PASI NEWS
since 1977

Volume 44 - Number 1 Spring 2020

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

## Market Update – *Unprecedented Uncertainty*

by David A. Jaffe, M.D.

Hoping time would bring some stability and add clarity to our forecasting, we made a conscious decision to delay production of this newsletter. Wishful thinking! Traditional reporting periods have always seemed somewhat arbitrary to me, but never more so than for the first quarter of 2020.

The S&P 500 logged its 13th record high for the year on February 19, 2020. A mere six trading days later, the stock market was in correction territory, defined as a 10% decline from the near-term top. The rapidity of the plunge was breathtaking. So, what happened? Today, we all know the answer. But events unfolded so fast it's hard to grasp the cascade which led to the worst stock market quarter since 2008 and the economic transition from record employment to record unemployment in a matter of weeks.

On January 10, 2020 China reported the first death from the novel coronavirus, dubbed COVID-19 by the World Health Organization on February 11th. Locking down the province of Wuhan two weeks later, unfounded hope prevailed that viral spread would be contained. By the third week of February, it was evident that the number of cases observed in China and neighboring South Korea was escalating rapidly. By late February, new cases surged in Italy and Iran, and the CDC warned of widespread risk in the U.S. Adding to investor worries, several companies including Apple and Microsoft warned that supply chain disruption would hurt quarterly sales.

Indiscriminate dumping of stocks, commodities, and high-risk debt erupted as investors fled to the perceived safety of gold and treasuries. Demand for safe harbor U.S. debt drove prices up and interest rates down, the 10-year Treasury hitting a record low 0.501% yield. On March 3rd, incongruent events occurred as the Federal Reserve intervened for the first (but far from last) time in the crisis with a 0.50% cut in short term interest rates, while the U.S. reported its first COVID-19 deaths. City-by-city and state-by-state, mandates were issued to close 'non-essential' businesses and for the population to shelter in place, virtually ensuring severe economic contraction. On March 11th, coincident with the WHO declaration of a coronavirus pandemic, the stock market entered bear market territory with the requisite 20% decline from the February highs. Characterized by extraordinary volatility and interrupted by a few large bounces in stock prices, the downward trend continued until the current year bottom of March 23rd, with the market down fully 33.9% from the February highs.

The stock market has regained 27% since the March lows (as of 4/20), a remarkable recovery driven by enormous support from the Federal Reserve and relief programs cooked up in Washington D.C. The Fed has literally thrown the kitchen sink at the credit markets, with moves ranging from zero short term interest rates to a commitment to buy up corporate debt, even high-risk issues. Meanwhile, Congress passed a funding package, with a minimum pledge of $2.2 trillion to help individuals and businesses survive the imposed economic shutdown.

There's an old Wall Street adage, "markets hate uncertainty". It's hard to imagine more uncertain times. Efforts to slow spread of the coronavirus pandemic have shut down much of the economy, both through physical closure of businesses and stalled consumer spending, a victim of historical levels of unemployment. We are faced with two monumental and related questions: how do we manage the health consequences of the virus, and how will that management affect the economy? The nuances of that connection are complex; a broad overview is offered by our senior equity analyst, Nathan Polackwich, later in this newsletter.

So, where are the markets for 2020? First, we must inject a point of clarification. Most investors agree that the S&P 500 is the best measure of the broad stock market, capturing the largest 500 companies in the U.S. However, the commonly cited S&P 500 is "market cap weighted", meaning that the influence of the individual components on the index is dependent on the market capitalization (or stock market value) of each component. In recent years, a small number of companies have grown to have an outsized influence on the index, and that aberration has never been greater than it is today. The weighting of the *five* largest companies by market cap, Apple, Amazon, Alphabet (Google), Facebook, and Microsoft now equals the weighting of the *350* smallest members of the S&P 500. And relative to the other 495 S&P 500 constituents, they have held up very well in 2020. The resulting aberration is such that the market cap weighted S&P 500 is currently down 12.09% for 2020, while the unweighted S&P 500 index has lost 20.59%, a dramatic disparity. Some day the big guns will no doubt lose favor and this relationship will shift, but for now the unweighted S&P 500 is probably a better reflection of the damage suffered by the broad stock market.

With the above caveat in mind, the traditional (weighted) S&P 500 ended the first quarter with a decline of 19.60%, and as of this writing (April 20th values) is down 12.09%. The composite PASI stock portfolio ended the quarter down 21.88%, and has recovered to show a current decline of 14.91%. All values include reinvested dividends.

Perhaps never in the 43-year history of Professional Advisory Services has the economic outlook for the next 1-3 years been so uncertain. The optimist in me believes that in the next 6-18 months the concerted efforts of scientists worldwide will produce effective management of this disease including medications, antibody treatment, rapid and accurate testing, clear understanding of the modalities of viral dissemination, and ultimately herd immunity and an effective vaccine, all of which will allow us to return to our pre-COVID lives. Regardless of the timeline and potency of such measures, one must acknowledge that the consequences of the economic shutdown will last far beyond our mandated social distancing, as Nathan outlines in his discussion.

The depth and duration of the economic impact is therefore unknown, and now more than ever the quality of the financial assets selected for our clients is paramount. The economy and the markets will recover, and as they do, we want to be sure that your investments are well structured to emerge from the downturn and help lead the way when growth resumes. On the following pages Ken Ligon III and Jeremy Goldberg discuss the safety and quality of our stock and bond selections in detail.

## The Value of *Strong* Companies in a *Weak* Economy

by Jeremy Goldberg, CFA

*"It's far better to buy a wonderful company at a fair price than a fair company at a wonderful price."* – Warren Buffett, 1989 Letter to the Shareholders of Berkshire Hathaway

Beauty is in the eye of the beholder, and as the beholder of your investments, Warren Buffett's wisdom is foundational to our tried and true investment philosophy.

The search for good investments isn't just a search for cheap stocks. Yes, finding companies that are trading below their fair value is always the goal, and the steeper the discount the better! But what defines cheap or expensive… what is fair value?

Fair value (or "intrinsic value") is what a share of a company's stock *should* be worth based on the underlying fundamentals (financial strength) and outlook of the company. It's generally determined by the equity analyst, the investment banker, or the individual investor, through a variety of valuation methods across a spectrum ranging from elementary to wildly complex.

The wisdom of crowds would suggest that after every participant comes up with their own fair value estimate, the average would be the most-right. The crowd is wise! But are they accurate? Well, sometimes, and other times certain criteria – like cash and the ability to pay off debt – are relaxed.

As many of our long-term clients have likely observed, we often don't conform to the crowd. At times, we may hold a handful of current "hot stocks," but we usually ignore market noise. Despite varying degrees of fundamental value, company-specific events, sector-specific outlooks, behavioral biases (cognitive and emotional), political motivations, and "FOMO" (fear of missing out) can weigh into the estimates of a stock's value. <u>All the while, what we value in any company is unwavering</u>.

In defiance of the inputs behind fair value estimates, a stock's price is ultimately determined through supply and demand. A stock is only worth what a buyer is willing to pay, and over time, the hope is that the fair value estimate and the price in which a buyer/seller agree is fair will converge. Determining what drives supply (sellers) vs. demand (buyers) is where things get complicated. Seller motivation can be rational, like the expectation of an underwhelming outlook, but if the seller is rationally motivated to sell a stock that has, in their opinion, weak prospects, then what is the buyer missing? And conversely, what is the seller missing that the buyer isn't?

Tasked with playing both the buyer and the seller, PASI's goal is to figure out what's missing on either side of the market. This is where beauty, or value, is in the eye of the beholder.

Given the current economic climate – depressed by the COVID-19 pandemic though partially buoyed by the Federal Reserve's kitchen sinks – capital structure is of utmost importance to every investor and every company. Here's the problem: those that are just now focusing on liquidity (ability to pay off short-term debt) and solvency (ability to pay off long-term debt) are too late.

This should be rudimentary! Does the company have cash or cash flow to pay off upcoming debt? If they don't, they default, or they issue more debt at a potentially higher cost to the company.[1]

YUM! Brands (YUM), owner of KFC, Pizza Hut, and Taco Bell, is illustrative. YUM started 2020 with $605 million of cash and $431 million of debt coming due by year-end. YUM had plenty of cash to cover the debt, with $174 million left over for other things like expanding the business or renovating locations. They spent $190 million on these other things in 2019 so their budgeting was all fine and well, especially considering they've generated ~$925 million in free cash flow annually over the past 3 years – until this pandemic.

Now that businesses are generating significantly less revenue than expected, cash flow isn't very reliable, so cash is king. YUM can manage this year with the cash on hand, but next year they have an additional $455 million of debt coming due. They won't have the cash on hand, and investors can't rely on the cash flow they may or may not generate, so what do they need to do? They need to issue new debt, and that's exactly what they did. YUM issued an additional $600 million of debt at the end of March with a 5-year term to refinance at least a portion of the 2020 debt maturities. But there's a kicker – they had to pay investors 7.75% interest annually to make the risk worthwhile. When the company issued 10-year debt in September 2019, they only had to pay investors 4.75%. (Despite better redemption features and less maturity risk, they had to pay investors more to hold comparable debt due to uncertainty about future cash flows). YUM was not in a uniquely weak financial position, but they were not expecting such a devastating economy. Though this is an extreme case, they are not alone.

Overall, the S&P 500 index companies have ~8.0x the amount of cash on hand relative to total debt maturing in 2020. That's pretty good (although partially driven by a few big players). After paying off the debt coming due this year, and assuming they don't add more debt to float the business over the short-term, they will only have ~6.6x the amount of cash available relative to debt that needs to be paid off in 2021. During this uncertain period, most companies aren't reinvesting in research and development, expanding businesses, or hiring employees. They are hoarding cash because they need it *now*.

[1] Companies could issue equity, but the cost of equity generally exceeds the cost of debt.

PASI stocks, on the other hand, have ~16.8x the amount of cash on hand relative to total debt coming due in 2020, and ~20.4x cash relative to debt coming due in 2021! So the volatility our companies are experiencing is not driven by financial weakness, rather systemic pressure. Our companies have the discretionary funds to withstand a much more significant downturn, which should expedite their performance recovery.

Just as we are stewards of your capital, the companies we invest in play an identical role. There may be more or less value in a company than the market gives credit for at any single point in time, but over the long term, certain companies tend to outperform – and this is where our 40+ years of experience and refinement has come in handy. Financial stability is a cornerstone of our investment thesis. We value earnings compounders. We value cash and cash management. We value real cash flow. And we value liquidity and solvency. These are mutually inclusive for all PASI stocks, and that will never change.

## Are My Bonds Safe?

by Ken Ligon III

As the old saying goes, "Plan for the worst, hope for the best and always save for a rainy day." Throughout our history, PASI has embraced this philosophy through our use of balanced investment portfolios which, besides stock, include significant corporate or municipal bond holdings. Historically, when stocks are down, high quality bonds increase in value, as investors flee stocks looking for the safety of fixed income. In addition, during economic downturns the Fed usually lowers interest rates to stimulate the economy. Lower rates make existing bonds more valuable because they yield more than newly issued debt.

Ultimately all bonds are only as good as the entities behind them. PASI reduces default risk by focusing on investment grade bonds. Per S&P Global, one of the three major rating agencies, over the past 38 years only 0.09% of investment grade bonds have defaulted. That's an astonishingly low number and strong evidence of their safety and quality. In contrast, the default rate on non-investment grade bonds – commonly referred to as "junk bonds" – is 3.99%, roughly 44 times higher.

PASI has never had a bond default in our 43 years in business, which includes the credit crisis of 2008-2009, the worst performing period for bonds since the Great Depression. In addition to the grades assigned by the ratings agencies, PASI's team of financial analysts routinely reviews the financial statements of the companies that issue the bonds we buy, as well as monitoring daily stock price movements, as they sometimes provide an early warning sign of an emerging credit issue.

Another way we manage bond default risk is by limiting the amount of money we're willing to commit to each individual bond position. While we may target up to 5% of the bond portion of our portfolio to an individual company's bonds, the vast majority represent just 2% of a client's total assets.

In addition to diversifying our bond holdings by issuer, we also diversify by sector and industry. We own bonds in almost every *sector* of the market (i.e. health care, industrial, financial, tech).

And within each sector, we invest in different *industries*. For example, in the healthcare sector we own bonds in the pharmaceutical and medical device industries.

Aside from default risk, rising interest rates are a significant risk factor for bonds. For instance, if you buy a bond at a 3% yield and interest rates rise to 10%, you'll be much better off if your bond matures in 2 years (so you can reinvest the proceeds at 10%) rather than having your money locked into that lower yield for 10 years or more. Thus, PASI mitigates the risk of higher rates by laddering our bond maturities over a relatively short 1 to 5-year period.

Some of our clients in high income tax brackets own tax-free municipal bonds, and we apply the same principles mentioned above such as investment grade, limited position size, broad diversification, and shorter maturities. Unlike corporate bonds, however, municipal bonds are backed by the taxing power or other revenue streams (utility, toll, water, etc.) of individual cities and states. So our diligence incorporates the fundamental strength of local municipalities' economies and budgets. Of course, in the current pandemic the budgets of many municipalities are likely to become strained. Positively, extraordinary times have called for extraordinary measures and as part of the Federal Reserve's economic stimulus package, they've pledged to provide a financial backstop to any municipalities that – due to extensive business shutdowns – find themselves temporarily unable to meet their obligations.

With interest rates historically low, high quality corporate and municipal bonds may not seem like the most exciting of investments. And they're not! But they provide important diversification to your portfolio when it matters most. In fact, in recessions almost everything – U.S. stocks, foreign and emerging market stocks, commodities, real estate, venture capital – will tend to fall together. But, uniquely, this is when high quality bonds swim against the current, holding or even gaining value when you need it most, and lowering your overall portfolio volatility. With your bonds, you own the best in class, and they've stood the test of time. The money will be there when you need it, especially during these uncertain times.

## Good and Bad News

by Nathan Polackwich, CFA

I'm going to give you the bad news first.

There is no modern historical analog for the economic impact of the coronavirus. Through recessions, depressions, oil crises, terrorist attacks, burst housing/Internet bubbles, and credit market meltdowns most businesses carried on as before. People still went to the movies, shopped for clothes, got knee surgeries, ate at restaurants, and went to Disney World. There's never been a crisis where most of the economy – save grocery shopping and in-home entertainment – literally ground to a halt for a sustained period. Unfortunately, this means that companies whose businesses would normally be resilient in a recession will see their revenue and profits fall just as rapidly as weaker, more economically sensitive firms. In this crisis there are few places to hide.

I also don't believe the global economy can just bounce right back after the economic gut punch delivered by the virus. A back-of-the-envelope calculation (basically all that's possible right now) by the Federal Reserve Bank of St. Louis estimated the U.S unemployment rate could reach an incomprehensible 32.1% over the next quarter. This is a worst-case scenario based on the number of Americans in high risk occupations (e.g. food prep, sales, manufacturing production) as well as high social contact jobs (hairstylists, physical therapists, flight attendants etc.). Not every one of these jobs will be lost. But given that the peak unemployment rate during the Great Depression was 24.9%, the St. Louis Fed's estimate gives some perspective on the potential scale of the problem we face.

Every person out of work will take a significant financial hit. Savings will decline, credit card debt will rise, and people will fall behind on their rent or mortgage. The longer the economy shuts down (or even operates at reduced capacity), the deeper the financial hole and the longer it will take to dig ourselves back out. The young couple saving for a house might have to put their plans on hold indefinitely. That's one less job for construction workers, electricians, plumbers, insurance agents, mortgage lenders, appliance retailers, and on and on. The cascading effects of layoffs and depleted savings is why the economy isn't just a switch we can flip back on once the threat of COVID-19 recedes.

In addition to the potential scale of the economic damage, I'm also worried about the complexity. We've spent the last few decades interconnecting our world – workforces have been outsourced, supply chains streamlined, financial markets globalized, knowledge and workflow digitized. We have greatly improved our efficiency but at the cost of increased fragility. This is an entirely modern phenomenon.

It's hard to imagine today, but historically large projects were finished on time and within budget (the Panama Canal being a notable exception due to malaria). The Empire State Building, which was completed in 1930, took just over a year to build and came in under budget! The London Crystal Palace, built for the 1851 Great Exhibition of the Works and Industry of All Nations, was planned and constructed in nine months. Built with cast iron and glass from a small number of local suppliers, the structure was roughly three times the size of London's St. Paul's cathedral.

But as Nassim Taleb wrote in his book, *Antifragile*, today unexpected problems "are necessarily increasing, as a result of complexity, interdependence between parts, [and] globalization…One problem somewhere can halt the entire project – so the projects tend to get as weak as the weakest link in the chain…The world is getting less and less predictable, and we rely more and more on technologies that have errors and interactions that are harder and harder to estimate, let alone predict."

What kinds of complexities?

**Exhibit A: Insurance Claims Processing** – Insurance claims processing is often outsourced to foreign workers in cities like Bengaluru, India. But India is now on full lock down due to the pandemic. And these workers can't continue to process claims at home because most don't have laptops or the necessary internet bandwidth and network security to do their jobs. Of course, this issue won't just be confined to insurance claims processing. Large companies around the world have entrusted their critical applications, networks, and infrastructure to Indian IT outsourcers and will encounter similar bottlenecks.

**Exhibit B: The Toilet Paper Market** – Some people are hoarding toilet paper, but that's not why store shelves are empty. The problem is that the toilet paper industry has evolved into two distinct and specialized markets – consumer (home use) and commercial (business/govt. use). Different companies serve each market. In addition, the toilet paper itself – the commercial market uses more utilitarian/thinner paper – as well as the packaging and distribution networks differ.

Normally, consumer and commercial toilet paper demand is steady and predictable. But with businesses and schools closed, the demand for commercial toilet paper has suddenly plummeted while consumer demand has soared. People are now using their home bathrooms much more.

Because toilet paper is such a high-volume/low margin product, however, producers must operate at extreme efficiency and full capacity. As a result, consumer toilet paper makers can't handle a huge increase in demand. For their part, the commercial producers could try to sell into the consumer channel, but that would require reconfiguring their products and packaging as well as developing new distributor and retail relationships. These aren't insurmountable barriers, but from the vantage point of both consumer and commercial producers, making the necessary investments to meet this temporary demand surge will almost certainly be a money-losing proposition once quarantines are lifted and things get back to normal.

The Indian IT outsourcing and toilet paper markets are isolated problems. But they illustrate how – even putting aside the historic drop in demand – the complex nature of our modern global economy will make it tougher for companies to quickly and seamlessly adapt to the abrupt changes wrought by the coronavirus. And if we step back and assess the broader picture, even greater uncertainties emerge.

Take the debt of developing nations. In volatile times the U.S. dollar tends to rise against foreign currencies – particularly those of weaker, less developed countries – thanks to its status as a safe-haven. In fact, emerging market currencies have already lost about 6% relative to the U.S. dollar this year. This could be a problem for those countries, as they've borrowed a lot of money over the past decade *in U.S. dollars*. In fact, emerging market U.S. dollar denominated corporate debt outstanding rose from $548 billion in 2007 to almost $2.4 trillion by the end of last year. A surging U.S. dollar coupled with a sharp global recession could push many of these borrowers into default – an unwelcome prospect for both developing countries' economies as well as the U.S. and European financial institutions that lent them the money.

What about government? Although many of the workers who lose their jobs will apply for unemployment benefits, someone, of course, must pay. Typically, the Federal Government and states share the financial burden. While the U.S. Treasury (with the help of the Federal Reserve) can effectively create money out of thin air to cover its portion, state governments depend on local tax revenue for their funding. But with most businesses shutting down, that income source is set to collapse. To offset the loss, states may be forced to cut costs by laying off employees. This is exactly what happened in the 2008/2009 recession, prolonging the economic downturn and hindering the pace of recovery.

I know I'm not painting a pretty picture here. The problems we face are daunting. But there's good news, too. Although we may see Great Depression-like levels of economic contraction and unemployment in the short-term, the decline won't be nearly as protracted or as damaging to the financial markets. Why not? Because unlike today, during the Great Depression the Federal Government and Federal Reserve pursued policies that were either ineffective or flat-out counterproductive to U.S. economic growth.

On the fiscal side, despite an astonishing 30% decline in U.S. GDP from 1929 through early 1933, the longstanding belief that the federal budget should be balanced in peacetime kept government spending flat. It took a new President (FDR) and a New Deal to reverse this policy and for the Federal Government to finally take an active role in encouraging economic growth.

If fiscal policy help was absent during the Great Depression, U.S. monetary policy was downright hostile. At the time, the U.S. (and many developed countries) operated its monetary system under the gold standard. Currency issued by the Federal Reserve was convertible into gold at a fixed price with the money supply mainly influenced by gold discoveries and flows from international trade. But as the Great Depression progressed, countries were forced to abandon the gold standard, as speculators redeemed substantial amounts of their currency for gold.

In September 1931, speculators turned their attention to the U.S. The resulting outflow of gold reserves forced the Federal Reserve to sharply raise short-term interest rates from 1.5% to 3.5% (higher rates giving people more incentive to keep their assets in dollars at banks). While this action stemmed the outflow of gold, much tighter monetary policy in the teeth of a recession led to a spectacular increase in bank runs and then failures. The collapse of the banking system caused the money supply to fall precipitously and the economic downturn to accelerate. The U.S. finally (effectively) left the gold standard in early 1933. It's no coincidence that this change in monetary policy, coupled with FDR's huge expansion in fiscal spending, marked the bottom of the Great Depression and the beginning of the recovery.

The lessons policymakers learned from the Great Depression, as well as every recession/financial crisis that followed, is why such an outcome is unlikely today. We've abandoned the gold standard so the Federal Reserve can support a recessionary economy by cutting interest rates. In fact, in response to the current pandemic, the Fed slashed short-term interest rates to zero on March 15. Further, with FDIC insurance, and the Fed acting as "a lender of last resort", bank runs are also no longer a threat.

In 2008/2009 the Fed also learned the importance of providing liquidity to frozen credit markets. And that's just what it's been doing with recent announcements that it will purchase (if need be) virtually all U.S. corporate and municipal debt affected by the crisis. This will enable otherwise healthy businesses to roll over maturing debt and keep the lights on until quarantines lift and the economy finds its footing. The Fed's credit market support also means that state and local governments should have no trouble borrowing to fund their soaring budget deficits.

In addition to monetary policy, the Federal Government has learned that it must increase spending to pick up the slack in a recession to offset reductions by consumers and businesses. On

March 27, the government signed a $2.2 trillion stimulus bill. Provisions include various tax credits, financial support for state and municipal governments, an expansion of unemployment benefits, and hundreds of billions in loans to small businesses that are potentially forgivable for those that maintain payroll. All in all, it's possible the Federal Budget deficit could hit a mindboggling 15-20% of GDP this year, a level of spending not seen since WWII.

The scale and complexity of the crisis we face is unprecedented, at least in modern times. But the size and rapidity of the government response has been equally unprecedented. That's not to say an economic crisis and sharp downturn in the economy will be averted. It can't. Tens of millions of people will still lose their jobs. Many businesses will still fail. It will take us time to fully recover from the economic impact of the pandemic. But as the saying goes, this too shall pass. Human ingenuity, if history is any indication, will win out in the end.

## Important: *IRA Alert !!*

One element of the recently passed CARES act suspended the Required Minimum Distribution for all IRAs for 2020. This means that *if you do not need to take money out of your IRA for living expenses*, you can probably reduce your tax bill by stopping IRA distributions for 2020. This would apply to clients who have alternative sources of funds such as an after-tax account or pension. Remember that IRA distributions are taxed as ordinary income, while distributions from an after-tax account include capital gains and dividends (generally taxed at 20% or less) and perhaps return of capital.

We have been reaching out to clients regarding this issue, but *if we have not contacted you* and you believe you have the option to stop scheduled IRA distributions, please call us to discuss this. If you have already taken IRA dollars that you believe you do not need, a long-standing rollover option allows us to return *one* IRA distribution without tax or penalty if it has been taken within the last sixty days. At this time, Congress has not otherwise addressed distributions taken earlier this year.

## 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.