Fortunato Asset Management (FAM)

Q4 2015 Newsletter

On the Horizon

As of the end of last week, the average S&P 500 stock was in bear market territory of -24% from it's highs. And last week was the worst first week of the year ever for the S&P 500 index with its 6% decline. China is a major worry of the market currently, as Chinese regulators halted trading twice last week due to the market hitting a decline of 7% tripwire in the Chinese indexes. Global growth concerns due to China's slowdown and transition to a more consumer based economy are persistent thoughts. The dollar remains strong and this can hurt developing countries. The U.S. Market is still fully priced and may face some reduced earnings expectations from analysts in months to come.

On the positive side of the equation although it's a bit counter intuitive, slower world growth of an estimated 3.5% (and 2.5% for the U.S.), low interest rates, and low inflation can actually be supportive of today's full priced stock market. Slowly growing is not a terrible scenario. There are industries and companies that are out of favor and well priced relative to their return prospects. We spend our time researching these companies from a fundamental bottom up standpoint.

Investment Processes

I've been asked what our investment research processes are like, so I will expound upon them here.

First we screen various sources for potentially undervalued or compelling investment opportunities. After finding an opportunity we believe is worth strong consideration, we start the research process. We perform diligent in-depth research on companies by reading the 10K annual report, 10Q quarterly report(s), company presentations, and articles about the company from various sources. We also listen to the most recent conference call of the company as well as performing some research on the industry and competitors in the space. We file notes on all of this information and develop a thesis on why we believe a purchase of the company's shares is a good investment or not. Finally, we review the potential company's operation and prospects against a proprietary list of questions.

After we've purchased or own a stock the more difficult part begins. I always say that Selling is more difficult than Buying, and Holding is more difficult than Selling. We listen to the conference calls and read the quarterly and annual reports and more articles on an ongoing basis – taking notes along the way. We look for changes to the initial thesis as well as weighing whether or not one of our sell discipline criteria has been met. Based on this information we issue an internal rating of whether to buy more, sell, or hold and many variations of this. Our philosophy on hold time is, “The longer the investment thesis holds up the better.”

Sector Ideas

We continue to like financials shares in the U.S. as the most undervalued sector with improving fundamentals. Regulation is a thorn, but banks and insurance companies are making more money and trading at low fundamental valuations.

One area we are becoming more interested in is the beaten down retail sector. There are a few opportunities there that are compelling. Another relentlessly beaten down sector is obviously energy, although most stocks in this space are very dangerous. There are however, companies that benefit from lower oil and gas prices such as the one below, and those are certainly worth considering.

The Best Part – Equities We Like

Every quarter I highlight a company or two which we like with a few notes on the reason.

General Motors (symbol: GM)
Last quarter I mentioned Bank of America as a favorite investment. GM is another company with a stain on its name from a government bailout during the financial crisis. “Government Motors” as it is sometimes deridingly (perhaps deservedly) referred to, has turned several nice corners since restructuring. The company is now a substantial taxpayer rather than a deadbeat, and earning cash while returning much of that to shareholders through dividends and share repurchases. GM's strategy lately has been to take market share in China which it is doing successfully while maintaining it's leading share in North America. North America accounted for 62.5% of sales in the 3rd quarter where the company is less concerned with its unit sales and highly focused on it's high margin SUV and Truck divisions. Due it's higher profit margins on SUVs and Trucks, GM is a sneaky beneficiary of low oil and gas prices as it sells a greater share of these products in its product mix. In a recent interview, Autonation's CEO Mike Jackson mentioned that luxury car sales were struggling in December and that there is deep discounting there, while SUVs and Trucks continue to sell well.

While many believe the wheels are coming off in China, GM China's sales rose 14% in December as the company continues to pickup market share there. I calculate a free cash flow yield of 11% at today's $30 share price and GM is not being stingy with the cash. The shares pay a hefty 4.7% dividend and $4.6B was returned to shareholders through the first three quarters of 2015 in the form of dividends and share repurchases. That's a 9.8% cash return at today's $47B market cap.

Head winds for GM include the cyclical nature of the business, continuing negative perception, South American currencies, underfunded pension obligations, recall costs, and the constant creep and tightening from government regulators. But another tail wind that I like is the introduction in late 2016 of the Chevrolet Bolt electric car which will travel 200 miles per charge and retail for $35K before rebates. Some in the industry believe the Bolt will be the most popular electric car on the road. GM is owned by some of the best minds in the investment business such as Warren Buffett, Bill Nygren, David Tepper, and Monish Pabrai.

News About the Fund Strategies

The market was very bumpy in 2015 with the S&P 500 index essentially finishing the year flat at -.73%

and 1.19% when adding hypothetical reinvested dividends.

Our strategies are concentrated compared to most, and there is increased concentration risk when that is the case. We believe we mitigate this risk to some extent by identifying the downside protection associated with the stocks we own.

Fees and Costs

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. 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.

Alignment with Investors

I have a substantial percentage of personal assets in the three Fortunato Asset Management strategies. Fortunato 2 charges no management fee to qualified clients, only performance fees – which are 20% of returns over 4% annualized (subject to high-water marks). 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 aligned.

Final Thoughts

Thank you for investing with FAM. It's a pleasure to serve you and manage your retirement money. If you should need a confidential financial evaluation, planning, or consultation, please remember that this service is included once per year with your Fortunato investment.