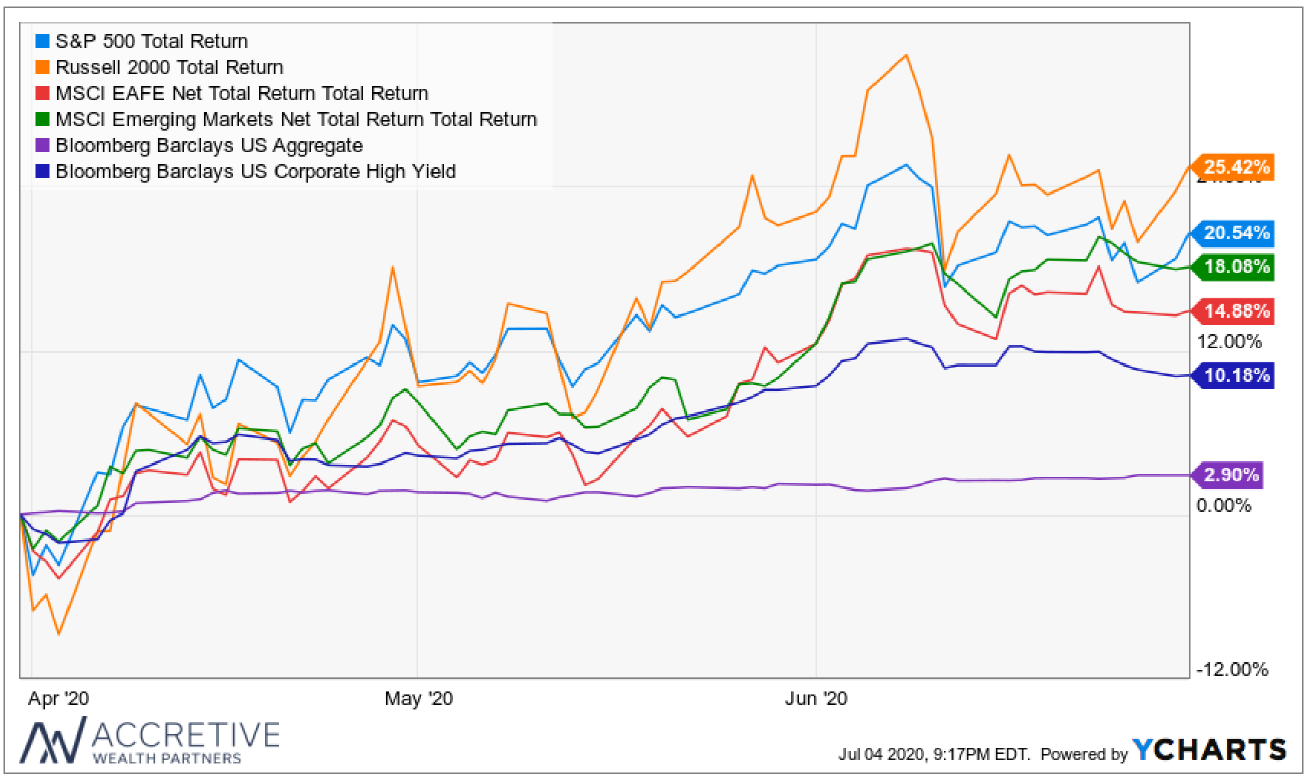
Accretive Q2 2020 Client Letter

Dear Clients and Friends of Accretive,

At the end of the second quarter, Accretive managed approximately $126 million for clients on a discretionary basis. As a result, we are waiving 2.5% of our management fee for the third quarter under [our Client Alignment Program™ (CAP)](). We should point out that $126 million is more than halfway to the next tier in our CAP initiative at $150 million. Eclipsing that mark would result in a 5% waiver in the following quarter. Based on our current activity we feel optimistic about reaching that milestone over the next couple of quarters, market permitting.

In some ways this quarter's letter is easier to write than last quarters, as markets have staged a rather remarkable recovery. In other ways this letter is more difficult to write because we continue to live in very unusual times.



Q2 Market Recap

The second quarter is not all the difficult to recap, we can do it in two words: markets recovered. That explanation is glib, but accurate.

For those interested in a more detailed explanation, here goes: The Fed and the US Government have gone "all in" to stop the economic damage from the pandemic. Because a recovery can be on the horizon, the market is looking through current economic data and earnings to that recovery. Against that backdrop, interest rates fell, credit spreads tightened, and equity markets rallied.

Quarterly Topic: The Market Recovery & Present Valuations

The market recovery has caught many advisors and investors by surprise. Many felt like there were, and are, too many unknowns and uncertainties for the market to recover. We were not, and are not, in that camp. We will confess that even we are surprised at the speed of the recovery.

A lot of what we said in our last letter bears repeating:

> 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.”

Additionally, the Federal Reserve is expanding its infinite balance sheet with infinite quantitative easing. In our last letter we prepared clients for some mind-boggling economic numbers. In this letter, maybe we should be preparing clients for some uncomfortable valuations.

This has been a market with winners and losers. In our opinion, the valuations placed on some companies viewed as winners are justified and some are not. Likewise, some of the valuations placed on companies that have not participated in the recovery or are viewed as losers are justified and some are not.

The stock market, represented by the S&P 500, is trading at a valuation higher than it has historically but we are in a much different environment than we have been in historically. Some comparisons are being drawn to 1999 & 2000. As we rang in the year 2000, the Fed Funds rate was about 4%, on its way to almost 7%, and the 10-year treasury was about 6.5%. At that time, there were many companies with questionable business models trading at sky-high valuations. Many investors remember former Fed Chairman Alan Greenspan’s famous “Irrational Exuberance” speech to Congress, but very few can recall when that speech occurred. The date of that speech was December 5th, 1996.

Let us use an anonymized example from the current market. There is a large, high profile company trading for roughly 24 times next year’s earnings. It has net cash that is equal to almost 10% of its market cap and it is expected to generate more cash over the coming years. If we invert the PE, it trades for a 4%+ forward earnings yield and consensus estimates are for those earnings to keep growing at a high rate over the next several years. In our opinion, the business has one of the widest and deepest moats that we have ever seen. In a world where the 10-year treasury yields about 0.65%, or earnings multiple north of 150x with no growth, does that valuation seem irrational? In our humble opinion it does not. Can it become irrational? Absolutely. Could it come down if expectations are too high? Sure. At what point does that happen? We think it remains to be seen.

In this low interest rate and low economic growth environment, companies with good business models and strong secular growth should be very valuable. As those companies and sectors become a larger part of the market, it will require investors to update their valuation framework for the market broadly. Furthermore, both accounting and business models have changed a lot over time. Investment in growth industries used to happen on the balance sheet and get expensed over time, while today a lot of it is expensed through the income statement immediately. This makes earnings comparisons to prior periods more difficult and less helpful. This accounting comparability issue, when combined with an interest rate environment that has no historical precedent, makes historical valuation comparisons far less useful than one might think. Anchoring too heavily on the past could cause investors to draw incorrect conclusions about current valuations and the future.

That said, we believe there are pockets of pure speculation. Another current example may be instructive. As we write this, there is a company that recently came public in an exciting emerging industry. This company, which is still **pre-revenue**, has a market capitalization that exceeds $20 billion. A large and very reputable investment bank recently published a research report that featured a price target supportive of the valuation by putting a high multiple on a forecasted **2027** earnings metric. Our opinion is that this an early stage venture investment and the valuation metric being applied by public market participants is "Price to Hopes & Dreams". As hopes and dreams transition to reality we think speculators could learn some harsh lessons.

We will close this thought by saying we believe that caution is always warranted, the future is always uncertain, and today is always a difficult time to invest.

What We Think Now

There is a lot of talk about a second wave of the virus. It ranges from whether the spike in cases observed in certain locations is a second wave or simply a continuation of the first to what the fall and winter will bring. To express a view on it would be nothing more than an opinion. Having coherent opinions on the market is hard enough, so we try not to venture outside our circle of competence by practicing armchair epidemiology. From an investment perspective, we would expect further disruptions in the economy caused by COVID-19 to be addressed with more fiscal action from the US government.

There are many different contexts to view the current economic environment and the markets. There is an alphabet soup of letters and a grab bag of symbols (check marks, Nike swooshes, etc.) used to describe how things may play out. We maintain that while the economy may have one shape, many companies and industries will have their own distinct recovery shape.

At this point we should mention that there is an election in November. Some may be wondering what the outcome may mean for markets. We are not going to make a prediction, but we will say if there is a change in leadership that may re-shape winners and losers in the market.

Our Portfolios

"The big money is not in the buying and selling, but in the waiting." ~ Charlie Munger

We made a lot of changes to portfolios in the first quarter and we detailed many of them in our last letter. This quarter, by comparison, had much less activity. It is our expectation that this trend downward in activity continues into the third quarter.

Last quarter, we said we felt that we positioned our portfolios to participate well in a recovery. This quarter, we can say that we are pleased with how our portfolios participated. Generally speaking, the outcomes make sense to us, given what transpired.

Conclusion

The first half of 2020 has been challenging in every respect. The good news is that it is half over, but the bad news is that it is only half over. Having good clients makes it easier for us to persevere through it all. So, thank you for collectively being a pleasure to serve.

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