SHELTON CAPITAL MANAGEMENT

Shelton International Select Equity

QUARTERLY
Commentary
As of March 31, 2020

Executive Summary

- International equity markets, as defined by the MSCI ACWI ex U.S. Index, declined during the first quarter as the COVID-19 outbreak prompted fears that economic disruption could last into summer and initial efforts by central banks to inject liquidity and confidence into markets were not enough to reverse the damage.
- The Shelton International strategy outperformed its benchmark as conservative positioning during the quarter mitigated downside risk.
- Mainland China was the best performing region as investors cheered the seemingly rapid containment efforts led by the central government.
- Latin America was the worst performing region as the dual shock of the economic sudden stop and the collapse of oil prices hit this region particularly hard.

Portfolio Performance

In the first quarter of 2020, the Shelton International Select Equity Institutional strategy (-19.21%) outperformed the benchmark MSCI ACWI ex U.S. index (-23.36%), underperformed the MSCI ACWI ex U.S. Growth index (-18.25%), and outperformed the MSCI ACWI ex U.S. Value index (-28.47%).

Portfolio Manager

Andrew Manton

Andrew Manton is the Portfolio Manager for the Shelton International Select Equity Fund. Mr. Manton has over 20 years of investing experience at WHV, Victory Capital Management, Deutsche Asset Management and Merrill Lynch. He earned an MBA from the Tepper School of Business at Carnegie Mellon University and a B.S. from the University of Illinois at Chicago.

Market Review

International markets finished lower in the first quarter of 2020 as COVID-19 spread rapidly and central bankers rushed to rescue markets in order to lessen the pandemic's impact on the global economy. Fears surrounding containment efforts, the lack of a vaccine and accessible testing and the lasting economic impact brought upon by the virus sent global equities on a plunge beginning in late February. The drop immediately erased more than $6 trillion in market cap from international stocks just one week after news of the virus broke. International equites, as defined by the MSCI ACWI ex U.S. Index, now sit at levels not seen since 2017.

Economic data out of the Eurozone in February portrayed an economy in frail condition even before the virus' outbreak. The Eurozone grew just 0.1% in the fourth quarter of 2019, marking the slowest pace of growth since the bloc's debt crisis in 2013. As expected, German growth flatlined during the quarter, driven by lower manufacturing output, consumer spending and lower exports. Germany's IFO business sentiment index also continued to contract, registering a 95.9 reading for January versus 96.3 for the prior month and expectations for a reading of 97.0. As if the global economic slowdown was not enough to threaten Germany's economic recovery, the coronavirus outbreak all but assures an impending economic crisis. German leadership is hoping that a $812 billion spending package announced on March 25th will mitigate some of the inevitable slowdown which has already been foreshadowed by Eurozone flash composite PMIs for the month of March. The flash PMI for the European Union in March declined by a record 20.2 points to 31.4, significantly below expectations for a sharp decline, driven by a broad deceleration in both the services and manufacturing sectors. While German and French PMIs showed record declines, the disastrous print for the region was driven by the country hit hardest by the coronavirus pandemic: Italy.

Italy found itself in the headlines as a national shutdown beginning on March 10th failed to contain the virus' spread through the Lombardy region. In fact, Italy saw its death toll overtake that of China towards the end of the quarter, largely attributed to the fact that Italy has the world's second oldest population after Japan, despite recording half of the number of China's 81,000 confirmed cases. The outbreak could not have come at a worse time for Italy, in which healthcare investments comprise just 6.8% of GDP, lower than its major European counterparts. Still struggling to contain a public debt crisis, which stands at 134% of GDP, Italy has recently been forced to make cuts to its national healthcare service, putting particular strain on hospitals and providers. Even Rome's planned €25 billion stimulus package to support exporters and unemployment services, combined with loan and mortgage forgiveness programs, may do little to prevent Italy from falling into its fourth recession in the past decade. Given, the retail and wholesale sectors, which employ a quarter of Italy's population, are likely to remain shut down for the foreseeable future shows just how deep of a hole in which the Eurozone's third-largest economy will find itself.

With European society shut down and growing awareness of economic shock brought about by the virus, all eyes naturally turned to the European Central Bank (ECB). On March 12, the ECB committed to purchase an additional €120 billion in bonds and slash rates on currency swaps, yet refrained from pushing interest rates further into negative territory. The decision failed to calm markets as European indices suffered their worst day in history after the ECB's announcement. Facing criticism for not taking more decisive action to protect the bloc from the impact of the pandemic, ECB President Christine Lagarde announced the Pandemic Emergency Purchase Program (PEPP), a €750 billion commitment to purchase additional government bonds and private securities. Most notably, Lagarde mentioned later that day on Twitter that the central bank would defend the Euro at all costs and that it would stand ready to increase the scale of its purchases if necessary. Combined with the fiscal and monetary action taken by individual governments, the ECB's commitment brought the total value of all European relief packages to combat the virus to over €2 trillion.

In the UK, Brexit headlines took a backseat to the coronavirus outbreak as Prime Minister Boris Johnson's strategy to combat the virus was met with heavy criticism. Unlike select European leaders such as Emmanuel Macron, who likened defeating the virus in France to being "in a state of war," Johnson initially refrained from enforcing quarantines because he believed the British public would build immunity if it spread naturally. After coming under fire for expressing what was viewed as careless, Johnson's tone shifted in mid-March when he recommended that all Britons work from home if able, avoid social contact and unnecessary travel. By the end of the month, Johnson had issued a strict, stay-at-home order, effective for the following three weeks, citing the fact that the British National Health Service would soon be overwhelmed if an onslaught of new cases were announced.

Already faced with a stagnant economy before the virus landed in the UK, the Bank of England (BOE) announced an emergency relief package in early March to assist domestic businesses and households through the impending economic shock. The policy decisions include: slashing the Bank Rate by 50 basis points to 0.25%, introducing a Term Funding Scheme for small and mid-sized business, allowing banks to loosen their capital buffers and offering banks four years of funding at the new Bank Rate plus a fee to ensure they could lend during uncertain times. The package serves to perhaps cement the legacy of former Governor of the Bank of England Mark Carney, who was replaced by Andrew Bailey on March 16th. Bailey's term is proving to be eventful from the beginning, as just three days into his service BOE officials voted to cut its benchmark rate to 0.1% from 0.25% and committed to buying £200 billion of UK government bonds. Citing disruption brought about by the coronavirus, the UK and European Union agreed to put trade negotiations related to Brexit on hold. A standstill period beyond the current December 2020 deadline is likely.

The Chinese economy essentially shut down after authorities acted swiftly to combat the spread of the virus beyond Wuhan, where two-thirds of total Chinese cases were recorded. Among the significant actions undertaken by local, provincial and national governments were imposing a full shutdown of Wuhan and a travel ban in and out of the city, enforcing quarantines in cities throughout Hubei Province, and closing all factories in more than twenty provinces through the end of February except for those supplying medical equipment. Not until early March did select offices in Wuhan start to reopen for business, while 95% of large companies and 60% of small and medium sized companies outside of Hubei had already resumed operations. As expected, economic data for the January and February combined period released by the National Bureau of Statistics revealed how significant a toll the virus had taken on the domestic economy. Notably, industrial production declined 13.5% YoY amid a widespread shutdown of manufacturing operations, despite expectations for just a 3% YoY drop. Retail sales also took a significant hit as mandated quarantines impacted consumer behavior, with the gauge falling 20.5% YoY, the first decline on record. Fixed asset investment, another significant measure of economic activity in the country, declined by 24.5% YoY. The collapse was also the first on record and fell short of analysts' expectations for a decline of just 2% YoY.

Despite the pandemic's severe impact on the Chinese economy, the People's Bank of China (PBOC) refrained from taking drastic action. In mid-February, the bank lowered its one-year loan prime rate from 4.15% to 4.05%, and its five-year rate from 4.80% to 4.75%, the first rate cuts since October 2019. It also lowered the interest rate on its one-year, medium-term lending facility to 3.15% from 3.25%. While the PBOC has refrained from announcing additional measures to shore up the domestic economy, it stated at the end of March that it stands ready to lower borrowing costs further for Chinese companies hit hard by the virus. The lack of a large-scale fiscal and monetary response to lessen the blow on the economy calls into question how China will continue to meet its robust, short-term growth targets.

Dovish attitudes were once again a unified theme for emerging market central bankers during the quarter. In Latin America, Brazil's central bank moved to combat weakness in the Real after the bank surprised the market by cutting its policy rate to a record low of 4.25% in early February. Seeking to soften the economic blow brought on by the pandemic, which had yet to impact Brazilian economic data, the bank's rate-setting committee announced another 50 basis point rate cut after its March meeting and pressed the government to follow through on planned reforms. Recovering from a 2.1% YoY GDP contraction in the final quarter of 2019 due to widespread anti-government protests, Chile also moved quickly to dampen any impending economic hardship by announcing an $11.75 billion stimulus package, equivalent to 4.7% of GDP, in mid-March. The package contains tax deferrals for companies with sales under $12 million and a boost to spending on health expenditures by utilizing a special clause in the constitution that allows the government to reallocate 2% of the fiscal budget. With 342 confirmed cases, the second-most to Brazil in Latin America, President Sebastian Pinera also declared a ninety-day catastrophe and closed Chile's borders, schools and limited public gatherings. Peru also declared a fifteen-day quarantine effective March 15th, shutting down national borders and public travel within the country, in addition to mandating individuals remain in their homes overnight. The Banco Central was also proactive, cutting its interest rate to a record-low 1.25% on March 19th, citing the potential for a meaningful deceleration in economic activity as the virus outbreak continues. It is widely believed that South America remains unprepared for what is certain to be an onslaught of new cases over the coming weeks.

In Southeast Asia, Indonesia's Bank Sentral continued to ease despite persistent weakness in the Rupiah as the economy was hit hard by the virus outbreak. After deciding to lower rates during three straight policy meetings during the fourth quarter of 2019, the bank again slashed its seven-day reverse repo rate, deposit rate and lending rate by twenty-five basis points to 4.5%, 3.75% and 5.25%, respectively, in mid-March. The bank also announced its intention to intervene in the foreign exchange and domestic bond market, and expanded daily reserve requirements for banks that lend to small and medium-sized companies. Citing a softening macroeconomic climate, the bank lowered its domestic growth forecast for 2020 to 4.2-4.6% YoY from 5.0-5.4% YoY and reiterated its stance that spillovers from the virus outbreak will hamper tourism, commodity exports and foreign investment for the remainder of the year.

The Monetary Board of the Bangko Pilipinas, just days after the stock market in Manila was shut due to heightened volatility, also moved swiftly to cut its policy rates by 50 basis points towards the end of the quarter. Notably, the bank also lowered its 2020 inflation forecast to just 2.2-2.4% YoY from 2.9-3% YoY as risks to the domestic economy remain skewed to the downside and will be exacerbated by adverse impacts from the virus. Thailand, with over 800 confirmed cases of coronavirus, continues to suffer after closing its borders to tourism, which accounts for one-fifth of the economy, and taking additional steps to halt its spread. Despite rolling out a $13 billion stimulus in the form of tax cuts and concessionary loans to small businesses to soften the blow from the coronavirus outbreak, it remains to be seen whether investors expect the package to positively impact liquidity conditions and shore up the nation's consumption-based economy. The country's benchmark SET equity index ended the quarter as Asia's worst performer.

In the United States, President Trump, Congress, the Treasury Department and the Federal Reserve worked tirelessly to minimize the economic damage brought about by the coronavirus, which some economists have warned will be more severe than that from the 2008 financial crisis. On March 8th, President Trump signed an $8.3 billion spending package to provide funding for government agencies fighting the virus and vaccine research. Within the next week, the president declared a national emergency and waived interest payments for those with student loans during the duration of the virus outbreak, while the Federal Reserve pledged to pump as much as $1 trillion into the market by buying bonds across a range of maturities, versus only short-term treasury bills during prior market operations. The Fed followed up on Sunday, March 17th by cutting rates to nearly zero and announcing a new $700 billion quantitative easing program, its first dramatic action since the 2008 financial crisis. The new list of Fed purchases not only includes $500 billion of Treasuries and $200 billion of agency-backed mortgage securities, but also municipal bonds. The Fed also announced the establishment of a Primary Dealer Credit Facility to provide short-term liquidity to significant financial institutions, as well as a Commercial Paper Funding Facility to purchase commercial paper from issuers, which Treasury Secretary Steven Mnuchin said could total up to $1 trillion.

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The most significant piece of legislation to emerge from the U.S. was a record $2 trillion stimulus bill agreed to by both the White House and Senate leadership during the early hours of March 25th. Passed in the Senate on March 26th following a 96-0 vote, the bill dwarfs the government's $787 billion response to the financial crisis passed under the Obama administration in 2009. Key components agreed to by Republicans and Democrats include establishing a $500 billion fund for distressed companies, cities and states, a $367 billion loan program for small businesses, sending $1,200 checks to low and middle-income Americans and their families, and expanding unemployment benefits and provisions for health care expenditures. It remains to be seen how much impact the stimulus will have on lessening the pandemic's impact on the economy, but the Trump administration's pledge to restart the American economy by mid-April seems all but unlikely. Not surprisingly, the government's weekly unemployment claims report released at the end of March revealed a record 3.28 million Americans filed for unemployment insurance, as over 211,000 American businesses have closed and major corporations across the country including General Electric, Delta Airlines and Marriott International have begun to furlough staff. The numbers will likely get worse, as some economists estimate as many as 30% of the nation's restaurants will shutter. With cases in densely populated regions of the country, particularly New York City, still on the rise, the question of when life in the U.S. will return to normal remains far from answered.

As uncoordinated as the world has been in its initial containment efforts of the CODID-19 virus, the one near universal reaction has been the use of significant monetary and fiscal stimulus packages with a "whatever it takes" attitude. These are surely unprecedented times and the enormity of these actions will be felt for years to come. In the U.S., the fiscal response thus far of over $2 trillion, or just over 9% of GDP, is roughly double the size of the 2009 package as a percentage of GDP. The rapid shift to quantitative easing has the Federal Reserve and Treasury now working in a coordinated manner to issue bonds in order to fund the growing deficit and then buy them back in lieu of a natural buyer. The Fed has gone well beyond the QE conventions of the 2008 crisis and is buying long dated treasury bonds, agency bonds, and now corporate bonds with an investment grade rating. Although quantitative easing has been a developed world phenomenon, the practice has now spread to the developing world with central banks in Poland, Colombia, Philippines, South Africa, Brazil, and the Czech Republic all moving to employ QE measures by buying their own bonds in the secondary market. As these experiments in Japan and Europe have taught us, the measures are not easy to reverse.

The duration of the economic standstill brought on by this crisis remains the crucial question that needs clarity. The secondary effects of this sudden economic stop are not yet known but are sure to be felt in areas such as unemployment, mortgage delinquencies, and non-performing loans at banks. As we move through the crisis, we are constantly updating our views on our portfolio structure and each company in the strategy. One thing that has held true in every crisis in history is that the darkest moments – those of peak fear and uncertainty – present the best buying opportunities. We pray for the health and safety of all our clients during this time. We are honored to be stewards of your retirement capital and our commitment is to proceed with the utmost passion and diligence.

Portfolio Review

The Shelton International Select Equity Institutional strategy (-19.21%) outperformed the benchmark MSCI ACWI ex U.S. index (-23.36) as international markets ended the first quarter significantly lower as the coronavirus sent equity markets into a rapid selloff and elicited pessimism over the pace of economic recovery over the short and mid-term. Growth stocks outperformed value stocks during the quarter as financial and material stocks drove down the value index. Already concerned about overall valuations in most markets coming into 2020, our conservative positioning and active repositioning of the portfolio allowed for significant outperformance in the quarter.

The top five contributors in the third quarter were Ambu A/S (Deceleration), Nomura Research Institute (Maturity), Itochu Corp (Deceleration), ASML Holdings (Deceleration) and L'Oreal SA (Deceleration). The biggest detractors were Aker BP (Innovation), Valeo (Deceleration), Bangkok Bank (Maturity), CAE Inc (Deceleration) and BNP Paribas SA (Maturity).

Regionally, the top contributors in the quarter were United Kingdom and Latin America, while Europe and Asia ex-Japan detracted most. Information Technology, Materials, and Consumer Staples were the top contributors by sector, while Consumer Discretionary, Communication Services, and Financials detracted most.

BUYs

Straumann Holding

Based in Switzerland, Straumann is the world's largest maker of dental implants and one of the largest players in dental technology. Implants are rapidly replacing bridges and dentures around the world, while the broader dental industry is quickly growing as health spending increases, especially in emerging markets, and as consumers care more about aesthetics. Straumann's brand, its history of execution and its ability to cross-sell to dentists is so widely regarded that the stock has historically traded at valuation levels well above that which we could reasonably model. We took advantage of its recent price decline in order to start a position.

HDFC Bank

India's largest private-sector bank, HDFC is another well-regarded company we have watched for some time. As COVID-19 spread into India and forced that country to lock itself down, local investors began to panic and sell down the shares on fear of impending loan quality deterioration. India's shutdown and its broader economic deceleration will hurt HDFC Bank over the next year but we feel its long-term runway for growth is more powerful than ever, as more Indians turn to formal finance and as HDFC Bank's competitors—state-run banks, other private banks, as well as nonbank lenders—reel under the weight of their bureaucracies and their bad loans. In this environment, HDFC Bank, which boasts better underwriting norms and cost control than rivals, can be opportunistic, just as we have been with its shares.

Smurfit Kappa Group

Operating in 35 countries, Smurfit Kappa is a paper-based packaging company dedicated to corrugated materials. The company has an integrated supply chain which allows for a responsible procurement processes with minimal cost volatility. As the industry continues to consolidate, Smurfit Kappa is in a good position to continue to benefit from this trend. In addition, the company is also benefiting from the secular trend of greater package delivery spurred by the online marketplace. As Smurfit is a family run company, we appreciate the alignment of management and shareholder interests and we took advantage of recent market turmoil to build a position of this well-run company.

Sells

Bancolombia SA

We originally bought Bancolombia in hopes that the secular shift to more of the population entering the mass of formally banked and the continued improvement of the Colombian economy would drive loan growth at this well-run bank. As the stall in recent economic growth in Colombia met with the dual burdens of the current COVID-19 crisis along with the oil price collapse, it became clear that the likelihood of rapid loan quality deterioration is all but assured. We decided to sell our position in order to preserve the gains we have made in the shares.

Dormakaba Holdings AG

dormakaba Holdings has been a long-term position in our strategy and was originally bought after Dorma merged with Kaba in 2015 and management set out to create value through cost synergies and their unique product offering. After some initial success, the company has recently failed to effectively compete in their home European market with their bigger competitor, Assa Abloy. With the low likelihood of this changing given the lack of innovation along with the current slowdown in the European construction market, we decided to exit the shares and reinvest in more promising companies.