COVID-19

At the time of the last quarterly letter global markets had corrected sharply, many states had recently locked down due to the COVID-19 pandemic and most people were anticipating that stay-at-home orders would last only a couple of weeks. Three months later, many states are still in early phases of reopening and several have had to renew restriction and closures due to COVID-19 flare ups.[i] The availability of COVID-19 testing in the United States is increasing but does not yet appear to be adequate. Several pharmaceutical companies have started vaccine trials but current projections indicate that the earliest a vaccine will be commercially viable is 2021.[ii] Still, despite the ongoing disruption and uncertainly, the S&P 500 has rallied and the NASDAQ has set new all-time highs.[iii]

Stock Market Rally

Managed Accounts Model Performance[iv]

Past performance is not indicative of future results. Inherent in any investment is the possibility of loss.

Strategy Performance	2Q20	YTD	10 Year Annualized
Anchor Small Cap Value (Pure Gross)	10.10	-20.80	9.59
Anchor Small Cap Value (Net)	9.27	-21.98	6.35
Russell 2000 Value	18.91	-23.50	7.82
Russell 2000	25.42	-12.98	10.50

There are several reasons for the rally despite the underlying recession affecting the economy. First, as we mentioned at the end of the last quarter, the Federal Reserve has come to the rescue and stated that it will do what is necessary to revive the economy.[v] It dropped interest rates to zero and now has expanded its balance sheet to $7.1 trillion,[vi] up from $4.0 trillion on January 1, 2020. A number of bond-buying programs that include almost all fixed income asset classes have also been introduced.[vii] We believe this large amount of liquidity has minimized investor selling and has supported all fixed income markets.

Second, Congress passed the $2 trillion CARES Act. Designed to help individuals and companies that were economically impacted by COVID-19, the CARES Act resulted in direct cash payments to unemployed individuals and forgivable loans to many small businesses to maintain workers on their payrolls – the Payroll Payment Plan or PPP.[viii] The combination of deferring income tax collection and direct payments has resulted in the Federal Government increasing its debt by $3.1 trillion since mid-January; financed by an additional $2 trillion in Federal Reserve holdings of Treasuries and willingness of foreign investors to hold U.S. debt.[ix]

Further supporting equities, some individuals have received more from CARES Act unemployment payments than they were making in their paychecks while employed, which has led some people to step up there trading of individual stocks. Discount brokers such as Schwab and ETrade had already dropped commissions to $0 and are now joined by newer entrants such as Robinhood that are, combined with recovering markets, enticing retail investor to make trades.[x] The volume in the retail market has increased significantly, as noted by the Citi trade desk, with some even investing in bankrupt companies like Hertz and JC Penney.[xi]

With interest rates so low, equity markets with dividend yields greater than 2% offer very compelling alternatives to holding fixed income investments.[xii] Finally, we believe investors have memories of the Great Financial Crisis (GFC) of 2008, when the government provided stimulus to the markets and, as a result, the markets took off on a ten-year run. This is likely contributing to investor's interest in equities now, as those who may have missed out on the post-2008 gains do not want to let an opportunity pass them by during another period of anticipated recovery.

U.S. Economy

As expected, the economy today looks very different from the first quarter of this year. Businesses across the U.S. shut down and a record 33+ million people filed unemployment claims.[xiii] A number of service oriented industries like restaurants, retailers, and travel, which generally pay workers lower wages, have suffered the most. As the economy slowly reopens, we are seeing people go back to work, albeit at reduced levels, and we feel it will take quite a while for employment to get back to pre COVID-19 levels. Government backing currently in place for workers will run out mid-July, which will require Congress to consider passing another round of support.[xiv]

Given how low economic activity fell, we are currently seeing a V-shaped sharp recovery trajectory. Economic indicators like retail spending dropped significantly at the end of March, but since mid-April (coinciding with stimulus checks) numbers have steadily improved.[xv] Home purchases, impacted by stay-at-home orders, came back fast in April and May as people took advantage of the low interest rates and followed up on delayed purchases.[xvi] Other indicators such as number of airline passengers,[xvii] hotel room occupancy,[xviii] and road miles driven,[xix] all point to the rebound in economic health.

Large vs. Small/Mid and Growth vs. Value

Consistent with an economic recession and recovery, small and mid cap stocks sold off more than large cap stocks in March, but since have rebounded more than large cap companies.[xx] That said, large cap stocks are still up more year-to-date relative to small and mid cap stocks.[xxi] It is believed that investor flows into ETFs and Indexes has resulted in outsized concentrations in the largest names. In particular, the five largest companies – Facebook, Amazon, Apple, Microsoft and Google – account for 50% of the NASDAQ Index and over 20% of the S&P 500.[xxii] While the size and extended valuation of these five names has resulted in the S&P 500 selling at high valuations, the remaining 495 of S&P 500 stocks are still down, some more than 20%, and are trading at what we consider to be attractive valuation levels.[xxiii]

This also has created a historically large dispersion between the growth and value indices. For the Russell 1000 (large cap stocks) indices, the spread is 26%, which has not been seen since 1999.[xxiv] Many believe that the growth stocks have the ability to keep growing, but we are hitting the law of large numbers. The top five stocks had combined trailing 12-month revenue of $915 billion.[xxv] Analyst consensus calls for revenue growth on average of 17% next year and 18% thereafter.[xxvi] In order to meet the growth required to maintain analyst's high valuations and prices, these companies would have to generate $155 billion in additional sales next year. To put that in perspective, in dollar terms, $155 billion is the total combined revenues that Johnson & Johnson and Procter & Gamble (#5 and #8 in the S&P 500) generate annually.[xxvii]

Finally, we are coming into a Presidential election where the outcome feels very uncertain. If we do have a change in the political regime, we may see more political/anti-trust focus on the big technology stocks. This period of time feels similar to the technology boom period of the late 1990's and is something we are watching carefully.

Federal Reserve/Fixed Income Market

The Federal Reserve acted quickly in March to provide liquidity and stability to the markets. The Fed quickly cut interest rates and announced it would provide facilities to buy back fixed income instruments including treasury bonds, mortgage backed securities, corporate bonds and ETFs, and even high yield bonds.[xxviii] Since mid-March, when we saw a significant pull back in the credit related bond markets and very low liquidity, the fixed income markets have recovered with the backstop of the Fed. In fact, with the bond market open and accessible to all borrowers, corporations have raised over $1.2 trillion – a record level year-to-date.[xxix] Even borrowers that are greatly impacted by the shutdown related to COVID-19, like Boeing and Macy's have been able to borrow.[xxx] There are concerns about zombie companies that have cash to keep them afloat.[xxxi] We do expect as the year progresses that the corporate bond defaults will increase to similar levels we saw in the Global Financial Crisis (GFC) of 2008. At the June Fed meeting, Fed Chairman Powell said that interest rates will remain at 0% until 2022.[xxxii]

Our Observations

There have been some companies and industries that are clear beneficiaries of consumers being required to stay at home during the shutdown. The increased use of technology, higher levels of streaming and increased use of online subscriptions benefitted stocks of related companies. Examples of this being Zoom, Netflix, DocuSign, Peloton, and Teledoc, as they all performed well during the shutdown.[xxxiii] In our value oriented portfolio we too have a number of stocks that have benefitted from the shutdown. As you would expect, consumer staples stocks such as Clorox, Procter & Gamble, and Mondelez saw a lift due to people stocking up on supplies and eating at home more.[xxxiv] Retailers that were deemed essential and remained open also continued to do well. For example, Dollar General and Wal-Mart both saw healthy sales over the quarter driven by people stocking up on household staples as well as more discretionary purchases as consumers received stimulus checks.[xxxv] Home improvement retailer Lowe's showed strong sales, which they expect to continue, as consumers stay closer to home this summer.[xxxvi]

Not surprisingly, Lowe's is just one of many retailers that noted a 100% increase in online sales. Retailers recognize that this trend will continue and are building e-commerce specific distribution centers to help support this increase. In 2019 e-commerce accounted for 16% of overall retail sales.[xxxvii] In a span of weeks during the shutdown, e-commerce penetration increased to 27%.[xxxviii] This shift amounted to over $600 billion of annualized e-commerce purchases moving online. The digital payments space continues to grow with the rise of e-commerce, digital wallets, contactless payments and the move away from cash and checks.

Thanks to government stimulus and companies having access to capital, those companies more impacted by the COVID-19 pandemic rallied as investors started to look beyond 2020 to what the recovery might be like. Many cyclical oriented companies including industrials and materials rebounded. With the upcoming election and the reality of a slower sustained recovery in jobs, we would expect the government to look to infrastructure as a way to support this recovery. Infrastructure spending would further support cyclical industries.

What did we do at Anchor?

Going into March, we raised cash as discussed in the first quarter commentary. During the market pull back and subsequent rebound we used that cash to add new stocks. We consistently and continuously add fully researched and vetted securities to our approved universe of stocks to buy. We have been patient investing though, waiting for the right valuation and price. The sell-off presented us with that opportunity. In late March and early April, we bought several high-quality stocks that we have wanted to own for a while and added stocks that we believe will benefit from the recovery. Examples of these stocks can be found in the highlights section below. As a result, our current cash levels are on the lower end and we are constructive about the stocks in the portfolio. We are conscious that the economy reopening may be choppy, that the timing of the vaccine is unknown, and that we are entering a divisive Presidential election season. However, we believe that our investing approach and the types of stocks we hold will provide both downside protection and upside opportunity during this time.

STRATEGY DETAIL

Quarterly Attribution[xxxix]

Security Contribution (5 Highest)
Ollie's Bargain Outlet Holdings Inc (OLLI)
ABM Industries Incorporated (ABM)
Perficient, Inc. (PRFT)
International Money Express, Inc. (IMXI)
Insperity, Inc. (NSP)

Security Contribution (5 Lowest)
PBF Energy, Inc. Class A (PBF)
Unitil Corporation (UTL)
Portland General Electric Company (POR)
Safety Insurance Group, Inc. (SAFT)
NorthWestern Corporation (NWE)

Sector Contribution (3 Highest)
Producer Durables
Consumer Discretionary
Financial Services

Sector Contribution (3 Lowest)
Utilities
Energy
Health Care

Quarterly Purchases

- First Hawaiian, Inc. (FHB)
- Mimecast Limited (MIME)
- PS Business Parks Inc. (PSB)
- bluebird bio, Inc (BLUE)
- STAG Industrial, Inc. (STAG)
- Hingham Institution for Savings (HIFS)
- Global Medical REIT Inc (GMRE
- PBF Energy Inc (PBF)
- Red Violet Inc (RDVT)

Quarterly Sales

- Gentherm Incorporated (THRM)

Further Insight: Stock Position(s)

First Hawaiian, Inc. (FHB)

We have held First Hawaiian Bank at Anchor for a number of years and it was added to the Small Cap portfolio during the recent pull back. Banking in Hawaii is dominated by local banks with the top four accounting for 92% of deposits.[xl] First Hawaiian is the oldest and largest bank in Hawaii and has seen strong growth over the years. The bank is known for its capital position, conservative loan underwriting, and a healthy dividend yield[xli]. The stock was down 40% due to concerns about the Hawaiian economy – 20% of which is tied to tourism – and the perceived risk due to its larger share of commercial business.[xlii] Due to First Hawaiian's conservative risk culture and strong capital to provide a cushion to withstand the crisis, we added the stock to the Small Cap strategy.

Mimecast Limited (MIME)

Mimecast, a cloud native security platform provides email security primarily to small and medium sized business. The software protects inbound email from malware, spam and email DDoS. Currently less than 50% of emails sent are being monitored.[xliii] What attracted us to the stock is that the total addressable market is growing to $23.8 billion as more companies move to the cloud and try to manage the volume of emails.[xliv] Furthermore, the customers are sticky with 98% recurring revenue.[xlv] In addition, Mimecast is introducing new products and the customers now have four products on average.[xlvi] The company is recession resistant and it has strong free cash flow growth.

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[ii] https://www.usatoday.com/in-depth/news/health/2020/06/30/covid-vaccine-progress-widely-available-coronavirus-expert-panel/3242395001/
[iii] FactSet Research and Analytics, Charting
[iv] eVestment Analytics. Gross of fee returns are presented Pure Gross and are calculated before management fees, custodial fees and transaction costs.
[v] https://www.reuters.com/article/us-health-coronavirus-fed-daly/fed-will-do-whatever-it-takes-to-help-us-economy-likely-in-recession-daly-says-idUSKBN21I2Y6
[vi] https://www.federalreserve.gov/monetarypolicy/bst_recenttrends.htm
[vii] https://www.investopedia.com/fed-kicks-off-unprecedented-corporate-bond-buying-program-4844639
[viii] https://www.npr.org/2020/03/26/821457551/whats-inside-the-senate-s-2-trillion-coronavirus-aid-package
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[x] https://www.cnbc.com/2020/06/09/retail-investors-buying-beaten-up-stocks-make-for-some-bizarre-trading-days.html
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[xii] FactSet Data & Analytics, Charting
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[xxi] Ibid.
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Small Cap Value Model Disclosures

MODEL DESCRIPTION: The Anchor Managed Accounts Small Cap Value (SCV) model was created on 12/31/05. The model returns do not reflect actual trading. Anchor Capital's Managed Accounts Division created this model for purposes of presenting performance results which approximate those of the Managed Accounts Small Cap sponsor program portfolios in aggregate. The investment objective for the model is to achieve a high rate of return through the purchase of small cap value stocks.

MODEL DISCLOSURES: The model transaction history does not reflect all portfolio transaction activity for accounts in the sponsor program. Model transactions correspond with trading activity generated in the course of investment for substantially all accounts in the sponsor Small Cap program. Model transactions and holdings do not reflect individual portfolio activity for new account investments, or account activity and holdings in various individual portfolios subject to tax considerations or individual client discretion. Model performance may differ materially from individual client portfolio results.

CALCULATION OF RATES OF RETURN: All securities in the model are valued at last sale price, as provided by independent pricing services. The portfolio valuation is reflected on a trade date basis. Model investment returns include the reinvestment of dividends and other earnings. Effective 1/1/2010, dividends (excluding income on money market securities) are credited on an accrual basis. Time-weighted portfolio returns are calculated for each monthly period in the prior quarter. Monthly model results are linked to determine annual returns. Individual client portfolio results may vary from the results presented for the model because of different investment objectives, tax status and other considerations. Returns of individual client accounts will be reduced by advisor fees and other expenses which might be incurred to provide investment management, custody, administrative, actuarial, accounting or other services to the client. The Russell 2000 Value Index excludes fees. The Managed Accounts Small Cap Value model returns are calculated on a pure gross of fee basis, before the deduction of Anchor Capital management and sponsor wrap fees. For all periods presented, the net of fee returns are calculated by compounding the monthly net returns to calculate the quarterly, YTD and annual returns. The numbers may be slightly different from net returns published in other Anchor Capital materials created outside of Style Advisor prior to 6/30/2017, which were calculated by simply subtracting 3% from the annual gross return. Additional information regarding policies for calculating and reporting model returns is available upon request.

BENCHMARK DESCRIPTION: Information about indices is provided to allow for comparison of the performance of the Adviser to that of certain well-known and widely recognized indices. There is no representation that such index is an appropriate benchmark for such comparison. You cannot invest directly in an index, which also does not take into account trading commissions and costs. The volatility of indices may be materially different from the performance of the Adviser. In addition, the Adviser's recommendations may differ significantly from the securities that comprise the indices. The Russell 2000 Value Index measures the performance of small cap value segment of the U.S. equity universe. It includes those Russell 2000 Index companies with lower price-to-book ratios and lower forecasted growth values. The Russell 2000 Value Index is constructed to provide a comprehensive and unbiased barometer for the small cap value segment. The Index is completely reconstituted annually to ensure larger stocks do not distort the performance and characteristics of the true small cap opportunity set and that the represented companies continue to reflect value characteristics. The Russell 2000 Index measures the performance of the small cap segment of the U.S. equity universe. The Russell 2000 is a subset of the Russell 3000® Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership. The Russell 2000 Index is constructed to provide a comprehensive and unbiased small cap barometer and is completely reconstituted annually to ensure larger stocks do not distort the performance and characteristics of the true small cap opportunity set. The benchmark returns include the reinvestment of income.

For a complete listing of all strategies contact Anchor Capital Advisors LLC (617) 338-3800.

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