March 23, 2020

SKBA Market Update

The Rules of Panic Versus Calculation

There's an old phrase in the investment business: "watch out for rules changes." This typically means that what has worked in the recent past no longer does, and that a new set of rules now applies. That results in a shift in the application of the '*what works*' method in selecting stocks, albeit short term in nature.

We are currently living through such an environment where the rules have changed compared to previous market responses. Obviously, the magnitude of fear surrounding the emergence of the coronavirus is the cause of this. Panic selling due to the unknown outcome has been the dominating force. Nothing regarding valuation this year has worked up to now. The overwhelming majority of investors have employed a method best characterized as "shoot first and ask questions later".

However, this will inevitably come to an end.

Once the number of infections has peaked and inevitably begins to decline, I believe a switch will effectively be flipped. At that point the economic impact will become a calculation that market participants have dealt with before. Then the questions are: how long will this recession last and where are valuations versus the earnings recovery possibilities? Note, it won't be necessarily how deep will the recession be, because it's going to be horrendous. I would not be surprised if 2nd quarter GDP plunges 5-10% given how much of the economy is being shut down on command of the federal and state governments.

At SKBA we have taken steps to respond to this temporary environment where we have seen new attractive valuations emerge. However, we have purposely not responded in an overly aggressive manner that might catch us jumping from the frying pan and into the fire. At the same time, given the magnitude of the equity market declines year to date, and after the hitting market valuation levels that suggest the risk of loss in stocks over the next two years has fallen back below 30% (which is historically low under SKBA's risk of loss analysis), we are moving to take advantage of these new value opportunities. This is not just a top-down action; we would not be moving if the values weren't there. We believe that repositioning given new opportunities will improve the portfolio's long-term positioning and characteristics during the recovery that will occur.

This by no means indicates that the current market decline is over. It could get worse than this level, but now seems to be the appropriate time to take greater portfolio action based on our long-term investment horizon.

Our very best wishes to you,

Andrew W. Bischel, CFA
Chairman & CEO

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