Chartwell Strategies Current Outlook and Investment Strategy

Summary

■ A broad and vigorous rally boosted stock prices in the second quarter as the Nation learned to deal with the pandemic.

■ Chartwell's managed accounts did well as our equity holdings outperformed the Russell 2000 Value, our reference index.

■ The economy is now rebounding after experiencing a record 32.9 percent drop in GDP during the second quarter. Auto sales are trending towards historical norms and housing starts are robust.

■ Further economic progress is dependent upon controlling the pandemic.

■ Additional market volatility may be created as the presidential campaigns get into full gear and investors become more familiar with each candidate's economic and tax policies. Investors are likely to favor the growth and tax policies of the present administration.

"Everyone wants to live at the expense of the state. They forget that the state wants to live at the expense of everyone."
-Frederic Bastiat

Background

Reacting to the shutdown caused by the COVID-19 pandemic, the stock market reached a climactic bottom on March 23rd, just days before the end of the first calendar quarter. Despite the health and economic uncertainties presented from COVID-19, a broad market rally ensued in April and lasted into the first week of June. For the second quarter, the Dow Jones Industrial Average (DJIA), Standard & Poor's 500, Russell 2000 Value and NASDAQ rose 18.51 percent, 20.54 percent, 18.91 percent and 30.95 percent, respectively. The massive rally surprised most investors, many of which sold shares in the last days of the market collapse. In fact, according to Lipper Fund Research, on May 13th, $4.67 trillion was "parked" in money market funds, which is indicative of the understandable caution that exists amongst investors, but also a statement of future buying power.

The Commerce Department, in its preliminary report, estimates that the economy contracted 32.9 percent in the second quarter. However, the stock market is more concerned about the future and most economic statistics have been encouraging. For example, the Institute for Supply Management Manufacturing Index, which reached a nadir of 41.5 in April, climbed back to 52.6 in June (numbers over 50.0 indicate growth). Similarly, the Non-Manufacturing (services) Index bounced back from a low of 41.8 in April to 57.1 in June.

In recent months, the primary strategy of the Federal Reserve Board (FRB) has been to keep interest rates low in order to spur economic growth. As shown in Figure 1, the yield on the 10-year U.S. Treasury bond is under 0.60 percent; consequently, consumers have shown a willingness to borrow money for a new automobile, or home. Prior to the impact of the virus, automobile sales were at 16.83 million units on an annualized basis. At the end of April, annualized sales dropped to 8.58 units, but rebounded to 13.05 units at the end of June. Although auto sales are still well below pre-COVID levels, the industry is regaining its health.

THE YIELD ON THE 10 YEAR TREASURY BOND CONTINUES TO TRADE NEAR HISTORICAL LOWS

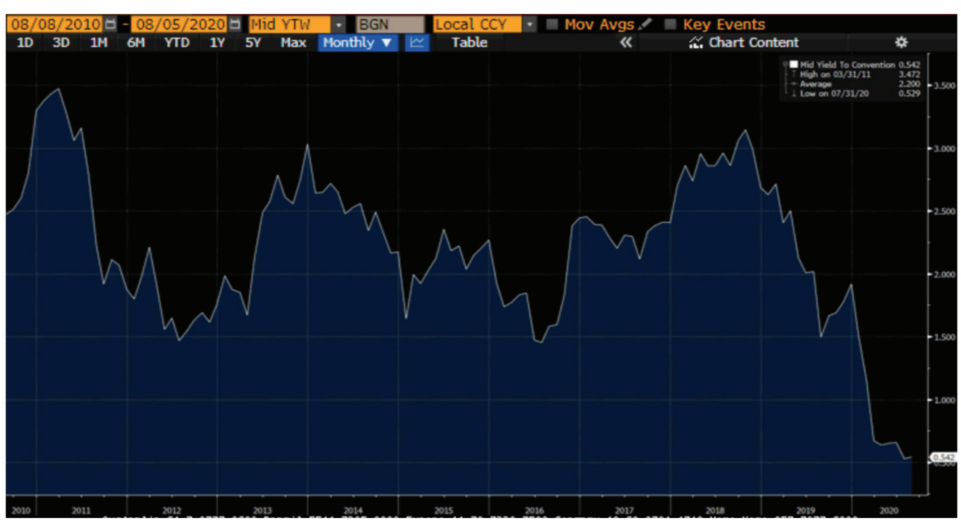

Figure 1: Twenty year graph of the yield on the ten year Treasury Bond
Source: Bloomberg

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Similarly, as shown in Figure 2, housing starts plummeted in March and April, but, like autos, are also snapping back. This recovery may be at a nascent stage; it is possible that housing will become a major pillar of economic growth for the foreseeable future. Housing starts peaked at the beginning of 2006 and then went into a severe decline, which culminated in April of 2009. Although single and multi-family housing unit construction has improved steadily for the past 11 years, it is believed to have consistently remained below the rate of new household formations. Housing starts were beginning to gain momentum prior to the shutdown and with interest rates even lower now, a resumption of that momentum in construction seems logical.

TWENTY YEAR GRAPH OF PRIVATELY OWNED HOUSING UNIT STARTS (SINGLE & MULTI-FAMILY) 06.30.2000 - 06.30.2020

Figure 2: Housing starts are rebounding but remain below former highs reached in the 2004-2006 period.
Source: Bloomberg

In part, the market rally in April and May was based upon the belief that the virus would become less contagious as summer approached and that the economy had the potential to experience a rapid, or V-shaped, recovery. Although this thesis has come to fruition in many states, as supported by the data in previous paragraphs, at least 25 states have now experienced a resurgence in COVID-19 cases as of this writing in early August. The cumulative effect of these spikes, which have been especially severe in Arizona, California, Florida, Georgia and Texas, is shown for the entire United States in Figure 3. After the initial outbreak, and then decline in new cases, it is evident that the number of new cases escalated as the economy opened up in June and although the curve seems to have peaked in recent days, there is no guarantee that the crisis will be eradicated

DAILY CONFIRMED NEW CASES OF COVID19 IN THE U.S.

(5 DAY MOVING AVERAGE AS OF EARLY AUGUST)

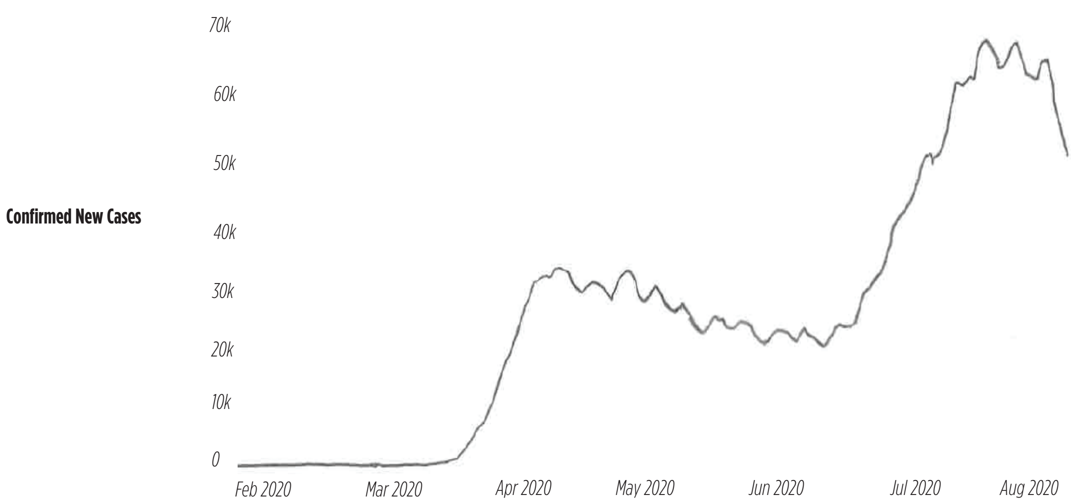

Figure 3: After a serious "spike" that began in June, new cases are now diminishing.
Source: https://coronavirus.jhu.edu/data/new-cases

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No doubt, this rise in new cases has caused fewer business re-openings and it has even led to re-shutdowns in some instances. This is beginning to have a slowing effect on the economy's growth as evidenced by a recent rise in unemployment claims. For the week ending July 18th, initial unemployment claims rose 109,000 from the prior week to 1.4 million. So, it is probably not an exaggeration to say that the economy is at a critical point where its direction and the direction of the stock market, are dependent upon the incidence of new coronavirus cases.

Thus far, the economy has been able to stabilize and now grow, by the practice of "social distancing" and the wearing of masks. For many, particularly the elderly, "sheltering in place" and using delivery services for the essentials of life has become commonplace. However, many industries such as airlines, cruise lines, entertainment, hotels, oil production and refining and many small businesses will never be able to return to full prosperity until the development of efficacious therapies, or the development of a vaccine. Fortunately, the mortality rate amongst COVID-19 victims has been falling due to the experience gained by the medical community in recent months and research is ongoing to further reduce deaths from this disease.

With respect to vaccines, the news is promising. There are now over one-hundred vaccines being developed by governments and private industry on a worldwide basis. According to Victoria Turk, features editor at WIRED UK magazine, four of these vaccines are in advanced trials and it is thought likely that a vaccine will be available within a six-month period. Beyond 2020, it is likely that many vaccines will become approved and one will emerge as the standard for use against COVID-19. The availability of a vaccine would be an obvious game changer for the stock market as anxiety amongst the public would decrease and industries most vulnerable to the pandemic could move towards historically normal operations.

Current Strategy

In the second quarter, our value-oriented portfolios participated in the broad market resurgence. Our Chartwell Growth composite performance and Balanced composite account returns gained 24.22 percent and 17.57 percent, respectively. Our all-equity dividend accounts rose 13.96 percent. Our equity performance, which is reflected by the Chartwell Growth performance, outperformed its reference index, the Russell 2000 Value**, by 5.31 percentage points, and our Balanced account returns exceeded their blended benchmark by 4.71 percentage points.

The three best performing stocks in the Growth and Balanced accounts were: Winnebago (WGO)(2.0%)*, up 141 percent; Arbor Realty (ABR)(1.2%), up 95 percent and Horizon Therapeutics (HZNP)(3.0%), up 88 percent. WGO a manufacturer of recreational vehicles, benefited from the desire for vacationers to seek outdoor destinations and avoid hotel stays. ABR, a real estate investment trust, offers mortgages to builders of multi-family housing and had become very oversold in the first quarter. When investors realized that ABR's mortgages were backed by solid, income producing properties, the stock rallied. HZNP, a biopharmaceutical company that produces medicines for pain and inflammation, reported a 33 percent increase in first quarter earnings.

The three worst performers in the Growth and Balanced accounts were: Fresh Del Monte (FDP)(1.2%), down 11 percent; Landec (LNDC)(0.8%), down 8 percent and Heidrick and Struggles (HSII)(1.6%), down 3 percent. First quarter earnings were disappointing for these companies; however, we continue to have confidence in their longer-term value.

In our dividend equity accounts, the three best performing stocks were: ABR (see above); Pulte Group (PHM)(1.3%), up 53 percent and Owens Corning (OC)(1.7%), up 44 percent. Both PHM and OC are benefiting from lower interest rates and increase in the construction of residential and multi-family housing.

The three worst performers in the dividend equity accounts were: Philip Morris (PM)(0.1%), down 2 percent; Excelon (EXC)(1.7%), unchanged and Merck (MRK)(0.2%), up 1 percent. These stocks are dependable dividend payers and are reasonably valued; consequently, we believe that the downside risk is limited. They lagged in the quarter because their defensiveness was not rewarded in the rally (after being solid performers in the Q1 sell off).

Looking ahead, the next three-months of stock market activity may be increasingly affected by news from the presidential campaigns. Although voters base their decisions by evaluating the positions of the candidates on many economic and societal issues, we will confine our remarks to considerations that are likely to affect our investing activities. This presidential election presents two candidates with an extreme difference in their views on National economic and tax policy, and we are concerned that these differences are likely to cause higher market volatility than normal.

Former vice-president Biden's policies have been clearly stated in the past several weeks. With respect to the economy, raising taxes is a priority; Biden proposes increases in the corporate tax rate, capital gains tax, payroll tax and the "death" tax; while other aspects of his tax policies are of importance, in the interest of brevity, we would refer readers to the editorial column in the August 1-2, edition of the Wall St. Journal, "Read Joe Biden's Lips: New Taxes" for a more comprehensive presentation. One major proposal, an increase in the corporate tax rate back to 28 percent, from 21 percent, would have a negative effect upon stock prices, reduce dividend outlays and creates the risk of international companies moving their headquarters overseas. A second proposal, raising the capital gains tax from the present top rate of 23.8 percent to as high as 39.6 percent would also make stock investments less attractive. Biden's platform also intends to raise the top marginal rate on incomes from 37 to 39.6 percent for high income wage earners and to un-cap the current social security payroll tax from the present level of $137,700. With respect to estates, Biden's plan would be to remove the stepped-up basis on inherited assets, thus increasing capital gains taxes without an adjustment for inflation.

*The numbers in parentheses following each company mentioned reflect the percentage of the portfolio's net assets comprised of such securities as of 06/30/2020. Holdings are subject to change. A full listing of portfolio holdings is available upon request.

** Effective March 31, 2020, the Growth Composite's primary benchmark was changed from the Russell 2000 Index to the Russell 2000 Value Index, which more closely aligns with the strategy's investments.

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On the other hand, the Trump administration continues to emphasize growing the economy and increasing revenue from an expanding Gross Domestic Product. Presumably, tax rates would remain the same. If the polls continue to indicate that he is unlikely to be re-elected, we would expect the stock market to retreat as the election date approaches.

In the absence of major changes in tax policy, or government regulations, the economy should continue the growth that we had been experiencing prior to the pandemic. Interest rates remain extremely low and the FRB has taken a very accommodative stance. The trade agreements made with Canada, China and Mexico should also be helpful in fostering growth. Although it may be premature to mention the dreaded "I" word, inflation, economists will be watchful for rises in the Consumer Price Index as the expansion, funded in part with government outlays, gains momentum.

Chartwell News

After a period where the company had been operating virtually, employees have now returned to the office on a staggered basis that is designed to promote social distancing. Fortunately, none of our employees have caught COVID-19. We wish the same to you and your families.

Earlier this year, a law went into effect allowing for suspension of RMDs for 2020, but some people had already taken some or all of their distribution before this occurred in March. Since then, the IRS announced that any distributions taken already in 2020 can be put back into tax-deferred accounts. However, this return of funds must take place by August 31. When returning an RMD, one can deposit the money in the account it came from or in another tax-deferred account. Please contact us if you would like any assistance in doing this.

You are a valued partner of Chartwell Investments and we greatly appreciate our relationship. We hope that your families remain safe and healthy during this time, and our thoughts are with those impacted by the virus. Thank you for investing your trust and confidence in Chartwell Investment Partners. And as always, please let us know if you have any questions on your account or would like a detailed portfolio review. Mike Magee (484-324-6835), Bob Killen (610-420-8650), or Pete Schofield (610-407-4858). Stay safe.

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Chartwell Investment Partners LLC, is an investment management firm dedicated solely to the investment advisory business. Chartwell's philosophy is to rely on proprietary, bottom-up research to find high quality investments across its various product offerings.

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The Chartwell Growth Strategy Composite includes all fully discretionary, fee-paying equity accounts with a growth objective whose asset size is $300,000 or greater at the beginning of the measurement period.

The Chartwell Balanced Strategy Composite includes all fully discretionary, fee-paying accounts with a balance between growth and income as a principal objective whose asset size is $300,000 or greater at the beginning of the measurement period.The composites do not include accounts where total cash flows exceed 10% of the account's value during any quarterly period or accounts holding securities purchased by anyone other than the Advisor. No accounts using leverage or short positions are included in the composites. An individual client's account may have performed better or worse than the composites' returns presented above. The composites contain taxable and non-taxable accounts. The returns are before taxes and net of all advisory fees and commission charges. The net performance results for each composite are presented after deducting the actual fee charged to each account in the composite based on the management fee schedule in the Firm's Brochure or the fee negotiated between the account holder and Chartwell. Returns include the reinvestment of dividends and interest (total return). Returns for other Chartwell composites are available upon request.

As of 06/30/2020, Chartwell managed $9.3 billion in assets, $8.7 billion as advisor and $0.6 billion as sub-advisor. During the most recent quarter, the Chartwell Growth Strategy Composite consisted of 9 accounts which represented 10.6% of total Chartwell Strategy Individually Managed Accounts and 0.1% of total Chartwell assets. During the most recent quarter, the Chartwell Balanced Strategy Composite consisted of 25 accounts which represented 41.3% of total Chartwell Strategy Individually Managed Accounts and 0.5% of total Chartwell assets.