LINCOLN CAPITAL

Lincoln Capital Equity Commentary
Issue #34 – October 2020

October Changes:

Tax-Deferred

New Additions	Complete Sales	Partial Sales	Additional Buys	% Of Account Traded
NMIH				0.9%
		MDLZ		1.4%

Taxable

New Additions	Complete Sales	Partial Sales	Additional Buys	% Of Account Traded
NMIH				0.9%
	MDLZ			1.7%

Summary of Month's Action:

Stocks hit some turbulence in the back half of October, with the S&P 500 declining 2.7% during the month. The last week of October saw the market drop 5.6%. Some analysts suggested the drop was due to election concerns, while others suggested it was due to coronavirus. We believe interest rates may have been the true driver of the market's recent performance. See bar to right.

From a factor perspective this month, value outperformed, while quality, minimum volatility and momentum all lagged. Utilities, communication services and materials outperformed this month, while information technology, energy, and health care were the major laggards.

Lincoln Capital's tax-exempt stock model outperformed in October. The top contributors to this outcome were Citizens Financial (CFG) and Zebra Technologies (ZBRA). Top detractors were Amgen (AMGN) and Mondelez (MDLZ). Citizens reported earnings that were in line to slightly below expectations in October. Despite the underwhelming results, CFG tracked regional banks higher this month as the 10-year treasury moved from 0.69% to 0.88% - suggesting higher revenues ahead for the group. Amgen reported results from multiple pipeline candidates in October. Amgen's heart failure candidate missed its secondary endpoint of a reduction in cardiovascular death, likely placing competing products in a stronger position.

Early Election Considerations – This note is being written the morning of November 4th, and at this moment, the most likely outcome of the election is a Biden presidency and a Republican senate. The second highest likelihood is Trump presidency and a Republican Senate. We will be addressing the election in more detail in writings in the upcoming weeks, but our initial thoughts are this outcome is mildly market positive. Key risks are if the election result will be contested, and, what the size of future stimulus will look like. More to come on these topics soon.

Quick Thoughts on Value v. Growth

Though lacking a data driven proof, it makes intuitive sense that growth stocks (which comprise the largest stocks in the S&P 500 and therefore exert large influence on the direction of the index) would underperform with higher rates relative to their value counterparts. Stock prices reflect the sum of discounted future cash flows. Growth stocks are more reliant on distant cash flows than value equities. As an extreme example, take Tesla – the stock trades at $400, and this year's earnings are expected to be $2.40, or a P/E of 167x. That $2.40 is relatively immaterial to TSLA's value, it is the future cash flow that is decades away when Tesla reaches its stated production goal of 20 million vehicles that is more meaningful. In this context, TSLA is like a long duration bond, and as interest rates rise and fall, its price should be impacted more than a shorter duration instrument. JP Morgan on the other hand is expected to generate $26.70 in EPS over the next three years relative to its price of $100. JPM is like a short duration bond, as the near-term cash flows are much more important to today's value.

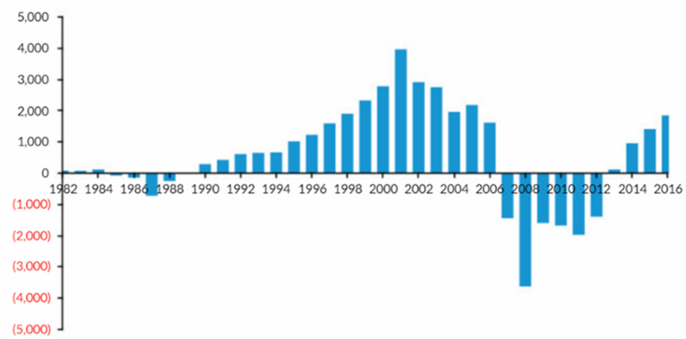
Security Specific Comments:

Mondelez International, Inc. (MDLZ) – We reduced our position in MDLZ to free up funds for NMIH.

NMI Holdings, Inc. (NMIH) – We purchased ½ of our intended position in NMIH during the month, with the second half expected to be acquired shortly. NMI operates under the National MI brand providing mortgage insurance primarily on Fannie Mae and Freddie Mac mortgages. The equity has been severely punished this year, currently trading at $22, versus a 52-week high of $36. I believe this is a classic case of the generals fighting the last war. During the last recession there was material and fatal damage incurred in the industry as credit underwriting was extremely lax, and housing prices propped up by this lax credit collapsed creating a surge of foreclosures and losses for lenders. Three of the eight mortgage insurers during the last crisis didn't make it through. The following chart shows the history of profits in the industry:

FIGURE 2

PMI Industry Historical Operating Income/(Loss), $ Millions, 1982–2016



Sources: Mortgage Insurance Companies of America and US Mortgage Insurers.

Radian and MGIC are still recovering and paying losses on pre-crisis vintages.

That was then. Today, capitalization levels amongst the six monoline private mortgage insurers are much improved and the use of reinsurance has taken the most catastrophic losses off the table. There are two key differences this crisis versus last that I believe will prove the mortgage insurers over reserved and their stocks primed to outperform: home prices and forbearance programs. Home prices are key ingredients in a consumer's decision to default on their mortgage (thereby creating losses for PMI insurers). If a consumer has equity in their home, either via principal paydown, or home appreciation, it is far better for their credit and their wallet to sell the home, pocket the equity, and move on. The surge in single family home demand, all-time low interest rates, and the exodus from cities to suburbs, likely puts a bid under home prices in the medium term, preventing material price declines. Forbearance programs have allowed consumers subject to COVID-19 related stress to forgo principal and interest payments for up to a year. Once this time is up – the missed payments can be made up in multiple formats, the easiest of which is getting tacked on to the end of the loan. Unemployment has already dropped significantly, and with a successful vaccine we expect it can drop further. As people regain employment, they will likely be able to pick up where they left off on their mortgage – and if not, again, they can sell the house if they have positive equity. JP Morgan has seen loans in deferral decline by half in the third quarter from the second quarter, and importantly, 91% of the loans that exited deferral programs remain current. This bodes well for the PMI industry.

NMIH has the lowest risk portfolio in the industry, but this is somewhat offset by lower levels of reinsurance. NMIH has been gaining share in recent years, which we expect to continue. I believe that market share gains, coupled with better than expected future losses will drive NMIH's shares close to $50 in the medium term. Despite one of the best risk reward relationships in the portfolio today, there is also a lot of downside risk associated with the business – given this, we are likely to keep this position small.

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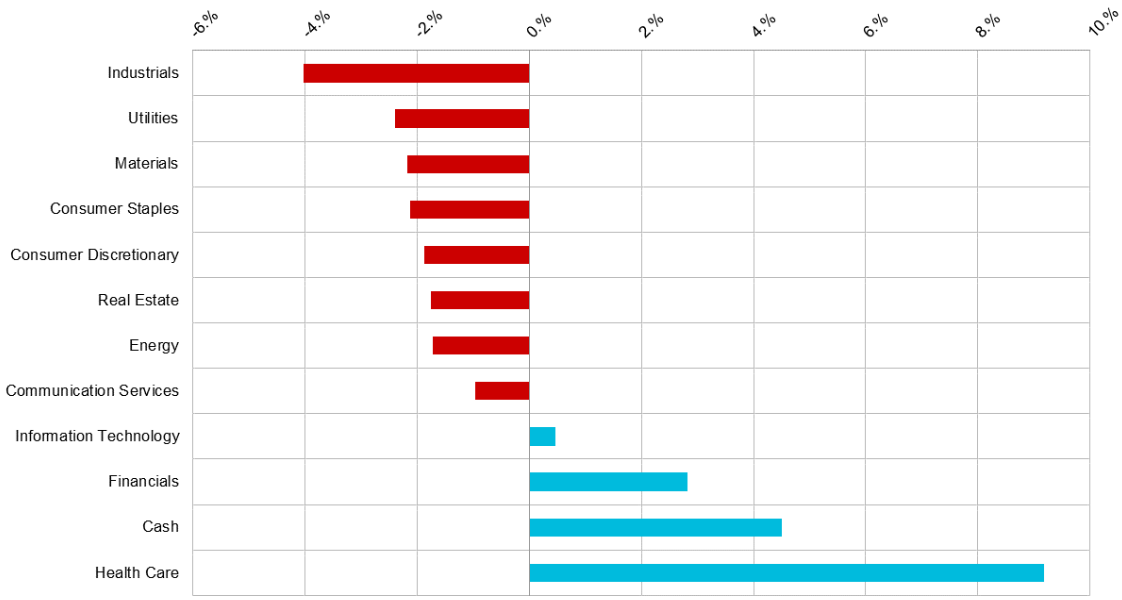
Taxable Models

Sector Weights Relative to the S&P 500:



Portfolio Holdings (10/31/2020)

Goldman Sachs ETF Trust - Goldman Sachs ActiveBeta U.S. Large Cap Equity ETF (ARCA:GSL	16.25%	Financials
Microsoft Corporation (NasdaqGS:MSFT)	10.52%	Information Technology
iShares Trust - iShares MSCI USA Quality Factor ETF (BATS:QUAL)	9.23%	Financials
Amgen Inc. (NasdaqGS:AMGN)	5.64%	Health Care
Apple Inc. (NasdaqGS:AAPL)	5.49%	Information Technology
JPMorgan Chase & Co. (NYSE:JPM)	4.94%	Financials
Citizens Financial Group, Inc. (NYSE:CFG)	4.70%	Financials
Verizon Communications Inc. (NYSE:VZ)	4.62%	Communication Services
CVS Health Corporation (NYSE:CVS)	4.51%	Health Care
UnitedHealth Group Incorporated (NYSE:UNH)	4.32%	Health Care
iShares Trust - iShares MSCI USA Momentum Factor ETF (BATS:MTUM)	3.23%	Financials
NVR, Inc. (NYSE:NVR)	3.11%	Consumer Discretionary
Schwab Strategic Trust - Schwab Short-Term U.S. Treasury ETF (ARCA:SCHO)	3.08%	Financials
Lowe's Companies, Inc. (NYSE:LOW)	2.86%	Consumer Discretionary
Mondelez International, Inc. (NasdaqGS:MDLZ)	2.68%	Consumer Staples
Alphabet Inc. (NasdaqGS:GOOG.L)	2.55%	Communication Services
AmerisourceBergen Corporation (NYSE:ABC)	2.42%	Health Care
Zebra Technologies Corporation (NasdaqGS:ZBRA)	2.23%	Information Technology
Emerson Electric Co. (NYSE:EMR)	2.19%	Industrials
Medtronic plc (NYSE:MDT)	1.58%	Health Care
International Business Machines Corporation (NYSE:IBM)	1.49%	Information Technology
US Dollar (USD)	1.42%	Cash
NMI Holdings, Inc. (NasdaqGM:NMIH)	0.93%	Financials
Total	100.0%	

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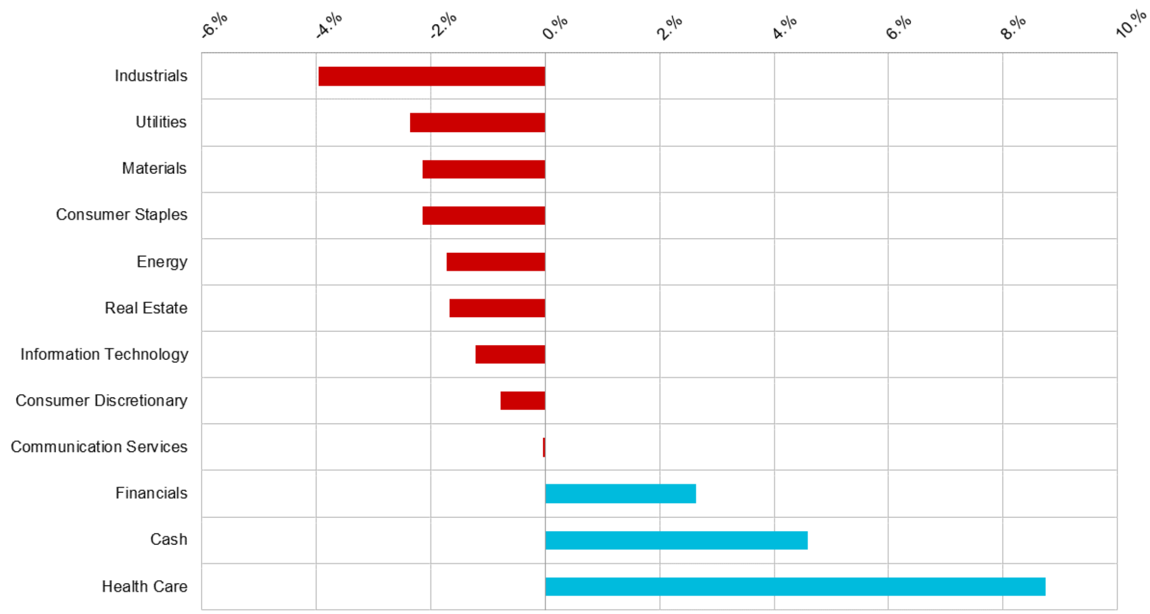
Tax-Exempt Models

Sector Weights Relative to the S&P 500:



Portfolio Holdings (10/31/2020)

Goldman Sachs ETF Trust - Goldman Sachs ActiveBeta U.S. Large Cap Equity ETF (ARCA:GSL	16.45%	Financials
iShares Trust - iShares MSCI USA Quality Factor ETF (BATS:QUAL)	9.36%	Financials
Microsoft Corporation (NasdaqGS:MSFT)	8.44%	Information Technology
iShares Trust - iShares MSCI USA Momentum Factor ETF (BATS:MTUM)	5.15%	Financials
Citizens Financial Group, Inc. (NYSE:CFG)	5.08%	Financials
Apple Inc. (NasdaqGS:AAPL)	5.00%	Information Technology
Verizon Communications Inc. (NYSE:VZ)	4.66%	Communication Services
Amgen Inc. (NasdaqGS:AMGN)	4.63%	Health Care
UnitedHealth Group Incorporated (NYSE:UNH)	4.41%	Health Care
JPMorgan Chase & Co. (NYSE:JPM)	4.28%	Financials
CVS Health Corporation (NYSE:CVS)	4.00%	Health Care
NVR, Inc. (NYSE:NVR)	3.89%	Consumer Discretionary
Schwab Strategic Trust - Schwab Short-Term U.S. Treasury ETF (ARCA:SCHO)	3.46%	Financials
Alphabet Inc. (NasdaqGS:GOOG.L)	3.18%	Communication Services
Lowe's Companies, Inc. (NYSE:LOW)	2.86%	Consumer Discretionary
AmerisourceBergen Corporation (NYSE:ABC)	2.65%	Health Care
Mondelez International, Inc. (NasdaqGS:MDLZ)	2.58%	Consumer Staples
Zebra Technologies Corporation (NasdaqGS:ZBRA)	2.33%	Information Technology
Emerson Electric Co. (NYSE:EMR)	2.21%	Industrials
Medtronic plc (NYSE:MDT)	1.75%	Health Care
International Business Machines Corporation (NYSE:IBM)	1.58%	Information Technology
US Dollar (USD)	1.11%	Cash
NMI Holdings, Inc. (NasdaqGM:NMIH)	0.93%	Financials
Total	100.0%	