Recent thoughts about the Market

As I may have mentioned in a previous newsletter, there are three stages to stock investment – *Buying*, *Holding*, and *Selling*. By far the most difficult of the three in my opinion is holding. Buying is easiest, selling comes in second. With the market trading at historically expensive levels by many measures except for interest rates, it's important to pay close attention to the fundamental short, medium and long term drivers of a company. It's difficult for all three of these to line up perfectly, but one industry I feel has potential storms brewing in the short and medium term is that of the auto makers. We have owned shares of GM, Ford and Fiat over the past several years. Due to low oil prices creating demand for their high margin SUV's and trucks, we landed on GM as our favorite of the three, and held the shares for years. The shares trade at incredible valuations of a little more than five times earnings.

However, the phrase "value trap" exists for a reason and recently we sold GM shares due to a few increased risks. One is that we believe the potential car buyer base has been expanded through ever riskier consumer loans in the U.S. The U.S. is by far the most profitable region for GM (and Ford and Fiat as well), and the expansion of the number of customers via riskier loans in the U.S. naturally increases auto sales. We well remember from the financial/housing crisis, loans to riskier consumers can lead to numerous defaults. As concerns about potential rising defaults on subprime auto loans increase, the availability of these loans decreases. While caution may be good for banks' balance sheets, it doesn't offer much relief for automakers, who have relied on cheap credit to fuel a seven-year stretch of booming sales.

A second risk is the number of used cars hitting the market. There have been extremely generous lease terms in recent years and millions are coming off lease, including four million in 2017. That's a million more units than 2015, and could hurt new car sales.

A third is that inventory has been increasing at a faster clip than sales over the past four months. Incentives, otherwise known as discounting, are on the rise. I was able to confirm this, not only through news sources, but directly from conversations with dealers.

GM may play out as a fine investment. But at this juncture, we believe the risks may keep a lid on the stock price for the foreseeable future.

Investor Highlight – Walter Schloss

At least twice a year we highlight the investment performance and characteristics of a great investor. This quarter the spotlight is on Walter Schloss.

You most likely have never heard of Walter Schloss. He never attracted much attention, however over his investment career he compiled a truly remarkable record. From 1955 to 2002, his *actively managed* investments returned one of the most consistent and impressive out-performances ever of 16% per annum on average after fees, compared with 10% for the S&P 500 over the period. To put that performance in perspective, his limited partners (investors) compounded gains *after fees* during his first 28 years was

6,678%. The S&P 500 index compounded gains over the same period was 887%.

Walter took no fees from clients unless the fund achieved a certain hurdle rate. Once the fund hit a certain Hurdle rate (6%) Schloss took 25% of the profit (the same performance fee structure as Fortunato for Qualified Clients). This fee structure set up is very similar to Buffett's original partnership.

Schloss was a Benjamin Graham disciple and a classic value investor. While he kept a low profile, he was one of Buffett's favorite investors.

Schloss' outperformance was due to a disciplined strategy of finding and investing in companies selling at a low price-to-book value or net asset value. He often refrained from telling his clients what he was invested in due to the beaten down nature of his holdings. He used ValueLine to find stock ideas and he loved companies selling at 52-week lows, below book value, and with little or no debt.

In a 1984 speech at Columbia Business School, Buffett called Schloss a "superinvestor.," and saluted him as "one of the good guys of Wall Street" in his 2006 letter to Berkshire Hathaway shareholders.

Upon Schloss' death, Buffett, who was a close friend for more than 60 years released the following statement: "He (Schloss) had an extraordinary investment record, but even more important, he set an example for integrity in investment management. Walter never made a dime off of his investors unless they themselves made significant money. He charged no fixed fee at all and merely shared in their profits. His fiduciary sense was every bit the equal of his investment skills."

Schloss remained devoted to Graham's "pure" style of value investing and did not evolve into more of a qualitative investor like Buffett. He maintained an aversion to debt throughout his investing career.

Further from Buffett's statement:

> "I first publicly discussed Walter's remarkable record in 1984. At that time "efficient market theory" (EMT) was the centerpiece of investment instruction at most major business schools. This theory, as then most commonly taught, held that the price of any stock at any moment is not demonstrably mispriced, which means that no investor can be expected to overperform the stock market averages using only publicly-available information (though some will do so by luck). When I talked about Walter 23 years ago, his record forcefully contradicted this dogma.

And what did members of the academic community do when they were exposed to this new and important evidence? Unfortunately, they reacted in all-too-human fashion: Rather than opening their minds, they closed their eyes. To my knowledge no business school teaching EMT made any attempt to study Walter's performance and what it meant for this school's cherished theory...

Tens of thousands of students were therefore sent out into life believing that on every day the price of every stock was "right" (or, more accurately, not demonstrably wrong) and that attempts to evaluate businesses – that is, stocks – were useless. Walter meanwhile went on over performing, his job made easier by the misguided instructions that had been given to those young minds. After all, if you are in the shipping business, it's helpful to have all of your potential competitors be taught that the earth is flat.

Maybe it was a good thing for his investors that Walter didn't go to college."

Recent Articles/News

In the Q1 2017 newsletter, we highlighted LGI Homes as a stock that we particularly liked. The price of the shares were around $31 at that time. Subsequent to the newsletter we decided to make LGI our largest position in the portfolio of Fortunato 1 due to our conviction that it was well undervalued, under-followed, and under-appreciated with excellent growth prospects. I followed that up with an article for Seeking Alpha, *7 Reasons LGI Homes is Undervalued and a Rare Buy.* Although we value investors believe disciplined patience is needed to allow the stocks we purchase to appreciate to fair value, in the case of LGI Homes the wait was transient and fortuitous. The stock currently trades at nearly $41.90, an increase of 35% since the last published newsletter.

http://www.fortunatofunds.com/newsletters/Q1%202017%20Fortunato%20Newsletter%202.pdf

https://seekingalpha.com/article/4078340-7-reasons-lgi-homes-undervalued-rare-buy

The Best Part...A Stock We Like

Bank of America (NYSE: BAC) $23

We wrote about Bank of America in the Q1 2015 newsletter as a stock we liked. Since then we held a large position in Fortunato 2, but sold most of our BAC shares in Fortunato 1 in favor of Citigroup, which we felt was more undervalued (we still own Citigroup). We mentioned in the report that Bank of America had several potential tail winds such as higher interest rates and lower legal costs going forward. These catalysts have come to fruition and are the reason that the shares have appreciated from $15 to $23 (at the time of our last purchase).

But the catalysts for the stock are still coming. Bank of America is projected to increase earnings at around 20% this year and mid-teens the next. It is still very reasonably priced at around 15X trailing earnings and close to book value. We purchased the shares again prior to the recent CCAR stress tests, believing that BAC would pass regulatory requirements allowing it to return more capital to shareholders through share buybacks and higher dividends. BAC easily exceeded the Dodd-Frank capital requirements in late June, and promptly increased the dividend by 60% to 12 cents a share per quarter. The bank also increased its share repurchase authorization to $12B.

In our opinion, Bank of America enjoys a lower cost of funds than most large banks, due to around 35% of deposits being non-interest bearing. As both long and short term rates have risen, BAC has not had to pay up for deposits as much as banks with a lower percentage of non-interest bearing accounts, causing the net interest margin (NIM) to improve. There are also opportunities to continue decreasing expenses due to lower regulatory pressure. These are a couple of the reasons for the higher earnings estimates.

Our Strategies, Fees, Costs and Alignment

We manage separate accounts for clients with three fund strategies. Our minimum investment is $250K. We have a low expense structure. Fortunato 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 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, Performance Fee is 25% over a 6% per annum return. On the first 6% return, no fee. Goal is a 15% 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. On the first 4% return, no fee. Goal is a 15% 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% of assets under management. Goal is a 6% average annual return.

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 for Fortunato clients.

My 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.

Final Thoughts

Many thanks to Brittany Rowland and Brian Jones for their valuable ongoing contributions to research and technology.

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.