PASI since 1977 NEWS

Volume 44 - Number 3 Fall 2020

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Market Update – *The Dog Days of Summer*

by David A. Jaffe, M.D.

Okay, the third quarter of 2020 wasn't exactly a sleeper, but everything's relative, right? After the extraordinary volatility of the March-April period, anything less than a new bear market is a relief. The S&P 500 actually climbed 15% through early September, sagged into correction territory for a day or two, before recovering enough to end the quarter with an 8.93% gain (including reinvested dividends). Didn't even notice, did you?

Positive stock market sentiment has been supported by better than expected measures of economic recovery and weekly jobs numbers, albeit besting very low expectations. Further, in August the Federal Reserve announced that they will accept levels of inflation above historical targets and expect to keep interest rates at current levels for at least 2-3 years. Stock investors cheer low rates, which leaves alternatives such as bonds and CDs relatively unattractive.

Recent stock market volatility has been largely characterized by vacillation between investor appetite for *pandemic stocks* vs. *recovery stocks.* The first category is comprised of companies seeing enhanced demand for technology infrastructure such as cloud providers (Amazon Web Services, Microsoft), e-commerce businesses (PayPal, Amazon, and by proxy UPS), and work from home beneficiaries such as your favorite neighborhood depot, Dollar General. On the sidelines have been traditionally cyclical companies including industrials and banks, not to mention shunned travel businesses (lodging, airlines, cruises).

The wide gulf in sentiment between the COVID stocks and the recovery stocks has created huge disparity in financial market pricing. Pandemic precautions have accelerated adoption of remote operation, now proven not only feasible but in many instances preferable. Growth in demand for the necessary infrastructure is here to stay, and those companies benefitting from this trend have seen their stock gains drive the market recovery, but also rise to historically high valuations. Seeking better *value*, investors anticipate a looming shift in the fortunes of stalled businesses as progress fighting the coronavirus emerges and optimism for reopening the economy grows.

Every other week, it seems, consensus swings between demand for recovery stocks, offering attractive buying opportunities, and COVID stocks, sporting high stock valuations but with the appeal of current and (promised) future growth. At least for now, investors are struggling to sift through the relevant news and economic data, with sentiment shifts driving market volatility.

The PASI portfolio is structured to navigate these turbulent waters: Along with positions in several COVID stocks, including Microsoft, Amazon, Google, Facebook, and PayPal, our holdings includes a broadly diversified group of companies that have a history of compounding earnings, with strong balance sheets and recurring cash flow and resources sufficient to cover all debt obligations and business investments. This *hedged* approach produced returns of 9.24% for the third quarter (including reinvested dividends), edging ahead of the S&P 500 returns.

One Wall Street analyst commented recently that the pandemic has forced businesses to adopt in five months an experiment (largely working remotely and work from home) which would have otherwise been cautiously implemented over five years. And the experiment has succeeded! With enhanced participation in the *new normal*, without dismissing the *old normal,* we are confident that the PASI portfolio will continue to perform well through all economic cycles.

Trust as IRA Beneficiary: *Changes Under the SECURE Act*

by Chris Steele, CFP®

We have several clients who have named their revocable or other trusts as their IRA beneficiaries. Trusts can provide asset protection from creditors and ensure a beneficiary does not receive a large and immediate sum of money.

Beginning in 2020, The SECURE Act brought substantial changes to the way non-spouse IRA beneficiaries may take distributions. As a non-spouse beneficiary, an *inherited* IRA must be created; you do not have the option of rolling the assets into your own IRA. Prior law allowed non-spouse beneficiaries to "stretch" distributions over their life expectancy, resulting in favorable income tax deferral and longer-term growth.

The Act, applying to any death in 2020 and beyond, requires all *inherited IRA* assets be distributed within 10 years following the death of the original account owner. There are no rules stating how much should be distributed in any given year, only requiring that the IRA be distributed entirely by the end of the 10th year. Not only does the Act increase taxable income to beneficiaries, it also creates additional complexity for IRA owners who have named a trust as the final beneficiary.

Previously, a properly drafted trust, known as a see-through trust, allowed trust beneficiaries to use the stretch provisions. See-through trusts are drafted in two types, accumulation or conduit.

An accumulation trust gives the trustee the power to decide whether to retain all, some, or none of the IRA distributions. Assets retained in an accumulation trust are not subject to the mandatory 10-year payout, and retaining IRA distributions maintains the asset protection feature and solves the problem of large distributions to beneficiaries. However, any income retained in the trust greater than $12,950 (for 2020) is *taxable to the trust* at the top trust rate of 37%, making it highly inefficient from an income tax perspective.

A conduit trust requires that all IRA distributions are paid to the trust beneficiaries; no income can be retained by the trust. Distributions may be limited to the annual *required minimum distribution*. However, under the SECURE Act, with the exception of *eligible designated beneficiaries,*[1] the entire balance of the IRA *must* be paid out by the end of 10 years. This accelerates the income tax due and the time until the trust beneficiary has the assets in their individual name.

If you have named a trust as the beneficiary of your retirement assets, we recommend you speak with your attorney to ensure the trust will still meet your goals under the rules of The SECURE Act.

Why Stocks Are Up When the Economy is Down

by Nathan Polackwich, CFA

Like a lot of kids in the 1980s I had a baseball card collection. Back then new cards were easy to find at Kmart or the local card shop, but vintage cards of the greats like Mickey Mantle or Hank Aaron were rarely seen and almost impossible to obtain for anything less than a small fortune – at least to a ten-year-old boy. I remember trading for a couple of no-name players in the 1968 Topps set and thinking they were the coolest cards in the world. A beat-up 1971 Reggie Jackson (for which I paid the princely sum of $20) was the prize of my collection. As I got older, of course, my interests changed, and my cards were relegated to a closet somewhere and forgotten.

Fast forward to 2012 and 33-year old me has two sons in Little League and a favorite team – the Tampa Bay Rays – who've managed to string together multiple seasons of above-average baseball. With the game on my mind, I dig up my old cards and go on eBay to see if they're worth anything. Disappointingly, my mostly 1980s era collection is practically worthless. But I notice that the vintage cards I coveted as a boy are also far more affordable than I expect. In fact, I can buy almost any player I want in reasonably good condition for less than $50! So, as is typical with me, I go a little overboard.

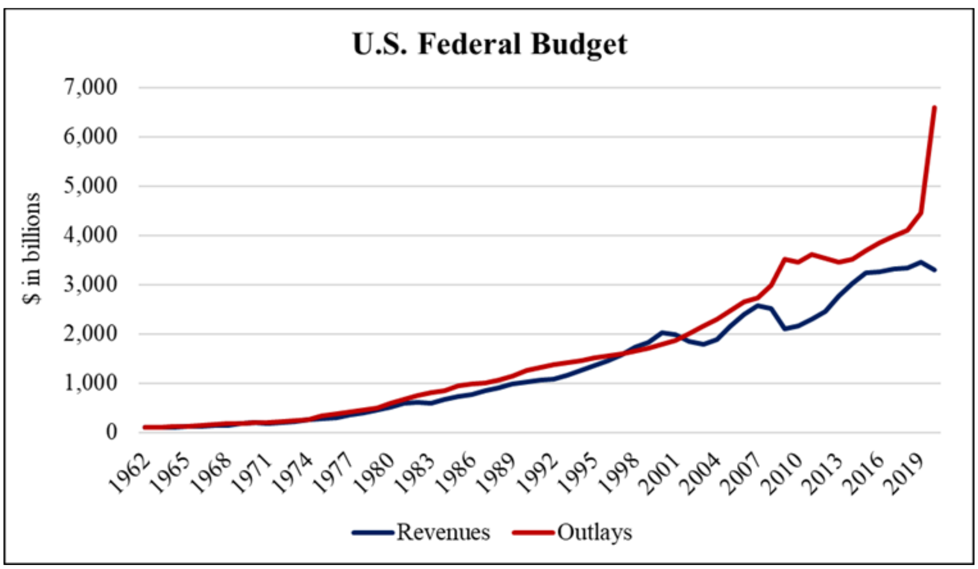
I end up buying every great player – including the aforementioned Mantle and Aaron and many more – in multiple years from the 1960s, 1950s, late 1940s, and even some tobacco cards from as far back as 1912. I also happened to purchase some modern rookie cards of two promising players that debuted in 2011, Bryce Harper and Mike Trout, for which I paid about $10 each. Harper ended up being a good but not great player. Mike Trout, on the other hand, is on track to be the greatest of all time.

[1] Eligible designated beneficiaries are a surviving spouse, a disabled or chronically ill individual, an individual who is not more than 10 years younger than the IRA owner, or a child of the IRA owner who has not reached the age of majority.

I bought four Mike Trout rookie cards, and every year or so I like to check the prices on eBay. The last time I looked (maybe two years ago) the cards were selling for about \$100 each, which I thought was pretty impressive for a 2½ X 3½ inch piece of cardboard…that is, until I checked the price a few weeks ago. Suddenly, the cards are going for more than \$1,000 and in perfect condition are fetching more than \$3,000! One particular rookie card of Mike Trout – a one of a kind autographed card I unfortunately didn't have the foresight to buy – sold in August for \$3.93 million, smashing the previous record of \$3.12 million for a 1909 Honus Wagner sold in 2016.

What's amazing about this price explosion in baseball cards is that it's occurring in the middle of a global pandemic and sharp recession with high unemployment and small businesses shuttering by the tens of thousands. And it's not just baseball cards ascending in price. Fine art, real estate, and, yes, the financial markets are all booming. With so many people struggling economically, the question is how?

The first piece of the puzzle can be found in the chart below, which shows the level of total annual government spending and revenue (taxation) since 1962. Note that the 2020 data represents the Congressional Budget Office's (CBO) current estimate as of Sept. 2020.



As is obvious, something incredible is happening this year. In 2019 the Federal Government's total expenditures were \$4.45 trillion. In 2020, the CBO expects spending to surge 49% to \$6.6 trillion, a reflection of the stimulus packages passed by the government (headlined by the \$2.2 trillion CARES Act signed on March 27). <u>The result is that the Federal budget deficit will increase from (an already high) \$984 billion in 2019 to an astonishing \$3.3 *trillion* in 2020</u>.

By assessing Personal Income data from the Bureau of Economic Analysis (BEA), we can see exactly where that money went.

($ Billions)	2019 DEC	2020 JAN	FEB	MAR	APR	MAY	JUN	JUL
Employee Compensation	967.0	976.2	985.4	957.0	885.7	907.9	927.5	940.0
Proprietors' Income	141.3	143.3	146.9	136.4	120.3	124.1	132.5	134.3
Rental Income	66.6	66.7	66.9	67.0	66.7	66.5	66.2	67.1
Interest/Dividend Income	248.7	249.2	248.7	248.2	245.2	242.0	239.0	238.1
Government Social Benefits	262.9	267.0	267.6	274.3	549.2	456.3	416.4	409.4
Social Security	86.6	88.7	88.9	89.4	89.6	89.7	89.6	90.1
Medicare/Medicaid	118.3	118.2	118.8	120.3	121.2	123.8	125.4	127.5
Other	55.6	57.8	57.6	58.4	297.1	128.5	78.9	78.2
Unemployment Comp.	2.4	2.3	2.3	6.2	41.3	114.4	122.5	113.7
Personal Income	1,566.7	1,581.1	1,593.0	1,563.6	1,754.6	1,681.4	1,664.4	1,670.2

As is evident by the declines in employee compensation and proprietors' income, the COVID-19 pandemic began to crack the economy in March, even before the government-imposed lockdowns began in April. As those lockdowns were subsequently lifted, employee compensation and proprietors' income started to recover though as of July remain about 5% and 9%, respectively, below February 2020 levels.

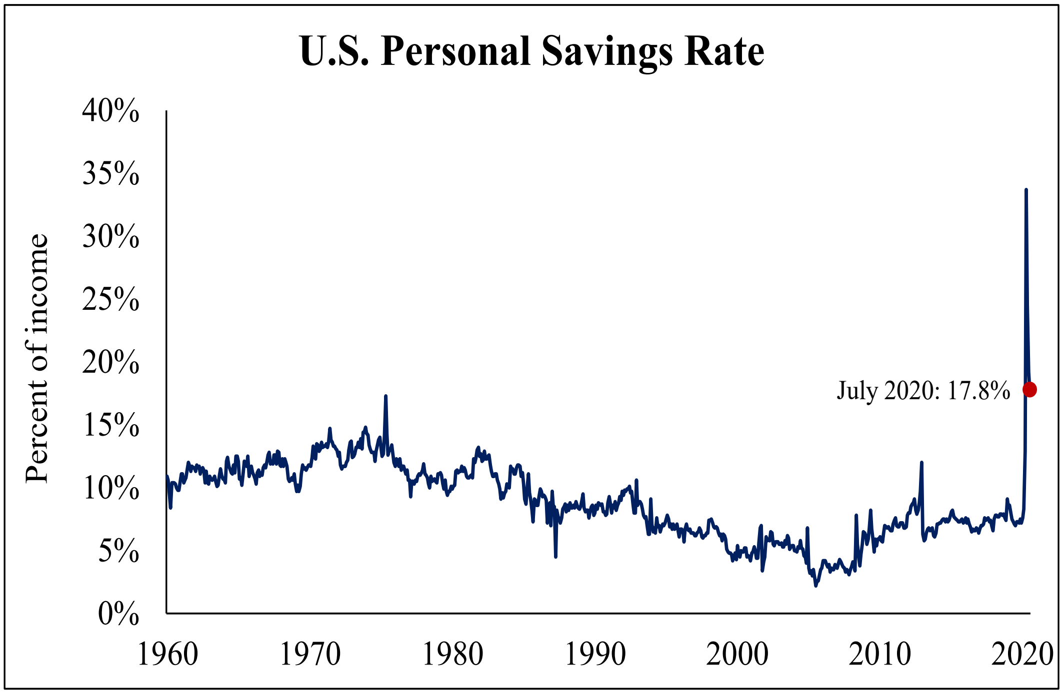
This lost income, however, has been more than offset by a frenzy of government spending beginning in April with much of the money from the CARES Act showing up in the "other" category as well as a rapid acceleration in Unemployment Compensation. Thus, despite economic activity falling 9.1% in Q2 2020 (vs. Q2 2019) and the unemployment rate peaking at 14.7%, **from April to July U.S. households saw their incomes *rise* by $400 billion more than had the pandemic never occurred**.

So what happened to this extra money? Unfortunately, the economic impact was mild, as very little of it seems to have been spent by U.S. households. Here's what Personal Consumption (household spending on goods and services) did over the same time.

($ Billions) Seasonally Adjusted	2019 DEC	2020 JAN	FEB	MAR	APR	MAY	JUN	JUL
Personal Consumption Expenditures	1,233.0	1,240.0	1,239.8	1,156.5	1,007.1	1,093.6	1,161.0	1,183.3

Despite hundreds of billions in extra income, U.S. household spending on goods and services still plunged in April and by July remained almost 5% below pre-pandemic levels. So where did the money go? – *into savings*. In fact, with income surging and spending falling precipitously, I estimate the total increase in extra U.S. household savings from April through July has already been almost $1 trillion.[2] As further evidence, here's a chart of the Personal Savings Rate, which peaked at an otherworldly 33.7% in April and was still about 3X pre-pandemic levels in July.

[2] Pre-tax Income grew $400 billion, lower taxes and government social insurance contributions added another $80 billion, and personal consumption fell $515 billion.



As of the end of July, then, thanks to the government's largesse and the pandemic related reduction in consumer spending, U.S. households had $1 trillion more to invest than they otherwise would have – that's a trillion extra dollars to purchase stocks, bonds, real estate, art, classic cars, cryptocurrency, and, yes, even baseball cards. If you were wondering how the stock market (or Mike Trout rookie card prices) can be so strong with the economy so weak, here is the answer.

The $64,000 question is where do we go from here? Another stimulus close to the size of the CARES Act won't be forthcoming, but the economy and consumer spending will continue to recover anyway as the threat of the pandemic fades thanks to better treatments, faster testing, and, most likely, an effective vaccine. So I expect the U.S. savings rate to normalize (by falling) next year. But that doesn't necessarily mean the financial markets have to suffer. While a tsunami of government spending kept stocks buoyant this year, 2021 will benefit from a stronger economy and associated higher corporate profits, which stocks have historically followed, at least over the longer term.

Speculating on Stocks: *Hertz So Bad*

by Jeremy Goldberg, CFA

Imagine a world without COVID-19. It's the start of a new year and you're in Las Vegas. You have extra cash in your pocket for your well-deserved vacation and you're feeling lucky.

You walk into Caesar's Palace and see a crowd at the entrance of the casino floor. Dozens of people, just like you, arrived in Vegas flush with cash. There's a slot machine your best friend won a small fortune on the week prior, and now it's your turn for the jackpot. It's no ordinary penny slot, however. Each pull costs $100 and you don't know the jackpot payout. You only know that with each losing pull, the chance of the next pull winning is slightly higher (or at least not lower). At some point, someone will eventually win and you want that to be you.

It's finally your turn. You pay $100. Pull. Nothing. You lose 100% of your bet. You pay another $100. Pull. Nothing. Again, $100 down the drain. Again. Again. Finally, after losing $500, you quadruple your $100 bet and turn it into $400! It feels great, your confidence is restored (ironically, because it's a game of luck and confidence shouldn't be considered), and you pull again, maybe not realizing that even though you made 300% profit on your last bet you are still in the hole. Again, a loss.

At what point do you *expect* to win the jackpot? Slot machines give the house (the casino) the highest edge, so gamblers have the lowest probability of winning and should carry with them the lowest expectations. Yet people will spend hours playing the same slot machines hoping that the occasional small wins compound into the jackpot that they have never hit, or at least compound enough to offset their losses.

For this reason – the opportunity to turn money into more money – gambling is often compared to investing. Advanced gamblers study strategies for table games to improve their odds of success. The martingale betting system in Roulette, for example, ensures the player wins back more than their cumulative losses with every next bet, but casinos limit the maximum bet so in practice it's virtually impossible to consistently cash out positive. Card counting techniques in Blackjack can move the odds in the player's favor to *nearly* 50%, but in every game the house will always have at least a slight edge.

This is where gambling differs from investing: in gambling, probabilities are known. Any motivated player can memorize the probability chart of any table game and no single player should have an advantage over another assuming they are equally studied. Two things always hold true: 1) the only advantage is held by the house, and 2) every bet has a negative expected return.

Yet, there are repeat winners – how? Since skill (understanding the rules and payouts) is a necessary foundation to be consistently average and edge is never in the players' favor, the two remaining mechanisms to consistently win must be: 1) luck and 2) emotional intelligence.

To be better than average, a bit of luck is needed. As poker hall of famer and multi-time World Series of Poker champion Amarillo Slim details in his book, *Amarillo Slim in a World Full of Fat People*, "I've lost approximately $30 *million* playing poker (you wouldn't believe me if I told you how much I've won), and very little came from making a mistake. It's not like chess, where the best players win all the time… <u>All you can do is make the plays that have a percentage of success and put yourself in a position to win.</u>"

Slim's gambling philosophy is underpinned by value investing principles. He understood, "Don't bet with your heart. Emotion is the greatest killer to any gambler…"

Once skill is achieved and luck is granted, emotional intelligence is required. Controlling emotional vulnerabilities at casinos, despite the challenging forms of psychological manipulation (such as free alcohol, bright lights, upbeat noises, no windows, no clocks, pheromones, and even oxygen pumped into the air), is no easy feat. On top of this environmental stimuli, gamblers must see through the "pokerfaces" of their competitors. The best gamblers have similar understandings of the game (skill) and have no control over the cards they are dealt (luck). The upside to their performance is derived from speculating on other players' (or the dealer's) cards based on their behavior (emotional intelligence). At the highest level, emotional intelligence is what sets gamblers apart from one another.

$\boxed{\text{No skill}} \rightarrow \boxed{\text{Skill}} \rightarrow \boxed{\text{Skill + Luck}} \rightarrow \boxed{\text{Skill + Luck + Emotional Intelligence}}$

As in gambling, emotional intelligence is a key element of investment success. Fundamental analysis (skill) should be the backbone of any investment. Short-term price fluctuations (luck) should come second to long-term asset selection. If fundamentals are favorable and the price is reasonable, then patience through market volatility is the emotional response needed to succeed in investing over the long-term.

In isolation, skill and luck can create value, but luck is uncontrollable and skill, just like in gambling, makes the investor average. For instance, skill is determining that a company will not default on its liabilities because it has the cash on hand to pay off its debt maturing this year. Luck is buying a stock that files for bankruptcy because it is suddenly cheaper than it was yesterday and then it unjustifiably increases eleven-fold. Emotional intelligence is holding a fundamentally strong position through short-term price volatility because the thesis is based on the underlying value of the business, not the stock price.

2020's stock market has experienced annual-like returns in weekly, and even daily time frames. This volatility is creating more opportunities for luck (sometimes disguised as skill), and it's conditioning investors to have higher return expectations.

The unjustified eleven-fold increase – as irrational as it sounds – was Hertz Global Holdings (yes, the rental car company). Hertz filed for Chapter 11 bankruptcy on Friday, May 22 when it was trading at $2.84. The following Monday, it fell to a mere $0.55. Then over the next 9 trading sessions, without any changes to the business, it traded up to $6.25. An investor (gambler?) was willing to pay $6.25 for a bankrupt company. The stock has since hovered around $1.40.

While Hertz is a clear-cut example of luck, Tesla's precarious stock price and shaky fundamentals are often ignored for the lofty goals of CEO Elon Musk and the corresponding *potential* profits. There's an expectation that investable companies will do better tomorrow than they did yesterday, otherwise there's no incentive to invest. This is taken to an extreme with Tesla. The amount of value implied by each share of Tesla dwarfs all competitors, no matter the economic positioning, and this can easily be illustrated by comparing Tesla to other auto manufacturers.

Understanding that Tesla does more than just manufacture cars (they also develop batteries, self-driving technologies, sensors, solar panels, and the kitchen sink), we can isolate its auto business to determine its value relative to the many competitors. In 2019, Nissan delivered 4.93 million vehicles. Their auto business is 90% of their total business, so their “auto market capitalization” is $13.6 billion (as of 9/22/2020). Therefore, the stock market is valuing each Nissan delivered at $2,766. General Motors is valued at $4,881. Daimler (Mercedes) is $13,870. Audi is $42,040. In total, between all of the major auto manufacturers, the average market capitalization per vehicle is $20,504.[3]

Tesla delivered 367,656 vehicles in 2019. 85% of its business is car manufacturing, so their auto market capitalization is $323.2 billion. The stock market is currently valuing each Tesla vehicle delivered at $878,998, a whopping 43x the peer group. If Tesla stock traded at the peer group valuation, it would be worth $10 today. Instead, it is trading at $400. This $390 premium is the *potential* earnings expected to be generated by the company in the future. It is the speculative aspects of the business that investors believe will pay off in spades – hence the massive valuation premium. In the meantime, the fundamentals do not support the lofty goals, at least sustainably based on current operating performance.

Tesla’s stock return has been fantastic this year, but it’s a critical distinction to recognize that while it’s been a great stock, it’s not a great business. Consequently, it carries far too much risk to be held as a core position in a conservative portfolio. This logic can be applied to gambling: A lucky gambler going home with a pocket full of cash likely wouldn’t quit their day job to gamble full-time.

On the other hand, there are examples of companies that appear to be overvalued superficially, but further study suggests they are in fact reasonably priced. TJ Maxx (TJX) is a great example of this paradox. We like TJX for its unmatched global supply chain, the “treasure hunt” nature of the business that shields it from online competition, and the discount-retailer pricing model. With a history of strong revenue and earnings growth, coupled with minimal debt default risk, TJX has the fundamental criteria of a solid investment. The valuation, however, may appear extreme.

Here’s why:

1) TJX is currently trading at $54. Last year, they earned $2.67 per share.[4] Using the traditional price-to-earnings multiple, shares are trading at 20.2x trailing earnings.

2) At the start of 2020 – before COVID-19’s impact on businesses – Wall Street estimated TJX would earn $2.85 per share this year (earnings growth of 6.7%).[5] Instead, 1Q and 2Q operations were impacted by store closures and Wall Street lowered its estimates to $0.15 per share. At its current price, that means shares are trading at an astronomical 360x forward earnings.

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[3] Includes Nissan (NSANY), Volkswagen (VWAGY), Fiat Chrysler (FCAU), General Motors (GM), Ford (F), Honda, (HMC), Daimler (DMLRY), BMW (BMWYY), Toyota (TM), Audi (AUDVF), and Volvo (VLVLY)
[4] TJX’s fiscal year ends in January.
[5] Wall Street estimate is based on the consensus estimate of 28 analysts

3) We concede this year is an anomaly in the long-term story of TJX's success. While the valuation currently looks high, normalized earnings (earnings next year) are expected to rebound to $2.50. This suggests shares are trading at a much more palatable 21.6x normalized forward earnings.

Stock prices have been exceedingly volatile this year, leading to valuation discrepancies like this throughout our portfolio. However, all current and potential PASI stocks must have a track record of earnings growth, strong balance sheets with healthy cash positions, and meaningful cash flow. If these criteria are not satisfied, the investment is not qualified. Once the fundamental aspects of the business are vetted, valuation and emotional intelligence drive the rest of the performance. If our thesis is still intact, we ignore short-term price fluctuations that do not necessarily reflect the underlying value of the business and may even opportunistically adjust our asset allocation to "buy the dip." When stocks have strong performance and become outsized positions in portfolios, we trim back to target. This risk management technique allows us to "buy low and sell high," and also ensures that a portfolio cannot be substantially impacted by unforeseen downside of any single company.

Emotional intelligence is one of the hardest aspects of investing, but it is much easier to regulate with a portfolio management team passionate about helping you achieve your retirement goals. Following extensive due diligence for each stock pitched, our eight-person investment committee discusses all investments and changes made to our portfolio so that no single uncontested opinion or "fire-drill" can sway the trajectory. With you in mind, we are betting on the long-term.

Disclosure