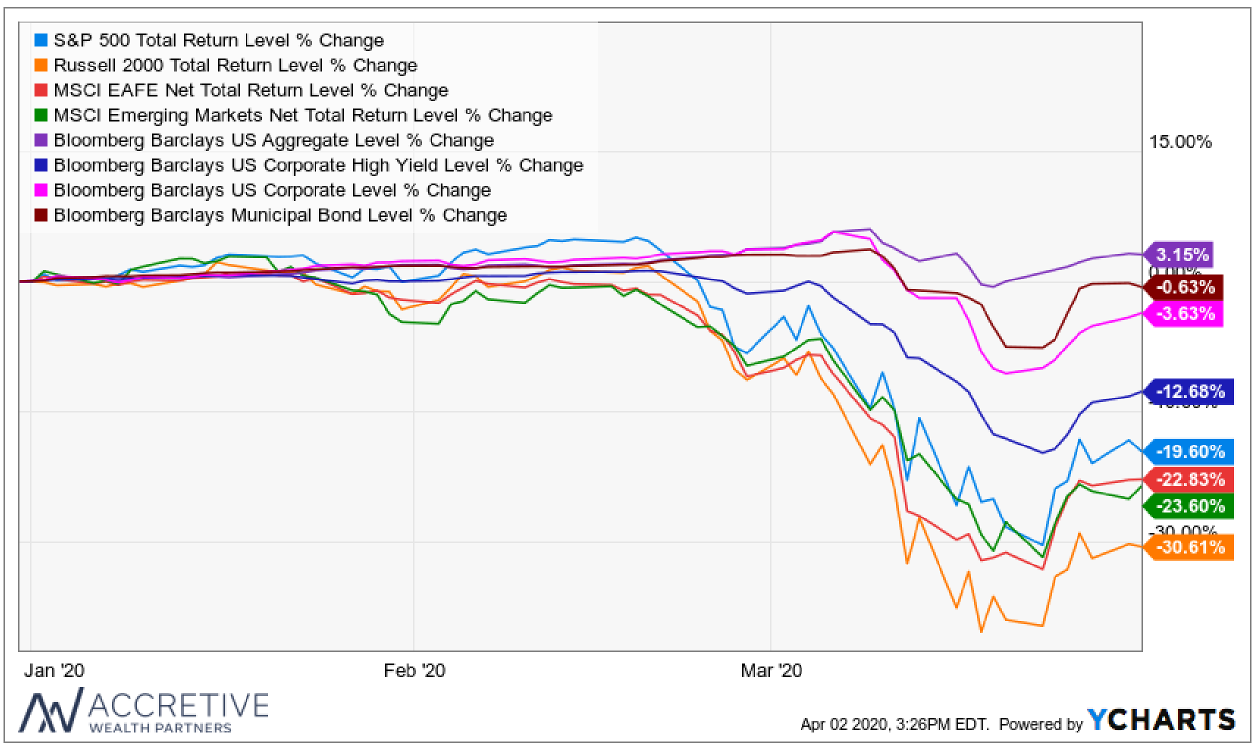
Accretive Q1 2020 Client Letter

Dear Clients and Friends of Accretive,

Before going into our letter, want to wish everyone the best health and safety for you and your loved ones during this difficult time. We also feel it is important to let you know that Accretive has, as a firm, made a commitment to doing pro-bono planning in 2020 and beyond. We feel it is important to bring financial advice to those who need it, but our industry does not typically serve. To that end, if you know someone affected or displaced economically by Covid-19, we would welcome the chance to help them.

At the end of the first quarter, Accretive managed approximately $101 million for clients on a discretionary basis. As a result, we are waiving 2.5% of our management fee under our recently released Client Alignment Program™ for the second quarter.

What a quarter to review, there's a lot to talk about. In this letter, we hope to share with you what transpired in the market, what the response has been from policy makers, how our thinking evolved, what we think now, and how we have positioned our portfolios as a result. We apologize in advance for its' length, but feel it necessary given the significance of what's transpired in the world and in markets.



Q1 Market Recap

As you can see from the above graph, to call this a tough quarter is an understatement. Covid-19's rapid spread started to impact markets in mid-February and as the measures to contain the virus escalated, the equity market began to process and react to an impending, open-ended global quarantine. The S&P 500 went from reaching an all-time high in mid-February to being more than 35% off that high a mere 4 1/2 weeks later. Other markets were similar in their reaction, and small cap US stocks fared even worse. Corporate credit took a hit as markets assessed which companies can weather a temporary and severe demand shock. Gold at first was a hedge, but then sold off with everything else as markets went into full liquidation mode. Even trading in US treasuries and agencies became erratic.

Policy Response

The most important response is the public health response. We are not qualified to speak intelligently about the nuances of the public health response, so we will not, but we do believe a well-executed response should result in better health outcomes for the nation, and that would be good for the economy in the long run. The more effective the response, the sooner we can get a handle on the economic ramifications and the markets can begin to look through the economic damage to a recovery.

There are two types of responses that we can speak intelligently about, and they address the economic shock. Those two responses are fiscal and monetary.

The monetary response comes from the Federal Reserve. The Fed, in coordination with other central banks, has been swift and robust in heading off a financial crisis. Chairman Powell dusted off the playbook from 2008 and then added some new plays to it. As the virus's impact on the market began to stress the system, they sprang into action by aggressively cutting rates, setting up lending facilities, setting up commercial paper facilities, and launching QE infinity. The stimulus bill has also capitalized the Fed with $500 billion to lend up to $4 trillion to US companies. These are just the most notable moves, but they also issued joint statements with other regulators instructing banks to essentially "work it out with your borrowers". The banks going into this were very well capitalized and ready to weather a severe shock. The last time they needed to be rescued, and this time their regulators are telling them to take one for the team.

The fiscal response comes from the Federal Government, which has also been robust. Congress passed a few different rounds of relief and legislation aimed at supporting the health care system, furloughed/dislocated workers, small businesses, affected industries and the broader economy. The most notable is the CARES Act, which provides over $2.2 trillion of stimulus. The good news is Congress and the White House got their act together pretty quickly to pass meaningful relief, but the bad news is these things take time to implement and they may be back for more stimulus to help control the collateral damage. As we write this, politicians are already discussing a fourth (and fifth) round of stimulus in the House and the President is suggesting a $2 trillion infrastructure bill. The US government has pulled out a financial bazooka and will likely keep firing it until it is no longer necessary. It is a war time spend, but it reflects the reality that we are at war with the virus. In the end, we feel confident that policy makers will spend enough cheap money to blunt the effect of an extreme contraction in GDP running from mid-March through the end of the war. We think the prevailing attitude can be summarized as "Do. Whatever. It. Takes."

Our Investment Thoughts as the Virus Spread

In mid to late January, we began to hear more about what is now called Covid-19. We thought it might weigh on global trade a bit, disrupting supply chains from China in particular, and if it resulted in a slowdown, we would get more easing from the Fed.

As we got into late February, it became clearer that the virus would be more disruptive than we initially thought. We attempted to jettison equities that we thought had real balance sheet risk in a recession. However, we were also of the opinion that the more significant the impact, the more significant the policy responses would be. At that time, we did not see a shutdown coming let alone consider all the ramifications of a large quarantine on the US and Global economies.

March came roaring in like a lion as it became clearer that more was required to combat the virus than practicing good hygiene and keeping a safe distance from others. The first three weeks (in markets) reminded us of the Global Financial Crisis: emergency actions from the Federal Reserve announced Sunday evenings before the Asian markets opened, emergency press conferences, and emergency legislation. Congress seemed to be at least a week behind in their measures, as a $750 billion bill became $1 trillion, then $1.8 trillion, until finally we got the $2.2 trillion bill.

What We Think Now

We think the United States will win the economic war on the virus. We believe the US has several key advantages that other economies struggling with the virus do not have. The federal government borrows in its own currency at low rates, a capability that most emerging markets do not have. The US population is generally younger and still growing, unlike the EU or Japan. The entrepreneurial spirit of its citizenry results in the US economy being fundamentally more dynamic than the rest of the developed world.

Globalization has been in slow decline since the Global Financial Crisis and this may have the effect of speeding that up. This could hurt all the countries that disproportionately benefitted from globalization. The good news is that the United States, with all its resources, can operate quite well as a fairly closed system. We would not be surprised to see companies build supply chain capacity in the U.S. and/or in North America as a result of this experience, particularly in higher value goods like pharmaceuticals and technology.

Compared to more authoritative governments we think that the United States may have had some disadvantages in initially confronting and combating the virus, but we believe it is the best positioned to handle the economic effects.

How We Have Positioned Portfolios

"When the facts change, I change my mind. What do you do sir?" ~ John Maynard Keynes

An early 20th century political philosopher/revolutionary once observed, "There are decades where nothing happens; there are weeks where decades happen." In that context, we have had a highly unusual level of activity in our client accounts, but that is because this is a highly unusual time. What has occurred is so significant and the situation so fluid, that we felt it necessary to make adjustments to the composition of our portfolios. We have done some tax-loss harvesting, but we have prioritized getting the proper positioning over realizing the tax loss. We will look to do more tax-loss harvesting in April and anticipate very little more to be done in the way of positioning.

We have not changed our long-term investment philosophy, and we continue to manage client accounts according to their stated objectives, but our long-term expectations have changed. All the changes we have made are intended to be long-term and we think we have made the lion's share of changes that we anticipate making. We expect the bulk of the changes to be in place for quite a long time.

We would like to give you a summary of changes that have been made and the basic rationale.

- The last week of March had us rebalancing portfolios back to target as the sudden drop left most clients very underweight equities.
- We increased our US exposure and decreased our non-US equity exposure, as we believe the US is in the strongest economic position to manage the fallout of the crisis. We have also made that exposure a

little more growth oriented than it had been. We think the end result is that strong companies will get stronger, and secular growth in a world starving for it will be valuable.

- We made a number of changes to our bond positions.
    - We owned bonds mostly in a mutual fund wrapper going into this. As the crisis unfolded, there were several Exchanged-Traded Funds (ETFs)with objectives and holdings that are very similar to the mutual funds we held, but that were trading at a discount to the published value of their assets by several percentage points. So, we sold the mutual funds to buy those ETFs at a discount. As the Fed stepped up its bond buying, those discounts collapsed, meaning that the shares of the ETFs are now trading at or near their published net asset values. We recently sold the ETFs to buy mutual funds.
    - We moved to buy more investment-grade corporate credit. We did this because yields rose considerably, and the Fed showed a commitment to a functioning environment for corporate credit. We chose to invest in actively managed, but low-cost vehicles. We did this instead of buying funds that track indices because we wanted someone thinking about the possibility of downgrades in the management of the portfolio. In our opinion, the cost differential is small, and we hope to get value in excess of the incremental cost.
    - We introduced some high yield corporate exposure, in a mutual fund wrapper. Costs for riskier borrowers went way up, and when we read the CARES act, we thought that most companies with a viable business before Covid-19 will have resources available during and after the virus outbreak to make it through at reasonably attractive financial terms. We did this with a low-cost active manager because we think avoiding bonds issued by companies that do not have viable businesses will be important.
    - We invested, in hindsight a little too early, in taxable municipals. Municipals are typically more creditworthy and more conservatively financed than corporations. We did not contemplate what a complete shutdown might do to the market at the time we invested because that did not seem to be a realistic possibility. In the end, we do not believe the Fed and Treasury are going to backstop corporate America and leave states and local governments to fend for themselves.
- We thought that regulated utilities looked attractive, having sold off with everything else as interest rates fell. This is not a normal reaction and we expect that to change at some point, so we added them to our equity mix. When we get into the recovery, it will be an income-starved world and we wanted to be ahead of that.
    - We had that same thought a month earlier and increased our US Real Estate exposure, a little too soon.
- We owned long term treasuries going into this and sold them. We think borrowing costs are pinned at 0% for the US government in the short-term but we think it's possible that longer-term rates rise with the massive amount of government borrowing combined with the possibility of some inflation in 2021.
- We increased our allocation to gold incrementally. We view gold as a hedge against all the fiat money that is being created by central banks.
- We have, in our individual equity portfolios, sought to minimize solvency risk, as well as exposure to industries that we view as having permanently impaired earnings power. Since almost everything has declined a similar amount, we have also looked for opportunities to trade up in quality, as we do not want to be underinvested in a recovery.

The Outlook

Be prepared for some mindboggling economic numbers, as we expect the rise in the unemployment rate and the GDP decline in the second quarter to be unprecedented. How that translates to the stock market remains to be seen. In terms of timelines, there is the timeline related to defeating the virus, then there's the timeline for economic activity to ramp back up, and the time horizon that the stock market is operating on. The market is forward looking and we think the more confidence we have in the measures being taken to address the virus's spread, the more likely it is that the stock market will look through the second quarter into the back-end of the year and possibly 2021.

There is a lot of discussion about the type of recovery we will have and whether it will be "V" shaped, "U" shaped, or "L" shaped. We think the answer to that question depends on the industry. Some recoveries will be shaped a "V", others more like a "U", there will be some "L"'s, and unfortunately a few "\"'s. In that environment, thinking about and understanding what you own will be more important than ever.

We think at the end of this, economically speaking, the strong will have gotten stronger. Assuming we avoid the very worst economic outcomes, and we believe the US Government will do whatever it takes to avoid them, the back end of 2020 could be alright and 2021 could shape up to be surprisingly strong.

Our Portfolios

The period between mid-February and March 23rd was brutal. There were several days where futures traded "limit down", a point where exchanges halt trading until a trader is willing to bid it higher or the stock market opens. There were also several circuit breakers that got tripped, which stopped trading for a time and the market experienced unprecedented volatility, both up and down. There was chaos in fixed income as the market went into full liquidation mode. There were rumors of bank holidays and a closure of the stock exchanges, which we think made the selling worse. Despite the pain, we are glad they kept the markets open because we think the politicians needed to see their approval ratings in real-time in order to get them to act quickly.

We'd like to say our portfolios were immune to the selling, but they weren't. We can say we felt well positioned for a business cycle slow down or normal recession. However, this is not a normal slow down or recession, it is an acute and unprecedented shock to the system. We had some cash, some treasuries, those things helped a little but only so much. Gold was a good hedge in the beginning, but then it too went into liquidation. We were not surprised by any particular outcome, given what happened. We would say that we believe we've participated the way we had hoped in the modest rebound thus far and feel well positioned going forward.

The Fed's actions have given us confidence that the system should hold up, and all throughout we felt the US Government would ultimately respond in a way that was proportionate to the problem we are facing. At a certain point we knew the most important job was to keep our clients as informed as they would like to be, in their seats and prepared to ride out the storm, and to try to position ourselves for a potential recovery. Up to this point, we believe we've done all three.

We thought the market could begin pricing a recovery when three conditions were present: a robust stimulus plan to address the economic hole, a willingness to do "whatever it takes" if that is not enough, and evidence that the public health measures being taken are starting to control the spread of the virus. We felt that evidence could be as simple as decelerating new case growth in major metropolitan areas, like New York City.

It is said that the market climbs a wall of worry. Absent meaningful setbacks in the response to the virus, it is possible we may enter that phase sooner rather than later. We have declared war on the virus. In the 1800's London financier Nathan Rothschild said, "buy on the sound of cannons, sell on the sound of trumpets". We think a bazooka is close enough to a cannon, and it's about to be fired multiple times. We also think it is possible that it fires one more shot than is necessary, just for good measure. There's a common saying among investors, "Don't fight the Fed", we would add "or the Feds", especially when they have declared economic war. In the end, we believe the war will be won. Sometime before that happens, we would expect the markets to start to recover. None of this means that volatility will disappear, that the bottom is in, or that we should be declaring victory just yet.

In Conclusion

During this difficult time, we want you to know that we are working hard on our clients' behalf. We cannot remember a time where we have worked harder day-to-day than over the last 6 weeks. We are hopeful and optimistic that the decisions we made during this period will bear fruit over the years.

We part by reminding readers that no one knows the bottom until well after it is established. You cannot time it, once you get out there will always be a litany of reasons for not getting back in, so we think you need to be invested when it happens in order to experience the recovery. The media is never going to say, "all clear, safe time to invest", and in fact, they are more likely to tell you all the reasons not to invest.

To our clients, we appreciate the trust and confidence you have in us. If you have any questions or concerns, please do not hesitate to contact us. To our friends, if there is anything we can do to help you, please reach out to us. We would welcome hearing from you.

Sincerely,

Gary C. Ribe, CFA, CFP®

Chief Investment Officer, Managing Partner