Belleros Capital Management

The Passionate Investor

2Q2020 Market Review and Commentary

*Market Review **

- Equity markets generally ***outperformed*** fixed-income markets with the S&P 500 rising 20.54% (including dividends; -3.08% YTD) and the Barclay's Capital U.S. Aggregate Bond index increasing 2.80% (+6.14% YTD).
- Small caps ***outperformed*** large cap stocks (S&P 500) as the Russell 2000 small cap stock index returned 25.42% (-12.98% YTD).
- Value ***outperformed*** growth during the quarter (as determined by the S&P 1500 broad market index which includes large, mid, and small capitalization stocks).
- Non-U.S. equity markets ***underperformed*** U.S. markets in both U.S. dollar (MSCI EAFE**: +15.16% and -11.07% YTD) and local currency terms (+13.14% and -10.25% YTD, respectively).
- Emerging markets generally ***outperformed*** both U.S. and non-U.S. developed markets as the MSCI Emerging Markets Index rose 20.54% in USD and 18.97% in local currency (-9.67% and -5.38% YTD, respectively).
- Most U.S. market sectors were ***positive***. Energy (+32.64%; -35.34% YTD), Consumer Discretionary (+30.48%; +7.23% YTD), and Information Technology (+28.06%; +14.95% YTD) stocks were most distinguishable given their strength. The Utilities sector was notable given its weakness (-1.39%; -11.14% YTD).
- High yield bonds climbed 12.90% (-4.66% YTD). The U.S. corporate bond sector rose 7.79% (+6.46% YTD). 10-Year U.S. Treasury yields fell from 0.67% at the beginning of the quarter to 0.65% currently (2.69% at the beginning of the year).
- The U.S. dollar rose versus the British Pound (+0.46%; +6.73% YTD), but fell versus the Euro (-1.83%; -0.06% YTD) and Yen (-0.19%; -0.73% YTD)

* *Unless otherwise noted, performances stated above reflect data provided by Standard and Poor's, Russell Investments, MSCI, and Barclay's Capital.*
*** The MSCI EAFE Index is a large capitalization, developed market benchmark that tracks non-U.S. or international equity markets.*

July 2020

"An Alternative Approach to Helping Investors Reach their Long-term Investment and Retirement Goals"

Inside this issue

Tim Hai, CFA®, CAIA®
CIO and Sr. Portfolio Manager

“Risk is not inherent in an investment; it is always relative to the price paid. Uncertainty is not the same as risk. Indeed, when great uncertainty – such as in the fall of 2008 – drives securities prices to especially low levels, they often become less risky investments.”
— Seth Klarman

Company Description

Belleros Capital Management is an independently owned investment management and advisory firm serving investors who have a desire to embark on an investment strategy that will help them reach their long-term investment and retirement goals. The firm actively manages investment accounts on a fully discretionary basis for our clients. Our primary purpose is to help investors reach their financial goals through a plan to minimize the “all-in” investment-related fees they pay, increase the value-add they receive from their investments, and by working with them to develop a strong level of investment discipline that will help them maximize their wealth generation potential.

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Market Commentary

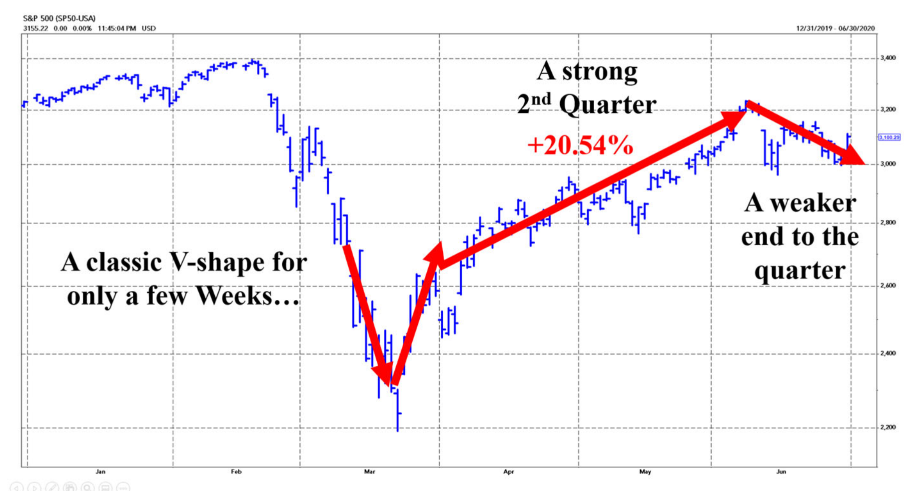
A very accommodative Federal Reserve, a large and expensive fiscal stimulus package from Congress, a flattening COVID-19 curve, easing lock-down restrictions, and rebounding economic data, led to investor optimism that allowed U.S. stocks to lodge their best quarterly return in over two decades. Investors took special note of better-than-expected economic data and positive revisions to most pandemic related forecasts. The S&P 500 responded by climbing +45.09% from its March 23, 2020 lows (through its peak on June 8, 2020), harkening many stock market prognosticators to warn of a disconnect between what they perceived as still poor economic prospects and the stock market rebound. Despite cooling off late in the quarter, the S&P 500 still increased 20.54% (it had hit an intra-quarter high of +25.55% through June 8, 2020).

Small cap stocks rose even higher (+25.42%) from their second quarter levels. Similar dynamics internationally allowed non-U.S. developed and emerging markets to rise 15.16% and 20.54%, respectively (in U.S. dollars). U.S. market sectors that under-performed the most last quarter became market leaders in the current one (Energy: +32.64%; Consumer Discretionary: +30.48%). And while the spring thaw in stocks did not extend generally to the bond market (which typically lags when investors become more risk-seeking; +2.80%), more equity-like, credit sensitive sectors like corporates and high yield bonds did participate (+7.79% and +12.90%, respectively). Benchmark 10-Year U.S. Treasury bond yields remained low after falling in the previous quarter to their lowest level ever. Similarly, risk havens like the U.S. dollar fell relative to most other currencies.

A "W" Shaped Recovery?

Performance gains in the stock market began to tail-off by quarter -end, leaving many stock market pundits to suggest an end to the "V-shaped" recovery (a situation where stocks rise in a symmetrical fashion after a fall) that started in late-March. However, we would submit that a classical "V-shaped" recovery never really transpired outside of the first few weeks after the trough experienced by stock markets (see chart below). Many of the same pundits have begun pushing the idea of a "W-shaped" recovery that implies multiple ups and downs or increased volatility. We would suggest a scenario (over the next several quarters or more) where multiple W's are strung together in cursive fashion. In other words, expect continued volatility.

S&P 500 Trailing 6-Month Performance



Source: FactSet

> *"In the short run, the market is a voting machine but in the long run, it is a weighing machine."*
> *— Benjamin Graham*

Investment Philosophy

Market Inefficiency

Equity or "stocks" are inherently volatile assets due to the sheer number of participants involved, the diversity of their motives, and the wide range of emotions they employ. Stocks are frequently prone to excessive volatility when emotions particularly run hot. We believe this excessive volatility is a sign of short-term stock market inefficiency. However, we believe the stock market is more efficient over the long-term as rational investment behavior reasserts itself. Similarly, excessive volatility causes the market prices of stocks to deviate from their intrinsic values. As time progresses, the market prices of stocks generally return to their intrinsic values. We believe that stock market inefficiency as represented by excess volatility is exploitable and represents an opportunity for profit. In our experience, excessive volatility can and does extend to all manner of companies and stocks. Even the best companies and their stock can be affected by stock market inefficiencies and come to exhibit excess volatility, creating exploitable investment opportunity for the astute investor.

"We steer clear of the foolhardy academic definition of risk and volatility, recognizing, instead, that volatility is a welcome creator of opportunity"
— Seth Klarman

Investment Philosophy

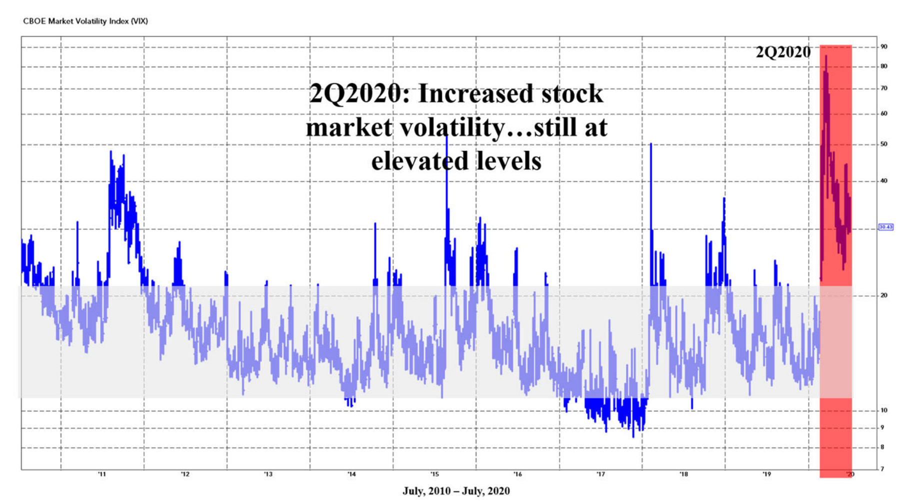
The Main Source of Risk to Long-term Investors

Belleros Capital Management believes that the investment industry's definition of risk as volatility is inappropriate and generally does not apply to all participants. Although the effects of volatility can be particularly disastrous to investors that have near-term income or liquidity requirements, long-term investors can and should be less constrained by it. As opposed to gambling or speculation, we believe that investing is by definition a long-term strategy. We believe that stock market volatility is a source of investment opportunity for long-term investors, especially when it is excessive. Investors with a strategy to benefit and exploit stock market inefficiencies and excessive volatility should therefore concern themselves with (and try to avoid) greater risks such as a permanent loss of capital, the risk of outliving one's wealth, or the failure to meet their long-term investment and retirement goals.

What's Causing this Volatility?

The stock market is believed to be a leading indicator of the economic expectations of its participants. In a normalized period with more clarity and a more homogenous opinion set, there is less volatility and variation in expectations. Forecasting always involves some level of guesswork but in this scenario, forecasting can be more accurate (if only slightly). However, the COVID-19 period has been anything but clear and expectations about the virus' contraction and mortality rates have been wildly inaccurate. And so, economic forecasts have also been quite poor. Additionally, the inability of corporations to accurately issue forecasts exacerbates the uncertainty as management reins in or suspends the quarterly guidance Wall Street analysts use to make their own predictions. The lack of clarity at many different levels has led to a more heterogenous opinion set with low levels of confidence. This translates to a high level of variability and volatility as expectations are diverse and the probability of meeting them is low.

CBOE VIX Trailing 10-Year Performance



Source: FactSet

An Active Lesson

We've written previously about our opinions regarding the active versus passive debate. Obviously, we are quite biased. We do not deny skeptic's claims of poor results and the many impediments to active investing (who said it was easy?). We do not defend the scorecard for the industry. However, although most active investors have not been able to add value consistently or persistently, we do believe that there are still at least some investors (professional or otherwise) that have been able to do so. And, given the retirement landscape and preparedness level of most Americans, it is something most investors not only need, but may be required to have in their portfolios.

Passive investors share the experience of the market they are indexed to. In a poor investing environment, passive investors (and buy and hold investors), must accept the volatility and likewise accept the (poor) performance of the index. By definition, there is no chance for excess returns. Indeed, after fees, performance always trails the index. Even before the pandemic hit, many market prognosticators had been warning of a decade's worth of poor stock market performance. The jury is still out on that, but it certainly doesn't bode well for the nearly retired or recently retired investor. The COVID-19 era has/is not a great start to your retirement. And, given extending life expectancy for the average American, and growing costs associated with old age, we believe most people cannot afford to forgo the opportunity represented by active investing – despite its many failures. We continue to believe that active investing is a necessary option for most investors – especially in a period of potentially poor passive stock market investing.

Distance Learning

Investors received a free lesson over the past few months on why market timing should be avoided. Our readers should by now understand that Belleros Capital Management is not an advocate for it. Market timing involves surrendering to one's emotions (and fear in particular) and abandoning a long-term investment strategy for short-term speculation. Market timing in this case attempts liquidate one's investments to avoid volatility and short-term investment losses. This is followed by steps to reinvest at lower prices (hopefully) once an "all clear" signal has been sounded.

"Wide diversification is only required when investors do not understand what they are doing."
— Warren Buffett

Investment Philosophy

Diversification

Belleros Capital Management believes that the idea of portfolio diversification is counter-intuitive and works against our active management goals. The idea of diversification is meant to limit the impact of stock market volatility. We believe stock market volatility represents an investment opportunity that is exploitable. Therefore, limiting the opportunities we seek to exploit would seem rather perverse. Diversification is a scale. Too little and you risk putting all your eggs in too few baskets; too much and your portfolio and expected return mimics the broader stock market (index). We believe excessive diversification (in addition to high investment-related fees) is a main contributor to poor active management performance relative to passive/index investing. We believe investors who seek excess returns above and beyond what one could expect to receive from the broader stock market should choose an investment manager that minimizes fees and concentrates their investment portfolio to ward of the indexing-like characteristic of diversification.

"Owners of stocks, however, too often let the capricious and often irrational behavior of their fellow owners cause them to behave irrationally as well. Because there is so much chatter about markets, the economy, interest rates, price behavior of stocks, etc., some investors believe it is important to listen to pundits – and, worse yet, important to consider acting upon their comments."
–- Warren Buffett

Please [contact us](#) for a complimentary review of your investment advisory fees, your current investment portfolio, and to discover how we can help you maximize your wealth generation potential.

Distant Learning (Cont.)

In reality, most investors who engage in market timing do not "time" their selling perfectly (potentially realizing considerable losses despite their actions), and they never receive the "all clear" message (leading to perhaps even greater opportunity loss) as the market rebounds too quickly and sooner than they expect. We continue to plead and recommend against investors making such rash and short-sighted decisions when emotions are running high. There is a reason why most investment professionals, whether they advocate for passive or active investing, warn their clients against it.

Closing Remarks

The COVID-19 pandemic has had a profound effect on the stock market. Despite this, we continued with our work in a methodical and emotionless fashion (as described in our [investment strategy and guidelines](#); included herein). We do this because it is our job to make tough but informed decisions in our client's stead - even as the stock market falls precipitously. As you would expect from an active investor, we were busy throughout the turmoil. We made capital allocation decisions based on what we believed were the best investment opportunities available at that moment in time. We defended positions we were extremely confident in, lowering our cost basis and hopefully optimizing their profit potential. We were also opportunistic at times and took advantage of stock market inefficiency by buying great companies that were too expensive only a few months ago. In some cases, positions were sold to free up cash for better opportunities. The hope is that through our combined actions, we and our clients will be able to benefit from these decisions over the next several years as the stock market and economy normalizes.

We continue to understand that investing is inherently a long-term strategy that requires a lot of patience. We want to thank our client and readers for affording us that consideration. We leave you with a favorite quote of ours that we believe describes our attitude towards tumultuous times (pandemic, stock market, or otherwise). Best wishes to everyone as we dig out of this storm and await brighter skies. Be safe.

"Adversity does not build character, it reveals it."
-- James Lane Allen

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Investment Strategy

We seek to exploit stock market volatility in the short-term through a **long-term**, active investment management strategy that purchases higher **quality** stocks with sustainable competitive advantages and economic moats, and at prices below our calculation of intrinsic value (otherwise known as "**value** investing"). These characteristics help us defend against what we believe is the biggest risk in investing: a permanent loss of capital. In addition, we intend to show our discipline and conviction in our investments by employing a concentrated portfolio mandate that is differentiated and allows us to focus on only the best investment candidates available. Further, we seek to show our conviction through our portfolio weighting scheme which skews exposure to the best investment candidate.

- Active investment management
- Long-term investing
- Seek higher quality opportunities
- Value investing
- Avoid permanent losses of capital
- High conviction
- Invest with confidence
- Disciplined approach
- Volatility is an opportunity
- Concentrated stock portfolio
- Differentiated from the index

"Risk is not inherent in an investment; it is always relative to the price paid. Uncertainty is not the same as risk. Indeed, when great uncertainty – such as in the fall of 2008 – drives securities prices to especially low levels, they often become less risky investments." — Seth Klarman

"We don't have to be smarter than the rest. We have to be more disciplined than the rest." — Warren Buffett

Biography

Tim Hai, CFA®, CAIA®

Chief Investment Officer and Senior Portfolio Manager

- 22 years of experience in the investment industry
- 6 years experience overseeing public equity and fixed-income assets for a $10 billion multi-employer pension plan
- 8 years of equity portfolio management experience
- 8 years exp. manager research and due diligence
- M.B.A. - Loyola College of Maryland, 2000
- B.S. Finance – University of Maryland, College Park, 1996

Tim has 22 years of diversified investment experience that includes the research and direct investment management of stocks and bonds for high net worth and small business clients. Additionally, Tim has experience in manager research and due diligence, having helped oversee and manage a $10 billion institutional pension fund. Tim had direct oversight of the pension fund's equity and fixed-income investment portfolios that were managed by outside investment managers. Tim had specific oversight over the pension fund's $1.2 billion concentrated managers program that sought to extract value add from some of the country's best investment managers through a mandate that required high conviction and a limited number of stock positions.

Tim received his B.S. in Finance from the University of Maryland, College Park and his MBA from Loyola College of Maryland. More recently, he also completed coursework in international investing and currency management with the Oxford International Investment Programme at the Said Business School at the University of Oxford, United Kingdom. Tim holds the Chartered Financial Analyst ("CFA") and Chartered Alternative Investment Analyst ("CAIA") designations. He is a member of the CFA Institute and the CFA Society Washington, DC. He is also a member of the Washington, DC Chapter of the CAIA Association.

Code of Ethics and Privacy Policy

Belleros Capital Management is a fiduciary; we will act in the utmost good faith, performing in a manner believed to be in the best interest of our clients. We believe that our business methodologies, ethics rules, and adopted policies are designed to eliminate or at least minimize material conflicts of interest, and to appropriately manage any material conflicts of interest that may remain. It is important to point out that no set of rules can anticipate or relieve all material conflicts of interest. Our firm will disclose to its advisory clients any material conflict of interest relating to the firm, its representatives, or any of its employees which could reasonably be expected to impair the rendering of unbiased and objective advice.

Code of Ethics

We have adopted a Code of Ethics that establishes policies for ethical conduct for our personnel. Our firm accepts the obligation not only to comply with all applicable laws and regulations but also to act in an ethical and professionally responsible manner in all professional services and activities. Firm policies include prohibitions against insider trading, circulation of industry rumors, and certain political contributions, among others. We periodically review and amend our Code of Ethics to ensure that they remain current, and we require firm personnel to annually attest to their understanding of and adherence to the firm's Code of Ethics. A copy of the firm's Code of Ethics is made available to any client or prospective client upon request.

Privacy Policy Statement

We respect the privacy of all clients and prospective clients (collectively termed "customers" per federal guidelines), both past and present. It is recognized that clients have entrusted our firm with non-public personal information and it is important that both access persons and customers are aware of firm policy concerning what may be done with that information.

The firm collects personal information about customers from the following sources:

- Information provided to us to complete their plan or investment recommendation;
- Information provided via engagement agreements and other documents completed in connection with
- the opening and maintenance of an account;
- Information customers provide verbally; and
- Information received from service providers, such as custodians, about client transactions.

The firm does not disclose non-public personal information about our customers to anyone, except in the following circumstances:

- When required to provide services our customers have requested;
- When our customers have specifically authorized us to do so;
- When required during the course of a firm assessment (i.e., independent audit); or
- When permitted or required by law (i.e., periodic regulatory examination).

To ensure security and confidentiality, the firm maintains physical, electronic, and procedural safeguards to protect the privacy of customer information. Within the firm, access to customer information is restricted to personnel that need to know that information. All access persons and service providers understand that everything handled in firm offices is confidential and they are instructed not to discuss customer information with someone else that may request information about an account unless they are specifically authorized in writing by the customer to do so. This includes providing information about a family member's account.

The firm will provide customers with its privacy policy on an annual basis and at any time, in advance, if firm privacy policies are expected to change.