe that the United States will ultimately take necessary actions to stem new cases, similar to responses we saw from the Chinese and South Korean governments. Though the Chinese stock market was down when the virus first hit the news, the country's market bottomed as the number of new cases peaked and is now one of the best performers year-to-date. Given our views on valuations and expected growth, Chinese stocks also represent one of our largest new international investments.

Data suggest the Chinese are slowly getting back to work and consumers are unleashing pent-up demand after weeks in lockdown. South Korea has given the Western world a model of how to fight the spread of the virus. Even Italy, where we have seen dire first-hand warnings on the risk of ignoring the spread, appears to be making progress. In the US, we are now advised to avoid restaurants, bars, discretionary travel, and gatherings larger than ten people. In sum, while we cannot predict the precise timing, there is evidence that cases will peak in this country. In the meantime, what we do know is that humankind has faced 13 epidemics since 1970 and has beaten them all.

Wild Daily Market Swings

Benjamin Graham, the "father of value investing," created a mercurial, fictitious character called "Mr. Market." He will call you up every day and offer to buy and sell any of your companies at various prices. Usually these prices are reasonable but, at times, Mr. Market will be exceptionally greedy or fearful and offer prices rich or dear. Mr. Graham believed that rarely should we trade on the same side as Mr. Market – we view Mr. Market as presently greedy for cash and fearful of owning businesses, which is creating attractive investment opportunities.

This is not to say we will not see more volatility, wild price swings, and potentially better opportunities ahead. But for pools of capital that are invested for the long-term, we are comfortable buying US companies for their future returns, even if their values are set back by current disruption. To illustrate, $100 invested twenty years ago at the height of the tech bubble held through the Great Financial Crisis in 2008 and now the coronavirus, is worth $234 today.

Recessions and Bear Markets

The market is in bear territory (-20% loss) and investors believe a recession is looming. This may very likely be true, but we should remember what recessions are and how this recession may be similar and different from previous recessions. By definition, recessions are two consecutive quarters when the economy shrinks. Since WWII, the US has experienced 12 recessions lasting an average of 11 months each. This past decade was the first since 1776 when the US has not experienced a recession. Recessions are normal.

Bear markets are also normal. On average, the S&P 500 experiences a bear market every 3.5 years and only 14 of the past 25 bear markets have actually led to a recession. Stock prices typically fall 3-6 months **before** an actual recession occurs with an average peak-to-trough decline of roughly 30%. The rapid 26% decline we have seen recently may suggest that we are in fact already experiencing what one of our outside managers called an "immediate onset recession." If we are indeed heading toward (or likely already in) a typical recession, we are close to the bottom in terms of typical market losses. The speed of the decline in stocks suggests the duration may be shorter than the 11-month average recession.

Many investors recall the previous recessions of 2000-2002 and the Great Financial Crisis of 2008-2009, which saw ~50% declines in stock prices. We recognize that this recession could drag on and cause some lasting near-term damage. There are many thorny issues that need to be ironed out, namely: uncertainty around the virus and the resulting economic threats to indebted companies, workers, and supply chains. But unlike our country's previous two recessions, we see the following key differences: banks and consumers are currently in much better shape and large employers, to date, have been slow to lay off workers and may be quick to rehire. Additionally, both the fiscal and monetary authorities, scarred from 2008-2009, are vowing to do "whatever it takes."

Our Investment Posture

First, we have been prepared for this volatility. We are overweight cash and hedge funds and underweight equities, high yield debt and real estate. We have improved our liquidity, reduced our complexity, and generally avoided indebted businesses and partners. We have cash available that stressed investors are greedy for and we are prepared to purchase businesses that others fear during these uncertain times.

We have been in close contact with our current and potential outside investment managers. Two of our potential biotechnology funds believe that while there may be some tough sledding in the near-term war against the virus, biotech companies have rarely been cheaper and their products are in high demand. Also, our distressed debt contacts, who buy the debt of troubled businesses in times like these, are finally seeing an attractive opportunity set. Finally, while many investors have worried that Facebook, Apple, Amazon, Netflix, and Google have grown too large and expensive, they are much cheaper now and well positioned for a world of social distancing. We are buyers here in each of these investment opportunities via our managers and passive strategies.

March 16th was the worst day in the US markets since 1987 and the second worst day in 124 years of market history. With the markets down 12%, we were net buyers and it was uncomfortable. We do not think the near-term road ahead will be easy or that markets have necessarily reached the bottom, but we do believe that now is the time to be more fearful of cash and greedier for strong businesses.

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