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Disciplina Capital Management
September 2020 Quarterly Insights

"If you do not find a way to make money while you sleep, you will work until you die."
- Warren Buffett

Third Quarter 2020 Insights

In his 90 years, Mr. Buffett has come up with a myriad of quotes related to the world of investing. The Oracle of Omaha is often cited for his patient, long-term approach and rigorous research into the companies he invests. The comment above most likely relates to the concept of income-generating assets, such as bonds or real estate, that pay a steady stream of cash flows over time. The subtle irony here is that he is still working quite hard in his 90's with no indication of retiring anytime soon. Clearly, he loves his job!

The concept relates not only to personal wealth but also to the institutional portfolios of pensions, endowments, and foundations that we manage for our clients. Those in the financial world often cite the term on having a "balanced" or "60/40" portfolio. In its most simplistic form, this refers to a portfolio of 60% equity securities and 40% fixed income securities. The equity portion of the portfolio offers exposure to the long-term growth of the economy and corporate earnings, while the fixed income component produces income and can work as a buffer to reduce volatility during rocky periods. This held true during the COVID-induced shock to the markets that investors experienced earlier this year. In the volatile first quarter, the Bloomberg Barclays Aggregate bond index posted gains of 3.2% while widely followed equity indices such as the S&P 500 and MSCI All Country World Index (ACWI) were down 19.6% and 21.4%, respectively. The challenge moving forward is that while bonds may still offer some ballast during volatile periods, income will be very hard to come by.

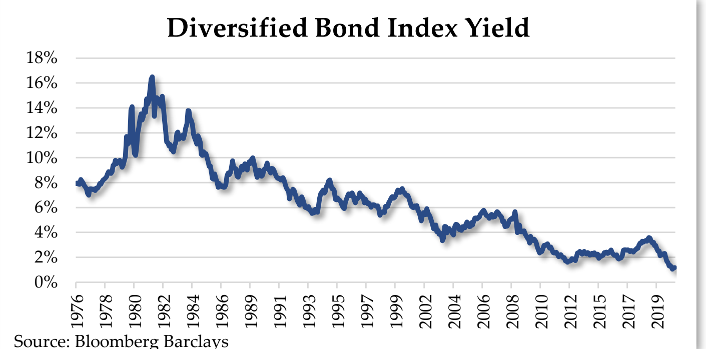
This quarter we will look at the implications of the current low-interest-rate environment on portfolio construction and the potential influence of elections on the bond market. One thing both parties seem to agree on is that they like to spend money and do not have much concern for increasing our national debt. They clearly differ on where to put the money and continued fiscal stimulus will have implications for the economy, interest rates, and the state of our national balance sheet for many years to come.

60/40 is Dead, Long Live 60/40!

To be fair, many in the market, including ourselves on occasion, have proclaimed the death of the generational rally in interest rates and the effect it will have on simplistic "DIY" 60/40 portfolios that some firms still promote as a viable solution. As we mentioned earlier, fixed income will likely still offer some form of a buffer in volatile environments, but meaningfully positive returns will be hard to come by over the longer-term. In simple terms, it can help you avoid losing money, but will not help you make much money.

Over the last several years, markets have migrated from one crisis to the other and global central banks have stepped in to support markets, expanding their balance sheets by purchasing fixed-income assets. This dates back to the GFC in 2008, the various iterations of the European debt crisis that followed, and this year's unprecedented response to the global pandemic.

Low, Lower, Lowest



In a 60/40 portfolio, in most instances, the "40" often refers to the Bloomberg Barclays Aggregate Bond Index, which is a market-weighted index consisting of investment grade treasury bonds, corporate bonds,

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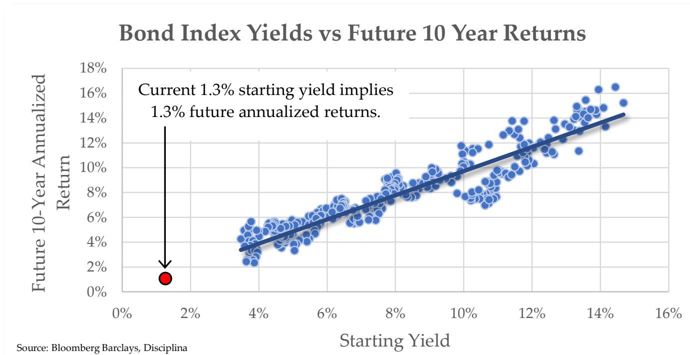
asset-backed and mortgage-backed securities. Thanks to economic uncertainty, limited inflation, and central bank support, yields on fixed-income assets have been driven down to microscopic levels with the yield on the Barclays Aggregate Index down below 1.3%. In 2008, the yield on that index was near 5.5%. To get that type of yield in today's market, you would need to invest in a portfolio of below investment grade, aka "junk" bonds.

The nuances of bond math can be quite complicated, but there are also some simple truisms as illustrated in the scatter plot below that compares the starting yield on the index with actual returns experienced ten years forward. In short, your starting yield is a meaningful predictor of expected long term annualized returns. For example, looking at historical data, if the current yield on the index is 5%, you will likely earn an average annual return of ~5% over the next ten years. Unfortunately, the current environment offers a yield of just 1.3%. This would imply that the fixed income contribution for a 60/40 portfolio over the next ten years would be about 0.5%. This leaves a lot of heavy lifting for the equity component of the portfolio. Many organizations assume 7.0% portfolio returns, which would require equities to gain 10.8% to hit their return and spending targets.

<u>Where You Start is Also Where You Finish</u>



As we look ahead, return expectations for fixed income allocations will need to be adjusted lower, which will have profound implications for institutions dependent on long-term pools of capital to fund a portion of their spending needs.

Solutions for a Low Yield Environment

Since long-term rates dipped under 1% earlier this year, we have avoided longer duration government bonds as the prospect for both income and risk diversification is quite limited. To generate income, we have implemented some unique short duration credit strategies that still trade at fairly attractive valuations. To provide a cushion from market volatility, we favor alternative managers that have shown a proven ability to generate returns in difficult market environments. We are also sitting on a touch more cash than normal to give us the ability to capitalize on market volatility as investors process the results of the election and upcoming phases of the pandemic over the next few months.

The Election and Potential Impact on Rates

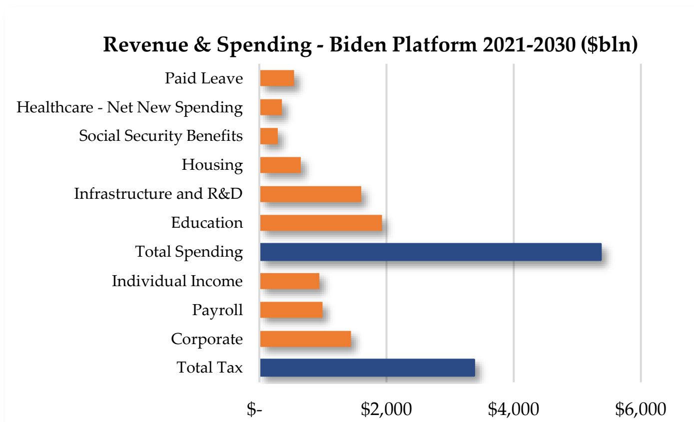
We would be remiss if we did not revisit the upcoming "most important election of our lifetimes" and the implications for the markets. By the way, has there ever been an "unimportant" presidential election? While recent history has taught us to take pre-election polling data with a grain of salt, it does appear that Vice President Biden is likely to win the Presidential election. Thus, we will focus on Biden's plans below. What still hangs in the balance is which party controls the Senate, which is still a very close call.

Vice President Biden's tax plan is estimated to bring in an additional $3.4 trillion over 10 years[1]; however, it seems to us that the markets do not fully appreciate his proposals for spending, which will increase by $5.4 trillion over 10 years, far outstripping the expected increase in government revenues from tax increases. A longer-term analysis of Biden's plan estimates that by 2031, the plan would raise more in revenue than in spending, and this positive inflow would continue past 2050 and work to reduce the deficit. Again, this will all depend on the outcome of the Senate, but even with a

[1] Penn Wharton Budget Model Analysis,
https://budgetmodel.wharton.upenn.edu/issues/2020/9/14/biden-2020-analysis

narrow Democratic majority, the deficit seems likely to grow before it decreases as neither party appears to be very concerned about increasing the deficit. When we drill down on spending initiatives, there are many wish list items unlikely to gain traction in a split government or narrow Democratic majority in the Senate. Education is the largest line item, with items such as two years of universal college, universal pre-k, and free public college for low-income families on the agenda. The infrastructure plan includes investments in water, high-speed rail, and clean energy R&D. Such education and infrastructure spending plans are expected to have a stimulative economic impact, particularly over the long-run, and will take some time for those dollars to be approved and flow through to the economy.

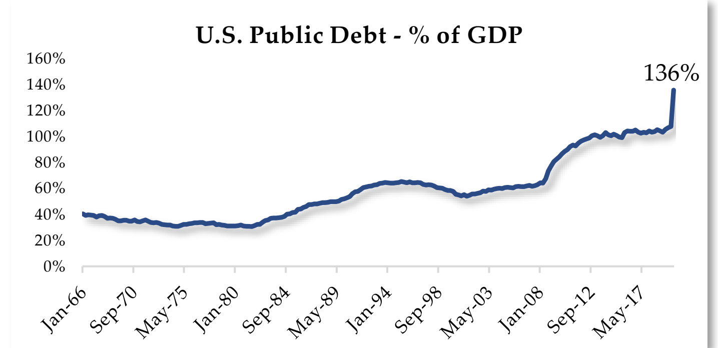
10-Year Additional Spending and Tax Revenue



Source: Penn Wharton Budget Model

Regardless of the outcome in November, our national debt appears that it will continue to increase in the near-term, one way or another. We initially wrote about the implications of our ballooning debt in the spring of 2019 [http://www.disciplina.com//app/uploads/2019/05/Disciplina-1Q19-Letter.pdf.](http://www.disciplina.com//app/uploads/2019/05/Disciplina-1Q19-Letter.pdf) The global pandemic has only exacerbated that challenge. During 2020, our debt/GDP has shot up from just over 100% to 136% with little interest by either party in Washington, DC on turning back. In fact, according to a Pew survey over the summer, 47% of Americans believe the federal budget deficit is a "very big problem" down from 55% in 2018.

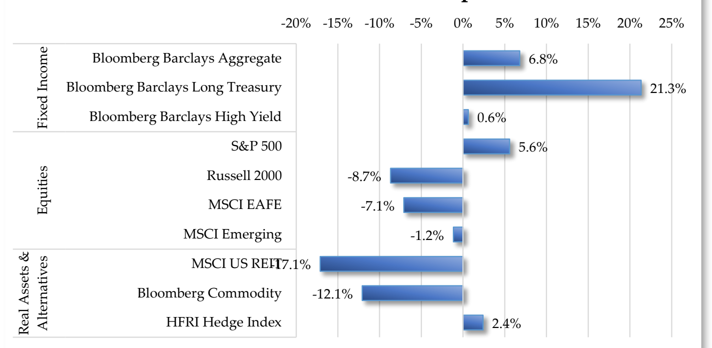
U.S. Balance Sheet Weakening



Source: Federal Reserve Bank of St. Louis

Market Update – Third Quarter 2020

While most equity markets were down during September, the third quarter of 2020 still posted strong returns for investors following the second quarter's rebound. The markets were especially resilient considering the summer uptick of COVID-19 cases across the U.S. and the lack of a new fiscal stimulus package out of Washington. A good portion of the package was set to extend benefits that ceased at the end of July. On the upside, the U.S. unemployment rate declined to 7.9% in September, from 11.1% at the start of the quarter. Still quite high, but the trend was positive.



Global equity markets rose 8.1% in the third quarter and were led by U.S. equities with the S&P 500 gaining 8.9%, outperforming international developed markets with the MSCI EAFE index up 4.8%. Year-to-date, the S&P 500 is

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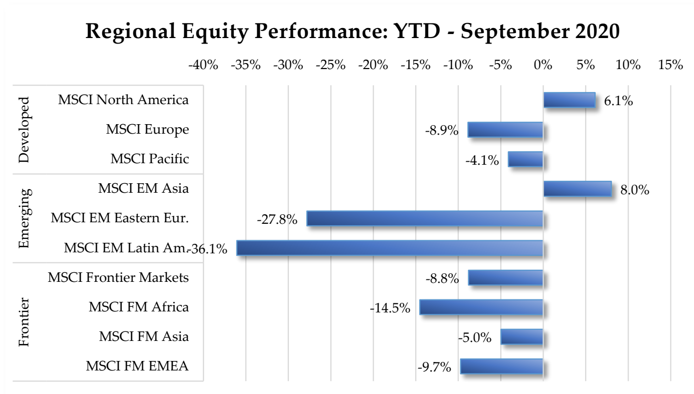
up 5.6% while international developed markets are still down -7.1%. Emerging market equities continued to rebound from a first-quarter swoon, outperforming the S&P 500 and gaining 9.6% in the third quarter. Emerging market equities remain down a modest -1.2% year to date. Technology stocks in the U.S. continue to dominate headlines and were up 12.0% in the second quarter, bringing year-to-date gains of 28.7%. The U.S. consumer discretionary sector has gained over 23.4% year-to-date as several companies such as Amazon and Home Depot have benefited from the COVID-related shutdown. Fixed-income assets were quite resilient considering the risk-on environment in the equity markets. The widely followed Bloomberg Barclays U.S. Aggregate Bond Index was up 0.6% and long-term U.S. treasury bonds were up 0.1% during the quarter. High yield bonds gained 4.7%, getting back to near breakeven, now down -0.3% year to date.



Real asset strategies experienced mixed results. U.S. REITs were up a modest 1.6% with the MSCI REIT index still down -17.1% year to date. Developed international REITs were up 2.1% for the quarter. The Bloomberg Commodity Index was up a respectable 9.1% in the third quarter but is still down -12.1% year-to-date. Oil lagged other commodities for the quarter and is down over 50% year-to-date. Double-digit gains were experienced in Grains and Natural Gas while Industrial Metals had strong gains as global growth continued to recover.

Firm Update

The third quarter was a very busy and productive period for our team. On the investment front, we are pleased that long-term portfolios kept pace with the strong rally in the markets and maintained their long-term edge over their respective benchmarks.

Our June note on diversity continued to generate interest and discussions with clients, prospects, and others in the industry. www.disciplina.com/disciplina-diversity/ Our CIO and Founder, Matthew Wright, was on a webinar hosted by Chestnut Advisory Group discussing his thoughts on the benefits of the boutique OCIO model. chestnutadvisory.com/events/ Our Chief Market Strategist, Brian Arsenault, was quoted in a FundFire article regarding market implications of the upcoming U.S. elections. These and other developments are creating strong business momentum as we transition towards year-end. As always, we appreciate the efforts of our friends, clients, investment managers, and colleagues as we all navigate a very difficult year.

Best Regards,

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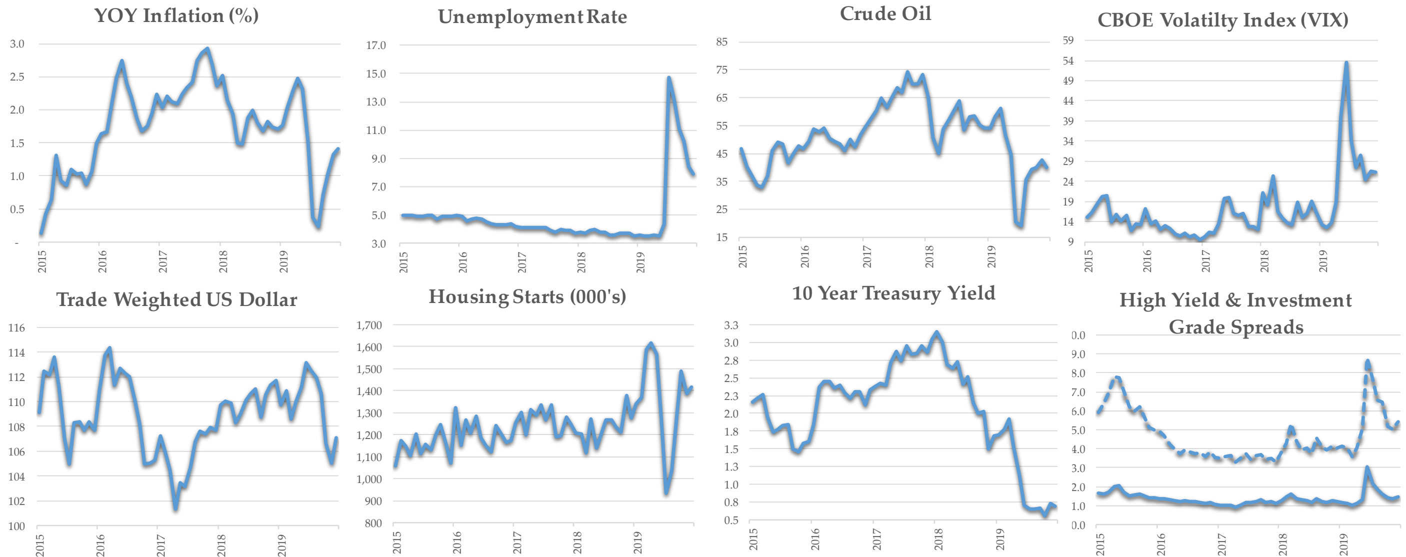

* Sources: BofA Merrill Lynch; US Departments of Labor, Commerce & Energy; CBOE; Federal Reserve Bank of St. Louis, Board of Governors of the Federal Reserve System

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