

Fortunato Asset Management

Q1 2020 Newsletter



If Not Now, When?

"Can't you understand what's happening here? Don't you see what's happening?

Potter isn't selling. Potter's buying!

And why? Because we're panicky and he's not. That's why. He's pickin' up some bargains. Now, we can get through this thing all right. We've, we've got to stick together, though. We've got to have faith in each other."

George Bailey (Jimmy Stewart)


"It's A Wonderful Life" (Frank Capra - 1946)

While the covid-19 virus has done damage to economies around the world, the biggest havoc has been reaped by societal and policy responses toward travel, business closings, social distancing, and isolation. I'm not stating these measures are not necessary to deal with the virus, simply that they are destructiveX10 degrees to the economic welfare of the country and world. There are two essential ingredients to wealth creation (GDP) for an economy - trade and innovation. Substitutable terms are *transactions* and *productivity*. Trade (transactions) is taking a major hit for most types of businesses which will ripple through the economy in unknown ways. The models our system works on is not set up for this.

Similarly, the models used in the financial world to project earnings and cash flow are not flexible enough to handle a two- or three-month gap of complete uncertainty. A recession is virtually guaranteed. I believe it will

be a shallow one. Our housing and banking sectors are much healthier upon entry.

Yesterday, I called Fidelity to liquidate some Treasury bills in my account so that I could buy some stocks. I dialed them because my online orders to sell the bonds would not go through. When I spoke to the representative, he said everyone had been selling stocks and buying treasuries. Well, that much is obvious by looking at share prices and the averages. The S&P 500 was down 31% peak to trough so far. The following is posted on the front page of the fixed income section of Fidelity's web site:

-  Recent extreme market conditions have resulted in a lack of liquidity, wide spreads (the difference between the price a customer can buy and sell a bond), large swings in prices, and substantial increases in pressure on trading systems. This can make it very difficult to determine fair and reasonable pricing on bonds. Fidelity continues to monitor the market environment and make every effort to ensure a fair and reasonable market for our customers.

If the largest brokerage can't handle it...that is evidence of some major dislocation and dislocation creates opportunity. You see some crazy things that don't make sense: Individual stocks dropping 40% in a day, Solid ultra-low-risk dividend investments paying 6.5%, the entire utilities sector rallying 13.5% in a day, the 10-year treasury shedding 75 basis points to yield .5%, the muni bond market tanking today, one stock we bought was down 45% yesterday and up 75% today. So much for the efficient market hypothesis. You don't see what's really going on just looking at the market averages. The volatility is incredible. This reminds me a lot of October and November 2008. The speed of the drop has been breath taking.

As I wrote in last quarters newsletter, *"many years of tepid inflation and ultra-low interest rates have investors paying up. The S&P 500 trades at a forward Price/Earnings ratio of around 20X, the highest valuation in 8 or 9 years."* This market was super expensive going in, so a fast drop when a calamity

struck doesn't surprise me. We were 75% cash and equivalents going in. We've since been deploying cash into companies we like on this massive weakness.

How Low Will It Go?

Who knows for sure? There are too many unknowns and variables in even the near future to gauge the economic destruction from this disruption. The market is an excellent leading indicator, and its decline will inform us about how bad the recession is going to be. But let's look at past crisis/recessions/depressions/bear markets back to 1929 for a barometer on what could happen and just for fun speculate on what this could look like.

Peak	Trough	Duration (months)	Bear market magnitude	Recession during bear?	1-Year return after trough
9/3/1929	7/8/1932	34	-86%	Yes	124%
3/10/1937	4/28/1942	61	-60%	Yes	59%
10/9/2007	3/9/2009	17	-59%	Yes	68%
3/24/2000	10/9/2002	31	-49%	Yes	34%
1/11/1973	10/3/1974	21	-48%	Yes	38%
11/29/1968	5/26/1970	18	-36%	Yes	44%
8/25/1987	12/4/1987	4	-34%	No	23%
5/29/1946	6/13/1949	37	-30%	Yes	42%
12/11/1961	6/26/1962	6	-28%	No	33%

11/28/1980	8/12/1982	21	-27%	Yes	58%
2/9/1966	10/7/1966	8	-22%	No	33%
8/2/1956	10/22/1957	14	-22%	Yes	31%
7/16/1990	10/11/1990	3	-20%	Yes	29%
09/20/2018	12/24/2018	3	-20%	No	37%
Average		22	-39%		47%

Source: Fidelity Investments, ISI, Bloomberg, National Bureau of Economic Research, Haver Analytics, FMRCo (Asset Allocation Research Team) as of February 26, 2020. Data based on S&P 500 Index price returns. Duration ends with a complete retracement of losses. Recessions are defined by the National Bureau of Economic Research. Past performance is no guarantee of future results. You cannot invest directly in an index. The S&P 500®, a market capitalization-weighted index of common stocks, is a registered service mark of the McGraw-Hill Companies, Inc

As we can see from this chart, the average peak to trough decline was 39%. Let's say we are *no-doubt-about-it* entering a recession. The average decline then increases to 43.7%. Consider that we are coming off the longest bull market ever, at least since sharp records have been kept - over 110 years. However, it was a slow growth bull market...in fact the slowest. Still, we had zero bound interest rate policy for 80% of the run, which stoked high asset prices. We needed a 15% decline just to get back to somewhat *reasonable* stock prices. We're at a total of 31% decline at the moment. Yet we're only a month in and the average decline is much longer. But wait, the Fed is pumping huge volumes of money into the markets. OK, I'm going to put my foot in the sand at around 43.7% as my best guess. What an exercise in futility.

The Bigger the Decline the Larger Future Returns

[Market declines since 1950](#)

Percent From High	3 Months	6 Months	1 Year	3 Year	10 Year	20 Year
0%-5%	2.0%	4.1%	8.3%	8.3%	6.6%	6.1%
5%-10%	1.8%	3.6%	7.1%	6.8%	6.4%	6.5%
10%-15%	2.2%	3.6%	7.1%	6.7%	7.6%	8.0%
15%-20%	0.9%	1.7%	9.3%	5.7%	8.5%	9.1%
20%-25%	1.3%	3.5%	9.5%	8.4%	7.9%	9.0%
25%-30%	2.4%	3.8%	8.4%	8.5%	6.9%	9.6%
30%-35%	5.2%	8.6%	13.7%	9.3%	7.0%	9.0%
35%-40%	1.7%	7.8%	14.0%	9.5%	7.2%	9.5%
40%-45%	4.6%	13.7%	23.8%	12.2%	8.2%	9.9%
45%-50%	8.7%	19.2%	34.8%	16.0%	10.0%	10.4%
50%+	24.2%	36.8%	53.1%	22.7%	14.2%	Data from Ycharts

Self-explanatory enough. The farther it falls, the harder it snaps back...

Oil Market Chaos

A Saudi sheik and Russian diplomat are hanging out clanking a glass of apple juice and vodka right now. The production “war” between the two is laughable. At just the right moment, when it’s clear there will be a massive drop in oil demand caused by covid-19 induced travel restrictions, they decide to have a fight and go all out on production. Could this be stratagem to deal a death blow to the American oil producers? Nah. They wouldn’t do that. They are nice guys. They love us, right? America is now the largest oil producer in the world and now has pipeline access to ports for shipping out of the country. I’m sure that doesn’t bother them.

But what OPEC may not comprehend is that this will not be the death blow to the U.S. oil industry. Large strong companies with better balance sheets and less leverage will take over the ones that go bankrupt. And production will resume its growth when prices recover to something reasonable. Brent crude, the global benchmark, is currently at \$27 per barrel. That’s less than U.S. producers need for positive cash flow, but there are many that can survive it. The cure for low oil prices is always low oil prices.

Quotes from some of the Best Ever

I wanted to leave you with a few favorite quotes that have particular pertinence during these times.

"Bull markets are born on pessimism, grown on skepticism, mature on optimism and die on euphoria. The time of maximum pessimism is the best time to buy, and the time of maximum optimism is the best time to sell." John Templeton

"I will tell you how to become rich. Close the doors. Be fearful when others are greedy. Be greedy when others are fearful." - Warren Buffett

"In investing, what is comfortable is rarely profitable." - Robert Arnott

"The stock market is filled with individuals who know the price of everything, but the value of nothing." - Phillip Fisher

"Know what you own, and know why you own it." - Peter Lynch

"You get recessions, you have stock market declines. If you don't understand that's going to happen, then you're not ready, you won't do well in the markets." - Peter Lynch

Our Strategies, Performance, Fees, Costs and Alignment

We manage separate accounts for clients by way of two fund strategies. The minimum investment is \$200K. We have a low expense structure, with Fortunato paying all its own operational costs including audit, legal, accounting, administration, tax and filing fees. None are passed on to investors.

Below is a recap of each strategy and fee structure for Qualified Clients:

Fortunato 1 Growth and Value Strategy. Invests in a combination of reasonably priced growth stocks and value stocks. No Management Fee.

The Performance Fee is 25% over a 6% per annum return with price breaks at \$1M and \$2M. On the first 6% return, no fee. Goal is a 14% average annual return over time.

(Note: Due to overlapping similarities in holdings and performance we have closed Fortunato 2 Concentrated Value Strategy for now).

Fortunato 3 Dividend and Income Strategy. Invests in a conservative mix of government short term bonds, mortgage backed securities, dividend paying stocks, and preferred stocks. Fee is .55 to .75% of assets under management. The goal is a 6% average annual return over time.

There are two components to beating the market indices. The first is to have low frictional costs (ie low fees and costs). And the second is to generate superior returns.

I maintain a substantial portion of our family's savings in the Fortunato strategies, aligning my interests perfectly with investors. I am bullish on the long-term future of Fortunato and plan on managing fund strategies as long as I am able. Many thanks to Brittany Rowland and Brian Jones for their valuable ongoing contributions to research, administration, and technology and thanks for reading!

Onward and Upward in 2020!

=SD