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PASI NEWS

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Market Update – *Makes Perfect Sense to Me*

by David A. Jaffe, M.D.

I remember watching the business news one night shortly after joining PASI in 1992. It was earnings season, and two reports that evening caught my attention. I don't recall the identity of the first, which disclosed modest earnings growth and a steady outlook. The second was Western Digital, a disk drive company which, true to its industry, was losing a ton of money. Guess which one dropped, and which saw a healthy 6% stock price gain on the news?

Of course, there are rational explanations for seemingly perverse financial market moves, especially when applied with adequate hindsight. Thank heavens Nathan Polackwich has tackled the topic in a following article (and with *insight* rather than *hindsight*), leaving me to report "just the facts", thank you!

The happy observation is a 20.5% recovery in the S&P 500 for the second quarter. That despite record unemployment, an escalating pandemic, and historically unrivaled uncertainty in the face of our binary potential near-term future (health-wise and economically, the two inextricably intertwined). But I digress.

The PASI composite stock portfolio recovered 23.0% in the quarter just ended (PASI and S&P 500 figures include reinvested dividends), standing down 3.93% for the year vs. a 3.08% decline for the S&P 500. The influence of a few large companies driving the *market cap* weighted S&P 500 persists, as discussed in our spring newsletter, with the *equal cap* weighted S&P 500 trailing by a wide margin, down 10.77% year-to-date.

The stock market recovery from the March lows reflects considerable optimism and patience. Optimism that we will soon have effective management of the COVID-19 pandemic, ideally both potent treatment modalities and an effective vaccine. Patience because there is broad consensus that under the best of circumstances, significant economic recovery is one to two years away. And in view of the widespread dislocation caused by measures to contain the spread of the virus, a wide range of businesses including financial, travel, hospitality, entertainment, sports, food services, commercial office space, home building, appliances, and many more … will take years if they ever return to pre-COVID status. In this context of extraordinarily uncertain times, we are working to structure your accounts to balance businesses helping all of us navigate this pandemic, and those likely to benefit when recovery arrives, while striving to moderate risk and provide the stability and security that you expect and deserve.

Important: *IRA Alert Part Deux !!*

As we wrote in our Spring Newsletter, the CARES act suspended the Required Minimum Distribution for 2020. While initial guidance for those who took early distributions was based on long-standing rules (rollovers to *return* an IRA distribution and forego the tax bill are limited to those returned within 60 days and to a single rollover each year), on June 23rd the IRS released more liberal guidelines allowing return of any and all 2020 distribution up to the RMD amount. *To qualify the funds must be returned by August 31st, 2020*. If you have questions about whether you should take advantage of this tax-saving opportunity, please call and discuss this with one of our portfolio managers.

Manic Markets and Binary Outcomes

by Nathan Polackwich, CFA

I was hesitant to begin writing this quarter's newsletter article, as I wasn't sure whether I'd be writing about a stock market mired in despair or delirious with euphoria. His political ideology aside, Vladimir Lenin was right when he said, "There are decades where nothing happens; and there are weeks where decades happen." From the market high on Feb. 20 (up 5%) to the low on Mar. 22 (down 31%) to the rebound back to even by Jun. 8 – all within the backdrop of a historic pandemic and nationwide protests over the police killing of George Floyd – the pre-COVID world of early 2020 really does feel like a lifetime ago.

Watching investors' stampeding panic turn on a dime into optimism and then exuberance, I feel like we're witnessing not two distinct market moods but the same mood, albeit a mirror image. As the Holocaust survivor and author Elie Wiesel wrote, "the opposite of love is not hate, it's indifference." Like love and hate, panic and euphoria are two sides of the same coin. The stock market's personality hasn't changed since Feb. 20 – crashing, soaring, terrified, ebullient, it's all the same – ***manic***.

What accounts for the stock market's present mania? I've written before about how financial market bubbles (euphorias) are usually accompanied by large secular change, or what the economic historian Charles Kinderberger called "displacements" in his book, *Manias, Panics, and Crashes* (1978). Such displacements usually arise from 1) the ascendance of a new economic power (e.g., the United States in the 1920s, Japan in the 1980s, China in the 2000s), or 2) new technologies that change the world (e.g., railroads, automobiles, radio, computers, and the Internet).

But displacements don't necessarily have to be positive. A pandemic that dramatically alters the economics – and in many cases the feasibility – of business models globally, certainly qualifies as a significant though negative displacement. Adding to investors' uncertainty, it's unclear whether the COVID-19 displacement will be short-lived or largely permanent.

Usually, the world changes little from year to year and by far the smartest bet is a continuation of the status quo. Thus, when we estimate stocks' values, the range of possible outcomes is typically narrow, at least in the short to intermediate term. But COVID-19 has thrown a wrench in our models. The value of an airline or restaurant, for instance, is wildly different in a world with a successful vaccine vs. a world without one. So, the outcome range for many companies, rather than a matter of degree, has become almost binary – i.e., they'll end up as valuable as they were pre-COVID or practically worthless. There's not much middle ground.

Revenue doesn't have to drop 100% for the value of a business to fall to zero. Most companies have large fixed costs. Restaurants, for instance, have rent, insurance, equipment, and other expenses that persist regardless of how many customers they serve. Given their already low profit margins, even a modest revenue decline would make most unprofitable.

Of course, some companies' outlooks are less binary than others. But the overall effect on the stock market has been one of heightened uncertainty. Will there be an effective vaccine/treatment? Will life go back to normal? Without a resolution to these questions, we expect the stock market's mood to remain manic, vacillating between panic and euphoria with each day's headlines.

For PASI, our goal from the beginning of this crisis was to replace our (newly) binary outlook stocks with similarly priced, high-quality companies with less exposure to the pandemic (or possibly even benefiting). A prime example of this strategy was our substitution of Disney (DIS) with Apple (AAPL).

Disney is a fantastic company we've owned successfully for a long time. But practically overnight the pandemic put much of its business in jeopardy. The Company has four major segments – TV (mostly ESPN and ABC), Parks/Resorts/Cruises, Movies (shown in theaters), and Streaming (Hulu and Disney+). The two most at risk are obviously Parks/Resorts/Cruises and Movies, which together comprise almost 2/3rd of Disney's profits. But TV and Streaming also aren't without issues.

In the TV business, Disney has spent tens of billions of dollars on broadcast rights for major sporting events like NBA Basketball, NFL Football, College Football, and Major League Baseball. It then charges cable and satellite TV providers affiliate fees (on a per subscriber basis) to carry its stations. To a lesser extent, Disney also generates advertising revenue.

Various estimates put total sports programming costs at 40-50% of the average household's $100 monthly cable bill with ESPN representing a significant portion. In fact, with the rise of direct-to-consumer streaming services like Netflix, live sports programming has become the primary reason households continue to pay for cable. But with unemployment historically high and the pandemic shutting down sports leagues, people have become less willing to shoulder a hefty monthly cable bill, pressuring Disney's revenue. Meanwhile, the Company's billions of dollars in annual sports broadcasting costs remain mostly fixed.

Certainly, sports will return, but will the fan experience be the same with empty stadiums? Will younger generations further lose interest in professional sports to video games and YouTube (already happened in my house)? Even before the pandemic, households were "cutting the cord" with traditional pay TV subscribers falling from a peak of 103 million in 2012 to just 83 million by the end of last year. COVID-19 looks to have accelerated that trend.

While the pandemic is helping Disney's Streaming operations, this business, unfortunately, is wildly unprofitable due to sky-high programming and IT costs (also a problem for Netflix). In 2019, for instance, Disney's Streaming segment lost $1.8 billion on $9.3 billion in revenue, a negative 19% profit margin.

All told, Disney's earnings are expected to fall from $5.77 in 2019 to just $1.45 this year. Interestingly, Wall Street analysts, who usually tend towards optimism, expect only a modest recovery to $3.21 next year.

We sold Disney stock on Mar. 20 at an average price of $92.60. That's a P/E (price-earnings ratio) of 63.9 on 2020 earnings and 28.8 on 2021 earnings. We replaced it with Apple stock over the following four days at an average price of $244. Apple's earnings, amazingly, are still expected to rise 4.1% this year to $12.38 and 20% next year to $14.86. This implies current and forward P/Es (at our original purchase price) of 19.7 and 16.4. Better yet, Apple holds an outrageous $92 billion in cash net of debt, while Disney's balance sheet looks strained with just $14 billion in cash vs. $55 billion in debt.

In addition to its better valuation and balance sheet, our thesis on Apple was that its business – unlike Disney's – didn't face such a binary outcome from the pandemic. If anything, the demand for technology should *increase* in a world with more limited in-person social interaction. So far, the stock market shares our view, with Apple gaining 53% since our purchase and Disney up a more modest 23%. Further, despite its outperformance, Apple's valuation at current prices remains significantly cheaper (25.2X 2021 earnings) than Disney (36.3).

Over the past few months we made similar calculations with other PASI stocks. For instance,

- ***We sold Booking Holdings (BKNG – online travel agency) and purchased Amazon (AMZN – online retail, cloud computing)*** – The pandemic is disastrous for travel but great news for AMZN's online shopping and cloud computing businesses (see Jeremy's article below). So far BKNG has recovered about 21% from our average sale price, while AMZN has gained 65%.
- ***We switched out of Raytheon (RTX – 50% commercial aviation/50% defense) into General Dynamics (GD – 30% private jets/70% defense)*** – We liked GD's higher exposure to less economically sensitive defense spending, but also believed its private jet business might benefit from the pandemic, as the wealthy avoid commercial air travel (where RTX is heavily exposed). Since our trade, RTX's stock is down 8% while GD's has risen 5%.
- ***We sold Otis (OTIS – elevators) and bought Carrier (CARR – HVAC systems)*** – The pandemic threatens to turn skyscrapers and high-rise office buildings into white

elephants. Conversely, the HVAC business looks less risky and could even benefit as systems are upgraded to improve air filtration. Since our sale, OTIS' stock has gained 21% while CARR is up 63%.

- ***We added to existing PASI holdings like PayPal (PYPL – online payments), CDW Corp (CDW – IT distributor), Stanley Works (SWK – building tools), and Kellogg (K – food)*** – Higher technology spending as business/household activity shifts online should lift PYPL and CDW revenue in the coming years. With SWK, we don't expect much change in residential construction and think renovation spending could even improve. Finally, Kellogg has been a beneficiary of people eating more at home (prior to the pandemic, restaurants accounted for more than 50% of U.S. food consumption). Thus far, we're up 82% on our PYPL trade, 15% on CDW, 70% on SWK, and 12% on K.

Although most of the moves we've made so far have worked in our favor, the main factor driving our decision-making wasn't short-term performance but *risk reduction*. In the case of a successful vaccine/treatment, our new stocks and added positions may not outperform. But nor do we expect them to underperform! And should a vaccine/treatment prove elusive, we think the PASI portfolio will now be significantly more resilient. "*Same upside, less downside*" may not be the sexiest investment policy, but with "decades" of change now happening in weeks, we think it's the most prudent.

COVID-19: Accelerating a New Norm

by Jeremy Goldberg, CFA

Samuel Slater, English cotton mill apprentice at 14, turned superintendent by age 21, opened the first industrial cotton spinning mill in the U.S. in 1790. Otherwise known as the "Father of the American Industrial Revolution," Slater is often credited with starting the First Industrial Revolution in the U.S. and catalyzing the mechanization of production.

Over the next century, the Second Industrial Revolution was characterized not by the mechanization of production, but by the electrification of (mass) production. Power sources such as water, steam, and coal were replaced by electricity, gas, and oil. Wooden railroad tracks were replaced by steel railways and installed across the U.S., expanding from only 75 miles in 1830 to 164,000 miles by 1890. Candles were replaced by lamps that were replaced by light bulbs. The telegraph became the telephone. The first successful American gasoline-powered automobile was designed in 1893, and by 1913, the U.S. was producing 80% of the world's approximately 600,000 motor vehicles.

Starting (arguably) the following year, the Third Industrial Revolution reflected improvements in healthcare, electronics, engineering, and information technology. Medical advancements led to the development of antibiotics. Televisions became common household essentials. Airplanes went from a luxury of the rich to just another form of travel for the average consumer. The 20th century introduced hearing aids, dialysis machines, video games, and eventually the most revolutionary technology known to man: the Internet.

The first workable form of the Internet, known as “ARPANET” (the Advanced Research Projects Agency Network), was established in the late 1960s, but failed its test of transmitting data from UCLA to Stanford. It wasn’t until 1990 that the Internet matured into its more familiar form as the World Wide Web, invented by computer scientist Tim Berners-Lee.

Over time, the industrial revolutions merged with the technological revolutions, and innovation that first started in the textile industry inspired the development of all the products and services we currently know and love. The Google Search Engine has already been around for 22 years! (Granted the 1998 version of Google was hardly the ‘know it all’ we admire today.) It’s clear that advancements have been exponential.

The ability to adopt and adapt to new technologies has been paramount to moving the U.S. forward as a global leader. A subtle difference, adopting new technology is accepting and incorporating it from the start, while adapting is ongoing tinkering to maximize output as consumer behavior changes. A very basic (and true) example would be: Pre-COVID-19, a company creates a Facebook page and buys a marketing campaign (adopting), but post-COVID-19, the company takes it a step further and sets up an online store through Facebook Marketplace so they can continue to sell items while their physical location is closed (adapting). If they don’t adapt to the new environment, they risk being eaten alive by others that welcome innovation.

Many companies fail because they fear change. Their demise isn’t driven by their inability to innovate, but by their unwillingness to take advantage of (adapt to) existing technologies. Netflix, a $200 billion market capitalization company, attempted to sell itself to Blockbuster for only $50 million a decade before Blockbuster conceded defeat in its digital transformation and filed for bankruptcy. Toys “R” Us had a contract with Amazon to be their exclusive vendor of toys in 2000 and failed to invest in their own e-commerce platform until it was too late. Borders opened too many brick and mortar locations.

Given COVID-19’s economic destruction, adaptation has never been more crucial, and I believe the ability to adapt – especially today – is one of PASI’s biggest strengths.

Amazon (AMZN) has long been a CNBC favorite. It’s been a top performing stock for a decade, posting nearly 10x the return of the S&P 500 index, and a regular “should PASI own?” inquiry from our clients. Until this year, we’ve been reluctant to add AMZN to our portfolio – the expensive share price was historically offset by modest earnings growth and weaker cash flow generation.

Then COVID-19 hit. We felt AMZN’s business was perfectly positioned, and the future value embedded in the stock price became more palatable. At its pre-COVID-19 high of $2,170 on February 19th of this year, AMZN was trading at 52X its 2020 earnings estimate. We bought AMZN on March 10th at $1,848, then trading at a more reasonable (albeit still relatively expensive) 44X 2020 estimates (and 33x forward cash flow). Since our entry into the position, we’ve earned more than 65%. Though more expensive today, Coronavirus-mandated isolation is still a tailwind that makes the shares an attractive opportunity.

Massive investments into fast delivery, like the $1 billion/quarter AMZN is currently spending to build its 1-day shipping infrastructure, is satisfying consumers' growing requirement for instant gratification. The diverse product offerings and in-stock availability, including perishable groceries, is the safer alternative to the local grocery store/retailer.

Most important to our thesis, however, is AMZN's cloud business – Amazon Web Services (AWS). "Cloud" is a term often used to describe services provided through the Internet rather than through a physical object. Cloud computing is the real-time delivery of information technology (IT) resources through the Internet, so instead of buying, owning, and maintaining physical data centers and servers, customers access the technology services through a cloud provider, like AWS. Notably, in addition to providing infrastructure technologies like compute, storage, and databases, AWS also offers emerging technologies, such as machine learning and artificial intelligence, data lakes and analytics, and Internet of Things (network of devices connected to the Internet, ranging from "smart" light bulbs to refrigerators).[1]

COVID-19 has accelerated the adoption of these technologies and is encouraging (*forcing* is probably a more appropriate term) businesses and consumers to take advantage of underutilized resources to adapt to the 'new' economy.

In today's new economy, there are too many uncertainties, but one hits closest to home:

> *How will my 6-year-old daughter (<u>insert anything</u>)? Go to school? Interact with other children? Study her hobbies (ballet and karate)? Make experiential memories?*

Fortunately, adapting to today's technologies – like AWS – has added some color to this very grey environment.

So far, my daughter has been able to keep up with most 'normal' activities virtually. She finished kindergarten remotely, using Zoom to meet one-on-one with her teacher and to enjoy group video-chats with her classmates. Her karate instructor created a virtual dojo, and they meet more often through the computer than they did in person! Unfortunately, we have yet to figure out vacations. On a similar note, PASI is using Microsoft Teams to conduct our weekly Investment Committee Meetings and to engage in collaborative projects real-time.

These are services that we never used before COVID-19, but will likely continue using even after the economy goes back to normal. And while Teams is obviously supported by Microsoft (another PASI holding), Zoom is largely run on the AWS infrastructure. ZM's Founder and CEO, Eric Yuan, said in June, "As our demand increased and we had limited visibility into the growth, AWS was able to respond quickly by provisioning the majority of the new servers we needed, so <u>sometimes adding several thousands a day for several days in a row</u>."

During this ramp-up period, ZM experienced 170% revenue growth (year-over-year) and an impressive 1136% mobile subscriber growth (from 14 million subscribers in March to a

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[1] aws.amazon.com.

whopping 173 million by June).[2] All the while, the only reason their infrastructure allowed them to keep pace with demand is because they outsourced a significant portion of their servers to AWS. And ZM isn't alone. According to AWS CEO Andy Jassy, Netflix, Disney+, Hulu, and Prime Video all run on top of AWS.

The economist John Maynard Keynes once said, "When the facts change, I change my mind. What do you do, sir?" One of the toughest challenges we face as investment advisors is synthesizing an enormous amount of information into actionable decisions. Information is constantly changing, especially in the current environment, and it's our responsibility to accept change, remain nimble, and always adapt.

Operations: All Systems Go … from Home?

by Chris Connett, PASI Operations Manager

When it comes to operations, the only constant is change. If you are not looking ahead, you are likely falling behind. COVID-19 has not only altered our interactions with you, but how we operate and communicate internally as an office, and with third-party vendors. While it is difficult to truly prepare for an event of this magnitude, PASI was largely ahead of the curve and ready for this paradigm shift to a "work from home" environment. Here is a glimpse into the journey and technologies that allow us to better serve you during these unprecedented times.

A brief history is critical to capture how we arrived where we are today, and where we are headed in the future. PASI was founded by Kenneth M. Ligon, II and Ronald J. Jaffe, M.D. and built on a foundation of integrity and personalized service. These principles were ingrained in the next generation, who have maintained them. For more than 40 years, PASI has been developing its own databases and software applications for all aspects of its business, including day-to-day transaction monitoring and auditing, performance reporting, portfolio management, client reporting, research, compliance, and more. What makes this so valuable? Simply stated, it provides us the flexibility to uphold the core value of personalized service to all our clients' needs. Each of you do not fit inside a "one size fits all" box, so why should your investment experience?

In 2015, David Jaffe fulfilled a dream and moved to Bozeman, Montana, yet continued to deliver his full attention and leadership to you and PASI. Additionally, with our home office located in Vero Beach, Florida we are acutely aware of our susceptibility to natural disasters, most notably hurricanes. In 2017, we received a reminder that hurricanes are not the only disaster to be prepared for when the floor directly above our space set ablaze. During 2019, over 900 accounts transitioned their custody services from State Street Bank to BNY Mellon. While this process experienced a few bumps in the road, it was a crucial upgrade leading to where things stand today and where we are aiming in the future. COVID-19 needs no further introduction. We feel fortunate that these experiences have driven us to keep our eyes toward the future and spurred major developments and investment into remote technologies.

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[2] CNBC.

All of this brings us to the present. On any given day there is typically one member of management and one member of our support staff present in the Vero Beach office. Gone are the days of traditional landlines, replaced with Voice over Internet Protocol (VoIP) phone systems. Calls today are routed through a series of servers strategically located across the United States. What exactly does this mean? We can answer our business line from anywhere in the world, assuming Internet or cellular reception is available. Should an interruption in Internet access occur, no problem! Our office phones can be routed directly to our cell phones. Additionally, through the same provider, we now receive all faxes via the Internet, direct to our email inbox.

One area that has always been of utmost importance is data security. We accomplish this through multiple defense layers, starting with an intranet. This is a local or restricted network where we store, organize, and share information across our organization. The network's security is monitored by a firewall which establishes a barrier between trusted internal and untrusted external traffic. To further enhance system security, we require strong passwords across multiple platforms that are periodically changed. However, in our current *work from home* environment, there is a critical need for data accessibility from outside the office. This is done through a virtual private network (VPN) which connects our office intranet to our home networks, with the same security measures applied to our internal ecosystem and end-to-end data encryption.

While all the technologies that allow us to continue operations from home are wonderful developments, there are still some limitations and drawbacks. Instead of one network, there are up to 15 networks to be monitored. Many of the technologies discussed require a great deal of bandwidth, which is the maximum rate of data transfer across a given path. Often home speeds are insufficient for these processing demands. If you have experienced poor call quality or latency, this is the probable culprit. Ours is a business that requires a great deal of client interaction that can never be replaced by technology; if you experience persistent communication difficulties please advise us of this.

None of us know exactly what the future holds but we will navigate it together, with your interest in-mind. New strategies and technologies are constantly being researched and implemented. You may have noticed our recent use of DocuSign for a variety of needs (e.g. new account paperwork, distributions, and online access). Not only does this allow us to quickly send and receive paperwork but it is environmentally friendly. This is just one of the immediate benefits made possible with our primary custodial change from State Street Bank to BNY Mellon.

Additional items being explored to improve internal and external engagement include Microsoft Teams, a unified communication and collaboration platform that combines workplace chat, internal video meetings, application integration, and more. While we have just scratched the surface on the possibilities with this tool, it has provided a seamless means of collaboration for our investment committee, particularly conducting their regularly scheduled meetings. We are testing multiple client video chat technologies to provide safe virtual meetings. Development has begun on procedures to enable us to facilitate ACH (Automated Clearing House) account contributions, with your security at the center. Continued development in paperless filing are being explored. These are just a few items to be expanded or implemented in the future.

WE WANT YOUR FEEDBACK

Please let us know what is working and what you would like to see improved. Our purpose is to provide services centered around each of you. We are dedicated to this mission and would like to hear how we can better serve you!

Hurricane Season – *Better Prepared than Ever!*

It's said that we have two seasons in Florida, *Tourist Season* and *Hurricane Season*. While the former is surely facing a "new normal", the latter is upon us. Added to our experience navigating the dislocation of Hurricanes Matthew in 2016, Irma in 2017, and Dorian in 2019, we can now weigh the "benefit" (hmm?) of working remotely for the last few months. Our hurricane procedures include preparation of our physical office to minimize the impact of water intrusion and moving our central computer to a secure location clear of the storm path. Telephone service is routed to our secretary's cell phone, with David's Montana office as backup. BNY Mellon will be alerted to initiate contingency processing for client needs. Today, in the face of COVID-19 and our experience working remotely, most of our team will be able to plug in phones and laptops and be ready to serve your needs limited only by availability of electricity and an Internet connection.

You can read our Disaster Recovery Policy on our web site www.pa-services.com. Please follow the "contact us" tab; you will find a link to the policy on the bottom left area of that page. In the event that primary communications are affected by a storm, we will make every effort to post updates and any important information on our web site. If you have any questions about our contingency planning, don't hesitate to call.

Disclosure

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