The Passionate Investor

4Q2020 Market Review and Commentary

January 2021

Belleros Capital Management

*Market Review **

- Equity markets generally ***outperformed*** fixed-income markets with the S&P 500 rising 12.15% (including dividends; +18.40% YTD) and the Barclay's Capital U.S. Aggregate Bond index increasing 0.67% (+7.51% YTD).
- Small caps ***outperformed*** large cap stocks (S&P 500) as the Russell 2000 small cap stock index returned +31.37% (+19.86% YTD).
- Value outperformed Growth during the quarter but under-performed over the YTD period (as determined by the S&P 1500 broad market index which includes large, mid, and small capitalization stocks).
- Non-U.S. equity markets ***outperformed*** U.S. markets in U.S. dollar (MSCI EAFE**: +16.09% and +8.28% YTD), but ***under-performed*** in local currency terms (+11.40% and +1.28% YTD, respectively).
- The MSCI Emerging Markets Index ***outperformed*** non-U.S. developed (international) markets in both U.S. dollar (+19.77% and 18.69% YTD) and local currency terms (+16.09% and +19.50% YTD).
- All U.S. market sectors were positive. Energy (+27.77%; -33.68% YTD) and Financial (+23.22%; -1.69% YTD) stocks were most distinguishable given their strength and partial recovery from poor full year performance.
- High yield bonds rose 7.66% during the quarter (+7.03% YTD). The U.S. corporate bond sector climbed 2.22% during the quarter (+10.06% YTD). 10-Year U.S. Treasury yields rose from 0.66% at the beginning of the quarter to 0.87% currently (+1.91% at the beginning of the year).
- The U.S. dollar fell versus the British Pound (-5.74%; -3.19% YTD), the Euro (-4.34%; -9.00% YTD), and Yen (-2.17%; -5.00% 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.*

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 actively manages direct stock portfolios on a fully discretionary basis for 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, potentially increase the value-add they receive from their investments, and by helping them invest for the long-term to maximize their wealth generation potential.

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Market Commentary

The S&P 500 climbed 12% during the quarter to its highest level ever, despite experiencing increased volatility and a pandemic-driven economic recession throughout the year. Additionally, investors shrugged-off a spring bear market as their worst fears of human and economic loss failed to materialize. One could sense the growing optimism in the year's second half as investors' mood changed from one of ***hope*** for a vaccine into one of certainty – despite growing levels of contraction, hospitalization, and mortality. Demand for stocks was also supported by a wave of new, perhaps speculative investors (Click HERE to read about this new class of investors) encouraged by cheap transaction costs, easy money (Click HERE to read about investors' increased use of margin debt and inherently leveraged options trading), less supervision in a remote work setting, and billions of dollars in newly available stimulus funds.

The resulting "risk on" environment allowed small capitalization stocks (+31%) to outpace their large cap cousins (the S&P 500), value stocks to rebound relative to growth stocks, and international stocks, both developed and emerging market stocks (+16% and +20% in USD, respectively) to outperform their domestic peers. Energy and Financial stocks, both among the worst performing stocks over the full year, outperformed in the fourth quarter (+28% and +23%, respectively). Below investment grade (riskier) or high yield bonds (+8%) out-performed the Barclay's Capital U.S. Aggregate Bond index (+1%). Ten -year U.S. Treasury yields improved marginally while the U.S. dollar continued its slide versus most other major currencies.

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S&P 500 - 2020 Full Year and 4th Quarter Performance

Source: FactSet

Rip Van Winkled?

One could perhaps forgive Rip Van Winkle, the title character of American author Washington Irving's famous short story of the same name (first published in 1819), if he concluded after waking up from a year-long hibernation (say between January 1, 2020 and December 31, 2020) that it was a typical year in stocks. Indeed, the S&P 500's headline gain last year was remarkable not only based on the higher-than-average nominal return it recorded, but also because of the way it got there. There were enough pandemic-driven events that impacted the last year alone to easily make more than a few years seem busy. From an investing perspective, 2020 will be memorable for a number of reasons including a bear market in stocks that was quickly followed by a raging bull that sent stocks collectively back to all-time highs; a collapse in oil demand that caused the price of oil futures to briefly fall below zero dollars per barrel (in addition to strife between OPEC+ members); and a severe recession that is still with us today. We also observed historically high levels of monetary and fiscal stimulus that included a promise by the Federal Reserve to keep interest rates at ultra-low levels indefinitely; multiple stimulus checks to struggling households; extended un-employment benefits for millions of dislocated workers; and bailouts for select industries, small businesses, and state and local governments. 2020 also included international events like Brexit and domestic ones like our own Presidential election. All of these headlines contributed to an elevated level of volatility that was present for most of the year (see chart below).

"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.

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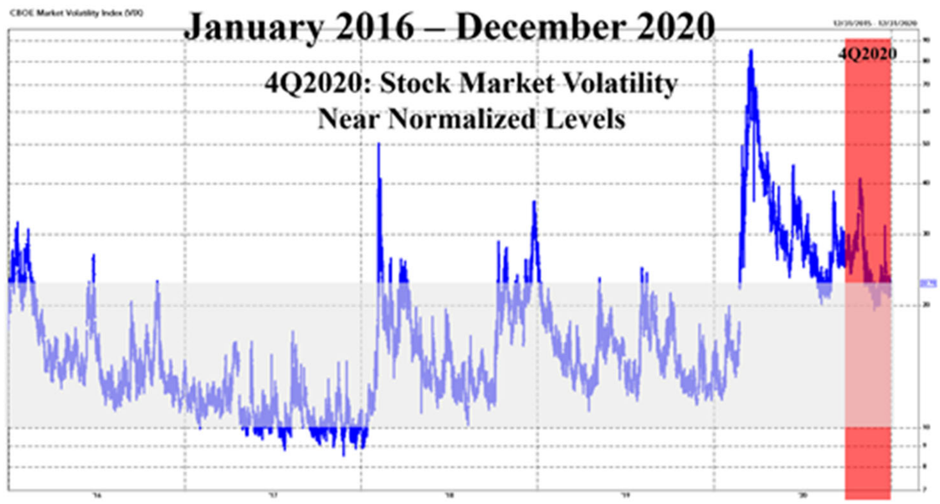
CBOE VIX Trailing 5-Year Performance
Volatility Near Normalized Levels



Source: FactSet

What Worked in 2020

We are not surprised to say that the three virtues that comprise our investment strategy were successful in 2020. The bear market made ***value*** stocks that sell at market prices below their intrinsic value attractive again. The extreme volatility that ensued allowed many of these stocks which were already selling at attractive prices prior to the correction, sell at an even greater discount during and after the phenomenon. The stellar rebound of some of the hardest hit stocks was dismissed by some to be a lower quality or junk rally. However, it has been our experience that in moments of strong market dislocation, even the stocks of some of the most attractive or highest ***quality*** companies can be purchased at a tremendous value. A long -term time horizon is also critical to successful investing because it allows one to be patient. Patience allows the discerning investor the opportunity to exploit short-term market inefficiencies that may benefit them over the longer term as things normalize. A long-term time horizon provides the patient investor valuable time to allow for their investments to potentially bear fruit.

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What Didn't?

Market timing is a two-step process that seeks to benefit from a stock market correction or bear market. The first step involves liquidating one's investment portfolio in anticipation of a market decline. The second step involves re-investing the proceeds from step one back into the market once a bottom has been reached. The problem with this scheme involves the timing of both steps. Getting the timing right in both steps requires speculation (guesses), incredible foresight, and/or a lot of luck. Most practitioners of this scheme fail because they do not "time" the market well and incur transaction costs (including taxes), a real and permanent loss of capital, and/or severe opportunity costs along the way. Many fail to implement both steps successfully; usually getting one or both steps wrong. Some fail in terms of precision (not timing the sell and buy transactions perfectly), and still incur the aforementioned costs.

The short duration of last year's bear market complicated market timing schemes further as it required greater precision. It took roughly a month for the S&P500 to descend from its all-time high on February 19, 2020 to its bear market trough on March 23, 2020; falling 34% along the way. It took the index roughly five more months for it to return to its prior high in February; soaring 70% off its low. This six-month period is significantly shorter than the typical bear market which lasts an average of 14 months. The S&P 500 returned 13% from its pre-bear market peak through the end of 2020, a stellar stock market return for ten months, let alone a full year. The point is, if one is a long-term investor or has a long -term time horizon, and had just stayed put and did nothing, one could have ridden out the bear market and been fine (pocketing 13% along the way and avoiding unnecessary risks and costs) as the stock market rebounded. The stock market has historically had a natural bias or inclination to trend up, positively, over the long-term. We believe that market timing for most people last year (in any year really) may likely have involved experiencing a real and permanent loss of capital in addition to considerable opportunity costs.

"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.

Closing Remarks

I'm sure I'm not the only one who is glad for 2020 to be in the rear-view mirror. Although things were good for me on a personal note, and we were able to successfully implement our investment strategy for our clients, I know and understand that there are still a lot of people out there who have been and still are enormously impacted by the pandemic. We are still muddling through this crisis and nothing is for certain. Despite this, I can honestly say that I am very optimistic regarding our future. Those of you who know me personally will understand that I'm generally an optimistic, happy go lucky person to begin with. Still, I can honestly say that I can envision us turning the corner in the relatively near future (how is that for being vague?). With regards to the market/economy, despite all-time highs in stocks and continued economic murkiness, I believe that there are still opportunities out there to be discovered.

On a human level, I am hopeful that as more people get vaccinated, newer/better drugs come to market, and herd immunity finally sets in, statistics on contraction, hospitalization, and mortality will become more favorable. Our animal spirits will once again get the better of us and we will begin to socialize – normally, and not with six feet between us - as it was meant to be. I can envision a time when I can enjoy the company of old friends again, play music with the band, or feel the warmth of a family member I've not hugged in a long time. Dare I say that I am excited for 2021 and am looking forward to what it has in store for us? I'm hoping this optimism foreshadows the future and rubs off a little on you too. Please let me know if you ever need help or if you have any questions. Best wishes to you all in this new year and beyond.

"An optimist sees an opportunity in every calamity;
a pessimist sees a calamity in every opportunity."

-- Winston Churchill

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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

- 25 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
- 11 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.

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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.