Alley Company Quarterly Letter
It's About the Future

January 14, 2021

> "Our belief is that investors who keep their eyes on the longer term horizon ahead, and not on the unsettled ground at our feet, will experience the best investment outcomes in the future…." *April 14, 2020 Alley Company Letter to clients*

As we look back on 2020 through the lens of investment management, there exists a glaring paradox. On one hand, there was a global pandemic-induced economic recession with unrelenting bad news surrounding COVID-19, and on the other hand, a sharply recovering stock market that rebounded to all-time highs despite the challenging headlines. This paradox reflects the notion that the "economy is not the market and the market is not the economy!" The challenge for investors throughout 2020 was understanding the "discounting mechanism," or forward-looking nature, of the stock market while coping with the real-time damage to the economy from COVID-19. This, of course, was not an easy task when one considers that there is no available playbook for investing in the first pandemic in over 100 years.

In retrospect, the stock market correction in February and March of approximately 34% in only 19 trading days was understandable given investors' unfamiliarity with the effects of a pandemic on the economy. The market correctly forecasted an impending economic recession. But very soon after the bottom was made on March 23rd, the market began a steady rise to new highs throughout the remainder of the year, albeit with some significant volatility in the early going. This is where the discounting mechanism of the stock market kicked into gear and began forecasting well beyond the recession itself with an eye toward an eventual recovery.

As the year progressed, the following factors began to be discounted in the stock market for their forward-looking impact on the economy:

- Favorable prospects for the medical science community to develop antivirals and vaccines to help deal with COVID-19.
- The Federal Reserve's early and seemingly limitless liquidity response to the pandemic.
- The CARES ACT putting money directly into the hands of individuals and businesses.
- The prospect for corporate America to produce operating leverage in the coming quarters, whereby recovering revenue growth is matched against a lower cost structure resulting in an outsized boost to earnings.
- The adaptability of businesses to use technology to navigate and, in some cases, prosper in an uncertain business climate.

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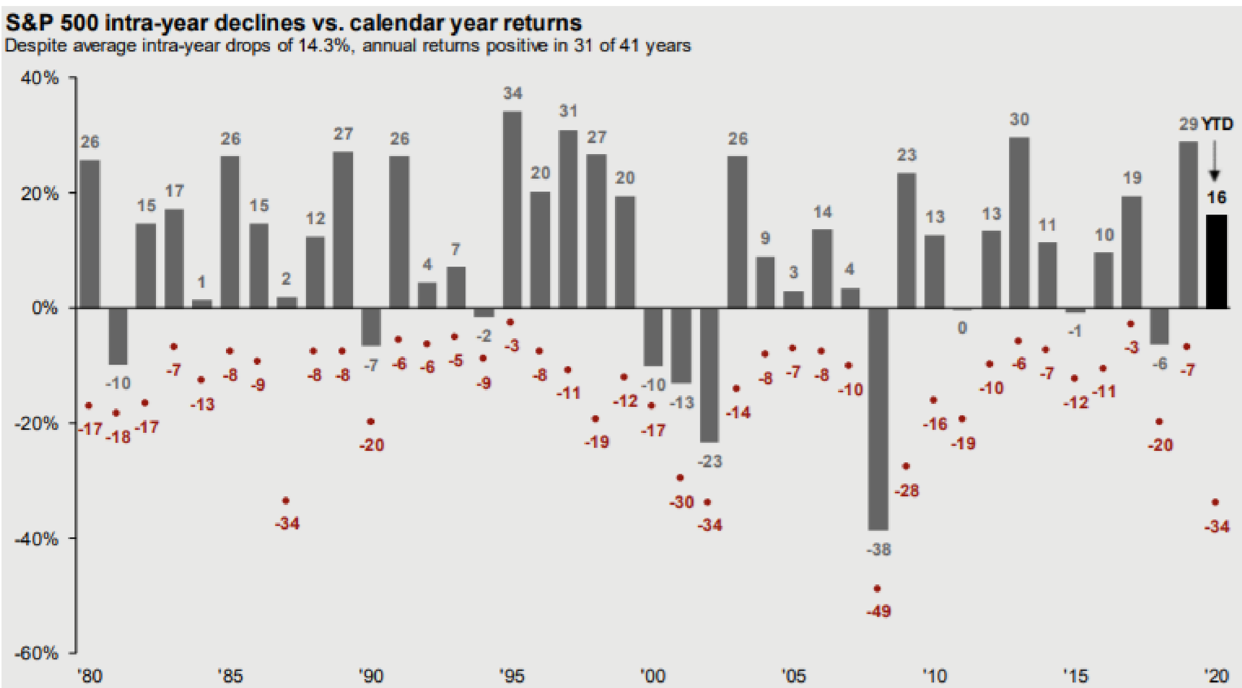
In real time, it was difficult for investors not to focus on the unsteady ground at their feet – businesses closing, rising unemployment, COVID-19 cases and deaths rising, the second wave coming in the winter, a divisive election, etc. But the forward looking mechanism of the market paid very little attention to the here and now and pressed on to the future prospects for the economy given the aforementioned remedies.

The stock market's discounting mechanism is always hard at work and while the market as measured by the S&P 500 has gone up 10.2% per year on a total return basis over the past 94 years, it still has a history of worrying about what can go wrong. Exhibit A below shows the past forty-one years of annual S&P 500 total returns with the corresponding corrections that occurred in each calendar year. Two key takeaways from this analysis are: 1.) the S&P 500 goes up in most years and in the years it goes down there are only three in the last forty-one where it went down more than 10%, and 2.) intra-year declines occur every year and have actually averaged 14.3% per year during this time period.

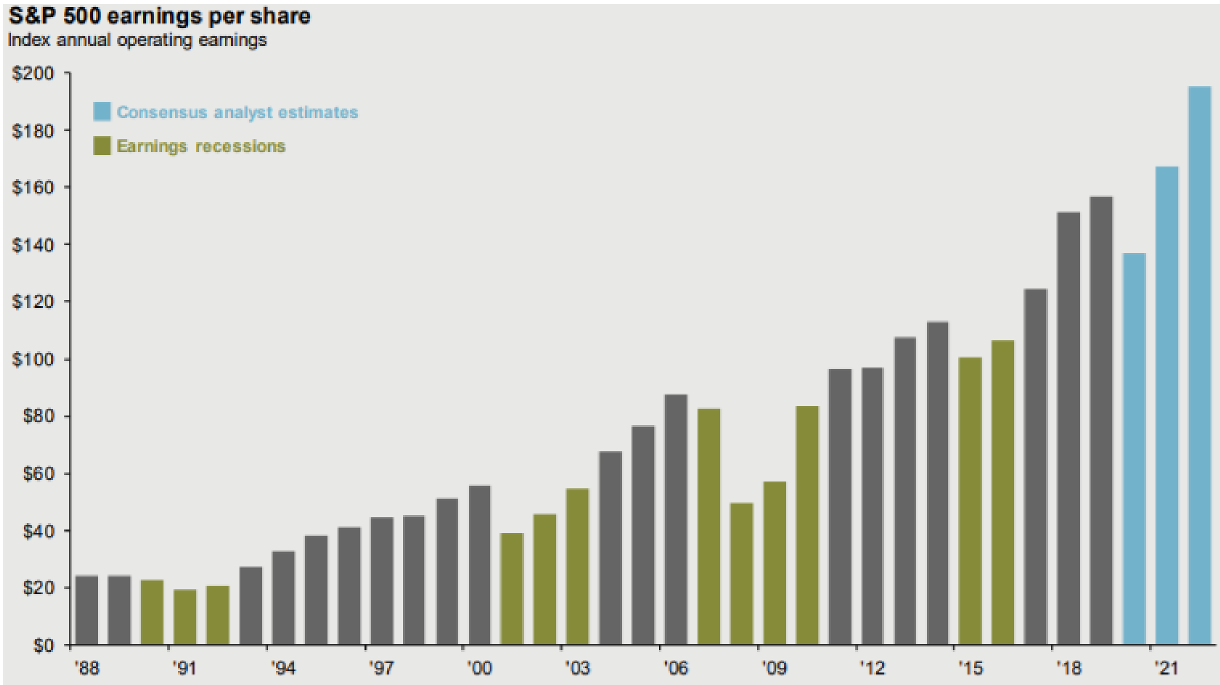
Exhibit A



Source: J.P. Morgan Guide to the Markets, December 31, 2020

Exhibit A underscores the notion that the stock market is a forward-looking creature and regularly gets concerned about adverse events that could impact the economy and corporate America. But as Exhibit B below shows, it is also a believer in the upward sloping trajectory of the U.S. economy where entrepreneurialism and innovation drive corporate profits to higher levels over time despite bumps along the way.

Exhibit B



Source: J.P. Morgan Guide to the Markets, December 31, 2020

The year 2020 has taught investors that investing is all about the future. And in that vein, our strongly held view for compounding investment returns over time is to own high quality companies that pay stable and growing dividends and have dominant market power in the markets they serve. As we look to 2021 and beyond, the wind appears to be at the back of a recovering global economy as the stock market has been signaling. There will surely be more corrections along the way as the market's discounting mechanism continues to be at work, but in any case, staying with quality is always a good idea for the future.

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