PASI NEWS
since 1977

Volume 43 - Number 2 Summer 2019

Professional Advisory Services, Inc.
2770 Indian River Blvd. – Suite 204 • Vero Beach, FL 32960
(800) 847-7274 • (772) 778-0552 • fax (772) 770-2979

Bank of New York Mellon – *Important Updates!*

As you are aware, we are in the process of opening client accounts at BNY Mellon for the upcoming transition of custody for all our client assets currently held at State Street Bank. We would like to thank everyone who has responded and signed all required documents, either through DocuSign or via physical copies.

Some things to know:

- As accounts are opened you will receive a welcome letter from BNY. It is important to note that although your account may be opened, *it will have a zero balance* until the targeted transfer date of August 26th.
- For those who have requested online access, there will be an email on how to set up your login credentials mid-August.
- All securities and cash will be transferred "in kind" to BNY.
- During the week prior and the week following the transfer, there will be limited access to trading and withdrawals.
- If you have not returned all requested documents and information by August 1st, the transition of your assets will be delayed until all documents are received.
- If your account does not make the initial targeted transfer of August 26th, there will be a two to three-week window where we **CANNOT** trade or make withdrawals.

Please contact us if you have any questions or concerns. We appreciate your patience and cooperation!

Market Update – *Not Too Cold, Not Too Hot!*

by David A. Jaffe, M.D.

What a difference a day makes! Or maybe that's a quarter? Or six months. Following the year-end sell-off of 2018, investors have done an abrupt about face and are buying stocks with abandon. After flirting with a bear market decline, a whisker shy of the requisite 20% drop, the S&P 500 ended the first half of 2019 up 18.54%. Better news yet for our clients, the PASI portfolio edged out the S&P 500 with a gain of 19.47% (both include reinvested dividends). Our corporate bond portfolio return stands at 4.35% YTD (with a bit of help from falling interest rates leading to rising bond prices), our "average" 60:40 stock-bond mix thus returning 13.42%.

A bit anxious about the three missing residents she may encounter, the best explanation for investor confidence must reside with our old time friend Goldilocks. Consider the following observations regarding the current economic environment:

- 121 months of economic growth, the longest expansion in U.S. history
- Cumulative 10-year GDP growth of 25%, far *below* previous expansions
- Predicted GDP growth for 2019 less than 2%
- Unemployment a scant 3.6% (May 2019), the lowest level since 1969
- Job growth 12%, *lagging* four of the last seven post-war recoveries

All this conflicting data makes our friend Goldilocks *so* happy. After all, slow but continued economic growth means little inflation risk and rising corporate profits, healthy employment with slow job growth equals little wage pressure, and modest growth predictions without inflation means a Federal Reserve nervous about sustainability of this record expansion. Goldilocks is done with her porridge and out there cheering for an interest rate cut! Recent comments by Fed Chair Jay Powell give Goldilocks cause for optimism on that front.

Market worries abound. They always do. Global economies are weak. Tariffs and trade wars loom, threatening already tepid economic growth. In the often upside-down world of stock investors, sentiment has been buoyed by this environment, which has sent 10-year U.S. Treasury yields down from 2.7% in January to just over 2.0% currently. With paltry returns offered by conservative fixed income vehicles and stocks regaining momentum after the 2018 sell-off, the U.S. stock market is widely viewed as the best investment arena. As always, we at PASI remain committed to our strategy of owning a diversified portfolio of top-quality companies, with a balance of bonds as dictated by client needs. Beyond that, we do our very best to tune out the noise of Wall Street and focus on long-term investment opportunities and delivering superior client service.

A Historic Extreme – *Growth vs. Value Edition*

by Nathan Polackwich, CFA

Everyone thinks they're a contrarian. Everyone imagines they'll be buying stocks hand-over-fist in the next bear market. But stocks don't fall in a vacuum. Steep declines happen for real and unsettling reasons like recessions, wars, bank failures, frozen credit markets, etc. And the more compelling those reasons (and sharply stocks drop), the harder it becomes to force your intellect to override the instinct to flee and just preserve the capital you have left. Herein lies the fundamental paradox of investing – the more obvious an opportunity, the greater the intestinal fortitude needed to exploit it.

Of course, opportunities don't just appear in general market declines. Sometimes they happen *within* markets. Specific sectors or industries – like Internet stocks in 1999/2000 or energy and commodities in 2007/2008 – may be wildly in or out of favor. More consistently, we also experience meaningful shifts in investors' collective preference for value (slow growth/cheap) vs. growth (high growth/expensive) stocks. Occasionally – such as the present moment – that preference reaches a historic extreme.

The chart above shows the relative performance of value stocks vs. growth stocks since 1975. Where the line declines, value stocks have outperformed. Conversely, a rising line signals the outperformance of growth stocks. This simple chart provides an astonishingly comprehensive depiction of stock market history over the past 45 years. For instance, the unwinding of the bubble in large cap growth stocks that formed in the late 1960s to early 1970s (the so-called "Nifty-Fifty" stocks) can be seen in value stocks' strong outperformance from 1975-1978. A decade later, the bull market in growth stocks that peaked and then famously crashed in 1987 is also readily apparent.

More recently, the chart shows the almost comical bubble in growth stocks (particularly Internet and technology) in the late 1990s/early 2000. The resolution of that bubble, which played out over the following eight years, saw value stocks recover all the ground they had lost and more. But then, ironically, by 2007/early 2008 value stocks – mainly financials, energy/commodities, and industrial companies – formed a bubble of their own, which burst spectacularly in the financial meltdown of 2008/2009.

Unsurprisingly, after 2008 investors once again rekindled their romance with growth stocks. But what began as an understandable rebound relationship has, in recent years, become an obsession that's led to the kind of outlandish valuations last witnessed in the 1999/2000 Internet bubble. A prime example is Uber, which the stock market currently values at $75 billion. While Uber is expected to generate $15 billion or so in revenue this year, its net losses will be around $3 billion. And it's possible that Uber will never be profitable – labor is the Company's largest expense, yet its drivers are already striking over poverty-level wages.

Or how about Tesla? The stock market says it's worth $40 billion. Yet, in nine years as a public company Tesla has never turned a profit. In fact, its annual losses have only gotten bigger and now exceed $1 billion. In contrast, the stock market thinks General Motors, with over $8 billion in annual profits, is worth just $52 billion.

There are numerous other examples of excess valuation from marijuana stocks like Canopy Growth (a $15 billion market valuation for a company that hilariously produced $78 million in operating losses on $75 million in revenue last year) to vegetarian meat company Beyond Meat ($10 billion market valuation on just $200 million in revenue and no profits) to one of the largest companies in the world, Amazon.com (an almost $1 trillion stock market value on just $13 billion in annual profits).

Growth, whether accompanied by profits or not, is the only factor currently catching investors' attention. The $64,000 question is how much longer this infatuation might last. One argument I've read posits that growth stocks' outperformance may continue indefinitely, as it's being driven by record low interest rates that are unlikely to rise any time soon thanks to aging populations across the developed (and increasingly developing) world.[1] The idea is that the tangible assets – buildings, real estate, machinery, etc. – of more mature companies have more value when money is scarce – i.e. interest rates are high.

Conceptually, it seems logical that established companies would be worth more when new businesses can't get the funding to compete with them. And today practically anybody with a business plan and a pulse can easily and cheaply obtain the money to take on entrenched competitors. Accordingly (the theory goes), investors have all but abandoned the stocks of mature, slower growth companies.

While I think there's some merit to the idea that growth stock outperformance can be precipitated by low interest rates, this hasn't always been the case. For instance, the rise of the Nifty-Fifty growth stocks in the mid-late 1960s and then subsequent fall in the early/mid 1970s

---

[1] The elderly borrow less than younger people for things like housing, education, and autos. Less demand for loans keeps interest rates low.

had little to no correlation with changes in interest rates – in fact, the ten-year U.S. Treasury rate doubled from 4% to 8% from 1962-1970 when growth stocks reigned. The ten-year rate then declined modestly from 8% to 7% during the years (1975-1977) that value stocks posted their best relative performance.

Now, from 1984-2001 there was indeed a pattern of growth stock superiority in periods of falling interest rates and value stock outperformance during and shortly after interest rate increases. But interest rates were steady from 2001-2007, a period when value stocks absolutely clobbered growth stocks. And the breakdown of value stocks relative to growth stocks that began in 2007 happened when the Fed started *raising* interest rates. Overall, then, I don't think the data supports the notion that low/falling interest rates drive growth stock outperformance, at least not directly. So, what might?

My view is that <u>growth stocks usually do best in times of rising investor optimism (possibly but not necessarily bolstered by low interest rates), which often originates from some positive "disruption" in the status quo</u>. For instance, the 1960s bull market and Nifty-Fifty growth stock bubble occurred during a time of increasing investor enthusiasm over the U.S.'s surging economy and rising political stature around the world (which was summarily demolished with the 1973 oil crisis, Watergate, and disillusionment over the Vietnam War). The mid 1980s bull market coincided with the taming of inflation, a strengthening economy, merger mania, and a more business-friendly Administration in the White House. Finally, the late 1990s growth stock boom clearly reflected the rapid growth in personal computing and rise of the Internet.

In the years immediately following the bursting of the Internet stock bubble in 2000, investors' preference for value stocks was initially just a valuation adjustment between wildly overpriced technology and growth companies and the historically cheap shares of slower growth, less exciting businesses. But just a few years later, value stocks – particularly financials, energy, and industrials – really took flight thanks to a global housing (and lending) boom, rampant Chinese infrastructure spending, and a bubble in oil and other commodity prices.

The credit crisis and consequent Great Recession in 2008/2009 then extinguished investors' desire to own value stocks, which allowed growth stocks to once again find their footing. And in recent years exciting advances (new disruptions) in technologies like smartphones, cloud computing, artificial intelligence, automation, and robotics have only added fuel to growth stocks' fire.

So we now find ourselves in a familiar position – investors are once again willing to pay almost any price for growth while the stocks of many highly profitable but less-exciting businesses have been left for dead. Fortunately, although PASI owns a handful of value stocks that have underperformed, we also hold several still-reasonably priced growth businesses that have helped drive our returns above the market over the past few years. Still, we remain on guard for the inevitable shift in trend back toward value stocks.

What might precipitate such a change? If history is a guide, something that puts a dent in investors' collective confidence. A downturn in the economy is the most immediate risk. Longer term, rising economic populism on both the Right and Left could threaten the economy and with it, investors' penchant for riskier stocks. But aside from the potential for a recession and/or political turmoil, I expect the pace of technological change will eventually (though temporarily) plateau – perhaps similar to 2001-2007 – and investors will be forced to confront the reality that many of the "exciting" stocks they bid to absurd valuations will never actually be profitable let alone succeed in toppling established competitors.

In the meantime, rest assured that PASI will always pay close attention to the market value of the companies in our portfolio. We won't own unprofitable businesses regardless of their revenue growth or whether their stocks are currently "hot." On the other hand, we're also not going to sell the stocks of more mature but highly profitable businesses just because they're out of favor. While these companies have been difficult to own of late, we know that periodic (and sometimes sustained) frustration is the hallmark of contrarian investing. As I noted in the beginning of this article, the best stock market opportunities are invariably the most difficult, emotionally, to buy.

Stocks vs. Funds – *Why PASI Favors Individual Assets*

by Jeremy Goldberg, CFA

Ever since mutual funds and ETFs ("funds") became prevalent in long-term portfolio management some 20 years ago, active managers have tackled the dichotomous question: Is it *better* to own stocks and bonds (individual securities) or funds (baskets of securities)? We get versions of this question often when asked about our PASI Equity Portfolio and during reviews of client/prospect outside holdings.

Active portfolio management is the process of buying and selling securities in an attempt to *outperform* a specified benchmark, rather than passively holding an index fund to match the benchmark's return. At PASI, we buy and sell stocks with the goal of outperforming the S&P 500 index while managing risk. Active fund managers do the same thing – they buy and sell a variety of funds, which are simply baskets of individual securities traded as a single investment product, with the goal of outperforming the respective benchmarks. It's important to note that the investment performance of these funds is strictly dictated by the underlying holdings, which can be stocks, bonds, commodities (like gold), etc.

Interestingly, funds don't have the best track record of success. Over the 15-year period ending December 31, 2018, our equity portfolio returned 9.02% annually before fees vs. the S&P 500's return of 7.77%. Even after deducting maximum annual investment and custodian fees of 1.00% and 0.10% respectively, and small transaction (brokerage) expenses averaging less than 0.05% annually, PASI still outperformed. Over the same time period, only 8.4% of all funds benchmarked to the S&P 500 achieved that goal.[2]

---

[2] S&P Dow Jones Indices LLC's SPIVA® U.S. Scorecard.

How have we been able to maintain such a strong track record? We own a small number of high-quality businesses that undergo significant due diligence and require a majority vote from our nine-member investment committee before we take any position. We currently have 31 stocks in our portfolio, diversified across the S&P 500 industries. Of the 673 actively-managed funds benchmarked to the S&P 500 index, the median number of holdings is 71.[3] If a client is invested in more than one fund, there could potentially be 100+ underlying investments that, in our opinion, should be monitored with the same scrutiny.

While the dilution of 100+ investments (through funds) may help a portfolio better weather the storm of a single falling stock, the opposite is also true: A portfolio will not benefit from significant outperformance of a single stock if it holds hundreds. First coined by Peter Lynch in his book *One Up on Wall Street*, this "diworsification" underpins the logic that once you own too many stocks, your performance will match that of the benchmark or index, making it impossible to outperform after deducting fees.

Importantly, with so many underlying investments in funds, there can be significant overlap between holdings. While this reduces the overall number of securities to monitor (maybe), it also makes maintaining an asset allocation more difficult. Further, some holdings may not be appropriate for the fund. It's common for a large-cap. fund to hold a cash position, but the because the fund is categorized as "large-cap.," the cash position may not be reflected in the client's asset allocation. If multiple funds hold cash, then cash may have a higher weight in a client's portfolio than planned.

This highlights another concern: transparency. One of the biggest issues we see with funds is the difficulty identifying expenses, i.e., the total cost of fund management. Funds can have a variety of expenses, including front-end load and back-end load charges (fees to buy or sell the fund that are in addition to transaction costs), 12(b)-1 fees (distribution, marketing, and service fees) and expense ratios (management, accounting, and other expenses). Generally, these are not presented to the client before investment and <u>these fees are in addition to the investment management fees paid to the advisor.</u> The average expense ratio of all actively-managed funds benchmarked to the S&P 500 index is 1.17%.[4] Again, these fees are on top of the annual fees paid to the advisor. Consider that if a fund manager were to charge 1.00%, for example, above and beyond the fund's 1.17% expense ratio, total client cost could be well be in excess of 2.00%.

Lastly, tax management is a service funds do not provide. We strategically review buying/selling opportunities relative to the client's potential tax liability. We perform tax-trades and take advantage of losses to offset gains when feasible and prudent. Actively-managed funds, on the other hand, face uncontrollable taxable events as a result of turnover, redemptions, and gains/losses in security holdings throughout the year that are automatically passed through to the investors. Again, this goes back to a lack of transparency; clients don't have as much color on the total costs of owning funds.

---

[3] PASI Investment Research.
[4] Ibid.

So back to the original question: Is owning individual assets better than owning baskets of securities? At the end of the day, we care about performance, transparency, and consistency, and we believe owning individual securities rather than funds allows the most flexibility and control, ultimately providing the best risk-adjusted returns for our clients.

Hurricane Season – *It's That Time of Year Again!*

It's said that we have two seasons in Florida, *Tourist Season* and *Hurricane Season*. The latter is upon us. While 2018 was relatively quiet, we were forced to close the office in advance of Hurricane Matthew in 2016 and again in preparation for arrival of Hurricane Irma in 2017. Each time, our physical office was prepared to minimize the impact of water intrusion, while our IT folks packed up our computer gear and headed for a secure location clear of the storm path. Telephone service was routed to our secretary's cell phone, with my Montana office as backup. State Street Bank was alerted to initiate contingency processing for client needs (Bank of New York will of course do the same). Within 24 hours our portfolio management system was up and running at the remote site.

As it turned out, Vero Beach dodged the worst of Matthew and Irma, and our office sustained no damage. Still, these drills reaffirmed the strength of our disaster planning. Rest assured – good systems are in place to serve you if the need should arise.

You can read our Disaster Recovery Policy on our web site www.pa-services.com. Please follow the "contact us" tab; you will find a link to the policy on the bottom left area of that page. In the event that primary communications are affected by a storm, we will make every effort to post updates and any important information on our web site. If you have any questions about our contingency planning, don't hesitate to call.

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.