Q3/2015 Fortunato Asset Management Newsletter

On The Horizon

The final day of September finished with the market averages up significantly, but did not save it from a much needed pullback of more than 10% during the third quarter. It's the first 10%+ correction we've seen since the summer of 2011 and it was long overdue.

China had the most to do with it as their stock markets started reversing a dramatic boom in April and May of this year. Though the Chinese government publishes positive GDP growth rates of around 7%, no-one really knows what the actual number is. Many believe the actual figure has slowed to around 2% as the Chinese manufacturing, industrial and export sectors declined. In response, China's government devalued it's currency against the dollar. As well, there has been widespread deflation in commodities as a result of China's slowdown, which causes devaluation of the currencies of commodity exporting nations.

Since China's economy is the second largest in the world, it was not lost on us, that their problems would reverberate through the global economy. In the U.S., the dollar has been strong against other currencies, which at least in theory hurts exports from many of our largest companies. "FX" currency exchange head winds are a consistent theme during many earnings conference calls, and are ultimately a hit to GAAP earnings.

Financial news is constantly absorbed by the Federal Reserve Bank raising the Fed Funds rate as the September open committee meeting came and went with no rise in rates. I believe when they finally do raise rates a small amount, the market will surprise by resuming its upward trajectory albeit with modest gains.

News About the Fund Strategies

During the past quarter I became more concerned about overall market valuation and spent a good deal of time researching the topic. I considered many of the typical gauges of market valuation and performed research as to which I thought were most accurate over time in predicting market behavior.

From my research, in early August I came to the conclusion that the market was a great deal more overvalued than some of the simpler indicators portrayed. From there, I created a formula for guiding allocation of cash vs. percentage participation in stocks. Without going into too much detail, the formula takes into account such considerations as Market Cap to GDP ratios, cyclically adjusted 10 year P/E (Shiller) ratios, some individual stock historical valuations, and the risk free rate of return.

The end result of the formula is simply to give me guidance for the cash holding percentage for Fortunato accounts. Having a formulaic allocation structure allows me to focus on the fundamental bottom up virtues of companies rather than have to delve deeply into top down macro economic thinking.

In early to mid August as a result of this research and formulaic implementation, I raised the cash percentages held in Fortunato accounts substantially. This allows us to deploy cash at better prices when the stocks we like drop. To paraphrase Warren Buffett and Charlie Munger, "we can be disciplined and wait for the fat pitch." This should lead to superior returns over time.

As a reminder, if we do not exceed 6% return for the year in Fortunato 1 or 4% return in Fortunato 2, there is no fee applied for the year for those accounts held by qualified investors. This fee structure can help allow for exceptional returns over time, by keeping frictional costs low.

The Best Part – Equities we Like

Every quarter we highlight at least one stock that we own and like..

Bank of America – (NYSE: BAC) $15.50

I know, boring right? Bad reputation and hangover from the financial crisis? Exactly, that's why investors can pick up shares of Bank of America for around equal to tangible book value and a forward P/E multiple of 9.6X right now. When we can buy a piece of a business that is making money for its liquidation value, we have tremendous downside protection. As a big added bonus, the bank should make more in the future, and returns to shareholders could increase substantially through higher dividends and stock repurchases. 90% of the banks legal problems should be behind it now and the tight restraints of regulators should ease some over time as the bank reduces its problem legacy assets and qualitative issues improve. As past problems fade into the rear-view mirror the bank stands a good chance of being reappraised to a higher P/E multiple by the market. Rising interest rates are a potential tail wind for the business and should help the credit card and commercial lending divisions improve earnings.

Final Thoughts

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.

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.