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October 1, 2020

Dear Clients and Friends,

"May you live in interesting times" is believed to be a translation of a Chinese curse. The attribution is apocryphal: no Chinese source has ever been identified. On the other hand, China is unquestionably where the SARS-CoV-2 pandemic began, most likely transmitted from an animal. From these humble origins, the Covid virus has gripped the world economy, drastically altering behavior globally and causing devastating loss for many. By countless measures, these times are perhaps too interesting.

Shock and Awe: A String of Extraordinary Swings

According to the Bureau of Economic Analysis, the U.S. economy contracted an extraordinary 9.5% in the second quarter. Think of it: almost one-tenth of our nation's output of goods and services vanished in just three months. We have to go back to the huge exogenous shock of demobilizing from a world war in 1946 to find a more severe contraction in domestic GDP. Ironically, about 25% of this most recent economic retreat came from reduced spending on healthcare, as routine visits to doctors and elective procedures were deemed non-essential or too risky. Another 35% is attributable to curtailed discretionary expenditures on transportation, dining out, lodging and recreation. While healthcare is gradually returning to pre-Covid levels already, it is hard to imagine a return to normal in these other categories absent a safe, effective and widely available vaccine.

Not surprisingly, the stock market's initial reaction to the pandemic was the fastest fall from record levels into a bear market that we know of: the Dow Jones Industrial Average and the S&P 500 Index fell about 37% and 34%, respectively, in a little over a month as the potential severity of Covid became apparent. What's followed since has defied expectations. From the bottom on March 23, stocks staged one of the most robust six-month advances in at least 80 years, with the S&P 500 gaining almost 52% as of September 30. As this remarkable recovery in stock prices was occurring, the online business rating service Yelp reported that 163,735 businesses closed between March 1 and August 31, and that some 60% of these have likely closed permanently. Is Wall Street underestimating the pain on Main Street?

In considering that question, it is important to dig below the headline market data. As of the end of the quarter, the five largest companies in the S&P 500 by market capitalization (Apple, Amazon, Alphabet, Microsoft and Facebook) comprised nearly 22.5% of the Index, and collectively accounted for 140% of the gain of 5.5% year-to-date. In other words, if one

excludes these five stocks, the S&P would be down 2.2% through the first nine months of 2020. Apple is up 58% year-to-date, accounting for roughly half of the index's gain all on its own. At one point over the summer, Apple's market capitalization exceeded the total value of the entire Russell 2000 Index, a widely used benchmark of smaller companies. The Russell 2000 has considerably less international exposure than the S&P 500 and is more representative of how the typical domestic business is faring; as of September 30, this benchmark was down 9.6% year-to-date.

The Road to "Normal"

The Federal government's reaction to the crisis, intended to prop up Main Street, also bolstered Wall Street. The US Congress passed a $2 trillion stimulus bill and the Fed promptly reduced the Federal Funds rate to nearly 0%. Fed Chairman Jay Powell announced the Central Bank would use any tools at its disposal to backstop the economy. Governments and central banks worldwide followed suit, softening the virus-induced hardship on both corporations and their customers. Since the stock market is heavily influenced by expectations of future earnings, the precipitous rise in the market suggests many investors are betting on the arrival of a swift and effective vaccine and a rapid return to "normal."

We are not so sanguine. While progress on a vaccine is occurring at an unprecedented pace, it will be some time before we fully understand the safety profile and efficacy of the new drugs. It may take longer than expected for consumers to return to restaurants, theaters, sporting events and travel. In addition, people are learning new ways to live and work which will result in a changed allocation of resources. For example, commercial offices might now hold lower relative value than home offices, causing a shift in commuting, office rent, expenditures on technology and urban center vibrancy. Just as many small business closures are likely to be permanent, we believe that many pandemic-induced behavior changes will not suddenly shift back to pre-pandemic norms. Finally, fiscal stimulus passed by Congress in the Spring was a stopgap measure designed to alleviate short term suffering. The pandemic's impact on the economy is continuing and we believe the consequences will be damaging if Congress fails to enact further fiscal measures.

With the national election about one month away, we have officially entered the "crazy season." Investors dislike uncertainty, and the wider the range of potential scenarios, the harder it becomes to handicap the likelihood of a particular outcome. Despite the persuasive evidence that there is virtually no fraud in ballot counting or voting, a substantial and growing minority of the electorate is prepared to believe that the election could be rigged. Because of Covid and the consequent increase in voting by mail, the outcome of the election in some States may not be known for days or longer after November 3. Investors can handicap a Biden presidency or a Trump presidency, but they can't handicap an unresolved presidency, especially one that could

lead to civil unrest if the resolution is delayed by weeks or months. We are keeping a close eye on this situation, and are prepared to act should short-term price fluctuations offer the opportunity to build positions in great companies whose long-term prospects remain undimmed or trim positions in stocks whose prices inflate to levels we deem excessive.

The Case for Stocks and Against Bonds

We are often asked whether or not the market is expensive and therefore vulnerable. We devote no time to predicting the direction of the stock market; we add value for our clients by building carefully constructed portfolios of thoroughly researched companies. Regardless of where the market is at a given moment, we remain as convinced as ever that the best way to preserve and grow wealth long term is to buy and hold the equities of high quality companies. We define "quality" as the ability of a company to compound per share value by building a defensible franchise and having the capacity to reinvest in maintaining and expanding that competitive advantage to create durable, growing and recurring free cash flow.

By many metrics the equity market is pricier than usual, but stocks are not getting much competition from bonds. The yield on the 10-year U.S. Treasury bond ended the third quarter at 0.68%, just above its historic low registered in August. With inflation running about 1.7% annually, the real yield on the U.S. 10-year is negative 1%. Investors buying this bond and holding it to maturity seem guaranteed to lose purchasing power. By contrast, the indicated dividend yield on the S&P 500 was 1.71% at the end of September. Over the last sixty years, dividend yields have rarely exceeded the 10-year rate, and never for very long. If stocks remain flat and dividends do not increase for the next ten years (events that seem unlikely to us), equities would still outperform the 10-year Treasury by about 2.5X, assuming one bought the bond today and held it to maturity. Accordingly, we recommend limiting one's exposure to bonds in favor of increasing one's allocation to stocks.

Merck: Under-Appreciated Growth Potential and an Undervalued Stock

The long-term advantages possessed by exceptional businesses can be overlooked by investors preoccupied with nearsighted fears. We think **Merck** epitomizes the characteristics we look for in a potential investment, and we recently added the stock to our Model Portfolio. Founded as an apothecary in Darmstadt, Germany, in 1668, Merck is the world's oldest pharmaceutical company. The U.S.-based Merck & Co. was founded 1891 as a subsidiary of the German firm and became an independent company shortly after World War I. By revenue, Merck is now the third largest pharmaceutical company based in the U.S. It has an extraordinary track record of researching and developing innovative treatments for pressing health needs. Merck was the first to develop such household names as Streptomycin, Vitamin B-1 and Cortisone. It also introduced the first commercially available statin, the first recombinant DNA-based vaccine, one of the first protease

inhibitors for treatment of HIV, and the first approved vaccine for Ebola. Merck invests about 20% of annual revenue in research and development, currently about $10 billion.

This relentless dedication to science has made Merck a recognized leader in the fields of oncology, vaccines, infectious diseases and others. It is on the forefront of immunotherapy for cancer. The company's leading medicine in this space, Keytruda, is growing about 30% annually and reached about $11 billion in sales in 2019. The research group GlobalData predicts Keytruda will be the world's top selling medicine by 2023 and will reach about $22 billion annually by 2025. The company has about 1,300 clinical trials ongoing with Keytruda which, if successful, could expand this blockbuster's franchise even further. Far from a one trick pony, Merck is investing heavily in its vaccine candidates, HIV treatments and other anti-viral medicines. It is working on multiple treatments and vaccines for Covid-19. Merck's strong balance sheet gives it ample flexibility to acquire promising medicines to complement its "in-house" developments.

In the first half of 2021, Merck plans to spinoff to shareholders its slower growing and lower margin women's health and legacy medicines businesses. We believe the spin-off will unmask for investors the higher growth and higher margins of Merck's core oncology and infectious disease efforts. The spinoff will give the shareholder oriented management team additional flexibility to distribute a growing amount of free cash to shareholders through increased dividends and share buybacks.

At this writing, Merck trades at a multiple of 13x expected 2021 earnings (before adjusting for the spin-off), a 36% discount to the S&P 500 based on Bloomberg consensus estimates. Merck's 2.9% dividend yield represents a 72% premium to the S&P's yield. As long-term investors, we are excited that the market has given us the opportunity to purchase this durable franchise at what we believe is an attractive price. We hope to hold Merck for many years to come.

Closing Thoughts

Despite the many challenges our nation faces, we remain optimistic that our economy is resilient and will navigate these tricky shoals with creativity and renewed vigor. We wish to express our sincerest gratitude to our clients, whose trust makes our work possible. We value the confidence you place in us and are grateful for the privilege of working for you. We encourage you to engage with us to help you chart your course through these daunting times. We are steadfast in our conviction that we will pull through these trials together and we all will be stronger for it. Be safe, and be well.

Sincerely,
Douglass Winthrop Advisors

Douglass Winthrop

[i] US Bureau of Economic of Economic Analysis of the Department of Commerce, https://www.bea.gov/sites/default/files/2020-09/gdp2q20_3rd.pdf. See Key Source and Data Assumptions, lines 40, 45, 50 and 59.
[ii] https://en.wikipedia.org/wiki/List_of_largest_biomedical_companies_by_revenue

Sources for stock market data: Standard & Poor's, FTSE Russell and Bloomberg.
Sources for bond market data: Bloomberg and The Governors of the Federal Reserve.

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