Vaughan Nelson

Market Commentary and Portfolio Positioning

The security and well-being of our colleagues, clients, families, and service providers is a primary concern for Vaughan Nelson and we hope that each of you are safe and taking measures to protect against Covid-19. Vaughan Nelson has taken significant measures to ensure business continuity while providing for the safety of our colleagues and community. With such measures in place, we are spending considerable time focusing on the current market challenges. We realize that opportunities are forming, and we stand prepared to take advantage when the time arrives.

During the market decline in the fourth quarter of 2018 we made the point that we had begun the process of recessing liquidity. Prior to Covid-19, the global economy was already going through a liquidity recession and the virus has accelerated those issues. In isolation, the global economy could have withstood the economic impact of the virus. However, coupling the virus with a liquidity recession has proven to be a hostile environment. The large daily market swings we are experiencing are indicative of the need for liquidity.

From 2009 to the end of Quantitative Easing, the liquidity provided by the Fed was above and beyond what was needed for economic activity. That excess blead into financial assets and suppressed volatility. When the Fed reduced liquidity in 2018, the liquidity recession began, and now Covid-19 has exasperated the breakdown in global liquidity.

The Fed's most recent rate cuts have pushed Treasury yields to all-time lows, causing money to exit Treasuries during a time when Treasuries should be serving as the primary source of liquidity. Yields may continue to drift lower, but we do not expect negative yields to materialize. The anemic Treasury rates are forecasting lower future economic growth, declining earnings, and lower market multiples.

In short, we have reached the point where liquidity is no longer enough to support asset prices <u>and</u> economic growth.

Thankfully, unlike 2008, the Fed, Treasury, and market participants are not blind to the liquidity situation. The Fed is going to fulfill its role as liquidity provider in order to assist the market in eventually arriving at price discovery. The Fed has now entered the 'whatever it takes' policy response.

Recent equity market daily price swings (both up and down) provide no insight into a possible market bottom but are rather simply consistent with extremely elevated VIX levels. Consequently, the equity market is not a reliable indicator and the credit market will continue to lead equities.

The December 2018 market low represented fair value; provided we were not nearing a recession. The markets have now breached those lows, which is providing opportunities. We are finding several companies that are now at levels where we are particularly confident in our ability to earn our target return over the next few years. In fact, there are a number of very specific opportunities that are approaching levels that we have not seen in nearly 20 years. However, the opportunities are unique and very targeted. A broad-based approach of simply buying the most depressed securities is not a road map to success in this environment.

There are many companies that relied upon an excessively robust liquidity environment in order to generate returns. Such companies have declined at least in-line with the broader averages, but they will not participate in the recovery as the liquidity landscape has materially changed. We are actively targeting companies that have fallen well below fair value and are companies that have demonstrated they are not simply a beneficiary of a generous liquidity environment.

Eventually the economic activity lost to Covid-19 will be replaced but we are hesitant to assume this will occur in a V-shaped fashion. Therefore, to participate in the upside, companies will need to be both financially healthy and be positioned in healthy end-markets.

We are slowly adding to our shopping list as we seek new names for our portfolios. While we will be judicious entering new names, we will not wait an extended time to put our ideas to work.

Specifically, we are looking for companies with long-term opportunities that operate in secular growth areas where the total addressable market is expanding. It is not enough to be simply oversold. Many of the secular trends that were in place before the liquidity recession will remain in place after and we are getting a unique opportunity to build positions at attractive valuations. The modifications we make as we navigate through this environment will likely lead us to exit this cycle with more concentrated portfolios that have better valuations and more upside compared to the pre-Covid-19 period.

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