Volume 47 - Number 1 Spring 2023

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Market Update –*Regaining Balance*

by David A. Jaffe, M.D.

Throughout the forty-six year history of Professional Advisory Services, adoption of a "balanced" portfolio structure has been a hallmark of our risk management strategy. Commonly employed in the investment world, a balanced portfolio typically describes a mix of two financial asset categories: stocks and bonds. While we vary the percentages to address client needs and risk tolerance, the classic balanced investment portfolio holds 60% stock and 40% bonds.

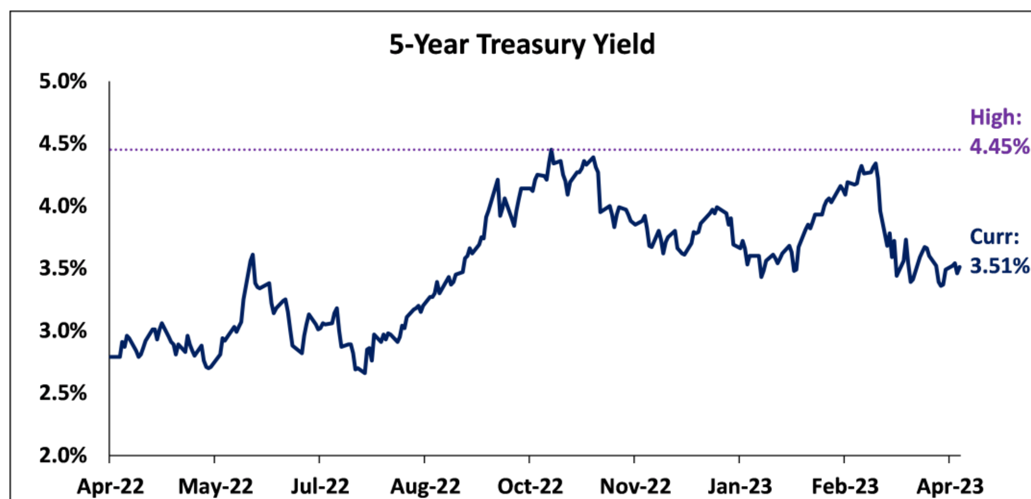
There are several advantages to a balanced approach to portfolio composition:

- Setting a fixed ratio of stocks and bonds imposes a healthy discipline as the manager rebalances regularly, "selling high and buying low" as market fluctuations dictate to maintain the target mix.
- Bonds, typically very stable in pricing, are a potential source of funds if an unexpected need arises during a period of stock market decline.
- Bonds cushion the volatility inherent in the ups and downs of the stock market, and in fact *typically appreciate in value in the face of a stock market decline.*

Okay … not this time. In fact, by some measures, 2022 was the worst year for the 60:40 mix since 1937. While most stock market declines result from anticipation of economic contraction and falling corporate earnings, circumstances in which the Federal Reserve is expected to come to the rescue by lowering interest rates, in the current inflationary environment the Fed has been the villain. Rising interest rates, as we have written before, depress bond prices.

While bonds suffered less than stocks in 2022, the simultaneous decline in both asset classes soured many investors on the balanced strategy, leading some to proclaim the demise of the "60:40 Portfolio".

Flip the calendar, and things are looking much brighter for the time-honored balanced approach. Stocks and bonds have both gained value, and 5-year interest rates have declined almost a full percentage point from the October 2022 peak of 4.45% to the current level of 3.51%:



In the first quarter of 2023 the S&P 500 gained 7.50%, while the Bloomberg 1-5 Year Corporate Bond Index (a benchmark which closely mirrors the PASI bond structure) added 1.68%. Using the benchmark returns cited, a 60:40 mix returned 5.17% in the first quarter (includes reinvested stock dividends).

A narrow group of companies, primarily in the technology industry, have been driving this year's market gains. After over-hiring to meet a pandemic-fueled surge in demand, they got an early jump on cost cutting with significant announced layoffs. Depressed valuations, a consequence of rising interest rates, are rebounding as rates decline. Finally, investors are comforted by the fact that these companies are very well financed. Three stocks alone, Apple, Microsoft, and Nvidia account for 50% of the 2023 S&P 500 returns. Against this backdrop, the broadly diversified PASI composite stock portfolio trailed the S&P 500 index, posting a return of 5.59% including reinvested dividends. The PASI corporate bond composite returned 1.38%, the average PASI 60:40 mix therefore gaining 3.91% in the first quarter.

Recent economic data shows slowing economic growth and employment trends. In an economy highly dependent on the consumer, credit is tightening and family balance sheets are weakening. March inflation measures demonstrate significant progress, leading investors to believe the end of the Fed's interest rate hikes is near. The key concern is whether a recession, with its associated earnings contraction and business disruption, is inevitable, and how deep and long it may be. Investors wrestle with the good news – bad news balance. For now, it seems the glass is half full one day and half empty the next. The direction of the stock market over the next few months will likely vacillate as we navigate our way through this uncertain environment.

Are My Assets Safe? – *Understanding Bank and Brokerage Custody*

by Christopher J. Connett

In light of recent bank failures, we feel it is especially important to reassure you that your assets are safe. First and foremost, the custodians we work with are global leaders in their industry, providing a layer of security through their financial strength and stability. Here is an overview of custodians housing the majority of PASI client assets:

THE BANK OF NEW YORK MELLON CORPORATION *as of December 31, 2022*

- Offers bank and brokerage custody services through its subsidiaries and affiliates
  - Bank custody: BNY Mellon N.A.
  - Brokerage custody: Pershing LLC
- One the world's largest global custodians
- $44.3 trillion assets under custody or administration
- One of thirty banks distinguished as a Global Systemically Important Bank (G-SIB)
  - G-SIBs are subject to increased oversight and regulatory requirements for capital, liquidity, and risk management, further mitigating the risk of their failure

PERSHING: BNY Mellon's Brokerage Custody Platform *as of December 31, 2022*

- Over $2.0 trillion in global client assets
- More than 7.5 million investor accounts
- Excess SIPC through Lloyd's of London and other Commercial Insurers[1]
  - An aggregate loss limit of $1 billion for eligible securities – in total for all client accounts custodied at Pershing
  - A per client loss limit of $1.9 million for cash awaiting reinvestment – within the aggregate loss limit of $1 billion

THE CHARLES SCHWAB CORPORATION *as of December 31, 2022*

- $7.05 trillion in global client assets
- 33.8 million active brokerage accounts
- Excess SIPC through Lloyd's of London and other London Insurers
  - An additional $149.5 million for securities and $900,000 for cash for each separate capacity, subject to the program aggregate of $600 million

Custodians offer two primary frameworks to hold and protect your assets – bank custody and brokerage custody. While we consider both to be safe, there are key differences to understand.

Bank custodians are regulated by the Office of the Comptroller of the Currency (OCC), which is a part of the U.S. Department of the Treasury. Customer assets are registered in the bank's

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[1] Supplemental coverage through private insurance is known as "excess SIPC"

"nominee" name but are required to be kept separate from the bank's and other clients' assets. As such, client assets are not subject to the claims of the bank's creditors, even in the unlikely

event of the bank's insolvency. It should be noted that cash deposits are not securities and potentially available to the bank's creditors. However, cash receives protection through the Federal Deposit Insurance Corporation (FDIC) with a federally insured standard amount of $250,000 per depositor, per insured bank, in each account ownership type.[2]

Brokerage custodians are regulated by the Securities and Exchange Commission (SEC), supplemented with self-regulatory organizations like the Financial Industry Regulatory Authority (FINRA). Brokerage assets are typically held in "street name" and included on the firms' books. PASI client assets are *fully paid securities* under Rule 15c3-3 – Customer Protection and must be accounted for separately through rigorous internal control measures. Customers of broker-dealers receive preferential treatment in the unlikely event of failure, and their assets are generally not available to creditors.

Additional safeguards include annual audits by independent firms, a Service Organization Control (SOC) report, and the passing by Congress of the Securities Investor Protection Corporation (SIPC) in 1970.[3] SIPC protects against the loss of cash and eligible securities up to the first $500,000 of a customer's portfolio, with a cash limit of $250,000. Supplemental coverage can be provided through private insurance known as "excess SIPC."

BANK CUSTODY
BNY Mellon N.A.

BROKERAGE CUSTODY
Pershing / Charles Schwab

Last, note that the safeguards presented protect against losses due to a financial institution's failure and not losses due to market fluctuations of your investments.

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[2] For a complete explanation of FDIC regulations, we encourage you to visit www.fdic.gov.
[3] For a complete explanation of SIPC regulations, we encourage you to visit www.sipc.gov.

"Pulling on a Rubber Band"

by Nathan Polackwich, CFA

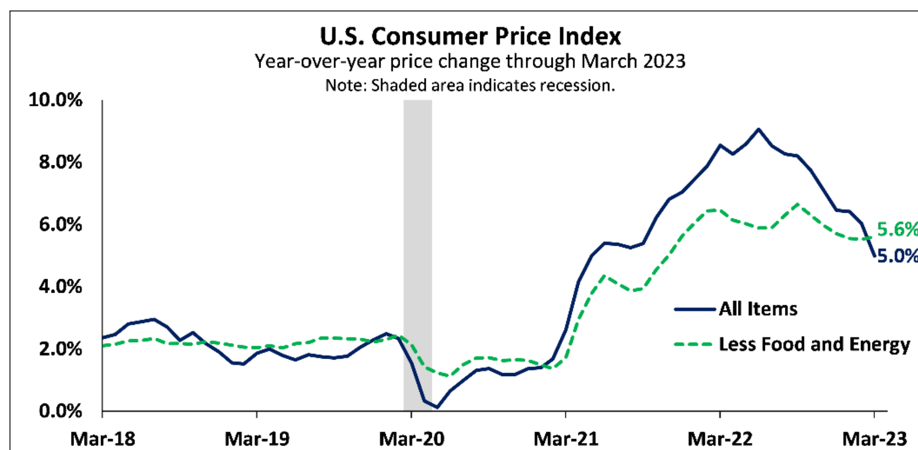
With the sharp rise in interest rates and troubles in the banking sector, there's a lot going on in the U.S. economy right now that I thought would be a little easier to digest in the format of a Q&A.

Why is the Federal Reserve raising interest rates? Because they're trying to slow inflation, which got uncomfortably high following the pandemic.

How do higher rates reduce inflation? Higher interest rates make borrowing more expensive for households and businesses (the private sector). So higher rates should reduce private sector borrowing and thus spending on things like new homes, cars, vacations, factories, equipment, etc. Lower demand should, in theory, lead to lower prices or at least a slower increase in prices (less inflation).

So far the Fed has hiked rates from 0.25% to 5.00% over the past year. Has the economy slowed? No. GDP growth was actually already slightly negative in Q1 and Q2 of 2022. It then grew 3.2% in Q3 and 2.7% in Q4. The Federal Reserve has a statistical forecasting model called GDPNow that currently projects a further 2.2% growth in Q1 of this year. Note that private sector spending in Q1 is expected to remain robust, but businesses have some excess inventory they can sell (without the need for replenishment), which will modestly dampen GDP growth.

What about inflation? Though the economy hasn't weakened, inflation *has* begun to slow, as the chart below shows.



If the Fed's interest rate hikes didn't slow the economy, why has inflation declined? With the economy proving relatively immune to higher rates, Federal Reserve policy doesn't seem to be the reason for inflation's deceleration. So what is? At its most basic level, an economy and price level changes simply reflect shifts in supply and demand. With this in mind, here's what we see currently driving events: First, the pandemic severely disrupted the supply of goods and services

produced by the global economy. Many older workers and women with children left the workforce, which led to an acute shortage of labor. Less labor meant a constrained supply of goods and services, which all else constant leads directly to higher prices.

Of course, less people working should have also meant lower household income and therefore a lower demand for goods and services. But demand remained strong, though government lockdowns and general risk aversion initially caused much lower spending on services like restaurants and travel. Despite working less, however, households remained flush with cash thanks to unprecedented government stimulus that ultimately increased their savings by trillions of dollars. According to Federal Reserve data, household deposits (cash) jumped from $1 trillion in 2019 to *$5 trillion* by early 2022 (the last time the data was released).

The good news is that most people have now returned to their jobs and the workforce is about back to where it was pre-pandemic. The supply of goods and services has thus recovered, which has helped alleviate some of the pressure on prices. But while supply has improved, household demand remains strong despite the lack of any new government stimulus and a sharp rise in interest rates.

Why is U.S. demand still so strong? The most obvious reason is that $5 trillion is still sloshing around the economy. This excess cash isn't that easy to absorb even for the U.S., which has an annual gross domestic product (GDP) of about $25 trillion. The reason is that money doesn't just disappear once it's spent – one person's expenditure represents the income of another. So the cash will continue to be recycled until it finally makes its way into the bank accounts of the wealthy, whose day to day spending on goods and services isn't greatly affected by changes in their wealth (the rich tend to just save cash windfalls).

What about the Fed's rate hikes? The Fed's interest rate hikes have had a limited effect because the U.S. private sector, having all this extra cash lying around, doesn't need to borrow in order to spend. In addition, since the U.S. housing bubble burst in 2008, households have pared their outstanding debt substantially and in aggregate have very healthy finances. Rising rates may discourage borrowing, but unlike the days of the housing bubble, private sector debt increases aren't currently propelling growth. So whether households borrow or not, the economy continues to maintain its forward momentum.

So what can the Fed do? Not much! In many respects the position they find themselves in today is the inverse of the months leading up to the Great Recession 15 years ago. Specifically, in September 2007 the Federal Reserve began cutting interest rates in response to the apparent bursting of the bubble in the U.S. housing market and a consequent rise in the unemployment rate. When they started, the Federal Funds Rate was 5.25%. Over the next 15 months the Fed cut interest rates ten separate times all the way to 0%.

The Fed hoped that by cutting rates they could induce the private sector to borrow more, increasing their spending on goods and services and thus giving the economy a shot in the arm. It didn't work. In fact, despite rapidly lowering interest rates, private sector borrowing still ground to a halt and the economy entered the deepest recession since World War II. And even though rates were kept at zero through 2015, borrowing and economic growth remained historically

weak. In fact, at the end of 2007, U.S. households and non-financial businesses had $14.4 and $10.1 trillion in outstanding debt, respectively. By the end of 2015, fully eight years later, U.S. household debt had actually *declined* to just $14.2 trillion, while non-financial business debt had risen only modestly to $12.9 trillion (3.1% annual growth).

In those years the joke was that the Federal Reserve's futile attempt to boost the economy was tantamount to "pushing on a string." Over the last year the Fed has attempted the opposite – to hold the economy back by raising rates. But it's not working. The appropriate metaphor today (which I invented and expect full credit for) is that they're "pulling on a rubber band."

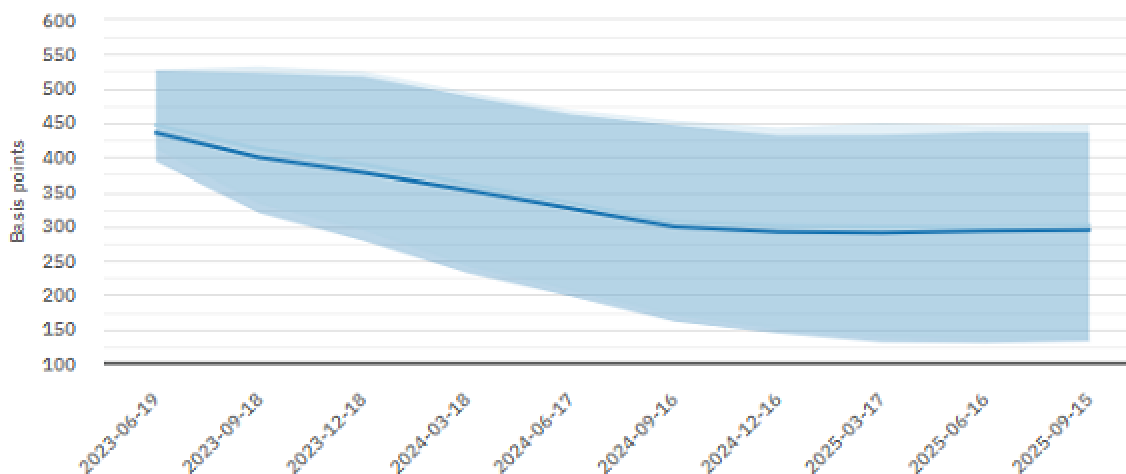
What happens if the Fed keeps pulling? Aside from the direction and intent, there's a big difference between pushing on a string and pulling on a rubber band. No matter how hard you push a string nothing will happen. But if you pull hard enough on a rubber band, it will eventually snap. The recent turbulence in the banking industry and failure of Silicon Valley Bank in California is a case in point.

Banks balance sheets have two major assets – the loans they write and the fixed income securities in which they invest (often U.S. Treasuries). On the other side of the ledger, banks typically have one major liability – the deposits of their customers. A bank becomes insolvent if the value of its assets falls below its liabilities. Usually this happens when banks make imprudent loans, borrowers default, and loan values have to be written down on their balance sheets.

This time, unusually, the problem concerns a significant loss in the value of banks' investment securities. The credit quality of these bonds is not in doubt. After all, many are long term U.S. Treasury bonds which carry the full faith and credit of the Federal Government. What's happened is that as the Federal Reserve has raised interest rates, the value of these securities has plummeted. For instance, if you buy a 30-year U.S. Treasury with a 2% yield and interest rates suddenly surge to 5%, the value of the bond will fall substantially in value (nobody wants to be locked into only earning 2% for 30 years when comparable bonds pay 5%).

For most banks, loans are their primary asset and fixed income securities are secondary. Silicon Valley Bank was an anomaly in that its balance sheet was mostly securities. So, the Fed's rate hikes had a particularly detrimental impact on its solvency. Moreover, an incredible 93.8% of its deposits weren't insured by the FDIC (because they were over the $250,000 threshold), and many of Silicon Valley's depositors – being concentrated in the technology and private equity industries – knew each other, which allowed a panic about the safety of their cash to spread like wildfire. As these depositors frantically started trying to pull their money out, Silicon Valley Bank's fate was sealed.

What happens next? The Fed is now in a difficult position. Despite little evidence of their effectiveness, the Fed still believes continued interest rate hikes are necessary to slow inflation. At the same time, it now knows that the higher rates go, the greater the potential for an accident in the financial sector that could spiral out of their control. For their part, financial market participants are already betting that the combination of banking industry turmoil and improving inflation numbers will have the Fed *cutting* interest rates by June of this year (see chart below).



We'll just have to wait and see who blinks first.

The Return of Travel, Tourism, and Booking.com

by Jeremy Goldberg, CFA, CFP®

Thomas Cook, a prohibitionist and founder of travel agency Thomas Cook & Son, was once a household name for the tagline: *Don't just book it – Thomas Cook it!* In 1841, Cook received his first commission check from the Midland Counties Railway after organizing an 11-mile railway trip for members of a temperance society. This success led to the creation of one of the first publicly available packaged excursions. Over the following decades, Thomas Cook & Son expanded globally into hotels, resorts, cruises, and airlines, becoming a dominant player in the travel industry with over $10 billion in annual sales. Despite its reputation and after 178 years of operations, the company filed for bankruptcy in 2019 due to several major flaws in its business model, including a reliance on brick-and-mortar stores, operating its own airline, and insufficient investments in technology. Today, travelers have moved away from traditional travel agents, guidebooks, and word-of-mouth recommendations, instead opting for online travel agencies (OTAs) where they can book flights, hotels, and car rentals themselves in a matter of minutes and consult online reviews on-the-go. As the world's largest OTA, Booking Holdings, or Booking.com, sits comfortably at the intersection of travel and technology, offering a wide range of accommodation and transportation options to all types of travelers with ease.

We previously owned Booking.com (BKNG) in the PASI core stock portfolio, but exercising prudence sold it in March 2020 when it was clear that the COVID-19 pandemic would significantly impact travel and tourism. We simply didn't know what type of permanent impact, if any, the virus would have on the travel industry. According to the World Travel and Tourism Council, this industry's global GDP fell more than 50% from $8.6 trillion in 2019 to $4.2 trillion

2020. The United Nations World Tourism Organization reported in January 2023 that it estimates global tourism will reach approximately 80% to 95% of 2019 levels by the end of this year. *Travel is finally back…and so is BKNG stock!*

Booking.com offers reservation services for over 2.7 million properties in more than 220 countries and territories in over 40 languages. It also operates five other primary brands: **Rentalcars.com** (car rentals), **Priceline.com** (North America discount travel reservations), **agoda.com** (Asia-Pacific travel reservations), **KAYAK.com** (search and compare travel itineraries), and **OpenTable.com** (online restaurant reservations in the United States). Booking.com is responsible for the majority of the company's total profit.

	Accommodations	Ground Transportation	Flights	Restaurants	Activities	Meta Search
Booking.com	✓	✓	✓		✓	
Priceline	✓	✓	✓		✓	
agoda	✓	✓	✓		✓	
Rentalcars.com		✓				
KAYAK						✓
OpenTable				✓		

Booking.com 2022 Form 10-K.

The *online* global travel industry is expected to grow from an estimated market size of $475 billion in 2022 to over $1 trillion by 2030 according to Statista, a leading provider of market and consumer data. Moreover, the share of global travel bookings made online has risen significantly from 38% in 2015 to 67% in 2022, indicating a growing trend of customers shifting towards OTAs such as Booking.com and leading competitor Expedia. With both companies controlling around 30% of the OTA booking market, it would be challenging for smaller new entrants to gain customer traffic or supplier scale due to the market's high fragmentation. Smaller companies would require significant human capital to build relationships with hotels, and massive investment in advertising, IT, data centers, and 24/7 support services to retain customers.

Booking.com's popularity and scale set it apart from its peers. According to *App Annie*, one of the largest sellers of market data on mobile apps, Booking.com is a top-10 travel app on iPhones in 153 countries, versus 79 for Airbnb, 25 for Expedia, and 5 for TripAdvisor. Travel booked via mobile devices is rapidly growing, especially in emerging markets where Booking.com and agoda.com have a strong presence. The company also has partnerships with Trip.com and Meituan-Dianping in China.

In developed markets outside the U.S., replicating Booking.com's leading network would be challenging and expensive for competitors. In Europe, 60% of all hotels are part of the small boutique category, compared to only 30% in the U.S. Due to their small size, they rely heavily on OTAs for marketing and distribution. Thus, limited staffing makes it difficult to actively manage inventory and relationships with multiple partners through multiple online distribution

channels. With over 70% market share of the OTA industry in Europe, Booking.com should remain the go-to agency for smaller hotels.[4]

A one-stop shop for travelers, BKNG's scale is unmatched. Customers reserved 896 million room nights through Booking.com in 2022 (up 52% from 2021) versus 394 million through Airbnb (up 31%) and 303 million through Expedia (up 29%).[5] Expected to earn $130/share, the company stock is currently priced at $2,550. This implies that shares trade at a price-to-earnings ratio of 19.6x, a 20% discount to its long-term average. With earnings growth at an estimated compounded annual rate of 22% over the next five years and a recently announced $20 billion share repurchase authorization (21% of the company's total market capitalization), we believe shares are attractively valued. Fortified with an incredibly strong management team and secular tailwinds, we're excited to own shares of BKNG.

Disclosure

Professional Advisory Services, Inc. may, from time to time, have a position in securities mentioned in this newsletter and may execute transactions that may no longer be consistent with this presentation's conclusions. Reference to investment performance of the PASI composite stock portfolio is made gross of expenses. For formal performance disclosure with net returns please contact our office.

[4] Statista.
[5] Companies' 2022 Form 10-Ks.