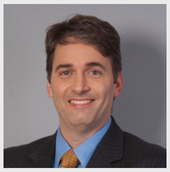
DoubleLine®

Portfolio Managers' Commentary

Emidio Checcone | **Brian Ear** | April 2020



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Mr. Checcone joined DoubleLine in 2014. He is the Portfolio Manager of the Equity Value strategy. Prior to DoubleLine, Mr. Checcone spent six years at Huber Capital Management, where he was a Principal and Portfolio Manager. Previous to that, he worked at PRIMECAP Management Company for six years, where he was a Principal and Financial Analyst. Mr. Checcone holds a BA in Social Studies from Harvard College and a JD-MBA from Harvard Law School and the Harvard Graduate School of Business Administration. He is a CFA® charterholder.

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Mr. Ear joined DoubleLine in 2016 as an Equity Analyst and is now a Portfolio Manager. Prior to DoubleLine, he spent two years at Compass North Advisors as a Consultant and six years at Palmyra Capital Advisors LLC where he was a Principal and Portfolio Manager. Previous to that, Mr. Ear worked for five years at Hotchkis and Wiley Capital Management as an Equity Analyst. He holds a BS in Economics from the Wharton School of the University of Pennsylvania. Mr. Ear is a CFA® charterholder and a licensed CPA (inactive).

April is the cruelest month, breeding
Lilacs out of the dead land, mixing
Memory and desire, stirring
Dull roots with spring rain.

- T.S. Eliot, *The Waste Land*

T.S. Eliot opened his famous poem "The Waste Land," paradoxically describing April as "the cruelest month." Written after the twin traumas of World War I and the Spanish Flu pandemic, the opening stanza of the epic work refers to the melting of forgetful snow, the mixing of memory and desire, and the stirring of dull roots with spring rain. Yet this is not Chaucer's April "sweet showers" bringing forth flowers. Rather, it is the laying bare of a failed society that has produced human tragedy on a global scale, thereby shaking one's faith in the entire order of things, including age-old traditions and institutions. Perhaps the greatest poem of the twentieth century, this modernist masterpiece presents conflicting shards of imagery to address the timeless themes of destruction, recovery, and anxiety in an uncertain future. Hardly uplifting stuff, but a very apropos perspective given our present, trying circumstances.

For long-only equity investors, it would seem that it was March, and not April, that was the cruelest month. We collectively braced as the invisible, deadly enemy, which had invaded our shores, was met with a total shut-down of our economy and way of life, and by the end of March, 32 of 50 states had ordered their citizens to shelter-in-place. The white swan of the coronavirus—for we were warned long ago of the eminent dangers of a global pandemic—was joined by the black swan of governments' surprisingly draconian attempt to shield us from the inevitable community spread of the coronavirus. Economically, this cure will likely be worse than the disease, and the destruction will probably prove unprecedented in scale. Markets and economies, which were richly valued and seemingly old and tired by the start of 2020, collapsed at record speed. Economic activity in March likely fell 20-30% year-over-year (YOY) because of the lockdown, and unemployment rates similarly spiked toward levels that will probably peak in this same range in the coming weeks. Meanwhile, the S&P 500 lost 29% within three weeks, and the broader equal-weighted indexes—likely a better proxy of the broad-based losses—fell 34% over the same period.

Yet as dramatic as those market losses appeared, perhaps still more surprising was the recovery from the worst of them during the following month. April saw an equally unparalleled market bounce, just as rapid to the upside, for the largest indexes, despite the lack of a similar reprieve in the real economy. The world still remained in lockdown at month's end. At least 30 million Americans were now out of work, with those numbers still rising. S&P 500 corporate earnings in 1Q '20 were down mid-teens year-over-year and expected to fall more than 35% YOY in 2Q '20. And critically, no one can really predict accurately yet the full array of adverse impacts of the pandemic on the global economy. The deceleration of new coronavirus cases in the US likely helped to allay the worst of fears, as did the positive, if tentative news, that Gilead's repurposed antiviral drug, Remdesivir, demonstrated apparent effectiveness in speeding recoveries from the disease. Yet the rapid recovery in equity and credit markets was undoubtedly largely spurred by the enormous interventions of unprecedented scale undertaken by the Federal Reserve and Congress, which now run into the trillions of dollars and dwarf the actions taken during the Global Financial Crisis. Whatever the reasons, the NASDAQ-100 by April 30th was essentially back to its pre-crisis level, while the S&P 500 Index had bounced to within 15% of its pre-pandemic price. Growth outperformed value as investors remained cautious even in the robust rally, favoring cash-rich balance sheets of large cap technology names; the Russell 1000 Growth Index rose 14.8%, while the Russell 1000 Value Index increased 11.2%.

The dramatic bust-boom tale of two months has created at the end of April the cruelest of conundrums for the investment manager. Should the market not still reflect more faithfully the depressed, risk-riddled economy, the devastation of which we still cannot fully measure or comprehend? Or should we count on the government's massive backstops once again to deliver us to safety? This is the critical question for investors at the present time. I also may prove to be the watershed moment dividing one investment era from the next. We do not pretend to know the answer to this question; however, we do have some tentative observations…

We believe the unknowns around the pandemic remain elevated, and so the risks of further damage to the economy and financial markets are hard to reckon. We do not have enough randomized test results using reliable antibody tests to determine the extent of the infection or an accurate assessment of the morbidity and mortality rates, and so we don't know how far we are from herd immunity. Moreover, we do not even know enough about our bodies' response to the virus to know how long one is contagious after showing symptoms—complicating the issue of asymptomatic transmission in the prodromal phase—and to know for certain whether a vaccine for this coronavirus is even possible. We do not know how well masks and social distancing will work as we contemplate lifting the lockdowns. There always remains the very real risk of a scary follow-on wave of infection, sickness and death, which even countries successful at handling COVID-19 (think Singapore) have already experienced. On the hopeful side, we recognize that we probably will not see Milan or even New York's experience play out in the wider US, now that we know what we are dealing with, and because we have ramped up our ICU and ventilator capacity, as well as unleashed herculean efforts to find effective therapeutics (i.e., anti-virals or therapeutic antibody treatments) or, better still, a vaccine. However, the fact remains that anti-virals and vaccines are hard and time-consuming, so the dynamics of the contagion will remain a key risk to the market.

We believe a V-shaped economic recovery is nearly impossible. There is no going back to where we recently were, and the reasons are myriad. First, the prior economic cycle was already long-in-the-tooth and ripe for a downturn, relying as it was on an overlevered consumer. Second, the psychological harm suffered by consumers and corporate executives will not fade quickly, dampening the desire to spend or invest so readily. Third, the current crisis is highlighting structural weaknesses of the prior cycle that must be addressed, such as the need to remake supply chains that are not dependent on China; standing up carefully orchestrated, global value chains would be hard in any environment, but remaking them in a world that is increasingly decoupling will be still more challenging. Fourth, China's leadership in the recovery should give us pause, as the country supposedly handled the pandemic better than the West but still is not close to a return to full capacity more than two months after its back-to-work orders. Fifth, the US has unique challenges and risks to reopening, including the perverse incentives of paycheck insurance precluding a race back to work, as well as the threat of tort liability for companies that reopen too quickly, and the likelihood that an impending Presidential election will politicize the crisis and make further cooperation across the political aisle impossible. Sixth, the moves by the government to address this crisis, both the near-term monetary and fiscal actions, as well as the expected longer-term actions, will raise debt and regulatory burdens, adding enormous incremental long-term drags on growth and productivity. Finally, the dramatic changes ushered in will undoubtedly carry multiple, adverse unintended consequences, from heightened vulnerabilities of unprecedented debt loads, to changed political realities, to greater international tension between the US and China. We will eventually emerge from this economic crisis, but it will be a long and tough road, and there will have occurred fundamental changes to the socioeconomic landscape, many of which are extremely hard to predict.

We believe the stock market is now likely ahead of itself. While markets need not follow GDP in the short-term, and indeed, tend to discount news farther over the horizon than most any individual investors, there seems to be a lot of discounting occurring at the moment. That the S&P 500 is now down only a fraction of the expected epic hit to GDP is, to our knowledge, an unprecedented development in the long history of economic busts. Stranger still, the market started its precipitous decent in the first quarter of this year from one of the highest valuations of all time, and now, adjusting for the projected earnings declines, is at a still higher valuation! This rapid turn of events in equities does not comport with historical patterns, where the stock market tends to trough at below-normal multiples on prior-peak earnings. Also atypical is the retention of familiar leadership seen so far in the April recovery: growth's outperformance over value has not mean-reverted but instead, has hit ridiculous levels, probably reflecting a flight to the safe-haven of fortress balance sheets and the reliable growth of the near-monopoly tech platforms and similar, smaller cloud plays. Meanwhile, the breadth of this April rally is, ominously, the narrowest it's ever been, with the NASDAQ-100 basically flat through this crisis because of a handful of tech giants, while the average stock in the Vanguard Total Stock Market Index, the broadest measure of equities, down 14%. Clearly, market internals and valuation levels appear disconnected from a global economy in severe recession and a world still ridden with many risky unknowns.

In light of these observations, we think an abundance of caution is in order at the present time. We recognize that investors cannot time the market and should stay invested to avoid missing the small percentage of strong rallies that drive a disproportionate amount of long-term returns—Nature's power law applies to the markets as well. However, we believe that it is prudent to be fearful when all around us are fearful of missing out, and we know that this is especially true during brutal bear-market rallies such as the cruel one we just experienced in April. So we are focused on losing less rather than earning more, while partially hedging against the possibility that Fed interventions and a surprising medical discovery could make the current crisis go away quickly. And while we do not know whether the government can succeed in supporting the capital markets as it attempts to stabilize the economy, as the robust equity rally following the Global Financial Crisis would portend, we will continue to seek sound, long-term investment ideas and strike reasonable balances among those ideas within our portfolio in an effort to secure solid relative returns regardless of the answer to that question.

We also think that active management is again becoming relevant, as consumers of passive products have been reminded that keeping up with indexes is only fun when markets move solely in an upward direction. Moreover, we expect that active management will show its value as the differences in relative company positioning begin to emerge through the crisis and into the changed, post-COVID-19 world. For example, less regulated sectors should carry a higher premium in a post-crisis world that invariably carries more big government, and companies less impacted by decoupling supply chains could carry a higher premium, etc. We also expect that human judgment will be increasingly important as the shift toward new leadership invariably occurs coming out of this investment cycle; while growth will likely continue to carry a premium amidst a depressed environment, many value names, which have underperformed to the extreme even after a decade of historic underperformance, represent loaded springs in the eventual economic recovery. Active management, if it is doing its job, will better navigate the transitions we expect to see in these volatile times.

Our value-sensitive, fundamentals-focused investment philosophy should be well-suited to the present environment. Our strategies look for risk-adjusted underpriced opportunities in both the historically durable, safe-haven franchises of the old (and still prevailing) leadership, while also searching for classic value amidst the cyclical, deeply discounted names that should have the potential to sustainably outperform once markets can more clearly digest the extent of current economic devastation and reasonably look beyond it toward the next broad recovery. Hence, these strategies are well suited to navigate through the current environment of evolving risks and opportunities, as they afford balanced exposure to low-multiple value names, and to high quality, less economically sensitive stocks trading at reasonable prices. We will continue to adhere to them in a disciplined way and with a longer-term orientation, as we wait patiently for the more attractive opportunities that we believe will yet appear in this down-cycle.

We thank you for your continued interest in DoubleLine Equity. ■

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Select Definitions

CRSP U.S. Total Market Index – This index, managed by the Center for Research in Security Prices, comprises nearly 4,000 constituents across mega, large, small and micro capitalizations, representing nearly 100% of the U.S. investable equity market.

Gross Domestic Product (GDP) – Total monetary or market value of all the finished goods and services produced within a country's borders in a specific time period. As a broad measure of overall domestic production, GDP functions as a comprehensive scorecard of a given country's economic health.

Nasdaq 100 Index – This index comprises the 100 largest U.S. and non-U.S. non-financial securities based on market capitalization listed on the Nasdaq stock exchange. The index reflects companies across major industry groups including computer hardware and software, telecommunications, biotechnology and retail/wholesale trade.

Russell 1000® Growth Index – This index measures the performance of the large-cap value segment of the U.S. equity universe. It includes Russell 1000® Index companies with higher price-to-book ratios and higher forecasted growth values.

Russell 1000® Index – This index typically comprises approximately 92% of the total market capitalization of all listed stocks in the U.S. equity market and is considered a bellwether index for large-cap investing.

Russell 1000® Value Index – This index measures the performance of the large-cap value segment of the U.S. equity universe. It includes Russell 1000® Index companies with lower price-to-book ratios and lower expected growth values.

S&P 500 Index – This unmanaged capitalization-weighted index of the stocks of the 500 largest publicly traded U.S. companies is designed to measure performance of the broad domestic economy through changes in the aggregate market value of the 500 stocks, which represent all major industries.

Vanguard Total Stock Market Index – This index tracks the investment results of the CRSP U.S. Total Market Index, comprising approximately 100% of the investable U.S. stock market. Vanguard index companies, which represent a cross-section of market capitalizations, primarily trade on the New York Stock Exchange and Nasdaq stock exchange.

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