The ACM Journal

Home

Life has certainly changed lately. There has been a great simplification in our country, and perhaps the world, as we respond to the coronavirus. I've read plenty of accounts of people trying to "cope" with so much time at home. Folks get irritable with those they are confined with and yearn for a return to "normalcy". I couldn't feel more different.

For me, this has been a refreshing interlude. I haven't been able to fully enjoy it because of the stresses at work, but if you could somehow separate the illness and economic damage of this period from the simplification, I think it would be a time to savor with everything we've got.

First off, everyone is home. The kids don't have their usual rigorous schedules of school, sports, homework, and outside activities. Everything is cancelled. There is enough e-learning and other structure to keep them busy, but not busy like they usually are. That means more time that we spend together. Nipa and the kids go for runs or hikes during the day, we all eat dinner together, and we now often play games or hang out together until bedtime.

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Portfolio Review

Our discussion of the capital markets for the first quarter could be quite brief: it was bad. However, there are some interesting sound bites worth noting:

- The S&P 500 fell more than 30% in four weeks, the fastest decline ever.
- The S&P 500 recovered more than 20% from the low, marking the quickest ever bear market and then bull market (though we don't believe the bear is completely over).
- The ten-year Treasury yield fell from 1.55% to a record low of 0.54%.
- 6.6 million people filed for unemployment benefits in a single week.

It has been a period of new records, which is probably appropriate since the global response to the pandemic is unprecedented. Never before have diverse nations enacted a coordinated shut down of the global economy. If we weren't living through it, no one would believe it was possible.

Because there isn't much precedent for such an occurrence, we don't have a lot of guidance on how long it will last. China has been an interesting model since the virus ran its course there first. However, while the Chinese economy has reopened, there are disturbing signs the virus may be coming back in a second wave. It would be concerning if the current social distancing and economic shut down were expected to last more than a couple months.

Yet, beyond the shutdown there are still things to worry about. The U.S. government alone has enacted significant economic stimulus to get us through the crisis. A $2 trillion stimulus package is just the tip of the iceberg. The Fed's balance sheet jumped to $5.8 trillion from $3.7 trillion in just a few weeks. This was a greater expansion than during the 2008 financial crisis, and it happened in just a blink of an eye. Additional fiscal policy measures are already being talked about.

Regardless of the final size of all these stimulus initiatives, it is clear there will be a lot more money coursing through the economy. The economy was already strong prior to the shutdown, so the prospect of inflation in the wake of the recovery is certainly a consideration.

However, there was significant government stimulus during the Great Depression and again in the 2008 financial crisis. In both cases there was discussion of inflation, but in neither case did a lasting, damaging inflation take place. So, it is anyone's guess what will happen this time. Inflation has not been a factor in our markets or economy for many years, so it would certainly

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be a game changer. In terms of investment portfolios, inflationary periods have generally been good for stocks. Rising prices drive up asset values as well as prices in the overall economy.

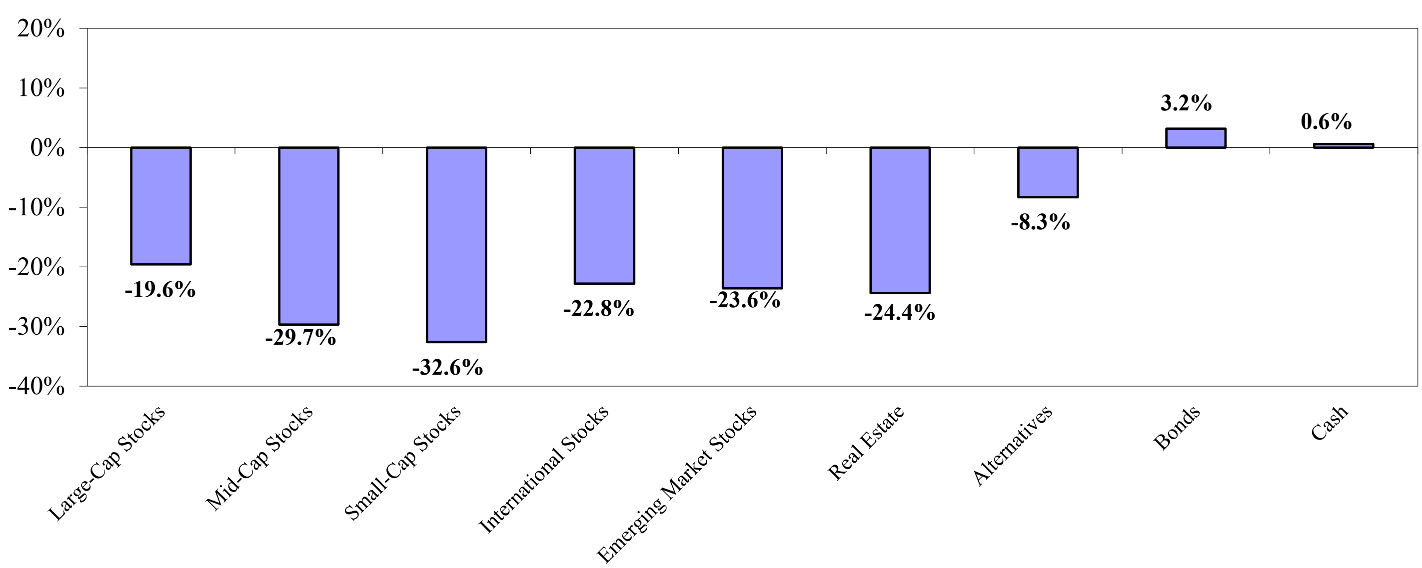
Inflation is bad for bonds, but candidly, we're not sure what will be good for bonds in the future. Imagine you had money to invest and someone offered you an opportunity to commit capital for ten years with an annualized return of less than 1%. Would you do it? There are certainly other reasons to invest in bonds, such as stability, but the return prospects look pretty dismal.

We have responded by reducing the duration of the bonds that we manage. Shorter-duration bonds are more defensive, and can help hedge against rising interest rates. After roughly forty years of declining interest rates, it is quite possible rates will reverse course and start to move higher. This, combined with inflation, would be a bad scenario for bonds.

This is one reason we have shifted money in recent years away from bonds toward alternative investments. While they haven't been anyone's favorite investment, we're happy to report that they held up quite well in the first quarter. An average of the funds we use would have been down around 3%, which is better than corporate bonds. Looking forward, these investments have much higher expected returns than the bond market, and they have just shown us that their risk profile is not significantly higher than bonds.

The first quarter was an aberration for stocks and bonds. Stocks are already starting to firm early in the second quarter, but the economy and stock market are not yet out of the woods. There may be more pain to endure, but eventually stocks will recover and we'll be on to better times.

First Quarter 2020 Asset Class Returns



Large-cap, mid-cap, and small-cap stocks are represented by the S&P 500, 400, and 600 indcies. International and emerging market stocks are represented by MSCI indices. Real estate is the Dow Jones Real Estate index. Alternatives are represented by the HFRI Fund Weighted Composite Index. Bonds are the Barclays Aggregate Bond Index. Cash is the yield on the 3-month T-Bill.

What are Factors?

Factor-based investing, or what has become known as "Smart Beta" is a strategy that has been prevalent in academic and larger institutional realms for many years. However, it is just recently trickling down to the investment advisor and retail investor world.

You may have seen ads for these types of funds in the Wall Street Journal or on CNBC. It seems lately that every large investment firm is racing to issue funds that capitalize on investment factors. We have been implementing this approach since the inception of our firm, but it continues to evolve.

So, what are factors? In general terms, they are stock market characteristics that tend to outperform the overall stock market over many years. For example, "value" stocks have generally provided stronger returns than "growth" stocks over longer periods. There is no universally agreed upon reason as to why this is the case, but it is generally accepted that value stocks have and should continue to generate outsized returns.

There have been dozens of factors identified in the academic literature, but many of these have been discredited over time. The four widely accepted factors that have been persistent include "value", "momentum", "quality", and "low volatility".

The other well-known factor this is regularly discussed is "size". That is smaller-capitalization stocks have historically generated larger returns than large-capitalization stocks. This has been examined over many decades, and the academic consensus is now that size is really not a factor for a number of different reasons. An interesting corollary is that while small-cap stocks may not be a proper factor, the other factors express themselves better in the small-cap part of the stock market, resulting in higher returns in that market segment.

While factor-based investing should provide stronger returns than the overall stock market, that is not always the case. Unfortunately, there is no investment approach that can always outperform, but factor investing does have some compelling return characteristics. The various factors also move in different patterns from one another, which increases overall portfolio diversification. Accordingly, we have been able to build an approach that reaches for higher returns, but without adding too much additional risk.

This diversified factor methodology helps mitigate the odds of underperforming the overall stock market but cannot eliminate it completely over shorter periods. For example, while momentum stocks have performed well over the past several years, their strong performance has been more than offset by weakness in value stocks.

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There are no agreed-upon definitions for factors, but here are some common guidelines:

Value: Value stocks are those that trade at a deep discount to their intrinsic value. That generally means they have low price-to-earnings ratios, often in the bottom 30% of all stocks. Some stocks have low valuations for a reason, often financial distress, and they go out of business. However, historically enough value stocks have been able to survive and improve their fortunes that a diversified portfolio of these stocks has performed quite well.

Momentum: Momentum simply means that stocks going up tend to continue going up, and those declining tend to continue declining. The time period is important, as short-term momentum tends to be statistical noise, and very long-term momentum tends to eventually reverse. However, capturing stocks with strong 12-18 month price momentum has been rewarding in the past.

Low Volatility: Ironically, stocks with lower volatility, or risk, have outperformed stocks with higher volatility over time. While risk and return are related, the common wisdom is that if you take more risk, you get more return. However, there are subtle differences in types of risk, and volatility is not always rewarded with stronger performance. This factor therefore gives hope of "having your cake and eating it too".

Quality: Stocks with higher quality, or those with stronger balance sheets and consistent earnings histories have historically generated larger returns than weaker companies.

Chris's Corner

Relief for some is on the way. As during most times of economic stress, our elected officials are racing to roll out multiple programs to help reduce the financial impact to businesses and individuals. Here are a few provisions that have been put into action that may be of help.

Suspension of IRA Required Minimum Distributions (RMDs)

The CARES Act waives all RMDs for 2020 for account holders and beneficiaries. If your RMD has already been distributed, there are potential mechanisms to recontribute the proceeds. For most, taking at least some portion of the RMD will still make sense if you will be in a lower tax bracket in 2020 than in the future. It also creates a planning opportunity for Roth conversions.

Stimulus Checks

Many taxpayers will receive a stimulus check. The amount will be based on your 2018 tax return info if you haven't yet filed 2019. The base payment is $1,200 for single filers, $2,400 for joint filers, and $500 per qualifying child (16 years or younger). For single filers, this amount will be reduced by $5 for every $100 that your adjusted gross income (AGI) exceeds $75,000. For joint filers, the same benefit reduction starts at $150,000 of AGI. Single filers with AGI over $99,000 and joint filers above $198,000 will not receive any benefit. Technically, the stimulus payment is a 2020 tax credit you receiving in advance, so if your AGI in 2020 turns out to be lower than 2018 (or 2019 if filed), you will receive the benefit when you file your 2020 return. Interestingly, even if you receive a benefit based on 2018 or 2019 returns, but your 2020 return shows you are not eligible, you still get to keep the money. Timing seems to be the real question. The Treasury has indicated that payments will start going out within three weeks (mid-late April), but the last time the government sent stimulus checks it took about three months.

Tax Deadline Extension

By now you've probably heard of the 90-day extension for filing and payment of 2019 taxes to July 15th. The extension also covers your first quarter 2020 estimated tax payment. It does not, however, cover your second quarter 2020 (due June 15th) estimated payment, and does NOT wave the penalties for failure to make estimated payments. New York State has extended its 2019 filing and payments as well.

$300 Charitable Deduction

The CARES Act will allow taxpayers who donate to qualifying charities, but who don't itemize and normally don't receive a charitable tax benefit, to deduct up to $300 in a new above-the-line deduction for 2020. So, save your receipts for any charitable contributions this year.

Qualified Medical Expenses

If you have an HSA or FSA account, the CARES Act now allows you to use pre-tax dollars for over-the-counter medications.

REAL ID Delayed Deadline

Although most of us aren't thinking about flying right now, the deadline to obtain a REAL ID, which will be required to board aircraft for domestic flights, has been extended until September 30, 2021 from September 30, 2020.

What are Factors? *continued from page 3*

Even though value stocks are expected to outperform the overall stock market over time, there have been fairly long periods when that has not been the case. We are in one now. If you were only invested in value stocks, that could have a significant adverse impact to your investments. But, diversifying across factors can reduce the impact of any one factor not performing well.

We have been using value and momentum stocks for many years. We added a low-volatility fund a while back and are now adding a quality fund as well. We are also expanding our factor approach to the small-cap, international, and emerging markets segments of the portfolio. After much research, we are confident this tips the odds of stronger performance in our favor without increasing risk, costs, or tax liability in any significant way.

We will be reporting portfolio holdings and performance going forward in more of a factor-specific manner. So, you likely will be hearing more about this topic in the future.

Firm News

Just like at home, life is very different at the office these days. We remain fully functional, and we're all grateful that we have relative stability in our jobs and the ability to work from home without undue disruption. It helps that our IT guy Craig is an absolute rock star and was able to securely set up a work-from-home solution in just a day or two.

Business as Usual

Financial organizations are on the list of businesses deemed essential in New York, so Chris and I continue to "hold down the fort". Yet, things are quite different. We can't go out to lunch any more. We don't have any meetings or appointments. And, no one really comes to the office. That means certain niceties have been suspended. Haircuts are no longer an option, neither of us has shaved in quite a long time, and business attire has given way to whatever pair of jeans is closest to the bed in the morning. We look more like investment hobos than investment professionals, but we continue to trade and manage portfolios. Given the vagaries of the stock market of late, the profanity in the largely vacant office may have escalated a bit as well.

Despite the new era, some things have not changed. You are still able to get in contact with any of us at any time. You can email us or call us on our cell phones. Operations are generally "business as usual". We have even continued our growth through this period and have added one new team member and have another waiting in the wings for after we return to normal office life.

Team Growth

Nick Russo, CFA has rejoined our team. He worked here a couple years ago, and then spent a couple years at the University of Rochester in the endowment office, helping to manage the $2.5 billion investment portfolio. Nick is back working in an investment capacity with us, managing portfolios and executing trades. His first week back was just as the stock market was taking the worst of its dive, but Nick was able to jump right in and help us keep portfolios on track.

New Stock Approach

Speaking of portfolios, we have made a few changes lately that happened much faster than we anticipated. We have been researching an extension of our factor-based investment approach for the past year or so. We decided there were some changes we would like to make but realized that because of embedded capital gains in most of our clients' portfolios, we would not be able to make much progress. However, with the stock market dropping recently, we were able to realize tax losses, do some rebalancing, and also largely implement our new approach.

So, you may see some new securities in your accounts. In some cases, we sold just about everything we held previously and replaced it with new investments. While this seems extreme, the changes we have implemented are more of an evolution than a revolution.

When we started the business, we tried to capture the "value" and "momentum" factors, and then a year or so ago we added a fund for "low volatility" stocks. We're now adding a "quality" factor fund and expanding the small-cap and international parts of the portfolio to include factor funds. Our research, as well as that of noted academics, suggest that this should further diversify our portfolios and increase the odds of long-term solid returns. Despite all the recent trading, these really are fairly subtle changes that are a natural extension of our long-standing strategy.

The wild market and the updated portfolio strategy have kept us pretty busy of late. So, if you haven't heard from us, and have questions about anything we're doing, please feel free to reach out.

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Second, there is time and capacity for home-based activities. For us this means home improvement work and farm chores. We finally got around to building a home gym in the basement so the kids could continue their workouts without structured sports practices. Nipa helped me paint the walls and Amer helped craft and install baseboards from some old flooring we had. The project itself was constructive, but now we enjoy it every time we go into the basement. I'm also already starting my garden, planting seeds indoors at first. I rarely get around to this so early in the year, but my daughter is helping, and she is now even watering the seeds out in the barn without being reminded. I pruned apple and pear trees last weekend, which I haven't had time to do for many years.

Third, there's a satisfaction in home-based work that contributes to our subsistence. I'm sure my daughter and I will enjoy the garden even more this year, having done the work together. The boys are collecting and selling eggs from our chickens, and I just ordered this year's crop of meat birds. I haven't been able to persuade anyone to help me process them yet, but I still have a few months to go. While all of this may be largely symbolic, it did bring us all a lot of comfort that we had a freezer full of self-produced food when the grocery store shelves were empty.

Wendell Berry is a professor, author, poet, and farmer who is the founder of the agrarian movement. He has written about the benefits and importance of a life built around home. That is a foreign concept for many of us, particularly those who live in apartments in large cities. However, it resonates with me. While building our business takes a lot of time away from home, ultimately home is where I want to be. So, while I certainly wouldn't choose to have the world subjected to the coronavirus, I'm enjoying the simplification and focus it has brought to our lives.

Compliance

We are in a highly regulated business, which causes a few headaches, but regulations are largely good; they offer our clients important protections. There are certain disclosures that we are required to make regularly regarding our policies and procedures. A couple of them are below:

The nature of our business requires us to obtain sensitive personal and financial information from our clients. As a registered investment adviser with the United States Securities and Exchange Commission (SEC), we must adopt policies and procedures to protect this nonpublic, personal information. Our policy mandates that ACM employees are prohibited from disclosing nonpublic, personal information to any person or entity outside of our firm, except as authorized by our clients or an appropriate regulatory institution. We also take all reasonable measures to ensure secure transfer and/or disposal of documents containing sensitive information about our clients. A copy of our full privacy policy will be sent to you shortly.

Additionally, registered investment advisors are required to file Form ADV with the SEC or state securities regulators on an annual basis. A copy of our updated Form ADV is available at any time upon request. A copy of this brochure is also available on our website. We encourage each of you to read it. Please let us know if you would like us to send you a copy.

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