Fortunato Asset Management Newsletter and Investor Insights Q3 2016

On the Horizon

Late Cycle Investing

The theory of the business cycle is that there are 4 stages that run into each other and produce better returns for certain types of businesses depending on the stage. They are Early Stage, Middle Stage, Late Stage and Recession. Each stage exhibits characteristics that benefit certain types of companies. For example, companies that are very reliant on economic growth (think an industrial company like Caterpillar) tend to benefit more during the Early stage as we recover from recession. I believe we are currently experiencing traits of the late stage of the cycle and that it started around late February of this year with the rebound in commodity prices. Companies in the Energy and Materials sectors are typically two of the winners during the Late stage of the cycle (think oil producers like Continental or Chemical producers like Dow Chemical).

Historically, stocks have delivered gains on average during the late cycle, however the mix of winners changes somewhat. Typical traits of the late cycle are slowing GDP, potentially lower earnings from companies as costs rise, and tightening credit. The average time frame of the late cycle is 1.5 years though this can vary greatly. Of all the factors affecting the late cycle, a rise in inflation is probably the most notable. In February we saw the beginning of a spike in commodities prices. The spike may have started due to futures contracts buying by the Chinese government, but it has not abated. Commodities price increases flow through to cost increases at companies, who then raise prices (if they have pricing power). We have already seen increases in the largest input to inflation – labor, and these will likely continue.

Along with Materials and Energy, Banks and Housing could also be late cycle winners this time due to the slow recovery of these two sectors after the last recession. Banks may see earnings increases from higher interest rates. The Housing industry is enjoying a low supply, high demand, low interest rate environment. It is critically important to look at the debt situation of each individual company, because interest rate increases makes existing debt more expensive to refinance.

After much research regarding sectors and how to benefit from the late cycle, we maintain that fundamental, bottom up research of each company is essential. Within the same industries, there are wide divergences in returns between individual company returns in the year to date period. Therefore, the strategy at the moment is to *lean* toward the industries or geographic regions that could benefit during the late cycle, but still perform the same research and invest in companies with sound fundamentals.

Market Valuation

The total Market Cap to GDP ratio is now around 122% well above the peak of ~110 in 2007 (September) and below the peak of ~148 in 2000 (March). The S&P 500 Price/Sales ratio currently stands at ~1.84X which puts it at the highest level except for the ~2.0X level of year 2000. In such a rich market by many measurements, I believe holding plenty of cash is essential to 1) safeguard capital and 2) be able to buy quality shares at better prices in the future. We never want to overpay, and we always want excellent value from our purchases. We use a formula based on several valuation inputs to decide what percentage of cash to hold.

The Best Part...

Stocks we Like...or in this case; do not Like...

Recently I wrote an article for Seeking Alpha titled: Overpriced Dividend Stocks to Sell, Sell, Sell! After researching several companies in the Utilities, Consumer Staples, and REIT sectors I came to the conclusion that many stocks in these sectors are wildly overvalued. In every rich market, there are certain sectors that lead the overvalued charge and these are the sectors that I feel fit that description. The reason is simple. The 76 million member Baby Boomer generation, among others, have been reaching for yield in the extended ultra low interest rate environment. To sum it up, many investors want or need income producing investments and with the 10 year Treasury bond yielding 1.6%, there are a lack of good alternatives. In the article, I spotlight 4 companies from these sectors that I believe are overvalued. Have a read through this link.

Fees, Costs and Alignment

The three fund strategies 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 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 assets under management.

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.

A large percentage of my personal assets are invested 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. If you would like to receive the Fortunato investor insights newsletter please send an e-mail to contacts@fortunatofunds.com and I will gladly add you to the list.