Fortunato Asset Management

Q3 2019 Newsletter

Around the Market

Recessions get a bad name. Do you cringe when you hear the word? In last quarters newsletter I commented that the recession leading indicator 2-year to 10-year yield curve had not yet inverted. Now it has. That's another checkmark for a potential economic pause at some point in the near future.

It's been 11 years since the last recession. When did recessions become such a bad thing? So loathed. We act like a recession is a disease on par with the Bubonic Plague of the 1300s or the Asian Flu of the 1950s. But the reality is that recessions are healthy for an economy. Our society just doesn't have much tolerance for them. Recessions clear out the dead wood, take out bad debt players in an economy, making way for productive growth. They free up labor and capital that is mis-allocated. This expansion has been prolonged by a few unusual factors such as: 1) a slower than normal expansion that hasn't come close to hitting 4% annual GDP growth, 2) over the past few years, a more business friendly regulatory environment, 3) the massive stimulus from tax cuts, and 4) a Federal Reserve bank that dragged its feet for years on raising rates, in part due to downward pressure from other central banks.

What is a recession? The official declaration comes from the National Bureau of Economic Research, a private organization of economists, which determines a recession occurs when there is "a significant decline in economic activity" that lasts more than "a few months.

While this is the longest continuous expansion in U.S. history according to data dating back to the mid-1800s, keep in mind that recent modern post WWII history is all that matters when comparing today's economic cycles – a relatively short period of 75 years. That's when the effects of the Federal Reserve have made their impact. Prior to the 1930s, there were recessions every few years and the value of the dollar went up and down from inflation to deflation like a yoyo. Contrary to what most believe, there was almost no inflation before the 1930s. Following is a quote from my upcoming book, *Joe's Dynamic Investments*, on the subject:

> "From 1650 to the early 1900s, there was little inflation, although there was a lot of volatility in price. Prices went up one year, down the next. Up for two, down the next three. One dollar in 1650 had the purchasing power of $1.12 in 1750, a total of 12% inflation (currency devaluation) over 100 years. By 1850, it took $1.37 to buy the equivalent of that 1650 dollar, or 37% inflation over 200 years – hardly anything. Prices were relatively stable over the longer term, rising only slightly. In 1913, the year the Federal Reserve was created, it would have taken $1.74 to equate in purchasing power to that 1650 dollar. Over this period, currency exchange rates were very stable as well, changing little."

Dampening volatility is thus one of the most prevalent reasons for the creation of the Federal Reserve in 1913, to help smooth out the cycle, and it has had that effect, especially post 1950, at least up to now. We are still knee deep in the Fed experiment. We may not know for another 100 years if it was a worthy idea.

So where does all this leave investors? At Fortunato, we want to buy shares of 1) exceptional companies at 2) attractive prices – preferably below the real (intrinsic) value of future cash flows. The second half of the equation is largely absent in the U.S. right now. However, negative sentiment, the trade war, and a slowing economy have kept Chinese shares in check. Some fast-growing technology companies there can be purchased for a third of the price of their American counterparts. Rather than search where the mine is about to be closed due to needed repairs, we're searching where the renovations and investment are close to being completed.

Interesting Facts

What is Berkshire Doing?

Recently, I began to wonder, "Am I crazy? Is the U.S. market really as expensive as I perceive it to be?" I decided to take a look at the most recent Berkshire Hathaway 10Q to see what Warren Buffett and Co. are up to. Berkshire has a $142B cash horde, comprised of short-term treasuries, cash, and a smaller amount of fixed income securities. This figure is up from $98B at the end of 2016. Buffett is mostly a U.S.-centric investor, so it looks as if Berkshire is having a difficult time finding palatable investments at home. Or, more likely, they are waiting patiently for better opportunities ahead. If history is a good guide, that's where and when the big money is made – on the buy side.

A Stock We Like

China Tech Opportunities

The opportunities in China look better to us, especially in the technology and internet space. Our research has been concentrated there lately. There are more people, more transactions, faster growth, and in some respects a freer market. China is expected to have a middle class of 800M people by 2030, up from only 300M today. Alibaba has 730M customers across China and believes it can achieve 1B active customers and $1.4T in revenue by 2024. A couple of years ago, I might have said that all these Chinese companies just copy their American counterparts and the government engages in protectionism to prevent American companies from competing there. That's true to a certain extent. That has certainly happened. But the more I research the large Chinese internet companies, the more I am impressed by their aggressive innovation and R&D. Many companies there are very forward looking. There has been a lot of copycatting, but there are a dozen or so very strong players that are really going for it, pioneering their own way. The market is huge. For example, China had online retail sales of $1.3T in 2018 compared to the U.S.'s $513B and China has a lower internet adoption rate at 59% compared to the U.S.'s 88%.

The Chinese are competing well in such spaces as cloud computing, social media, video gaming, mobile device payments, artificial intelligence, electrification of vehicles, and autonomous driving. Chinese companies lead their U.S. counterparts in some of these areas such as video gaming, mobile device payment, and EV development.

Closing Thoughts

Patience and geography are two keys to success currently with our Fortunato 1 strategy. While negative sentiment and trade wars are punishing stocks in emerging markets, we want to be active there, searching for the best opportunities. In our Fortunato 3, 6% goal strategy, we have found a few rare deals in bank preferred stocks to help maintain our yield with a focus on safety.

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. The 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!