



MERISTEM

FAMILY WEALTH

A Way Forward From Here

It has been said that there are decades when nothing happens and there are weeks when decades happen. That sentiment certainly seems appropriate considering all that we have experienced thus far in 2020. The word unprecedented is tossed around quite a bit these days, but we are surrounded by aspects that draw few analogues. There are countless issues we could tackle (the Federal Reserve's Balance sheet, the ballooning federal deficit, the rate of new COVID-19 cases), but in this paper we focus on three key themes that are forming as we enter the 2nd half of 2020:

- 1) Economy - Though stabilizing, the economy has a long road to recovery where overall levels will matter
- 2) Equities – Concentration risk is increasing in U.S. equity markets
- 3) Diversification - While unpopular at times, diversification is one of the best tools to combat the uncertainty ahead

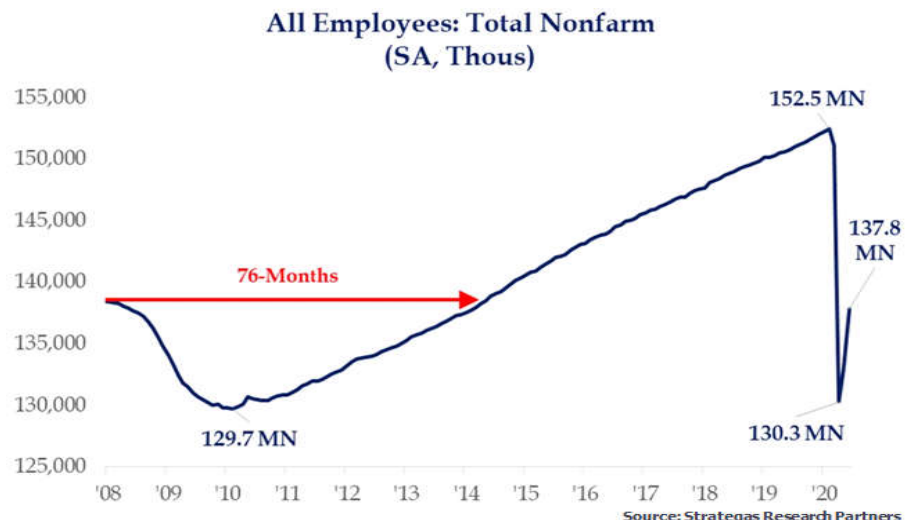
The Economy - Focus on the Levels

What do the letters “V”, “U”, “W” and a hockey stick have in common? They all have been used by market participants in an effort to describe the potential shape of the U.S. economy through the Great Lockdown. It remains to be seen what direction the economy takes from here, but it appears we have bottomed and are now bouncing off the lows.

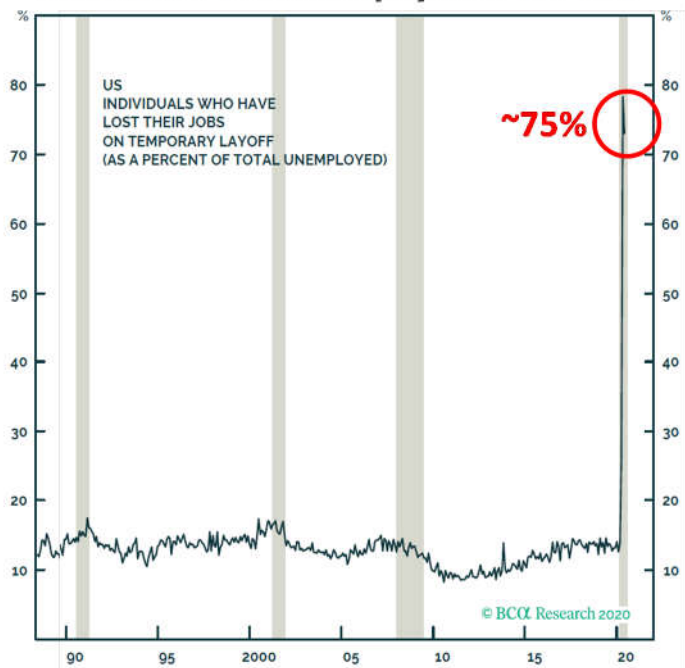
One of the areas we are focused on is the employment backdrop. Prior to the COVID-19 pandemic, unemployment here in the U.S. dropped to levels not seen since World War II. Fast forward to the economic shutdown, the unemployment rate has skyrocketed to over 14%, a high only eclipsed in the Great Depression. Some estimate that number was actually closer to 16%, but was understated for a variety of reasons.

Because of these potential variances, we believe it is more accurate to look at existing payrolls – the number of people gainfully employed. The chart to the right highlights that we lost

approximately 10 million jobs in the Great Financial Crisis and it took us over six years to recover. All of the job creation we have enjoyed since then was wiped out in a few weeks with the pandemic.



Temporary Laid Off Workers Account for Most of the Increase in US Unemployment This Year



You may come across headlines that the American economy has added 7.5 million jobs and the percentages associated with those additions will be eye-popping. While certainly true and a welcomed trend in the right direction, remember these changes will be based off of historically poor comparisons. By our estimate, 10-15 million Americans continue to be without jobs so we have a long way to go to dig out of the unemployment hole. Focus on the absolute levels of economic data being released, not the percentage changes.

The chart to the left highlights that approximately 75% of those that have been laid off this year view their situation as temporary (e.g., furloughed). We are hopeful that is indeed the case, but we think these expectations are entirely too sanguine. Phrasing this another way, we

would anticipate that a much larger percentage of these laid off workers will unfortunately become permanent in the months ahead.

We would be more upbeat about the prospects of these layoffs being temporary if there was supportive economic metrics and alternative data. For example, a large portion of the unemployed are in hospitality industries. When we distill the data and track booking trends at hotels, online reservations at restaurants, or overall mobility trends, the country is far from a return to normalcy at this point.

The data also leads us to believe that there is one letter we can eliminate from our alphabet soup for potential recovery – the “V.” We see the economic recovery ahead as a long, difficult slog. One that will eventually be framed in terms of quarters, perhaps years, and not in a handful of months.

The S&P 500 – A Broad Index?

If one were looking at the performance of the S&P 500, it is logical to think that companies in the U.S. have held up much better to other regions. Intuitively it would make sense as the headline print of the S&P 500 is down 3% year-to-date – a lower decline than international stocks. However, if we peel back the layers of the onion, we find that most companies that comprise the index have been much more in-line with their international brethren year-to-date.



The preceding chart highlights the performance of the five largest constituents of the S&P 500 Index, as well as the other 495. The five largest companies realized year-to-date returns through June of 26%. What if we look at the returns other 495 companies? Their returns year-to-date have been significantly lower with a decline of 9%. That is much more on par with what we have seen in international stocks (-11%). This “have and have not” dynamic has only hastened as the bottom 495 companies have languished since April, while the top five continue to march higher.



As the performance for these five large companies continues to surge, so too does their weighting in the S&P 500. What has been particularly alarming is how fast this trend has accelerated the last nine months. The chart to the left illustrates that we have now eclipsed previous highs set back in the dotcom era. Several of the companies that comprised the top five back then cratered when the bubble burst (e.g., Intel, Cisco) and were down as much as 50%.

Make no mistake, we have a lot of respect for the current “Big 5” companies and they are some of the largest holdings across our investment platform. Yet, as we watch their stock price and valuations climb higher, it gives us pause. It can be difficult not to succumb to herd mentality and put more chips with performance standouts. But we are students of history and though history may not repeat itself, it tends to rhyme. When these concentration trends have reversed historically, it has been violent and swift. We think it is crucial to maintain a disciplined approach to portfolio construction where balance is the key.

Diversification Can Often Be Unpopular

There is the old saying that the only free lunch in finance is portfolio diversification. It should also

2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	YTD
Municipal Bonds 5.8%	High Yield Corporate 58.2%	Small Cap Stocks 26.9%	Dividend Stocks 12.4%	NASDAQ 17.5%	NASDAQ 40.1%	Dividend Stocks 15.4%	NASDAQ 7.0%	Dividend Stocks 22.0%	NASDAQ 29.6%	Municipal Bonds 1.7%	NASDAQ 36.7%	NASDAQ 12.7%
Hedge Funds -20.9%	NASDAQ 45.3%	Dividend Stocks 18.3%	Municipal Bonds 6.9%	Intl Stocks 17.3%	Small Cap Stocks 38.8%	NASDAQ 14.7%	Municipal Bonds 2.4%	Small Cap Stocks 21.3%	Intl Stocks 25.0%	High Yield Corporate -2.1%	S&P 500 31.5%	Municipal Bonds 2.2%
High Yield Corporate -26.2%	Intl Stocks 31.8%	NASDAQ 18.0%	High Yield Corporate 5.0%	Small Cap Stocks 16.3%	S&P 500 32.4%	S&P 500 13.7%	S&P 500 1.4%	High Yield Corporate 17.1%	S&P 500 21.8%	NASDAQ -2.8%	Small Cap Stocks 25.5%	Hedge Funds -1.3%
Dividend Stocks -31.0%	Small Cap Stocks 27.2%	High Yield Corporate 15.1%	S&P 500 2.1%	S&P 500 16.0%	Dividend Stocks 29.1%	Small Cap Stocks 4.9%	Hedge Funds -0.2%	S&P 500 12.0%	Dividend Stocks 15.4%	Hedge Funds -3.3%	Dividend Stocks 22.1%	S&P 500 -3.1%
Small Cap Stocks -33.8%	S&P 500 26.5%	S&P 500 15.1%	NASDAQ -0.8%	High Yield Corporate 15.8%	Intl Stocks 22.8%	Hedge Funds 3.4%	Intl Stocks -0.8%	NASDAQ 8.9%	Small Cap Stocks 14.6%	S&P 500 -4.4%	Intl Stocks 22.0%	High Yield Corporate -3.8%
S&P 500 -37.0%	Hedge Funds 11.5%	Intl Stocks 7.8%	Small Cap Stocks -4.2%	Dividend Stocks 10.8%	Hedge Funds 9.0%	Municipal Bonds 3.2%	Dividend Stocks -1.6%	Intl Stocks 1.0%	High Yield Corporate 7.5%	Dividend Stocks -5.9%	High Yield Corporate 14.3%	Intl Stocks -11.3%
NASDAQ -40.0%	Dividend Stocks 11.1%	Hedge Funds 5.5%	Hedge Funds -5.0%	Hedge Funds 4.8%	High Yield Corporate 7.4%	High Yield Corporate 2.5%	Small Cap Stocks -4.4%	Hedge Funds 0.4%	Hedge Funds 6.9%	Small Cap Stocks -11.0%	Hedge Funds 8.1%	Small Cap Stocks -13.0%
Intl Stocks -43.4%	Municipal Bonds 7.4%	Municipal Bonds 3.4%	Intl Stocks -12.1%	Municipal Bonds 3.0%	Municipal Bonds 0.8%	Intl Stocks -4.9%	High Yield Corporate -4.5%	Municipal Bonds -0.4%	Municipal Bonds 3.1%	Intl Stocks -13.8%	Municipal Bonds 5.4%	Dividend Stocks -21.7%

Source: Morningstar Direct; YTD returns as of 6/30/2020. A series of indexes are used above to represent the return of a given asset class, region or country. Included in this list alongside the popular S&P 500 and NASDAQ are: Municipal Bonds - Barclays Muni 5 Yr; International Stocks- MSCI EAFE; Dividend Stocks- DJ US Select Dividend; High Yield - Barclays US Corporate High Yield; Small Cap Stocks - Russell 2000; Hedge Funds - HFRI FOF Diversified Index. The reference to a diversified portfolio references a 60% (MSCI ACWI Index, 20% HFRI FOF Diversified Index & 20% Barclays Muni 5 Yr Index, rebalanced annually.

be said that sometimes the free lunch is better than others. The “quilt” chart highlights the cyclical nature of asset classes and how drastically performance can differ from one year to the next.

Successfully timing markets and navigating the best and worst assets on a consistent basis is impossible. Maintaining a truly diversified portfolio across different asset classes, styles and unique drivers can mitigate a good deal of the volatility and provide investors with a much smoother return profile. If we were to overlay the returns of a diversified portfolio on the quilt, the line would bounce around slightly from year to year, but would typically hover around the middle – not shooting the lights out, but not shooting your foot off either.

Index	YTD Return	5 Year Return
Global Stocks	-6.3	6.1
S&P 500	-3.1	10.7
NASDAQ Composite	12.7	16.4
US Large Dividend Stocks	-21.7	5.4
US Small Cap Stocks	-13.0	4.3
International Stocks	-11.3	2.1
Municipals	2.2	2.8
US High Yield Bonds	-3.8	4.8
Hedge Funds	-1.2	1.6

Source: Morningstar Direct; Returns as of 6/30/2020. A series of indexes are used above to represent the return of a given asset class, region or country. Included in this list alongside the popular S&P 500 and NASDAQ are: Municipal Bonds - Barclays Muni 5 Yr; International Stocks-MSCI EAFE; Dividend Stocks-DJ US Select Dividend; High Yield Bonds - Barclays US Corporate High Yield; Small Cap Stocks - Russell 2000; Hedge Funds - HFRI FOF Diversified Index.

Preservation of capital is paramount to not only maintain existing wealth, but to grow wealth by the power of compounding returns. The idea is if an investment loses 30%, you have to generate a return of more than 40% to break even. As a long-term investor, you win by not losing and the most effective way to do that is through portfolio diversification.

There are times, however, when maintaining discipline around portfolio diversification can be more challenging. The period we are in now is a quintessential example. The chart to left illustrates various returns of strategies a prudent investor may have in a diversified portfolio. You will see that outside of a small pocket of outsized winners (technology in the U.S.), the five year returns for most assets tell a different story.

So what are we to do in these periods where diversification is difficult? Rebalance – rebalance-rebalance. The answer may seem simple, but rebalancing on a periodic basis is an extremely powerful tool. It puts a systematic plan in place and it mitigates potential pitfalls of human behavior in investing.

Focus on Key Trends Amidst So Much Uncertainty

There is an old Chinese curse that loosely translates into, “may you live in interesting times.” While it does not feel like we live in cursed times, the first six months of the year have been like nothing else we have ever experienced. With so much uncertainty and the potential for such a wide range of outcomes, we think it advantageous to not make predictions and focus our attention on the important trends. We see three of those key characteristics as:

- 1) The economic recovery will be a difficult ascent and absolute levels matter
- 2) Be wary of rising concentration risk in U.S. equities
- 3) Though diversification can be difficult, it is a powerful tool for long-term investing

What is in store for the markets and the economy the second half of the year? Time will tell, but in such a volatile environment, it is important to use a disciplined, process-driven approach to navigate through the noise and focus on what is most impactful to your portfolio.

From all of us at Meristem, take care and stay healthy.

IMPORTANT DISCLOSURES**July 10, 2020**

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