ENTASIS ASSET MANAGEMENT

QUARTERLY NEWSLETTER

3Q2020

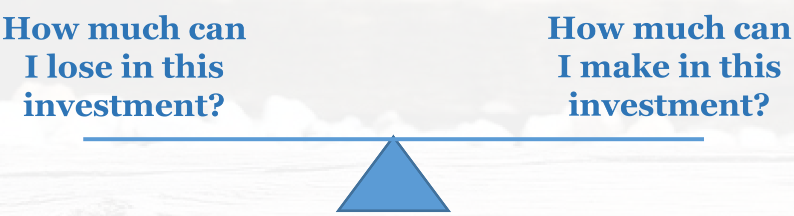
CEO Comments

While preparing for this newsletter I came across an article that said in paraphrased terms, the longer I am in this industry the more I move from “how much can I make in this investment?” to “how much can I lose in this investment?”

It struck a chord with me immediately for two reasons: it reflects my pattern of thought having been in the industry now for 24 years and it has specific application to the current environment.

Some might argue that makes me a value investor, although I would beg to differ. I am always sensitive to the price paid for any investment, because buying something cheap with no reference to growth prospects can be just as problematic as buying growth with no reference to the price being paid.

As my career has evolved it is not as if I stopped asking the question, “how much can I make in this investment?” It has just evolved to also asking “how much can I lose in this investment?” Some might call this demanding a margin of safety in the investment. (A few misguided investments in your 20’s will quickly do that.)



It is essentially a balancing act because both perspectives, in the absence of each other, creates too much weight on one side of the scale and leads to permanently impaired capital. My experience has taught me that permanently impaired capital is perhaps the single largest impediment to long-term wealth compounding.

What is permanently impaired capital?

When investing in stocks, it is a stock price that goes down forever due to business fundamentals with no hope of recovery, or actual bankruptcy (Remember Blockbuster video?) or a stock price that declines and stays down for an extremely long period of time (Remember our discussion of Microsoft if purchased in 2000?).

In the former scenario, you would need an investment of equal value to Blockbuster to double and then it would only offset the losses with no gain. In the latter scenario, depending on the decline, you would need the investment itself to double, triple or more from the trough depending on the extent of the loss. Both can take considerable time and result in a huge opportunity cost, or unnecessary risk taking to chase the loss.

Bob Batchelor, CFA®, CFP®
Chief Executive Officer

Summary

“How much can I make in this investment?” and “How much can I lose in this investment?” These two questions should carry equal value.

Both perspectives, in the absence of each other, creates too much weight on one side of the scale and leads to permanently impaired capital.

Permanently impaired capital is a stock price that goes down forever due to business fundamentals with no hope of recovery, or actual bankruptcy, or a stock price that declines and stays down for an extremely long period of time.

The current environment reflects little balance in perspective. Unfortunately, the outcome of this lack of balance and discipline is likely going to be a lot of permanently impaired capital. We, however, always weigh both questions equally in our analysis.

CEO Comments

As I reviewed sector returns year-to-date while writing this, it is clear many technology and consumer companies are being purchased with not enough investors asking, "how much can I lose in this investment?" The draw of "how much can I make in this investment?" is too strong right now. I am sure it is possible for some technology companies to grow exponentially in the near-term. Zoom, for example, has seemingly become the Kleenex or Google of its industry as its brand name has become ubiquitous with video calls. But not every consumer and technology company is, or will, enjoy the same pattern. Conversely, when you look at the performance of energy, financial and industrial stocks, no one seems to be asking, "how much can I make in this investment?" as most investors appear to be convinced that those sectors have zero growth potential in the foreseeable future. It is almost as if each of those sectors is doomed to the fate of Blockbuster – particularly the energy sector. I think it is unlikely that Chevron and Exxon will go the route of Blockbuster (especially in the near-term). Some energy companies might, but it will take time, not just COVID-19, to make a sector obsolete.

In short, it seems obvious that the current environment reflects little balance in perspective. Unfortunately, the outcome of this lack of balance and discipline is likely going to be a lot of permanently impaired capital in investor portfolios. As a result, we continue to ask questions to provide a balanced perspective and determine the best course of action for clients.

C.J. and Mike will expound on the landscape in their broad areas of expertise and how it is impacting our outlook. As in the past, each section has a summary if you would prefer the cliffs notes. Just click on the boxes below to get to each summary page.

Bob

Market Performance

Equity Portfolio Comments

Fixed Income Portfolio Comments

Click on any button to skip to a new section.

Market Performance

Annualized % Returns (As of 09/30/2020)

Source: Morningstar Direct

Index Name	Index Category	1 year	3 year	5 year	10 year
S&P 500 Index	Large Cap Stocks	15.15	12.28	14.15	13.74
Russell 1000 Index	Mid/Large Cap Stocks	16.01	12.38	14.09	13.76
Russell 1000 Growth Index	Growth Stocks	37.53	21.67	20.10	17.25
Russell 1000 Value Index	Value Stocks	-5.03	2.63	7.66	9.95
Russell 2000 Index	Small Cap Stocks	0.39	1.77	8.00	9.85
MSCI EAFE Index	Non-U.S. Developed Market Stocks	0.49	0.62	5.26	4.62
MSCI Emerging Markets Index	Emerging Markets Stocks	10.54	2.42	8.97	2.50
MSCI ACWI Ex USA Small Cap Index	Non-U.S. Small Cap Stocks	6.97	0.93	6.80	5.31
BofAML Preferred Stock Fixed Rate Index	Preferred Stocks	4.34	4.97	6.16	6.29
Barclays Municipal Bond Index	U.S. Municipal Bonds	4.09	4.28	3.84	3.99
Barclays Aggregate Bond Index	U.S. Bonds	6.98	5.24	4.18	3.64
Barclays Intermediate U.S. Gov/Credit Index	Government/Corporate Bonds	6.32	4.43	3.39	2.91
BofAML U.S. Treasury Master Index	Treasury Bonds	8.25	5.65	3.87	3.25
BofAML U.S. Mortgage Backed Securities Index	Mortgage Backed Bonds	4.42	3.78	3.04	3.03
BofAML U.S. Corporate Master Index	Corporate Bonds	7.84	6.38	5.96	5.14
BofAML U.S. High Yield Master II Index	High Yield Bonds	2.22	3.81	6.60	6.27
BofAML Convertible Bonds Index	Convertible Bonds	38.61	17.35	15.92	12.77
BofAML Euro Broad Market Index	European Bonds	8.07	2.93	3.74	2.28
BofAML Local Debt Market Plus Index	Emerging Markets Bonds	0.72	2.27	5.49	1.58

Calendar Year % Returns (QTD, YTD as of 09/30/2020)

	QTD	YTD	2019	2018	2017	2016	2015
S&P 500 Index	8.93	5.57	31.49	-4.38	21.83	11.96	1.38
Russell 1000 Index	9.47	6.40	31.43	-4.78	21.69	12.05	0.92
Russell 1000 Growth Index	13.22	24.33	36.39	-1.51	30.21	7.08	5.67
Russell 1000 Value Index	5.59	-11.58	26.54	-8.27	13.66	17.34	-3.83
Russell 2000 Index	4.93	-8.69	25.52	-11.01	14.65	21.31	-4.41
MSCI EAFE Index	4.80	-7.09	22.01	-13.79	25.03	1.00	-0.81
MSCI Emerging Markets Index	9.56	-1.16	18.42	-14.57	37.28	11.19	-14.92
MSCI ACWI Ex USA Small Cap Index	10.50	-3.64	22.42	-18.20	31.65	3.91	2.60
BofAML Preferred Stock Fixed Rate Index	4.90	2.29	17.71	-4.34	10.58	2.32	7.58
Barclays Municipal Bond Index	1.23	3.33	7.54	1.28	5.45	0.25	3.30
Barclays Aggregate Bond Index	0.62	6.79	8.72	0.01	3.54	2.65	0.55
Barclays Intermediate U.S. Gov/Credit Index	0.61	5.92	6.80	0.88	2.14	2.08	1.07
BofAML U.S. Treasury Master Index	0.18	9.22	6.99	0.80	2.43	1.14	0.83
BofAML U.S. Mortgage Backed Securities Index	0.11	3.74	6.51	1.00	2.45	1.67	1.46
BofAML U.S. Corporate Master Index	1.69	6.61	14.23	-2.25	6.48	5.96	-0.63
BofAML U.S. High Yield Master II Index	4.70	-0.38	14.41	-2.27	7.48	17.49	-4.61
BofAML Convertible Bonds Index	15.05	27.94	23.06	0.68	16.03	11.94	-1.15
BofAML Euro Broad Market Index	6.00	7.30	4.11	-4.39	14.61	0.37	-9.30
BofAML Local Debt Market Plus Index	0.64	-4.25	16.44	-4.90	14.71	6.53	-12.02

How should you use the information provided in the table?

- The returns are not projections. They are historical. Future returns will vary.
- Annualized returns can generally be used to understand historical return trends.
- Calendar returns provide a general understanding of year-by-year return volatility.

Equity Portfolio Comments

Corporate Earnings and Market Valuations

Based on our own unscientific survey of financial news and articles, most of the investing public's attention was focused on a handful of topics in the third quarter:

1. Upcoming U.S. elections
2. Stimulus hopes
3. Coronavirus cases
4. Ballooning government debt
5. Fear of missing out (FOMO) on the increasingly "bubbly" and speculative areas of the equity market. (How much can I make? To steal Bob's reference.)

What did not garner much attention, and was seemingly way down the list, were corporate financial metrics such as earnings, profit margins, and revenue growth, to name a few. Considering the high degree of short-term groupthink that has enveloped the equity market, it is not surprising that many investors ditched underlying company fundamentals in favor of headlines. During these times, investors tend to lose sight of the forest (long-term) for the trees (short-term) as "speculation" gets confused with "investing." Speculation may work for a time, and therefore, may boost investor confidence as behavioral biases (recency bias and overconfidence bias, among others) drive market returns, but inevitably long-term returns gravitate back to underlying fundamentals. Certainly, not all investors have abandoned focus on company fundamentals. However, we bring this to the forefront of the discussion this quarter because there continues to be a clear disconnect between stock prices and earnings (in aggregate). See the chart below, which compares fourth quarter earnings expectations relative to broad stock market performance (as represented by the S&P 500® Index).

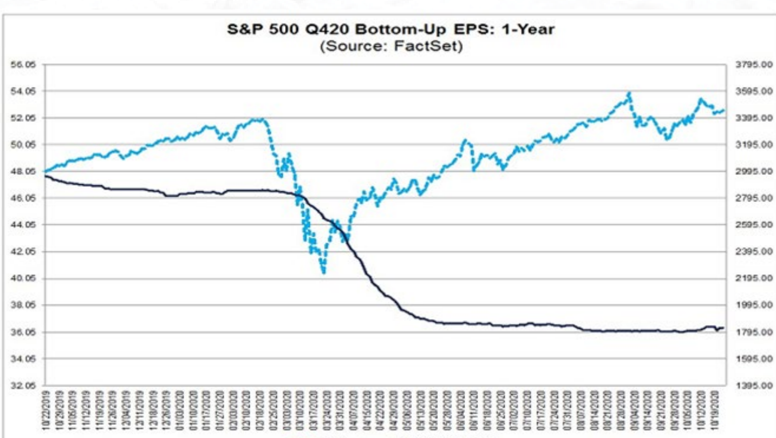


Chart courtesy of FactSet Earnings Insight (October 23, 2020)

Charles (CJ) Batchelor, CFA
Chief Investment Officer – Equity

Summary

Considering the high degree of short-term groupthink that has enveloped the equity market, it is not surprising that many investors ditched underlying company fundamentals in favor of headlines.

The forward P/E (price-to-earnings) ratio for the S&P 500® Index (21.7x) remains well ahead of its five-year average (17.3x) and ten-year average (15.5x).

Large divergences among asset classes and sub-asset classes have gapped even wider this year. (Large-cap v. small-cap, growth v. value and U.S. v. emerging markets.)

The current duration of the divergences has been lengthy. Relative performance differences between these sub-asset classes tend to revert over time.

We have made investments in emerging markets. We have yet to make significant adjustments in portfolios to domestic small-cap stocks and domestic value-oriented stocks.

As we have noted in past communications, earnings may deviate from stock prices over the short run, but over longer periods, market performance generally tracks the path of earnings. This relationship can be seen in the chart below, which examines performance of the S&P 500® Index, along with forward 12-month earnings per share expectations for the past decade.

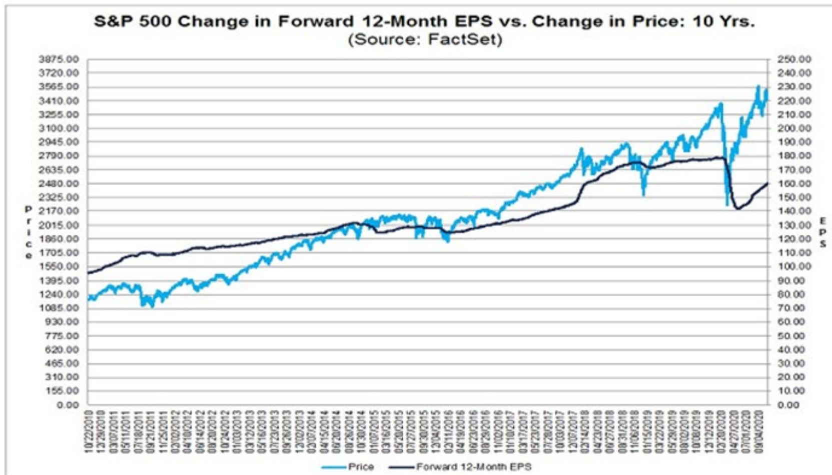


Chart courtesy of FactSet Earnings Insight (October 23, 2020)

What is also apparent in the chart to the right is that earnings estimates and the performance of the stock market have diverged significantly from one another in 2020. However, even though the gap between expected earnings and market performance remains quite large, earnings expectations have begun to rise more recently after being cut sharply earlier this year. The uptick in earnings expectations has been a welcome sight, but the increase also calls into question whether investors are setting themselves up for disappointment if earnings do not meet those heightened expectations.

As of October 23, calendar year earnings estimates for the S&P 500® Index were roughly $134 and $167 for 2020 and 2021, respectively. The increase for calendar year 2021 ($167) would equate to a significant year-over-year jump in earnings (+24%). To achieve this level of earnings in 2021, analysts are projecting a considerable increase in revenue growth (+7.9%), to go along with a sizable improvement in profit margins. If earnings were to rise by this amount in 2021, it would place the S&P 500® Index earnings slightly ahead of the aggregate earnings level achieved in 2018 ($161) and 2019 ($163). In our opinion, this small amount of growth is not necessarily a reason to celebrate. Even with the improvement, it would still stand in stark contrast to the sharp rise in prices (see previous chart) over the same timeframe.

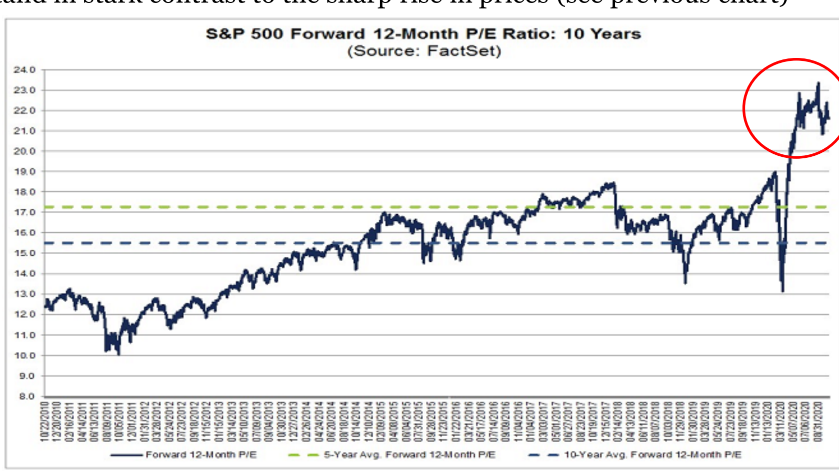


Chart courtesy of FactSet Earnings Insight (October 23, 2020)

On the valuation front, U.S. equities remain overvalued relative to history (in aggregate). The forward P/E (price-to-earnings) ratio for the S&P 500® Index (21.7x) remains well ahead of its five-year average (17.3x – green dotted line) and ten-year average (15.5x – blue dotted line). See the chart to the right.

Absent a price decline, current valuations appear to reflect a belief that earnings will continue to grow at a relatively rapid rate well into the future. What are the odds this occurs? No one can say with any degree of certainty. However, we seem to be less optimistic than the average analyst. This primarily stems from our belief that analysts are currently banking on a number of events to unfold positively, which includes an uncontested election, a quick and effective roll out of a vaccine, a significant stimulus package, continued strength in consumer spending, a sustained move lower in the unemployment rate, an uptick in global growth, and an accommodative Fed to provide a backstop for any unforeseen weakness. This optimistic scenario is certainly within the realm of possibilities; however, we believe that current earnings projections and valuations reflect a nearly perfect outcome on many fronts. In other words, we think the market is priced to near perfection and therefore does not represent an exceedingly positive risk/return proposition.

As we discussed in our last newsletter, the degree of concentration in the largest companies in the S&P 500® Index (the five largest companies are approaching 25% of the entire index) has played a large part in pushing forward P/E valuations higher as companies' stocks that have led the market continue to get priced higher. While there are certainly pockets of relative attractiveness, most areas of the U.S. equity market are expensive compared to their own history. The table below divides the U.S. equity market into "style" and "market-cap" categories and utilizes Russell Index data (with the exception of the "large blend" category, which utilizes S&P 500® Index data) to reflect current (top) and 20-year average (bottom) forward price-to-earnings ratios.

Current P/E vs. 20-year avg. P/E

	Value	Blend	Growth
Large	17.2 / 13.7	21.5 / 15.4	30.5 / 18.6
Mid	18.0 / 14.3	22.2 / 16.2	38.0 / 20.3
Small	20.6 / 16.6	36.8 / 21.1	124.4 / 64.2

Current P/E as % of 20-year avg. P/E

	Value	Blend	Growth
Large	126.3%	139.7%	163.6%
Mid	125.6%	136.9%	187.4%
Small	123.9%	174.6%	193.8%

Notice in the bottom table (Current P/E as % of 20-year avg. P/E) that all values are above 100%, which means that current P/E ratios are above their 20-year average P/E. However, it can also be seen that there are varying degrees of "overvaluation." For instance, the table indicates that all "growth" categories are the most expensive on a price-to-earnings basis relative to their 20-year averages. At the same time, even though "value" categories are relatively expensive when compared to their own histories, they are attractive when compared to "growth" categories. Other factors undoubtedly need to be considered when viewing data in these types of tables, such as timeframe measured, economic/business cycles that are captured in the data, future growth prospects, and so on and so forth. Our opinion is that data is just data without understanding the context and meaning of the data. What this does provide is one additional way to look at valuation data on a more granular basis as opposed to just viewing the "market" as one index, such as the S&P 500® Index.

In summary, there do not appear to be any glaring bargains among U.S. stocks (in aggregate) from a valuation perspective (based on forward P/E ratios). However, that does not mean there are not opportunities for investment. As we have said, stocks do not simply go up or down based on valuation. Valuation helps to provide us with a better picture of the long-term return potential of various asset classes and sub-asset classes. At some point, price matters. We will continue to position client portfolios in areas we believe have the greatest potential to generate relatively solid risk-adjusted returns over the long-term.

Outlook

Markets have waffled to start the fourth quarter, largely because of stalled stimulus negotiations, the upcoming election and mixed news surrounding the pandemic (surge in cases vs. vaccine developments). On the corporate front, third quarter earnings have been mixed and economic data has vacillated between positive and negative. The result has been an extremely short-sighted market that has blindly grasped at headlines and other data that may end up having little bearing on market direction 6-12 months from now. Looking ahead, we believe there are a number of risks that could negatively impact markets in the coming months such as the possibility of a contested election, stimulus packages that are delayed longer than expected, a large-scale COVID-19 resurgence, weaker-than-expected corporate earnings, a rise in unemployment following initial gains, and a further tightening of credit for small businesses and individuals, among many others. At the same time, many of these potential risks could become positives if they surprise in the opposite direction. Unfortunately, we are not epidemiologists and we certainly do not partake in any type of political punditry or projections, so we remain focused on underlying business fundamentals, which have not carried as much weight in the day-to-day movements of markets. This longer-term focus is by design since we do not think we can add significant value by trying to predict short-term market movements. Instead, we remain focused on longer-term trends as it relates to positioning portfolios.

While not discussed nearly as frequently by finance news networks as the shorter-term topics noted above, large divergences among asset classes and sub-asset classes have gapped even wider this year. In this section, we will focus on three of these historically wide divergences and discuss how they have (or may) impact portfolio positioning as we move forward. Long-term charts (10-year returns compared every month-end.) are shown below that display the relative performance of three sub-asset class comparisons:

1) U.S. large-capitalization stocks vs. U.S. small-capitalization stocks.

2) U.S. growth stocks vs. U.S. value stocks.

3) U.S. stocks vs. foreign stocks (In this graphic illustrated by emerging markets equities.)

Chart 1: U.S. Large-Caps (S&P 500® Index) vs. U.S. Small-Cap Stocks (Russell 2000® Index)

Large-cap stocks significantly outperformed small-cap stocks in the late 1990's, prior to significantly underperforming small-cap stocks in the early to mid-2000's. In turn, small caps enjoyed a relatively long period of outperformance for the first decade of the millennium. This relationship changed course once again in the last decade.

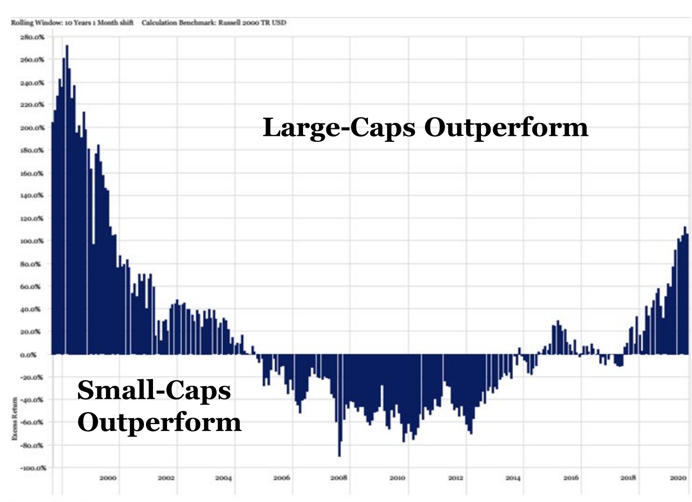
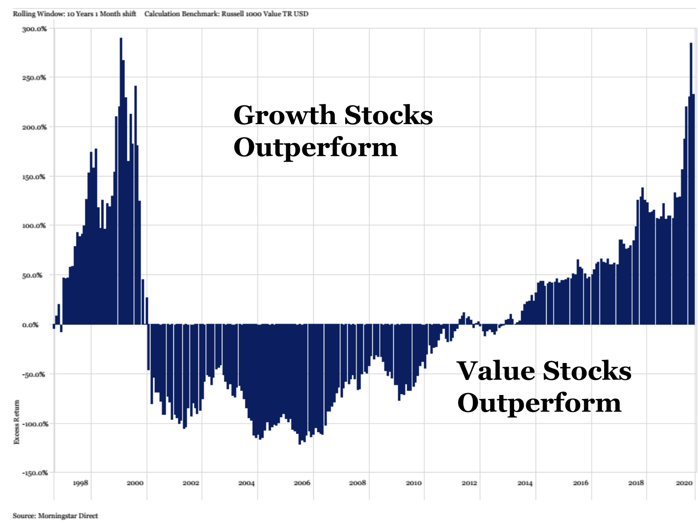
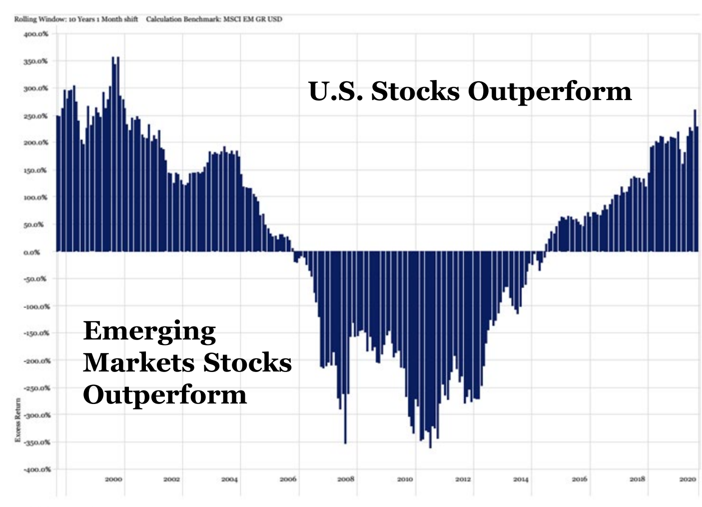


Chart 2: U.S. Growth (Russell 1000® Growth Index) vs. U.S. Value (Russell 1000® Value Index)



Growth stocks have enjoyed two periods of significant outperformance. The first period was during the technology, telecom, dotcom boom of the late 1990's into 2000. More recently, technology and consumer-related technology companies have pushed the relative performance of growth stocks back to their previous relative performance peak of the dotcom era. Value stocks enjoyed an extended period of strength relative to growth stocks for much of the first decade of the millennium as the excesses of the dotcom era reversed course.

Chart 3: U.S. (S&P 500® Index) vs. Emerging Markets (MSCI Emerging Markets Index™)



U.S. stocks enjoyed two periods of significant market strength relative to emerging markets equities – during the late 1990's into the early 2000's and once again during the most recent decade. In both periods, the U.S. dollar strengthened significantly, which provided a tailwind to U.S. results. The first period was also influenced by the Asian Financial Crisis, which called into question the overall fiscal health of emerging markets countries, among many other factors. This reversed course during the 2000's as many emerging markets countries became more fiscally responsible and benefited from a surge in commodity demand. More recently, U.S. stocks performed strongly due to easy monetary policy and strong corporate earnings growth, while emerging markets equities lagged as many countries' economies began the transition from export-driven growth (external demand) to consumer driven growth (internal demand).

Despite the many observations that could be gleaned from the three comparisons above, our main takeaways from the charts are:

1. In recent years, markets have experienced historically large divergences between the sub-asset classes shown.
2. The current duration of the large divergences has been lengthy.
3. Relative performance differences between these sub-asset classes tend to revert over time – nothing lasts indefinitely.

Where does this leave us regarding our current positioning and outlook? So far, we have aggressively positioned the foreign allocation in portfolios to have a significant emphasis in emerging markets equities. Because we believe these markets are relatively inefficient, we have allocated capital to active managers our research has shown have the ability to outperform their benchmarks on a risk-adjusted basis over the intermediate- to long-term. On a year-to-date basis (through 9/30/20), this has been beneficial. One notable change that was made in portfolios during the third quarter was the sale of a foreign small-/mid-cap value-oriented manager and subsequent purchase of an emerging markets value-oriented manager. While this is a part of the market (emerging markets value) that has relatively few active managers, we believe our research led us to an active manager that has the necessary people, process and overall structure to benefit shareholders over the long-term. In addition to our confidence in the manager chosen, we are also confident more broadly that emerging markets are positioned well to generate attractive returns in the future. This is based on positive underlying dynamics, such as decreased dependence on developed foreign countries and regions (i.e. the U.S. and Europe) to drive growth through exports, less reliance on commodities to fuel growth, a rising middle class buoyed by increased per capita income (internal demand), a rising share of trade and trade growth among emerging markets countries (intra- emerging markets trade), a positive outlook for currency appreciation (in aggregate, relative to developed market currencies), a relatively strong economic growth outlook (rising share of overall global growth that is attributable to growth in emerging markets) and a more attractive “starting point” for valuations and future earnings growth. Historically, these markets have experienced higher levels of volatility; however, we believe the potential reward outweighs the potential risks (relatively favorable risk/reward ratio) especially when viewed over a longer investment horizon.

Where we have yet to make significant adjustments in portfolios is among domestic small-cap stocks and domestic value-oriented stocks. We remain “underweight” small-caps (relative to a broad-based market index), and are largely “style” neutral, with a primary focus on high-quality companies (relatively low debt companies with healthy balance sheets that may also be growing their dividends). We believe this more conservative approach among domestic equities helps to somewhat offset the relatively more aggressive positioning in foreign markets.

Even though we have yet to make any significant changes to the domestic side of portfolios, we anticipate that we will eventually make adjustments to capture these historically large disparities at some point in the coming quarters. However, we remain patient in the face of heightened uncertainty in the immediate-term. What would change our minds to act sooner? Typically, we aspire to follow the “mosaic theory” to influence our decisions, which means that we base our decisions on a wide range of factors as opposed to only one or two data points. That being said, a couple of the more notable areas that we believe may influence a rotation to value from growth include: 1) signs that the economic recovery may accelerate (one such factor may be the approval of an effective vaccine that is distributed quickly among the population); and 2) rising inflation expectations, which may cause a reexamination of current valuation multiples (rotation from stocks with higher valuation metrics to stocks with lower valuation metrics).

Our patience to avoid simply chasing divergences in sub-asset classes (no direct investment in domestic small-caps or domestic value stocks) without any supporting data from a macro perspective (underlying business environment) has been beneficial thus far. For instance, on a year to date basis (through 9/30/20), the Russell 1000® Value Index has declined -11.58% while the Russell 1000® Growth Index has gained +24.33%. Similarly, larger cap stocks have returned +6.40% (Russell 1000® Index) compared to a decline of -8.69% for smaller cap stocks (Russell 2000® Index). This helps to illustrate some important points: 1) it is not only what you own, but also what you do not own that makes a difference; 2) just because something is relatively inexpensive from a valuation perspective does not necessarily make it a good investment over short timeframes; 3) the underlying economic environment and location in the business cycle influences what types of investments perform relatively well over the short-term; and 4) patience is critical when investing over long timeframes.

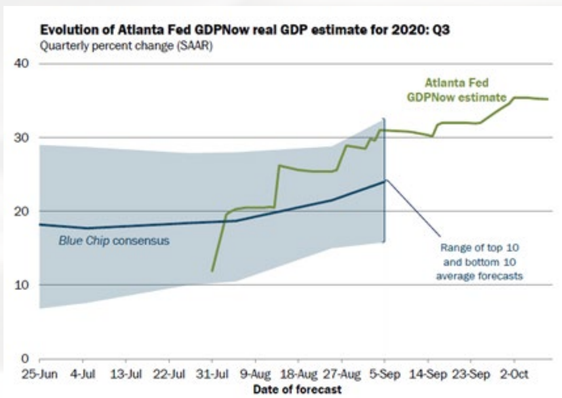
We remain vigilant on monitoring underlying business fundamentals, broader market fundamentals, and uncovering attractive long-term opportunities for our clients. Our “bench” of investments is large. All that remains at this juncture to make further adjustments in portfolios is to arrive at what we believe to be a favorable intersection of value, price, and opportunity. As always, communication is a hallmark of our firm’s commitment to our clients, so we will share our rationale and research for portfolio changes as they occur.

Fixed Income Portfolio Comments

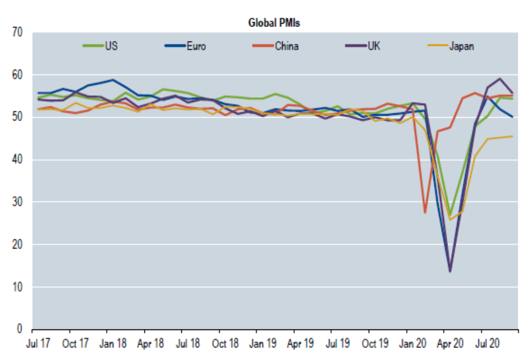
Economic and Policy Review

After nationwide lockdowns forced the U.S. economy to post a record -33% drop in the second quarter, it bounced back faster than expected in the third quarter. The Atlanta Fed's GDPNow indicator forecasted a +35% increase (actual results were +33%), but not all is rosy. When we look under the hood, we see massive divergences. The "stay-at-home" sectors including housing, online retail and autos have experienced a meaningful recovery while others such as the labor market, travel and entertainment industries have struggled to regain their footing given changing consumer demand patterns.

Going forward, significant uncertainties remain. It is likely the re-opening "V" shaped rebound from the depths of the pandemic is behind us. Evidence the pace of the recovery is slowing can be seen in several leading indicators including, PMI's, industrial production, and labor force participation. As a result, the next phase of the recovery will likely be more difficult.



Source: Atlanta Fed



Source: Western Asset

The extent of the difficulty is highly dependent on the path of the pandemic, fiscal stimulus, unemployment and the election. All of which have a wide range of potential outcomes.

Pandemic

While we have seen periods of improvement domestically and globally, we have yet to get a major handle on COVID-19. Until we do, there will be significant sectors of the economy that will be underutilized or completely unproductive. The hope is that help may be on the way, as the scientific community has been making progress

Mike Peters, CFA
Chief Investment Officer – Fixed Income

Summary

The U.S. economy posted a record -33% drop in the second quarter. The Atlanta Fed's GDPNow indicator is forecasting a +35% increase in the third quarter, but significant uncertainties remain.

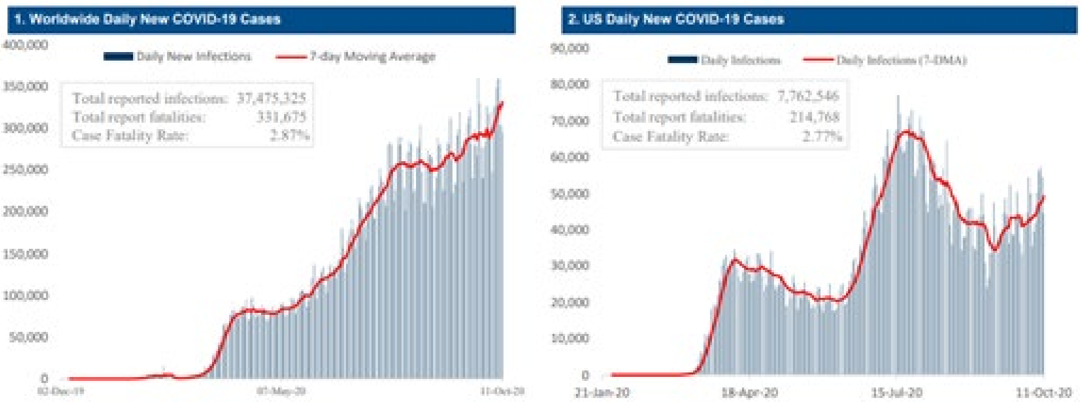
Despite progress, layoffs are still coming in at historically elevated levels, with more than 800,000 people filing for unemployment per week.

Going forward, it is likely the Fed will continue to do whatever it takes to support the economy through the pandemic. This creates a high probability that U.S. Treasury yields will remain in a low and relatively tight range.

We are managing duration near client benchmarks.

We continue to be somewhat defensively positioned within the corporate sector, as spreads have narrowed and valuations appear rich.

on vaccines and treatment options. There is the potential we will have them broadly available by mid-2021. However, the longer the delay, the longer the recovery will take. See uptick in COVID cases below.



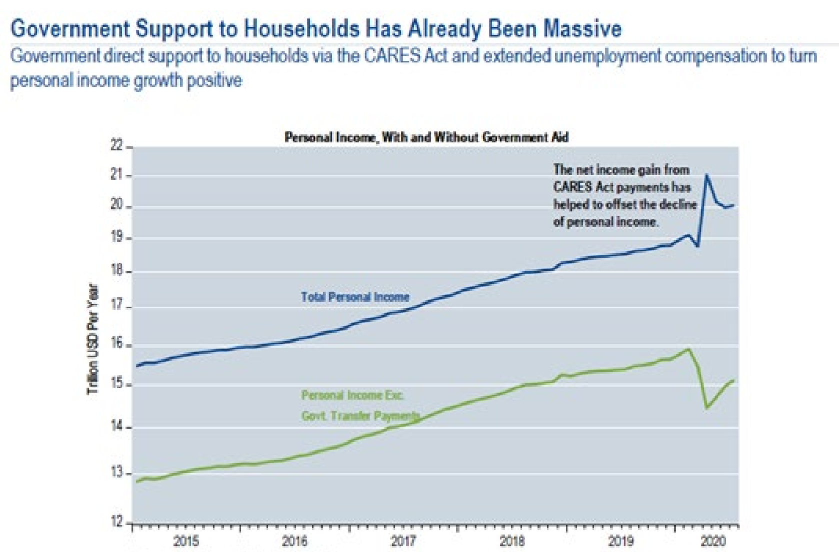
Source: Goldman Sachs

Fiscal Stimulus

As you can see in the graph below, in aggregate, the CARES Act did a good job supporting personal income during the shutdown phase of the pandemic. This allowed many consumers to continue mostly normal spending habits. However, many of the tools used to create the stopgap, such as enhanced unemployment benefits and paycheck protection loans, have expired. Without a new package from Washington, which appears to be getting moved further and further out, we could see some of the improvements we have made reverse course. This could take an exponential toll on the recovery considering the economy's current fragile state.

Unemployment

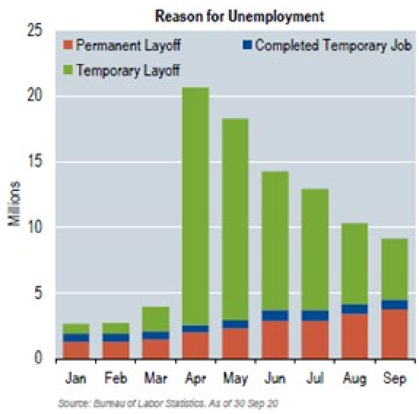
Despite progress, layoffs are still coming in at historically elevated levels, with more than 800,000 people filing for unemployment per week. These levels are higher than what is typically experienced at the end of a recession and compares to a pre-COVID average of 200,000. Labor market stress is also seen in continuing unemployment claims volume, which most recently came in at 11.8 million, almost ten times that of a more normal economy.

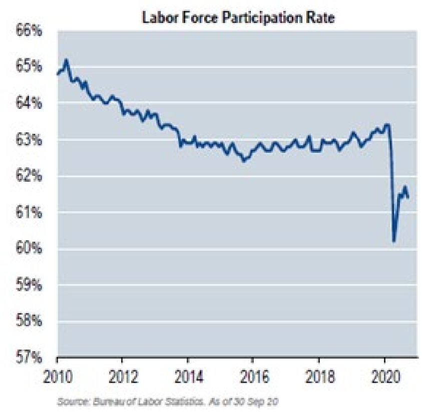


Source: Western Asset

Risks of Significant Scarring Remain

"Permanent" layoffs have steadily increased since March, even as "temporary" layoffs declined.
Labor force participation is depressed; decline in the unemployment rate overstates strength in jobs.

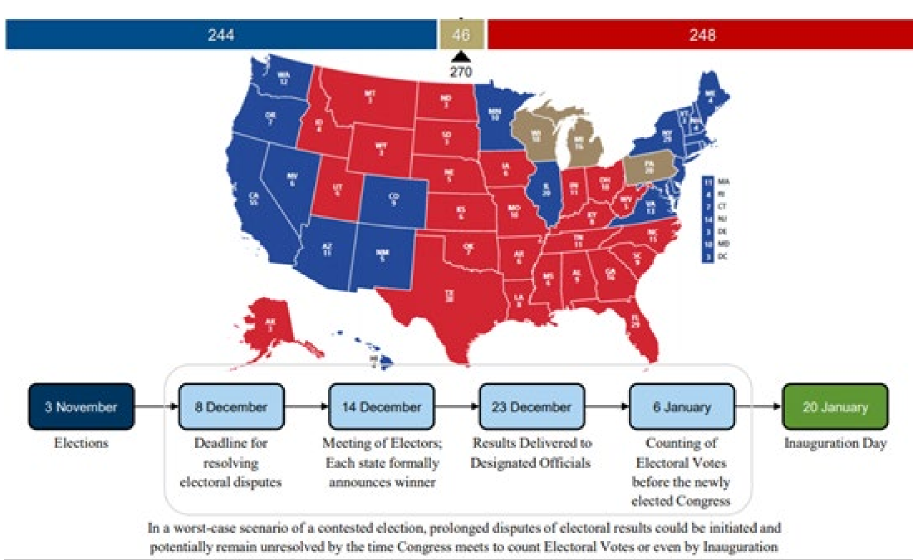




Source: Western Asset

Election

As of the writing of this newsletter, the betting markets are placing an almost 80% chance of a Biden presidential victory. They are also predicting the Democrats will win a majority in the Senate and hold on to the House. Even though it is estimated that certain Democrat policies could hurt future business profits, it is likely already priced into the market, considering the odds of them sweeping the election are so high. Where things could get tricky is if there is a contested election, which drags on over several weeks to months. This seems more likely than in a "normal" election year, considering the impact of mail-in voting. A contested election would bring significant uncertainty, which is something markets do not respond well to.



Source: Goldman Sachs

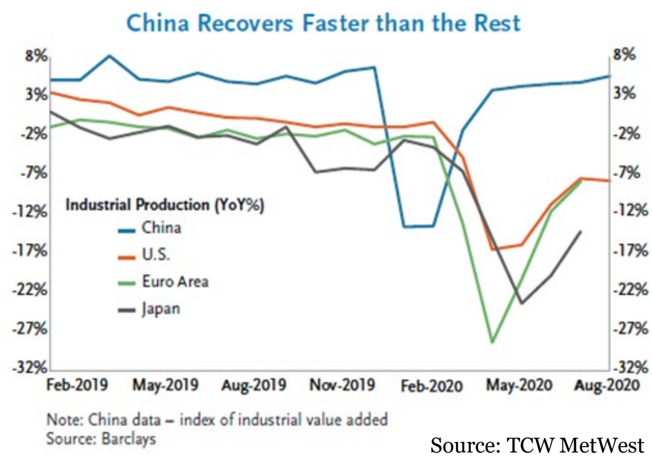
Fixed Income Portfolio Comments

Global Economy

Outside of the U.S., the global economy has also bounced back faster than expected, but that does not erase what is projected to be an unprecedented -4% to -5% decline for the year. The recovery has been uneven across countries, due in large part to the pandemic. Europe has seen a resurgence of new cases, while several emerging market countries, such as Mexico and India have struggled to get the first wave under control. Interestingly, China, the epicenter of the pandemic, is leading the global recovery. Several leading indicators have returned to pre-pandemic levels including industrial production and retail sales, and urban unemployment.

Quarterly Performance Review

Overall, fixed income had a solid quarter with every major sector experiencing spread tightening and positive total returns. The benchmark 10-year U.S. Treasury bond increased 3 basis points (0.03%) for the quarter ending at 0.68%. Treasury bonds returned +0.18% for the quarter. U.S. Investment Grade Corporate bonds generated a +1.36% return, leading the way in the investment grade space. The performance came on the back of 14 basis points (0.14%) of spread tightening over the period, bringing the sector to within 30 basis points (0.30%) of its pre-COVID levels (+136). High-yield corporate bonds led all domestic fixed income sectors as the sector tightened 109 basis points (1.09%) and generated a +4.70% return. Securitized sectors finished in the middle of the pack with more modest returns.



Source: TCW MetWest

Fixed Income Outlook

<u>Interest Rates</u>

During the quarter, the U.S. Federal Reserve (Fed) announced a new monetary policy framework with the hope of better achieving its price stability and full employment mandates. It replaced a 2% inflation goal with a flexible approach targeted at achieving inflation that averages 2% over time. This means the Fed will let inflation run above or below 2% to make up for past periods. The Fed also intends to no longer raise rates based simply on unemployment falling below historic estimates of where inflationary employment pressures should result. Altogether it is likely the Fed will leave rates low (near the zero bound) for a long period, even if inflation rises and unemployment is very low.

Going forward, it is likely the Fed will continue to do whatever it takes to support the economy through the pandemic. This creates a high probability that U.S. Treasury yields will remain in a low and relatively tight range. If economic data continues to improve, we believe the 10-year Treasury could increase to near 1.00%, but it is unlikely the Fed will let rates climb much higher, as it wants to maintain low rates to keep borrowing costs low, which in turn helps markets. Additionally, low rates aid the government's deficit funding.

From a portfolio construction standpoint, we continue to maintain duration near client benchmarks and prefer a more bulleted portfolio focused on strategies with intermediate durations (4-6 years). Our approach is designed to capture yield while also play defense against an increase in yields on the long end of the yield curve (20-30 years).

Corporate Bonds

The Fed's backstop, formally known as the Secondary Market Corporate Credit Facility, paired with record low Treasury yields, led to the overall corporate index dropping below 2% for the first time. The strong performance has come despite a record $1.5 trillion in gross issuance.

The Fed backstop equated to purchases of over $300 million in bonds per day in June. Currently, the program is only buying $15 million in bonds per day, but despite its minimal usage, the Fed extended the program from September to December to guard against future potential downturns.

We continue to be somewhat defensively positioned within the sector, as spreads have narrowed, and valuations appear to be rich. As the Fed's backstop became apparent, we added managers with strong corporate credit teams that focused the portfolios in corporates but were not mandated by prospectus to maintain a certain percentage. These funds can lower investment in corporate credit, or go up in quality, if market conditions warrant such a change. We remain confident the managers will actively manage the risk in the space and provide access, while also diversifying portfolio return streams.

High-yield issuers have taken advantage of the low rate environment as well, raising nearly $300 billion of new debt this year. Strong investor demand has allowed this debt to be issued with record low coupons. Investors continue to be disconnected from the deterioration in credit quality in the space. Default rates continue to rise, topping 8.7% during the quarter, and are estimated to hit 12% in 2021. Leverage has also increased meaningfully, topping a record 5.6x, driven by a decline in earnings, as well as increased borrowing. This area of the market is not nearly as supported by the Fed, so we continue to wait for a better opportunity for investment.

Securitized Bonds

The economic fallout from the pandemic continues to create challenges for certain segments of the securitized market, particularity non-agency commercial mortgage-backed securities and low-rated asset-backed securities. These areas have been hit particularly hard as the work from home and unemployment trends have hurt underlying fundamentals. We have moved on from investments that were negatively impacted by these trends. However, we maintain a position in one investment because of its attractive yield and focus on high-quality securitized assets. The fund is diversified, but primarily invests in government guaranteed mortgage-backed securities. Despite being default risk free, they currently offer attractive spreads due to cash flow uncertainty and are also supported by Fed purchases of $40 billion per month.

Municipal Bonds

Municipal bonds, like their taxable counterparts, had a strong quarter (+1.23% return). Under the hood, longer maturities and lower quality bonds accounted for most of the return. Fundamentally, state and local tax revenues have fallen less than initially feared. Recent data that adjusts for the filing extension show that the average year to date state tax revenue declines have averaged just -2.5% for the 47 states that have reported. Despite good news on this front, and $182 billion dollars from the CARES act, in aggregate, municipalities are projected to face a $200 billion dollar shortfall through 2022. Ongoing stimulus negotiations continue to be critical to address the problem. The House is currently asking for over $425 billion dollars to put municipalities on a sound footing. The Trump administration has offered far less, not wanting to, in their eyes, bailout states for issues created prior to the pandemic. The administration's current offer is approximately $250 billion, which would be sufficient to cover the projected gap. Based on the current backdrop, we continue to invest in managers focused on high-quality intermediate municipal bonds.

Our Team

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CEO
Co-Founder

Bob J. Batchelor, CFA®, CFP® is Co-Founder and Chief Executive Officer of Entasis Asset Management. Bob has 20 years of experience in the investment industry. Prior to founding Entasis, Bob worked at Artisan Partners where he held a variety of roles including Head of Corporate Communications, Managing Director, Head of Marketing and Technology and Head of Marketing and Communications. He also served as a member of Artisan Partners Executive Committee. Before Artisan Partners, Bob worked at Strong Capital Management as Client Account Manager and Director of Investment Research and Communication.

Bob holds an M.B.A. from Marquette University and a B.B.A. from the University of Wisconsin-Madison. He has earned the right to use the CFA designation. Bob is a member of the CFA Institute and CFA Society of Milwaukee. Bob has also earned the Certified Financial Planner™ certification.

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CIO – Equity
Co-Founder

Charles J. (C.J.) Batchelor, CFA® is Co-Founder and Chief Investment Officer – Equity of Entasis Asset Management. C.J. has 15 years of experience in the investment industry. Prior to founding Entasis, C.J. worked at Cleary Gull, a multi-billion dollar investment advisory firm, as Director of Investment Research. He also served as a member of Cleary Gull's Investment Policy Committee, Investment Committee and Equity Strategy Group.

C.J. holds a B.B.A. in Finance from the University of Wisconsin-Milwaukee. He has earned the right to use the CFA designation. C.J. is a member of the CFA Institute and CFA Society of Milwaukee, where he currently serves on the Board of Directors.

Mike Peters, CFA®
CIO – Fixed Income
Co-Founder

Mike Peters, CFA® is Co-Founder and Chief Investment Officer – Fixed Income of Entasis Asset Management. Mike has 15 years of experience in the investment industry. Prior to founding Entasis, Mike worked at Cleary Gull, a multi-billion dollar investment advisory firm, as Fixed Income Portfolio Manager. In his role he served as voting member of Cleary Gull's Fixed Income Strategy Group and Complement (Alternative) Strategy Group. Before Cleary Gull, Mike worked for several years at Madison Investment Advisors, a multi-billion dollar asset management firm, as a Fixed Income Analyst.

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David LaCroix
Senior Financial
Advisor

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David received his M.B.A. and B.B.A. in Finance from the University of Wisconsin-Madison. He has served as a member of the Archdiocese of Milwaukee Investment Committee, as a Trustee for the Village of Shorewood and as Director/Treasurer of Milwaukee Summerfest.

IMPORTANT INFORMATION

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The **Dow Jones Industrial Average℠** is a price weighted index that measures the performance of thirty component large-cap U.S. stocks. The **S&P 500® Index** is a market capitalization weighted index that measures the performance of 500 leading companies in leading industries of the U.S. economy. The **Russell 1000® Index** measures the performance of roughly 1,000 U.S. large-cap companies. The **Russell 1000® Growth** Index measures the performance of U.S. large-cap companies with higher price/book ratios and forecasted growth values. The **Russell 1000® Value Index** measures the performance of U.S. large-cap companies with lower price/book ratios and forecasted growth values. The **Russell 2000® Index** measures the performance of roughly 2,000 U.S. small-cap companies. The **MSCI EAFE® Index** is a market capitalization weighted index that is designed to measure the performance of developed markets, excluding the U.S. and Canada. The **MSCI Emerging Markets Index** is a market capitalization weighted index that is designed to measure equity market performance of emerging markets. **The MSCI ACWI Ex USA Small Cap Index** is a market capitalization weighted index that represents the performance of smaller capitalization companies in developed and emerging markets excluding the U.S. The **Barclays Aggregate Bond Index** tracks the performance of intermediate-term government bonds, investment grade corporate debt securities and mortgage-backed securities with at least one year to final maturity. The **Barclays Intermediate U.S. Gov/Credit Index** tracks the performance of intermediate U.S. government and corporate bonds. The **Barclays Municipal Bond Index** is considered representative of the broad market for investment grade, tax-exempt bonds with a maturity of at least one year. The **BoAML Fixed Rate Preferred Securities Index** tracks the performance of fixed rate U.S. dollar denominated preferred securities in the U.S. domestic market. The **BoAML Treasury Master Index** tracks the performance of the direct sovereign debt of the U.S. Government. The **BoAML U.S. Mortgage Back Securities Index** tracks the performance of U.S. dollar denominated fixed rate and hybrid residential mortgage pass-through securities publicly issued by U.S. agencies in the U.S. market. The **BoAML U.S. Corporate Master Index** tracks the performance of U.S. dollar denominated investment grade corporate debt publicly issued in the U.S. domestic market. The **BoAML High Yield Master II Index** is a broad based index consisting of all U.S. dollar-denominated high-yield bonds with a minimum outstanding of $100 million and maturing over one year. The **BoAML All Convertibles All Qualities Index** measures convertible securities' performance of U.S. dollar denominated convertible securities not currently in bankruptcy with a total market value greater than $50 million at issuance. The **BoAML Euro Broad Market Index** gives exposure to euro-denominated investment grade debt publicly issued in the Eurobond or euro member domestic markets including government, quasi-government, corporate, securitized and collateralized securities. The **BoAML Local Debt Markets Plus Index** is a broad composite designed to track the performance of local currency sovereign debt of emerging markets countries. Past performance is no guarantee of future results. All indices are unmanaged. Investors cannot invest directly in an index. Index returns do not include expenses.

Investment Terms

Valuation levels are typically shown by calculating the price level of an index or a company relative to any number of characteristics of an index or company. For instance, the price-to-earnings valuation metric looks at the price of an index (or stock) divided by the total earnings of an index (or stock). Based on the multiple (in this instance, the multiple is how much investors are willing to pay – the price – for a given amount of earnings), it provides investors with a general sense of how expensive, or cheap, the overall market is at the present time. While there are a significant number of valuation metrics that are used in practice, and many ways to vary/modify the calculation of the price-to-earnings ratio, in this summary we are focused on the price investors are willing to pay (the level of the S&P 500® Index) divided by earnings expectations for the equity market (S&P 500 Index) over the next 12 months. This valuation metric is referred to as the forward P/E. A **yield curve** is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality but differing maturity dates. The most frequently reported yield curve compares the three-month, two-year, five-year and 30-year U.S. Treasury debt. A **basis point** is a common unit of measure for interest rates and other percentages in finance. One basis point is equal to 1/100th of 1%, or 0.01% (0.0001). **Interest coverage** is a measure of a company's ability to meet its interest payments on its debt. **Federal funds rate** is the interest rate at which a depository institution lends funds maintained at the Federal Reserve to another depository institution overnight. It is one of the most influential interest rates in the U.S. economy, since it affects monetary and financial conditions, which in turn have a bearing on key aspects of the broad economy including employment, growth and inflation.

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