Chartwell Strategies Current Outlook and Investment Strategy

"If we are to guard against ignorance and remain free, it is the responsibility of every American to be informed."
-Thomas Jefferson

Summary

- The equity markets rallied in the third quarter as the economy continued to experience a sharp recovery from the pandemic-induced shutdown that began in March.
- In the third quarter, our Chartwell Growth and Chartwell Balanced Composites outperformed their reference benchmarks. Our Dividend Equity accounts also outperformed their reference benchmark by a decisive 100 basis points.
- A change in market leadership began to take place in early July. At the beginning of the fourth quarter, small-cap and cyclical stocks outperformed the senior indices.
- On November 18, the development Pfizer Inc. and BioNTech announced the development of a vaccine with 90% effectiveness that is expected to become available within a few weeks.
- Neither a "blue" or "red" wave occurred in the fall presidential election. The financial markets seemed pleased with this result.

Background

Against the background of a substantial economic rebound, an intransigent pandemic and contentious political climate, the equity markets continued to score major gains during Q3. Equity gains were led by the indefatigable NASDAQ Index, which rallied 11.23% during the three-month period. Certain stocks in the NASDAQ, such as Amazon, Netflix and ZOOM have benefited from the pandemic as people spent more time in their homes. The Dow Jones Industrial Average (DJIA) and Standard and Poor's 500 Index (S&P 500) also did well, gaining 8.22% and 8.93%, respectively. All performance figures stated in this report are on total return basis.

The economic uncertainty caused by the pandemic, inability of the Government to pass another stimulus bill, and concern over the impending presidential election, caused investors to be wary of stocks with smaller capitalizations. Indeed, the Russell 2000 (RTY) and Russell 2000 Value (RUJ) Indices rose 4.93% and 2.56%, respectively, in the third quarter, just a fraction of the gains registered by the senior indices. In fact, the disparity in performance between the NASDAQ and the small-cap indices over the past several years has never been wider. However, it is important to realize that the NASDAQ is distorted by a handful of stocks whose performance dominates the results of the index.

On July 9th of this year, the NASDAQ reached a peak in momentum versus the broader market. On this date, five stocks, Apple Computer, Microsoft, Amazon, Alphabet and FaceBook represented 40.6% of the NASDAQ, which contains 2,838 stocks! Therefore, unless investors have been willing to disproportionately weight their portfolios to these volatile "glamour" stocks, their results will almost inevitably trail this index. History has repeatedly shown that the images of these favorites will tarnish and at some point; declines in the NASDAQ are apt to be accelerated and severe.

In October and through the post-election period, the equity markets have remained surprisingly strong, with small-cap stocks leading the advance. On November 9th, the investor optimism displayed in October was validated when Pfizer, Inc. and its partner BioNTech announced that they had co-developed a vaccine, which proved to be ninety percent effective in a clinical trial with 44,000 participants. This result eclipsed the expectations of most members of the medical community and based upon this news, the DJIA rose 834 points that day.

As we approach the mid-point of the fourth quarter, the RTY and RUJ have risen 15.81% and 18.62%, respectively, while the DJIA, S&P 500 and NASDAQ have climbed 6.97%, 6.81% and 5.92%, respectively. So, the market has been ignoring the near-term economic impact of rising COVID-19 cases and has interpreted the election results positively. It is most probable, in our opinion, that the market is focused on the intermediate term where it is signaling a return to a growing, and COVID-19 free, economy.

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As mentioned in the second paragraph, the performance of the NASDAQ Index versus that of the RUJ peaked in early July. As fears of the pandemic's effect upon the economy have receded and as confidence in a return to a robust recovery has increased, small-cap and cyclical stocks have begun to be stock market leaders. Examination of Table 1 illustrates how the RTY and the RUJ have gone from being laggard performers in the third quarter, to leading performers in the fourth quarter. As we go to press, the small-cap Russell 2000 Index made a new high (11/13), the first one in 555 trading days.

RELATIVE PERFORMANCE OF THE MAJOR INDICES

INDEX	PERCENTAGE INCREASES	
	06/30/20 TO 09/30/20	10/01/20 TO 11/13/20
DJIA	8.22	6.97
S&P 500	8.93	6.81
NASDAQ	11.23	5.92
RUSSELL 2000	4.93	15.81
RUSSELL 2000 VALUE	2.56	18.62

Table 1. In the fourth quarter, momentum has shifted away from the senior indices and to the broad market
Source: Bloomberg

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In the third quarter, our value-oriented portfolios provided gains in excess of their benchmarks. The Chartwell Growth composite gained 2.8% versus the RUJ's 2.56%. The Chartwell Balanced composite rose 2.9% as compared to 1.9% for its blended benchmark. Finally, our Dividend Equity accounts gained 6.6%, beating its reference index, the Russell 1000 Value, which rose 5.6% in the three-month period.

The three best performing stocks in the Growth and Balanced accounts were: Bloomin' Brands* (BLMN)(1.4%), up 43%, Horizon Therapeutics (HZNP)(4.3%), up 40% and Dycom (DY)(2.0%), up 36%. Supported by a strong take-out business, BLMN's second quarter results exceeded expectations; same-store sales were stable across all four brands (Outback Steakhouse, Bonefish, Carrabba's and Fleming's Steakhouse), even as COVID-19 cases rose in important casual-dining states like Florida and Texas. HZPN, a biopharmaceutical company that focuses on the treatment of rare autoimmune diseases, advanced when several Wall Street firms raised earnings estimates and stock price targets. Specifically, HZPN's revenue momentum is being propelled by Krystexxa and Tepeeza, treatments for severe gout and thyroid eye disease, respectively. DY, a provider of fiber infrastructure to large telecom companies, experienced solid profit-margin improvement in its most recent quarterly results.

The three worst performers in the Growth and Balanced accounts were: Hill-Rom Holdings (HRC)(2.7%), down 24%, Winnebago Industries (WGO)(2.6%), down 22% and Hess (HES)(2.0%), down 21%. HRC, a provider of hospital beds and healthcare technology products, had a "pull-forward" of demand from COVID-19 and is now experiencing a slowdown in demand. Similarly, WGO, one of last quarter's best performers, had explosive revenue growth in its August reporting period, but investors are now questioning the sustainability of that momentum. Like most energy stocks, HES's revenues and earnings have declined due to the stay-at-home orders, which have reduced gasoline consumption and consequently, oil production.

In our Dividend Equity accounts, the three best performing stocks were: United Parcel Service (UPS)(4.3%), up 51%, PulteGroup (PHM)(3.7%), up 36% and Ally Financial (ALLY)(2.6%), up 28%. UPS has a new CEO in place, Carol Tome, and has been benefiting from increased on-line purchasing due to the pandemic. Appearing as one of our best performers for two consecutive quarters, PHM continues to ride the wave of a red-hot housing market, which is driven by an exodus from high tax urban centers, escape to more rural areas having lower incidences of COVID-19 and a decade-long dearth of demand for starter homes. PHM's prospects are further buoyed by historically low mortgage interest rates. ALLY, a major lender to automobile purchasers, has benefited from the largest increase in consumer loan originations in five years, rising earnings and an improvement in its asset-quality metrics.

*The numbers in parentheses following each company mentioned reflect the percentage of the portfolio's net assets comprised of such securities as of 09/30/2020. Holdings are subject to change. A full listing of portfolio holdings is available upon request..

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The three worst performers in the Dividend Equity accounts were: Western Digital (WDC)(2.4%), down 17%, Lincoln National (LNC)(1.9%), down 14%, and Intel (INTC), down 13%. Driven by broad-based demand weakness for their high capacity disc drives and lower flash drive pricing, WDC has been trading in a narrow range as it attempts to stabilize from the effects of the pandemic. We believe that WDC's businesses will return to growth in calendar 2021. LNC's life insurance division and investment operations were adversely affected by the pandemic. Higher claims due to the pandemic, reverses in the investment portfolio and lower interest rates, combined to reduce earnings in the second quarter. Recent trading activity has been encouraging and the stock is rebounding at the present time. INTC's earnings have been muted by the pandemic and the stock price has declined to a bargain basement level. Of concern to investors, is the production delay in the development of their 7-nanometer semiconductor chip. Now trading with a dividend yield of nearly 3%, INTC offers us an attractive total return over the intermediate and long-term.

The outcome of the presidential election did not deliver a complete victory to either Democrats, or Republican voters. Although President-elect Biden won the popular vote, his victory is being challenged by President Trump who has alleged election irregularities in certain "swing" states. The Democrats retained control of the House of Representatives, although their majority has narrowed. In the Senate, the Republicans narrowly retained control, however, a run-off election in January will determine the final status of the Senate. So far, the equity markets have applauded the election results presumably because our government remains divided and major changes to the health care system, tax code and Supreme Court will be difficult to make. In addition, with the election over, a bipartisan bill to stimulate those areas of the economy that have been especially vulnerable to the pandemic would seem to be a high priority.

Finally, as mentioned in our last report, we have been concerned about the possibility of higher taxes under a Biden presidency. Strategas Research Partners, in their October 30th publication, echoed our discomfort with the following:

"Even relatively modest increases in capital gains taxes are often associated with market declines in the short-term and lower PE's over the long term. This says nothing of a plan to increase the top rate on gains from the current 23.8% to the proposed 43.4%. Perhaps a surfeit of central bank liquidity like the one we enjoyed in 2013 will allow capital to ignore an increase in the after-tax cost of capital. Still the magnitude of the proposed change at one time is enormous."

Since the Republican Party has retained control of the Senate the possibility of a damaging tax bill has receded, however, the Georgia senatorial run-off election, scheduled for January is critical to the Republicans keeping their edge in this body.

In the absence of a destructive tax on capital, the availability of a vaccine imminent and another stimulus program likely, the markets should continue their upward course in the next few months.

Chartwell News

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. As always, please let us know if you have any questions on your account or would like a detailed portfolio review. Mike Magee (610-407-4867), Bob Killen (610-420-8650), or Pete Schofield (610-407-4858). Stay safe.

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