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May 2018 Investment Commentary

During the month of May, financial news outlets bombarded investors with speculation about politics in Italy and potential U.S. involvement in trade wars. In response to these short-term events, U.S. financial markets experienced daily swings of several percent, both up and down. Yet while these events made great talking or writing points for commentators, our Group doesn't view them as important for investors. In fact, while the media, commentators, and speculators focused on the above two events, our Group believes a far more important investment scenario has developed which no one seems to talk about. Specifically, our Group has observed that high quality companies with stable businesses and strong cash flows have recently declined substantially in stock market value, while businesses with no cash flows and uncertain long-term business prospects have continuously increased in value[1][2].

Throughout almost every facet of society, we observe the human tendency to like and pursue what's popular. Unfortunately, this tendency works against investors. As history has shown through past economic cycles, the most popular investments are the ones that eventually lead to trouble. Over the past several decades, in reverse chronological order, U.S. investors have experienced crashes and losses from oil, mortgage/financial companies, technology companies, airlines, and auto companies, just to name a few. In all of these cases, the most popular investments fell the most during the eventual market correction. As we survey the investment landscape today, some sound companies still sell for lower prices than they did nearly twenty years ago. While some of these companies are good businesses with strong cash flows, popularity drove them to prices that it may take them twenty years, thirty years, or even longer, to once again reach[1].

Unfortunately, the damage hasn't been limited to the most popular individual investments. For investors with 401Ks and other similar retirement vehicles with investment options limited to mutual funds and index funds, the impact of over-popularity has spilled over. The reason is that the most popular individual investments become the largest components of mutual and index funds as they rise to higher and higher prices. When the tide turns and investors finally come to their senses, the dramatic decline in the prices of these popular investments cause dramatic declines in the levels of mutual and index funds. For example, over the time period 1964 to 1981, the Dow Jones Industrial Average index returned nothing. Warren Buffett attributes this partly to over-enthusiasm for auto and airline companies. More recently, the S&P 500 index returned nothing from 2000 to 2013, a result driven by over-enthusiasm for technology and then financial companies[3].

At the beginning of this commentary, we mentioned the media's focus on political turmoil in Italy and potential tariffs and duties between the U.S. and other countries. Political change has always and will always occur in Italy and in all countries around the world. Fortunately, this has not prevented stocks from increasing in value over time. In fact, while most commentators in the U.S. stated that U.S. stocks would fall if Donald Trump were elected, the exact opposite actually happened. The same can be said for the tariffs contemplated by the Trump administration. International trade has always ebbed and flowed, with governments imposing and removing various tariffs and duties. In the past forty years, we experienced the Regan administration imposing significant tariffs on Japan, we've seen countries adopting stricter trade rules under the World Trade Organization in the 1990's, and we experienced steel tariffs under the Bush administration in 2002. None of these measures had a negative impact on stocks, and the U.S. in fact experienced one of its greatest bull markets through the 1980's and 90's[4].

But as we mentioned above, overenthusiasm for various investments can and has prevented stocks from increasing in value over prolonged periods of time. When companies with unproven long-term business prospects, that do not generate cash flow, continuously move upward to new high prices, that sends a message to us that we need to exercise ever greater caution with our investment selection. As Warren Buffett wrote, "you only learn who has been swimming naked when the tide goes out." The fact that sound companies with proven business prospects and strong cash flows have fallen in stock market value, presents us with a great opportunity to invest in stocks for future growth while also adopting a naturally defensive investment position[5].

As we've written in the past, sitting in cash and bonds and waiting for the stock market to crash is not a strategy for investment success. We've had many clients come to us after years of sitting in cash as a result of fear of stocks, with years of strong gains in stocks passing them by. Since no one can predict when stocks will correct and in what manner (it will differ from how corrections in the past have happened), investing is the right thing to do when an investor can buy stocks at reasonable and low prices. Additionally, investors need not wait for stock market crashes in order to get a great deal on an investment—great companies crash 30, 40, 50, and 60 percent in value all the time. Typically, great companies correct upward in value quickly, and these opportunities will have passed by the time a general market correction occurs. Furthermore, as we've seen with two of our clients' largest investments this year, even when the market as a whole falters, a great company can violently correct upward in value when investor sentiment turns positive.

In the present investment climate, with unproven companies moving ever upward in stock market value, our Group will continue to shun the crowd and look for proven companies with strong cash flows selling for fair value or less. We will do this in order to achieve returns in excess of inflation for our clients, while also avoiding the most popular issues that have the potential to lead to bubbles and long-term stagnant investment returns and losses.

Best Regards,

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<u>Sources:</u>

(1) S&P Dow Jones Indices LLC
(2) Company reports
(3) The Snowball (Alice Schroeder)
(4) CNBC
(5) Berkshire Hathaway 2004 Chairman's letter

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The Dow Jones Industrial Average covers 30 blue chip U.S. companies selected by the editors of the Wall Street Journal. The Dow represents about 25 percent of the NYSE market capitalization and less than 2 percent of NYSE issues.

The Standard and Poor's 500 is an unmanaged, capitalization weighted benchmark that tracks broad-based changes in the U.S. stock market. This index of 500 common stocks is comprised of 400 industrial, 20 transportation, 40 utility, and 40 financial companies representing major U.S. industry sectors. The index is calculated on a total return basis with dividends reinvested and is not available for direct investment.