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Market Update – *An Extraordinary Decade*

by David A. Jaffe, M.D.

In his book *Thank You for Being Late*, author Thomas Friedman poses detailed and compelling arguments suggesting that our planet is experiencing one of the greatest inflection points in world history – catalyzed by the accelerating impact of technology, globalization, and climate change. It is a well-documented and compelling read.

In the shadow of this postulate, the “twenty-tens” were a pretty good but hardly extraordinary decade in the financial markets. Consider: the 256% total return of the S&P 500, translating into an average annual return of 13.5%, makes it only the fourth best decade since the 1930s (yawn).

Of course, one could be forgiven for exaggerating the magnitude of the decade’s progress when taken in the context of recent history, specifically following on the heels of the “twenty-oughts”. Dubbed by some the “lost decade”, investors holding the S&P 500 from 2000-2010 experienced a *decline* of 0.86%, even after reinvesting cash dividends. The lost decade earns the dubious distinction of being the *worst* 10-year investment period since the 1930s, thanks to the Great Recession and stock market plunge of 2008-2009.

The dreary market experience of that era set the stage for the healthy recovery that we have all enjoyed over the last ten years. Governments around the world pumped trillions into projects which spurred economic growth, while central banks led by the U.S. Federal Reserve lowered interest rates effectively to zero. In a monetary experiment called *Quantitative Easing*, the Fed purchased $4.5 trillion of U.S. debt, adding an equal amount of cash to our economy. Most remarkable: it all worked! The “2010s” were the first decade without a single recession since the 1850s. Inflation is at its lowest rate since the 1960s, and unemployment has fallen from 9.9% at the beginning of the decade to a 50-year low of 3.5% in December of 2019.

With advances in almost every economic sector, 2019 closed out the decade with a healthy 31.49% gain in the S&P 500. Further, the PASI composite stock portfolio bested that broad market average, climbing 33.40% (both include reinvested dividends). Not a bad conclusion to a middling decade!

Ironically, we worry when the market is down and we worry when the market is up. The current bull market now spans 126 months, the longest in history and besting the historical 53-month average by a wide margin. That’s no bull!

Beyond the powerful but limited intervention which helped propel us out of the Great Recession, other broad trends are helping support the current bull market. This is truly a “Goldilocks” economic environment, with steady but modest growth, historically low inflation and unemployment, muted energy and financing costs, and innovation which has propelled U.S. business dominance in such areas as technology, communication, and health care.

Will the stock market continue to advance, or is a correction inevitable? Well, both, of course. Volatility and periodic market declines are inherent in stock price behavior. Whether the next correction occurs in six weeks, or six months, or six years, is however unknowable. Does the outsized gain of 2019 set us up for a 2020 disappointment? History says “probably not”. Since 1933, the S&P 500 has posted gains exceeding 25% seventeen times. Twelve of the seventeen were followed by positive returns the next year. While those are pretty good odds, more important is the knowledge and belief that the odds of *long-term* financial success are bolstered by confidence in the U.S. economy and growth of U.S. businesses, and their associated stock price appreciation.

SECURE - *Setting Every Community Up for Retirement Enhancement*

Effective Jan. 1, 2020, the “SECURE Act” mandates significant changes for IRAs and retirement plans. *These new provisions may have major implications to your estate plans and tax situation,* so it is important that you review them in 2020 with your tax professional and estate attorney. Below is a synopsis highlighting the major changes covered in the SECURE Act.

1) The biggest change in the Act is the elimination of the “stretch” provision for inherited IRA accounts. This means that a beneficiary can no longer spread out distributions over their lifetime. Instead, all retirement assets must be distributed from the IRA within 10 years of the account owner’s death. There are exceptions for a surviving spouse, minor children, chronically ill, disabled and anyone less than 10 years younger than the account owner. This new rule applies to all IRAs inherited on or after Jan. 1, 2020.The good news is that the stretch option is maintained for IRAs inherited before January 1, 2020.
2) The new Act pushes the age that you are *required* to begin IRA distributions from 70 ½ to age 72. This allows an extra 18 months of tax-deferred growth for those who can wait.
3) Under the old rules traditional IRA contributions had to stop by age 70 ½. There is no longer an age limit, a nice benefit as more people work later in life. Even if you have reached age 72 and are taking required withdrawals, you may still make contributions to your IRA, although the tax deductibility may be limited by your tax bracket.
4) New parents are allowed to withdraw up to $5,000 penalty-free from their IRA, although they will still owe income tax on the withdrawal.
5) Individuals may withdraw up to $10,000 from their 529 plans tax-free to make payments toward student loans.
6) The SECURE Act modifies some 401(k) rules, making it easier for employers to offer an annuity inside their 401(k) plans, requiring employers to disclose to 401(k) participants the amount of monthly income their balance could support on a sustainable basis, and expanding the ability of small-business employers to join together with similar employers to offer 401(k)s for less cost and with fewer liability concerns.

Theory vs. Practice

by Nathan Polackwich, CFA

A client recently asked about the relatively focused nature of our portfolio, curious as to why we hold fewer stock positions than many other investment managers. Currently, the PASI portfolio owns 32 stocks (diversified by industry) and one Exchange Traded Fund (ETF) tracking the Oil and Gas sector of the S&P 500. Each of these 33 positions comprises somewhere between 2% and 4% of the overall portfolio. How did we arrive at this portfolio structure?

There are two ways to approach an infinitely complex problem like the stock market.

1. Start with a theory of how the system works and apply the processes you believe will perform best.
2. Learn, through practice/experience, what works (and what doesn't) and refine your processes over time.

Method 1 is only useful for closed and simple systems. For instance, you can fix a washing machine just by studying how it works and then using what you've learned without experience. But in far more complex domains with infinite variables – like the economy, financial markets, politics, health, etc. – naïvely applying theories is almost always a recipe for disaster. In that case, Method 2 – refinement through practice/experience – is the wiser path.

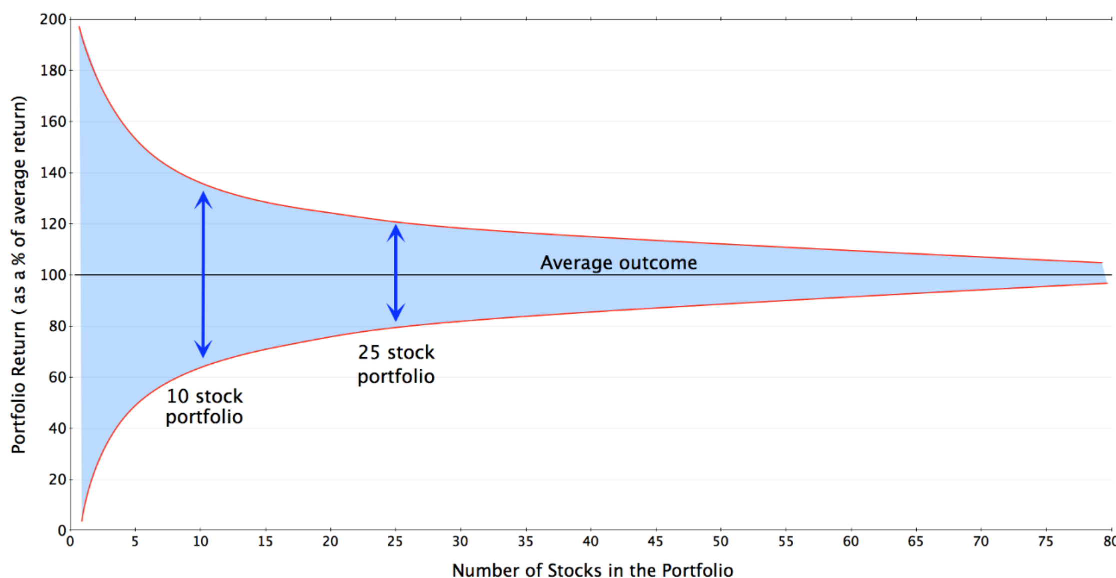
The distinction between these two approaches – theory vs. practice – has long been recognized. In his *Histories*, the ancient historian, Polybius, when comparing the Spartan legislator Lycurgus to Rome observed that Lycurgus, "by a process of reasoning, whence and how events naturally happen, constructed his constitution *untaught by adversity*." Conversely, the Romans didn't develop their government "by any process of reasoning, but by the discipline of many struggles and troubles, and always choosing the best by the light of the experience gained." While Sparta was a regional power in Greece for a few hundred years, Rome endured for a millennium, exercising hegemony over the entire Mediterranean (and beyond) for much of that time.

Roman practicality and the Greek affinity for theory are even apparent in their philosophers. The trader and author Nassim Taleb notes in *Antifragile* how the great Roman thinker, Seneca, "focused on the practical aspect of Stoicism,…mostly, how to handle adversity and poverty and, even more critically, wealth…Other philosophers, when they did things, came to the practice from theory. Aristotle, when he attempted to provide practical advice, and a few decades earlier Plato, with his ideas of the state and advice to rulers, particularly the ruler of Syracuse, were either ineffectual or caused debacles. <u>To become a successful philosopher king, it is much better to start as a king than as a philosopher</u>."

The development of the PASI stock portfolio has been far more "Roman" than "Greek" in orientation since the firm's founding in 1977. Our investment process has evolved as lessons have been learned and markets have changed. Earlier in our history we owned both fewer and more positions in the stock portfolio than the current 33. But we ultimately arrived at this number because it provided the optimal blend of diversification, positive impact from good ideas, and limited downside from bets that didn't pan out as hoped.

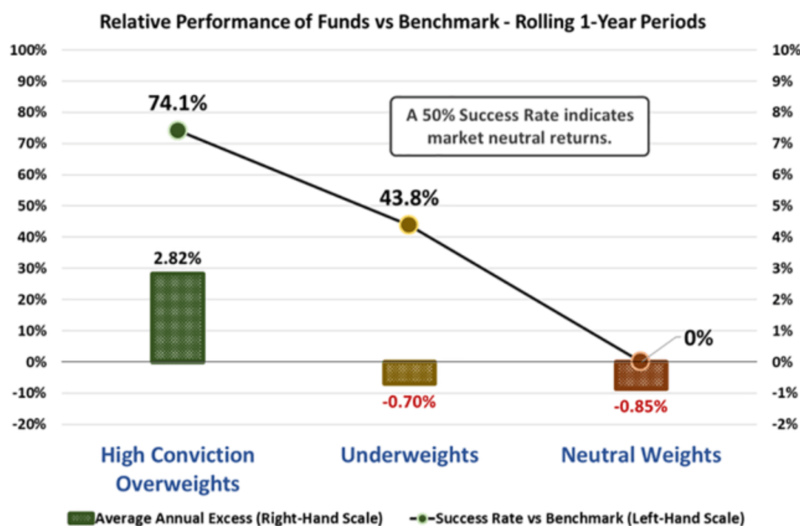
Interestingly, the economic literature (theory!) now supports our portfolio structure. The following chart shows the probability of matching the stock market averages as you add stocks to a portfolio.

Note that at 25 positions, a stock portfolio captures the vast majority – about 80% – of the benefits of diversification.[1]



Why not try to be 100% rather than 80% diversified? One issue is that the more stocks you include, the lower your odds of achieving *above-average* results. As an extreme example, it would be impossible for us to outperform if we bought all 500 stocks in the S&P 500 index.

Holding just 33 positions also allows us to concentrate on our best ideas. This focus matters because studies show that active investment managers' high conviction stocks – those they overweight in their portfolios – strongly outperform the stock market averages.[2]



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[1] Newbould, Gerald & Poon, Percy. (1996). Portfolio Risk, Portfolio Performance, and the Indvidual Investor. The Journal of Investing. 5. 72-78. 10.3905/joi.5.2.72.
[2] Panchekha, Alexy, CFA (2019). The Active Manager Paradox: High-Conviction Overweight Positions. https://blogs.cfainstitute.org/investor/2019/10/03/the-active-manager-paradox-high-conviction-overweight-positions/.

Most active investment managers have stock-picking skill. But they dilute the benefit of their high conviction ideas by allocating money to less attractive stocks in the name of increased diversification. At PASI we've found that owning about 33 stocks helps us avoid this drag while simultaneously obtaining most of the risk-reducing benefits of diversification.

In addition to a more focused portfolio, we've refined our investment process in numerous other ways. For instance, many years ago we noticed that poorly performing stocks often take much longer to recover – if they ever do – than investors anticipate. Accordingly, we put strict limits on the money we'll add to an underperforming stock. (In investment parlance adding more and more money to a declining stock has been dubbed "catching a falling knife.")

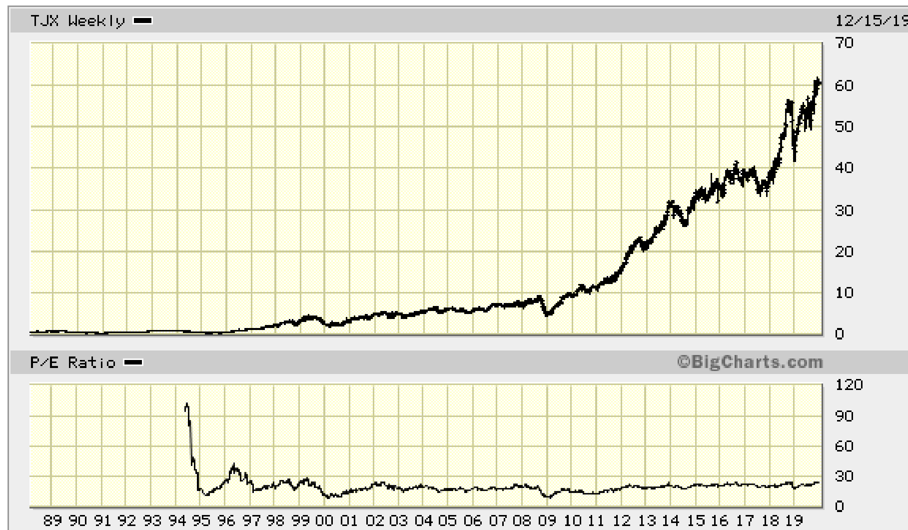
The converse to the falling knife is a stock advancing much farther and faster than you ever imagined. This is a good problem to have! But it presents a challenge for disciplined investors because overvaluation dampens a stock's long-term return. Even a great company will be a lousy investment if you pay too high a price.

How do we handle such a scenario? We've learned it's usually a good idea to hang in there when a stock's performance exceeds our expectations (within reason). Often, it turns out the Company is growing faster – and therefore worth more – than we originally thought. Moreover, while troubled companies usually take a long time to turn their businesses around, successful companies with strong competitive advantages can thrive indefinitely. And PASI determined early on that it's precisely these kinds of companies that make the best long-term investments.

A stock may appear inexpensive relative to its earnings or book value, but that doesn't necessarily mean it's a good opportunity. Auto maker Ford illustrates this phenomenon well.

Ford's stock almost always appears "cheap" relative to its earnings. But those earnings – and therefore its stock – never achieve lasting gains because Ford operates in a slow-growing, extremely competitive industry. The result is a stock that's been highly volatile but ultimately has been dead money for the past three decades.

In contrast to companies like Ford, at PASI we look for "compounders" or durable businesses that operate in expanding markets and can grow their earnings year after year. A great example is PASI holding TJ Maxx (TJX), a terrific business that's proven to be a compounding machine.



This is the kind of performance a growing business with sustainable competitive advantages can achieve. Notice how TJX's Price/Earnings ratio (bottom chart) remained steady throughout most of the stock's meteoric rise – Earnings have risen right in line with the share price! While not every PASI stock will perform this well, TJX is a prime example of the kind of high-quality company we've come to prefer. And this policy – like all our investment decision-making processes – is the product of more than four decades of constant refinement and adaption.

Don't Fear the Retail Apocalypse

by Jeremy Goldberg, CFA

JCPenney's stores are a wasteland, Sears has resorted to selling their display shelves, and Dillard's is desolate. And it's not just malls…. Office Max and Office Depot merged in 2013 because they couldn't remain competitive. Toys "R" Us, once the iconic children's superstore, filed for bankruptcy in 2017 and closed its domestic stores (it has since rebranded as "Tru Kids" as it struggles to make a small-scale comeback). And it's not just office and toy retailers either…

Sports Authority, American Apparel, and PacSun, among others, filed for bankruptcy in 2016. The following year's list includes Radio Shack, Vitamin World, and Gander Mountain. The trend continued in 2018 with Nine West, Southeastern Grocers (parent company of Winn Dixie), Brookstone, and more. And last year, Forever 21, Gymboree, and Barneys New York, to name a few, all filed for bankruptcy. During this time, global retailers like Best Buy, Walmart, and Target invested heavily in their brick-and-mortar stores and significantly enhanced their online shopping experiences to remain competitive.

The takeaway – whether these companies are rebranding, restructuring, liquidating, or simply gone forever – remains the same: nearly all segments of the retail sector are represented.

The past decade has seen a massive shift in consumer spending behavior, driven largely by increased access to the internet. You've probably experienced this yourself: consumers, in search of convenience and/or cost-savings, are buying less stuff in stores and more stuff online, and companies that cannot

adapt do not survive. In fact, consumers are buying 3x more online today than they were 10 years ago![3]

Readers have likely heard this phenomenon called the "Amazon effect," which is essentially Amazon's ability to undercut competing retailers by selling similar or identical products online for the same price (or less) with free one- to two-day shipping. Companies that cannot adapt, i.e. lower their prices or improve their product offerings, are forced out of business.

While Amazon's valuation relative to its historically modest (albeit recently stronger) earnings growth has precluded us from investing, we respect the threat Amazon poses to the entire retail landscape. Our admiration – and the due diligence on our investments it has engendered – has largely sheltered our equity portfolio from the carnage of the retail apocalypse.

Nowadays, almost anything can be purchased online, so naturally PASI companies that sell physical products are intuitively the most at risk – TJ Maxx (TJX: discount retailer), Dollar General (DG: discount retailer), LKQ (LKQ: replacement auto parts), MSC Industrials (MSM: metal work), and CDW (CDW: information technology products) – but others that sell services are also vulnerable, primarily UPS (UPS: competes with Amazon's own delivery fleet) and Microsoft (MSFT: Microsoft Azure's cloud computing services compete with Amazon Web Services).

Although the seven PASI companies above all operate in sectors highly sensitive to the threat from e-commerce (and Amazon), they've proven to have unique advantages that differentiate them from the competition, which in turn has allowed each to thrive.

Within the Consumer Discretionary sector, we own TJX, Dollar General, and LKQ. Customers love TJX for the "treasure hunt" nature of its offerings, which helps shield it from online competition. Through its unmatched global supply chain, TJX searches for the best goods from top designers within their network of vendors (thousands of them!) to sell at discount prices. Shoppers tend to spend more impulsively if they know the item might not be available again – TJX's bread and butter. New merchandise is introduced constantly, so inventory remains "fresh" at reasonable prices, encouraging regular customers to return again and again for another treasure hunt. TJX's model has been so successful that they're in a class of their own as the only major international off-price apparel and home fashions retailer in the world.

Dollar General (DG) offers cost-effective instant gratification. 75% of Americans live within five miles of a DG store, and 80% of all items sold at DG are less than $5. Not coincidentally, items priced at $5 or below are much less profitable to Amazon and other online retailers (especially when including the cost of shipping), and it doesn't always make sense to buy in large quantities. DG offers smaller pack sizes of regular goods that cost less on an absolute basis (but cost more per unit), benefitting customers living paycheck to paycheck and allowing DG to maximize their profit.

LKQ, MSC Industrial (MSM), and CDW are not your traditional retailers; they sell niche products bundled with specialized services. LKQ is the largest alternative auto parts distributor in North America and Europe, and its customers are largely independent collision/mechanical repair shops and car dealerships. Product expertise and inventory availability are essential, and LKQ's 1,700 global distribution centers ensures customers are "rapidly" delivered the correct products. MSM is the leading distributor of metalworking and maintenance, repair, and operations products and services. With its

[3] Online shopping accounts for 11.2% of all consumer retail spending per the U.S. Department of Commerce as of September 30, 2019.

team of specialists (metalworking, technical, safety, inventory), MSM works directly with clients to build customized products and inventory management solutions. CDW is a one-stop shop for information technology (IT) ecosystems; the company sells over 100,000 products, from phones and computers to accounting software and office furniture. CDW works hand-in-hand with clients to design and implement IT solutions necessary to meet the clients' needs. All three companies do more than just sell a product, they offer specialized customer service, a major element incredibly difficult for Amazon and others to replicate.

Replicating delivery was, however, another story. Amazon trucks are everywhere, and that's okay! UPS did not become the global package behemoth it is today by delivering Amazon packages, which is why it accounts for only 1.4% of UPS's revenue.[4] Amazon started its own delivery fleet because it needed distribution for products sold on its website during peak times, like Prime Day or Black Friday, when other delivery companies (UPS/FedEx/USPS) were overwhelmed. This is vitally important: Amazon delivers for Amazon. Exclusively. Yes, they deliver a lot of packages, but they have one customer: Amazon. UPS, on the other hand, has a broad range of customers including individuals, businesses, and governments. Even if Amazon offered delivery services on behalf of other companies, retailers (physical and online) would still choose alternatives to Amazon because companies wouldn't outsource their shipping to their biggest competitor. And importantly, UPS's fleet and delivery scale dwarfs Amazon's. Amazon's delivery fleet includes 20 planes (leased) with plans to ramp up its fleet to 70 by 2021,[5] 30,000 delivery vans, and 20,000 trailers.[6] With 255 operating planes, 298 short-term leased or chartered planes, and 123,000 package cars, vans, tractors, and motorcycles, UPS's distribution abilities are far superior.[7]

Lastly, we own MSFT, and Microsoft Azure competes with Amazon Web Services (AWS). While AWS is bigger than Azure, MSFT's cloud platform is growing rapidly, almost doubling in size each year. Technically considered a "hybrid cloud," Azure is an extension of and enhancement to customers' existing IT assets, rather than a complete replacement (like AWS) – a flexibility within IT infrastructure that gives MSFT a competitive edge. Also, in October MSFT won a $10 billion Pentagon technology contract to be the federal government's go-to cloud computing vendor. MSFT beat out the likes of AWS, Oracle, and IBM for the Joint Enterprise Defense Infrastructure contract, reinforcing its strength in the space.

Our portfolio is flexible and dynamic; we are always searching for companies that compound earnings throughout market cycles, generate real cash, have sustainable balance sheets, and are differentiated from the crowd. The threat of e-commerce is real, and Amazon was the spark that lit the fire. But with change comes opportunity; TJX, DG, LKQ, MSM, CDW, UPS, and MSFT are companies which have demonstrated expertise in capturing that opportunity.

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[4] Bloomberg L.P.
[5] Amazon Press Release
[6] Car and Driver
[7] UPS Fact Sheet

S.E.C. Compliance

Pursuant to the Investment Act of 1940 and specifically Rule 204-3 thereunder, a registered investment adviser shall annually deliver or offer in writing to deliver upon written request to each of its advisory clients a disclosure statement prepared in compliance with the requirement of this rule. Part II of Form ADV complies with this rule and you may request a copy by calling or writing our office.

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Additionally, the SEC issued Regulation S-P on June 22, 2000. The operating premise of this ruling is to effect compliance with the Gramm-Leach-Bliley Act which prohibits the sharing of any nonpublic personal information with any nonaffiliated third party unless the firm has provided initial notice of its privacy policies. The ruling requires we provide a copy of our Privacy Policy to our customers on an annual basis. A copy of our Privacy Policy is included with this newsletter.

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.

PROFESSIONAL ADVISORY SERVICES, INC.

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Clients will be provided with our Privacy Policy annually. Potential clients will receive a copy of our Privacy Policy.

1) We will safeguard, according to strict standards of security and confidentiality, any information our clients share with us. We maintain physical, electronic and procedural safeguards to guard your nonpublic personal information. These safeguards include password protection for server and workstations, 24/7 video surveillance, encrypted data back-up, a virtual private network (VPN) for secure remote access to the PASI network by authorized PASI personnel, secure ShareFile utility for emailing sensitive documents, and monitored secure shredding for document destruction.

2) We will permit only authorized employees, who are trained in the proper handling of client information, to have access to that information. Employees who violate our Privacy Policy will be subject to company sanctions.

3) We gather nonpublic personal information about you from the following sources:
    - Information we receive from you on an application or other form
    - Information you provide us in client meetings or other forms of communication such as fax, e-mail, letter, and telephone
    - Information about your transactions with us and your designated custodian

4) We will not reveal nonpublic client information about you to anyone, except as permitted by law.

5) Whenever we hire other organizations (third party) to provide support services, we will require them to conform to our privacy standards or agreed upon privacy standards in writing.

6) We will strive to keep client files complete, up-to-date, and accurate. We will provide our clients with this account information when requested.

7) If you decide to close your account(s) or become an inactive customer, we will continue to adhere to the policies and procedures as described in this notice.