Q2 2016 Fortunato Asset Management Newsletter and Investor Insights

Around the Market

Recently the “Brexit” referendum reminded me of a an excellent quote by Winston Churchill, “Never let a good crisis go to waste.” Mr. Churchill was referring to using a crisis situation to be able to take an action which otherwise may not have been achieved. Value investors sometimes paraphrase this quote to refer to taking action (buying stock) in a panicked area of the market. Another quote, “The time to buy is when there is blood in the streets,” is attributed to British nobleman and famed investor Baron Rothschild. Both of these thoughts are apropos in the current market. With regards to the latter, I think in today's globalized world a better way to think about it is, “The *place* to buy is *where* there is blood in the streets.” Early this year we were able to purchase oil shares in Continental and Enterprise Transfer Partners at extremely depressed levels due to the crude over-supply crisis that caused $25 per barrel oil. Currently, we are purchasing extremely beaten down shares of some European banks that we believe will do fine regardless of the British referendum to leave the EU.

Some Historical Perspective on the Market

Recently I was reading an article about famed art forger Wolfgang Beltracchi. The European art market had stalled due to the Gulf War recession of 1990-1991, so Beltracchi decided to put his art-forging career on hold. He purchased an 80 foot sailboat and proceeded with plans to sail around the world while shooting a documentary about pirates.

This story strikes me in a couple of ways. First, who knew that you could put a career like art forgery on hold due to a recession? Second, recessions and shocks to the economic system have wide ranging impact. That the high-end art market in Europe was this affected by the Gulf War and somewhat light recession of 1990-1991 demonstrates that not much goes untouched during a GDP downturn.

I'm not predicting that there will be a recession soon even though we are certainly closer than we were last year or the year before that. Recessions occur on average once every 4.2 years since the Great Depression and are defined simply as two or more quarters of declining GDP (before the Great Depression, recessions occurred more frequently). They are a normal part of the economic cycle. When recessions occur, bull markets *sometimes* end. A bear market is normally defined as a drop of 20% or more in the broad market indices such as the S&P 500 index. Currently, we are 7.3 years into this economic expansion and bull market. That may sound like a lot, but the average bull market is 8.8 years since 1926, and there have been 4 bull markets lasting longer than 12 years. The following graph provides an excellent illustration to the opportunities of being invested in the stock market over the long term:

The reason I'm pointing all this out is that we like to hold plenty of dry powder (cash) when the market is expensive, to be able to deploy it during corrections or the occasional bear market. We want to be able to buy quality companies at attractive prices. The overall market is expensive, but there are some reasonably priced stocks in areas of consumer discretionary, airlines, homebuilders, financial institutions, energy, Europe, and others. How can the overall market be expensive with inexpensive sectors? Folks have been paying up for safety in today's market. Telecoms, utilities, and consumer staples have outperformed, but I would argue that there is not much value there and that those sectors are overpriced. Let's move on to the...

Best Part..A Stock We Like

Western Refining (NYSE: WNR)
Western Refining, Inc. is an independent refining and marketing company with refineries in El Paso, and Gallup, New Mexico. The retail segment includes retail service stations, convenience stores, and unmanned fleet fueling locations in Arizona, Colorado, New Mexico, and Texas. Western also owns the general partner and approximately 66% of the limited partnership interest in Western Refining Logistics LP (WNRL). WNRL has storage facilities, pipelines and other infrastructure assets and generates steady fee-based income.

There are many reasons to like Western Refining: For one, the market is very down on the stock. 2014 and 2015 were banner years for refiners and margins have compressed since then. As a result, WNR's share price is down 60% from a high of $50 to today's $20. And yet, all is not so dismal. At that $20 price tag WNR trades for 8.5X 2013's free cash flow of $211M. 2013's free cash flow was less than half of that in 2014 and 2015, so we know where this stock can go if crack spreads (the spread between buying oil and turning it into usable fuel) improve.

If crack spreads don't improve we get paid well to wait. At the current share price, WNR has a dividend yield of 7.5% and trades for ~1.25X tangible book value. The balance sheet of WNR is fairly strong. And refineries are one of those businesses that do not see a lot of encroaching competition due to large up front capital costs and logistical challenges. WNR is geographically well-positioned next to some of the best oil basins in the country. There have been several insider buys recently by the CEO and the company founder.

One potential risk is that crack spreads and margins may remain low due to recent legislation allowing oil from the U.S. to be exported. This could have the consequence of keeping gasoline that was previously being exported at home, thus inventories elevated. It's a consideration to watch closely.

Our 3 Strategies

Fortunato 1 Growth and Value Strategy. Invests in 12 to 20 stocks, a combination of growth and value stocks.
Fortunato 2 Concentrated Value Strategy. Invests in a concentrated portfolio of value stocks usually between 5 and 12.
Fortunato 3 Dividend and Income Strategy. Invests in dividend stocks, preferred stock and bonds.

Fees, Costs and Alignment

The three fund strategies have a low expense structure and I consider it a competitive advantage. FAM pays 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 the fee structure for qualified investors:
Fortunato 1 – No Management Fee, Performance Fee is 25% over a 6% annual return. On the first 6%, no fee.
Fortunato 2 - No Management Fee, Performance Fee is 20% over a 4% annual return. On the first 4%, no fee.
Fortunato 3 - .40% to .75% of the investment.

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. Low frictional costs will assist in superior long term performance.

My family has a substantial percentage of our assets in the three Fortunato Asset Management strategies. I am bullish on the long-term future of Fortunato and plan on managing fund strategies as long as I am able. Our interests are completely aligned.

Final Thoughts

Thank you for investing with Fortunato. It's a pleasure to serve you. No matter what the future holds, there will be excellent opportunities to invest in great companies.