Fortunato Asset Management

Q2 2019 Newsletter

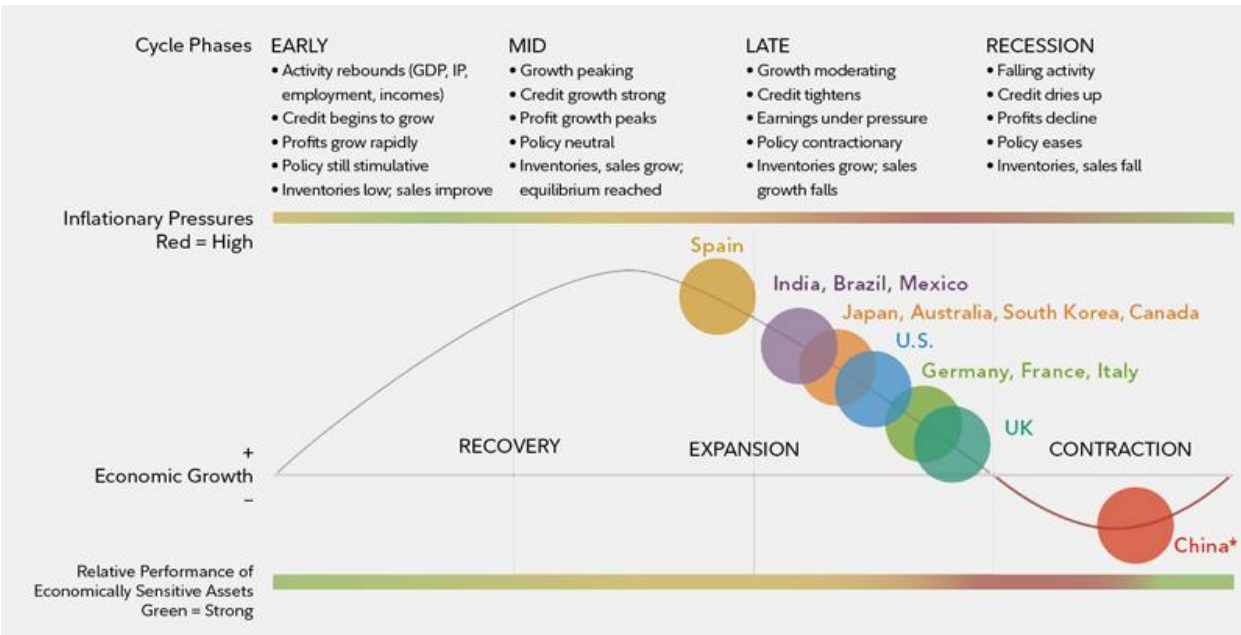
Around the Market

The stock market is hitting all-time highs, buoyed by what it sees as a certainty that the Federal Reserve will lower interest rates late this month to try to stave off a recession. Years ago a friend explained to me that the Federal Reserve simply follows the market rate for the secondary market 90-day treasury rate when setting the fed funds rate. I've been following both now for a couple of years to check his theory, and I believe it's largely accurate. The 90-day treasury yield stands today at 2% flat, which is .25% to .50% lower than the fed funds rate. So we'll see soon whether the theory continues to hold.

Yield curve inversion sometimes signals a coming recession. The 90-day treasury bill pays more than the 5-year treasury bond on the secondary market. This has likely been one of the most pressing concerns for the Fed, even with the economy growing, inflation tame, and the unemployment rate in the U.S. at 50-year lows. Most of the yield curve has inverted, but not all of it. The important 2-year to 10-year curve has yet to invert.

The two points I would like to make are, 1) the coming Fed rate cut is already priced into the market, and 2) we are likely nearing the end of the expansion phase of the economic cycle.

Related to the second point is the following chart. Imagine a company (brokerage) that makes its money from management fees from mutual funds, and from the commissions and fees from selling stocks and bonds, coming out with a report that the U.S. economy is likely at the end of the last stage of the business cycle. What happens normally at the end of the last stage of the business cycle? Stocks drop, decreasing fees and income to brokerages and mutual funds managers. Having followed Fidelity's business cycle charts for years, I believe that they are true to the task and applaud them for publishing worthy content, despite the fact that it might mean less profits for them in the short run.



Source: Fidelity Investments

Notice on the chart the point at which the blue U.S. circle sits in between expansion and contraction. Then, look below at the color bar which represents "relative performance of economically sensitive assets", (i.e. stocks). As you can see, if this chart is correct, the U.K., Germany, France, Italy and the U.S. markets should be entering the orange/red portion of the performance graph, which portends poor stock performance. China on the other hand is further along. Having had a tough, slowing economy in 2018 well before the trade tensions even began. China is now solidly in the contraction zone and almost ready to *possibly* enjoy the green recovery stage in share prices. This research concurs with what we have been finding from a valuation standpoint. U.S. equities are expensive, and we prefer not to purchase anything, stocks not excluded, when we believe they are overpriced.

Stocks We Like

Continuing with the rationale that China has already seen some rough times, there are a few opportunities that we have been attracted to due to their current value combined with future growth prospects. One is Baidu, the Chinese search engine leader. Baidu, has great positions in travel (through Ctrip,) has a majority of a Netflix type service called Iqiyi, is heavily into cloud services, and has the market leading AI technologies for autonomous driving - all of this along with 85% of mobile search market share. The stock trades for 2.6X sales and 13X last year's earnings. Compare that to Google, which trades for double at 5.3X sales and 27X earnings and you can see the value difference. And Google is pretty cheap compared to where it has historically traded. Baidu had a high cost quarter that caused a small loss and the stock cratered. They are in an investment phase at the moment and I believe the long-term future is bright behind CEO Robin Li, who has deployed capital well in the past.

A second Chinese stock we like is MOMO, the Match-like online dating service of China. They also own a Tinder-like site called Tantan, which they recently acquired. There is a significant male/female imbalance in China owing to the past one child policy. 15% of men in China in years 2020 to 2050 will find themselves without a wife. This is a real problem and MOMO has a business that solves it for many in an efficient way. Facilitating love and the matchmaking process should be a good business for a long time in China.

The Chinese government recently blocked new Tantan downloads which caused lots of distress in the stock price. MOMO is working through the problem. This high growth stock trades for 2.9X sales, and 20X trailing earnings. They are investing heavily in growth which is robust. I believe the government setback will prove transitory. U.S. based Match has been a fantastic stock. For valuation comparison it trades at 11X sales, 40X earnings and is not growing as fast as Momo.

Interesting Facts

Discerning between fact and fiction, truth and myth is one of the challenges with successful investing. You may have heard about the ghost cities of China in the past and the real estate bubble there that was just waiting to explode. While doing some research about China, I ran across the following video clip from Matthews Asia, a prominent Asian fund company based in the U.S. It dispels the CBS special about ghost cities as inaccurate
https://us.matthewsasia.com/perspectives-on-asia/video-detail.fs?artID=922

Final Thoughts

We look forward to the day that we can feel opportunistic in deploying a larger portion of assets into stock holdings. Currently we maintain a large percentage of dry powder. Sometimes it takes a high level of discipline and boldness to *just say no* to overpriced stocks. Concurring with our views is the following comment from the aforementioned Fidelity article,

> "As a result, even if the possibility of a prolonged late cycle has risen across some indicators, the potential upside for asset markets may not have improved materially. The late cycle remains a time for great uncertainty and a generally less favorable risk-reward trade-off, implying a smaller overweight to risk assets than earlier in the expansion."

Our Strategies, Fees, Costs and Alignment

We manage separate accounts for clients by way of three 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.

Fortunato 2 Concentrated Value Strategy. Invests in a 5 to 10 value and deep value stocks (concentrated positions). No Management Fee. Performance Fee is 20% over a 4% per annum return with price breaks at $1M and $2M. On the first 4% return, no fee. Goal is a 14% average annual return over time.

Fortunato 3 Dividend and Income Strategy. Invests in a conservative assortment of bonds, 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.

Our family maintains a substantial portion of our savings in the three 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!