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Dear Atherean Wealth Management client:

Enclosed is your portfolio summary report for the quarter ending September 30, 2020, a summary of your investment objectives and target asset allocation as per our records, and an investment advisory fee statement for the fourth quarter of 2020. It is important that you review your investment objectives and target asset allocation and let us know if any of it is incorrect or if there are any changes to your overall financial profile. As stated in our last quarterly letter, for the sake of simplicity and brevity, we no longer list the individual positions in your accounts in our firm-generated reports. We encourage you to refer to your statements generated by the custodian for a full report of the holdings in your accounts.

Fiscal and Monetary Actions

In a Jackson Hole speech in August, the U.S. Fed chairman discussed in depth the Fed's recent amendments to its "Statement on Longer-Run Goals and Monetary Policy Strategy"[1]. This working document was originally formulated in 2012 with the aim toward making Fed policy transparent to the public and to markets, and was updated this past August for the first time since 2012. The Fed continues its price stability mandate with a target inflation rate in the 2% range, a policy which has been in place since 2012. But overall the mandate has been complicated by the unusually low inflation that occurred during the hot pre-COVID labor market. During the Jackson Hole speech, the Chairman noted that the flattening Phillips curve which characterized the economy pre-COVID has recently resulted in complications related to keeping inflation within its long run range. Despite the hot labor market and low unemployment pre-COVID, inflation remained low during this period. This was a very unusual situation as periods when the economy is operating at or above full employment have, in the past, typically been accompanied by high inflation. As a result of the pandemic-related shock to the economy, and, on top of this, having to compensate for a limited amount of inflation above the target range during the hot labor market before the pandemic hit, the current Fed rate is now close to the lower bound of its policy range and is anticipated to remain there for the forseeable future. On top of this, the policy rate range itself is considerably lower than it has been in prior years, primarily due to a much lower and declining r-star, or neutral policy rate[2]. The low neutral policy rate is primarily the result of structural, long term factors, specifically a declining potential GDP, now estimated by the FOMC to be in the 1.75% range. This

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[1] "Statement on Longer-Run Goals and Monetary Policy Strategy", Board of Governors of the Federal Reserve System, adopted effective January 24, 2012, as amended effective August 27, 2020

[2] For an explanation of r-star see, for example, "Measuring the Natural Rate of Interest", Thomas Laubach and John C. Williams, Board of Governors of the Federal Reserve System, November 2001

potential GDP estimate is at a historically low level, and the Fed chairman, in remarks during a press conference in September, went so far as to suggest that fiscal stimulus is needed. Such a statement related to fiscal policy is quite an unusual remark coming from the historically and traditionally politically neutral federal reserve. What is perhaps most significant about the decline in potential GDP is that it is only secondarily a result of demographic factors, such as slowing population growth and declining labor force participation, which are to be expected somewhat, and primarily a result of declining labor force productivity. We will explain is more detail how we are are allocating client portfolios in response to these low growth rates in the sections below.

Equity, Fixed Income and Commodity Markets

The equity markets have been characterized by a high amount of retail trading during the last two quarters, a scenario reminiscent of the internet bubble of the late 1990s. This situation, combined with fears surrounding further economic shutdowns this fall and uncertainty surrounding future fiscal stimulus continue to result in high market volatility, with the Chicago Board Options Exchange S&P 500 Volatility Index ("VIX") clocking in at a level of 40 as of the writing of this letter. We believe that at least a portion of the market uncertainty and volatility will be eliminated once we obtain some clarity as to the makeup of the U.S. Presidency and Congress for the next term. Year-to-date as of the end of the third quarter the S&P 500 index is up about 6%, the MSCI EAFE (Europe, Australasia and Far East) index is down about 7%, and the S&P 1000 index is down about 11% on a total return basis.

Economic Review and Outlook

As of the writing of this letter, the Federal Reserve Bank of Atlanta estimates GDP growth of 35.3% annualized for the third quarter, which would imply annualized output of just over $21T, a number just shy of the annualized output in the first quarter of 2019. While U.S output is still below its all-time high, the third quarter estimates imply a very rapid recovery after the record 34.3% annualized drop in GDP in the second quarter. While unemployment still remains high at 7.9%, it is far below the recent peak levels of 14.7% in April of this year and 10.1% in October of 2009.

Portfolio Management

For much of 2020, companies with high valuation multiples have performed well, with the S&P 500 technology sector currently trading at a price-to-earnings ratio of almost 40, compared with a price to earnings ratio of the overall S&P 500 of just over 30 (see Figure 1 in the *Appendix* for more detail). The Shiller S&P 500 Cyclically Adjusted Price to Earnings ratio was at a 32 level as of the writing of this letter, close to its recent high of over 33 in January of 2018 (see Figure 2 in the *Appendix* for more detail). As one well-known value investor put it recently, valuation multiples are primarily a function of optimism, growth, and interest rates. Optimism and growth are seemingly low, which leaves interest rates as the remaining explanatory factor. Seen through this lens the current high valuations make sense given the Fed's recent statements related to its short-term rate as well as its long-term neutral policy rate, r-star, anticipated to remain near record lows for the forseeable future.

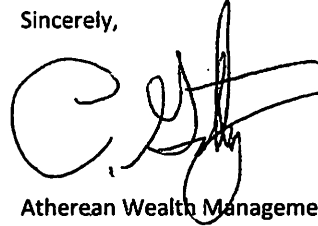
That being said, we do not believe that the high overall valuations which we are experiencing can be sustained given the sluggish economic growth environment. Expected returns of stock prices, at their most basic level, can be said to be a function of anticipated GDP growth, dividend yield, valuation multiple expansion, and share count reduction. And being that the primary reason for low interest rates is low potential GDP growth, and given that multiples are near all time highs at the same time that interest rates are close to the bottom of their policy range, we can not think of a logical reason for many companies to remain so richly valued given the current growth and interest rate environment. We are, as always, sticking to our core investment philosophy, which is to overweight companies with attractive relative and absolute valuations whose revenues, earnings and most importantly cash flows are growing at rates significantly faster than the economy as a whole. Of

course, it goes without saying that as always there are currently numerous sectors, industries and companies which are experiencing a rate of growth which is significantly larger than that of the S&P 500 and the overall economy.

Extra Space Storage (EXR) is an example of a U.S.-based real estate investment trust which is growing faster than the economy, and in July we took a position in Extra Space Storage in our client accounts[3]. Founded in 1977 and taken public in 2004, Extra Space Storage owns, operates, and manages just under 2,000 self-storage properties throughout the United States. The company is a growth leader amongst its peers, having increased its same store revenues at a 4% annualized rate over the past decade. By enhancing same-store growth through rollups of independently owned operators over this period the company has managed to grow revenue at an impressive annualized rate of just under 17% over the last decade. We took the position in July at a price to earnings ratio of approximately 29, only slightly less than the S&P 500 price to earnings ratio of just over 30, and this holding is amongst the most richly valued equities in our portfolio. We believe, however that the company's valuation is justified given the exceptional growth of the company's top lines, bottom lines, and cash flows with respect to those of the storage and industrial REIT industry, the real estate sector, the S&P 500, and the U.S. economy as a whole.

As always, feel free to reach out via phone or email if you would like to review your portfolio, discuss your financial plan, or have any other questions or concerns.

Sincerely,



Atherean Wealth Management, LLC

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[3] The particular securities which we discuss in this letter are not necessarily allocated to all of our client accounts. Whether or not we choose to allocate a particular security to your account will depend on your risk tolerance, investment objectives and liquidity needs. Nothing printed in this letter should be construed as a solicitation or an attempt to effect transactions in securities.

Appendix

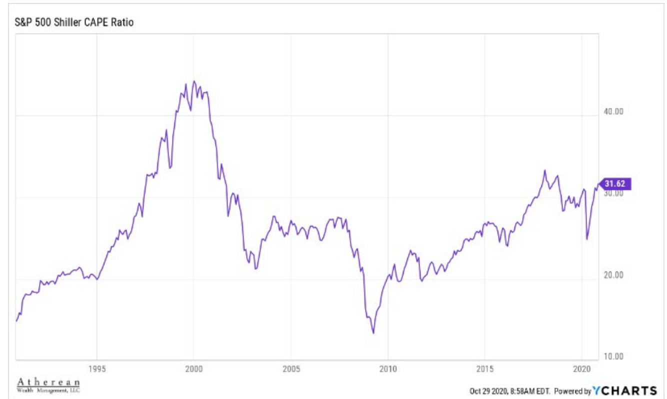

Figure 1: S&P 500 Price to Earnings ratio
October 2010 – Present (source: YCharts, Standard and Poors)

Figure 2: S&P 500 Shiller CAPE Ratio
Q3 1990 – Present (source: YCharts, Robert Shiller)