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"It's later out there than it used to be."
Attributed to Yogi Berra circa 1960

Dear Friends,

As you know, we have been fussing about valuations on stocks for the past two years. To no avail. Think here: stopped clock. Credibility comes in handy in our business. We went so far in our letter a year ago to title one of the sections "Bear Market 101" which went on to discuss the leading indicators and the nature of down markets. That discussion, of course, led to an *egg-on-your-face* up market in 2019 that appreciated 22% as measured by the Dow in the ensuing 51 weeks. (We are in the market for a new crystal ball.) Fortunately, the majority of the assets we manage were invested in what we deemed to be defensive stocks that performed as well, or in some cases, even better than the broad market leading to a rewarding year. Read here: a collective "whew". Which leads to the question, now what?

All Any Investor Can Do

Last year the *Economist* magazine discussed the over-extension of credit it observed occurring in Australia. Their hypothesis, which in many ways parallels our markets today, was set up thusly:

> *"There are two ways to film the banana-skin-joke, said Charlie Chaplin. The first begins with a wide shot of a man walking down Fifth Avenue. Cut to the banana skin on the pavement. Go to a close-up as foot meets peel. Then pan out to reveal the man landing on his backside. Ha ha ha. The second version is like the first except in this one the man spots the banana skin and carefully sidesteps it. Blind to other hazards, he smiles to the camera and immediately falls down an open manhole. The second version is funnier, perhaps because it carries a deeper truth: a mishap avoided can lead to a greater calamity down the road. This seems to be a pattern in financial affairs."*

As we fortuitously avoided the mishap of failing to participate in last year's bull run, it's fair to ask, *what now?* A good place to start might be to determine what has changed from a year ago. The malaise of microscopic interest rates (and therefore what we can earn with bonds and CDs)? Not better, in fact worse. The return we can earn through dividends? Another No. The average dividend return on the Dow has actually eroded as stocks rose faster in price than dividends were increased. The relationship between the price of a stock and the earnings a company is producing? *Yes*, there was substantial change here. But yet again for the worse. We entered the year 2019 with stocks in the Dow selling at about fifteen times expected earnings* and finished the year at nearly twenty times. In other words, investors simply got less for their money by a factor of one-third. This strikes us as a solid reason to add to our holdings of short term bonds, at the expense of stocks, with emphasis on those companies selling at higher multiples to earnings than historically has been the case. Investing is the discipline of relative selection. **All any investor can do** is to find the best relative opportunities. As a result, we were net sellers of equities in Q-4 in favor of CDs in hopes of avoiding a *greater calamity down the road.*

*Source: Wall St. Journal January 4, 2020

Banking on Banks

Suffice it to say that we are favorably inclined toward banks. We have a good deal of money invested in them. Why? First, it is an industry we believe we understand. Your writer served on the board of West Coast Bancorporation for a dozen years chairing both the Audit and the Loan & Investment Committees during this tenure. While the business is highly regulated, it is not complicated. Gather deposits at 2% and lend it out at 4 ½% to credit worthy borrowers. When you can, charge a few fees.

As a result of the banking crisis between 2008 and 2010, regulations changed, especially as it relates to capital. With very few exceptions, analysts today agree that the industry is *fully if not over capitalized*. Most banks have some form of stock repurchase program underway to utilize surplus capital as they see their stocks selling cheaply at about 11 ½ times forward earnings and at a modest premium to book value. This compares to the stock market at large, which is selling at nearly twice those metrics.

Growth? Bank earnings are generally expected to grow in the range of 3-4% in 2020, roughly in line with growth expectations for stocks making up the S&P 500. What about dividends? Our universe of banks averages over 3% in yield and all are expected to raise dividends over the course of 2020. For the sake of comparison, the S&P 500 currently yields 1.81%.*

So, what's the stigma associated with this industry? The most obvious is perpetually low interest rates. Bank earnings primarily come from spread income: the difference between what they pay to attract deposits and where they can rent the money out. Spreads today are not much over 60% of normal and are showing few signs of widening, at least at this time. Embracing technology and cost saves are the primary drivers of growth.

Finally there is consolidation: Bank A buys Bank B, overlapping branches are closed, overhead gets cut and waves of technological innovation on a larger, more cost effective platform ensue. Plan on do-it-yourself banking: a nifty way for banks to widen margins. We believe we own banks that offer exposure to most if not all of these positive attributes while selling at about half of the valuations of the broad market. We think of this industry as offering a full component of reward while assuming a lower degree of risk: *superior relative value*! **All any investor can do.**

The SECURE Act

We first discussed this piece of legislation with you in our July letter. You might think that a now enacted law entitled the SECURE Act (Setting Every Community Up for Retirement Enhancement) would result in your retirement savings becoming more secure. Sadly no. Apparently Congress is not bound by any truth-in-labeling laws. The most significant change is the elimination of the longstanding "Stretch IRA" which allowed non-spouse beneficiaries who inherit a traditional IRA to spread out distributions over their lifetime. The new law will require that non-spouse inheritor (most often a child of the original owners) to liquidate the account within ten years of the former owner's death. Not only will this change accelerate the government collecting income taxes on these assets, but often at a higher tax rate. Consider the case of a married couple with one child where the first to die had a $400,000 IRA and a spouse with a $200,000 IRA who passed two years later. The ultimate beneficiary who inherits the two IRAs is the child who is 55 and in his or her peak earning years. The required minimum distributions will

*Source: Barron's January 6, 2020

come on top of their earned income and will likely push the income tax rate of the adult child into materially higher tax brackets than would otherwise have been the case. That applies to both their earned income and the IRA distributions as well. Yet Congress labeled this new set of distribution mandates as SECURE. More poignant is the case where a grandparent wished to leave all or a portion of their retirement savings to a grandchild to help provide care and support for the balance of their lifetime. No longer possible: it's a ten-year dump. The new law does permit conversion to a Roth IRA but that event is in itself a taxable event. If it feels to you like Congress has their hand in your pocket, retroactively, we agree.

The government also would like for we elders to continue to work longer as our compensation results in our continuing to pay into the Social Security system. The reward for that choice is that continuing workers will be able to contribute to their IRA and defer required minimum distributions until they turn 72. Individuals will also be allowed to take a penalty free early withdrawal of up to $5,000 from their plan due to the birth or adoption of a child but this would be a taxable event. There is more in the bill but these are the chief features dealing with IRA accounts. The bottom line is that the most significant change will be large mandatory withdrawals for non-spouse beneficiaries at an earlier date and often at a higher income tax rate. Please consult with us if it would be helpful to you to dig a bit deeper into these changes and how they may affect you.

2020 Foresight

The last time we had a handle for a year as poetic as 2020 was Y2K: the year 2000. Coincidentally, the market's build up to this event was wildly speculative and resulted in what became known as the Tech Wreck: an eighteen-month bear market. Valuations were in the top decile, dividend payments in the bottom decile, venture capital and IPOs were flowing like beer at a Friday afternoon college kegger. Consider the old saying which goes...History may not repeat itself but it does rhyme. As we stare into the year 2020 with foggy glasses, it seems to be a particularly wonderful time to emulate old school, disciplined investing. As in, what would Warren Buffett (who is sitting on the largest cash hoard in the history of Berkshire Hathaway) do? It's our guess he would sit on his hands and wait until the real deal comes along. As we are fond of saying, don't do something, just stand there. Works for us! Hopefully for you as well.

Please accept our best wishes for a Happy and Prosperous New Year.

Best regards,

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The Klavins Report – Thoughts From Outside the Corner Office ***January 10, 2020*****)**

"War, huh, good God. What is it good for?…"

— Edwin Starr (War…from 1970's *War & Peace* album)

As you are no doubt aware, Iranian Major General Qassim Suleimani — a fixture of the Iranian military establishment dating back to the Iran-Iraq war of the 1980s — was killed by a US drone strike in Iraq on Friday, January 3. Suleimani was Iran's top security and intelligence commander, and led the Quds Force, the Revolutionary Guards' special forces branch responsible for operations conducted outside of the country. In the days since the strike was made public, media has been filled with stories about how Iran will respond and how the situation may escalate. Will Americans be targeted overseas or here at home? Will our companies fall victim to cyber-attacks? Will allies in the region suffer attacks that might affect the oil markets? Might we again be dragged into a more conventional war in the Middle East? All are good questions, and we do not profess to know the answers.

A legitimate concern you may have is: How might the financial markets, and specifically the stock market, react to this event and whatever may follow? While we do not get to know in advance, it might be helpful to look back at prior military engagements/actions and see how the stock market fared over the following months.

Fortunately Barron's did the heavy lifting for us. In an article from the April 20, 2017 edition titled "War is Hell – but Not for The Stock Market," author Mark Hulbert "focused on seven discrete events since the early 1980s." Those included:

- the U.S. invasion of Grenada (1983)
- the U.S. invasion of Panama (1989)
- the first Gulf War (1991)
- the U.S. bombing of Kosovo (1999)
- the U.S. war on Afghanistan (2001)
- the second Gulf War (2003)
- the U.S. bombing of Libya (2011)

He found that:

> *"On average over the month prior to the beginning of these seven events, the Dow fell 0.6%, or 1.4 percentage points lower than the average of all months since 1983. But this underperformance was quickly reversed: In the month after the U.S. military entered a conflict, the Dow soared an average 4.0%—3.2 percentage points greater than the average of all months since 1983…Over the three months after the start of these seven events, the Dow rose 6.7%, compared to an average gain of 2.4% across all three-month periods since 1983. And six months after those beginning dates, it was 7.2% higher, versus an average gain of 4.8%."*

I thought I would add for consideration the killing of Osama bin Laden, a figure who, like Suleimani, had few admirers in the U.S. or the West but clearly had fervent supporters in other corners of the world. While officially stateless, he was a more significant figure on the global stage, and at the time of his death the fear of reprisals was also heavily discussed. The S&P 500 closed at 1364 on April 29, 2011, the final trading day before bin Laden was killed on May 2. Three months later, on August 2, the S&P closed at 1254, down 8.1%, and after six months the S&P closed at 1238 on November 2, down 9.2%. While the market fell over those 3- and 6-month periods, the fall was not cataclysmic. More importantly, I believe the fall had more to do with concerns over the contagion of the European debt crisis and the downgrade of US debt from AAA to AA+, not bin Laden's death. Whatever the reason, on May 2, 2012, a year after he was killed, the S&P closed at 1402, up 2.8% over the prior 12 months, not including dividends.

What is the takeaway? While we still can't predict what will happen in response to this military action, the historical context gives some sense that markets generally take it in stride and eventually work higher. As such, we will continue to look to the fundamentals as our guide, and as Steve pointed out it is the fundamentals, not this recent action, that give us some reason for caution.

CK