Q4/2016 Fortunato Asset Management Newsletter

On the Horizon

Thorough Confusion in the Markets

Conflicting signs abound in the market today. President-elect Trump's pro-growth platform has stimulated a nice end of year market rally that has made many expensive stocks more exorbitant. Some stocks have been left behind, especially those of the interest-rate-sensitive, bond proxy variety that we wrote about in September as being over-valued.

Let's look at the four late business cycle traits mentioned in the last newsletter for conflicts. On the one hand we now have predictions of increasing GDP growth due to potential increased infrastructure spending and reduced taxes. And earnings estimates are rising for next year, rather than falling due to future gains in the energy, materials and financial sectors. On the flip side we do have tightening credit in the form of the Fed raising rates, albeit slowly, and possible increases in inflation. As mentioned last quarter, of all the factors affecting the late cycle, a rise in inflation is probably the most notable. Since I believe we will see increases in inflation due to a tighter labor environment, I also think our thesis that we are in the late cycle is still intact, despite potentially better growth from the incoming president's policies.

While it's impossible to predict whether the market will go up, down or sideways in the short term, I expect that 2017 may be a stockpicker's market due to lower correlations among sectors for the above mentioned factors. In other words, there will be winners and losers rather than a majority of stocks moving together... a market of stocks rather than a stock market.

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.

Among U.S. sectors we favor financials, housing, and technology. Fast growth stocks tend to perform well in inflationary times, and many of the fast growth stocks found today at reasonable valuations are in the technology sector. Supply and demand dynamics should continue to support housing stocks. Higher interest rates, decreased regulation and low starting prices should support banks. Due to the U.S. market's valuations as emphasized below, we are also looking abroad and taking advantage of mis-priced risk where we can find it. For example, after the Brexit vote sent European stocks on a downward spiral, we were able to pick up shares of Netherland's ING bank, and Barclays bank from the UK at very attractive prices.

Market Valuation

The Total Market Cap to GDP ratio is now around 125% (*see charts below*) 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 ~1.87X which puts it at the highest level except for the ~2.0X level of year 2000. There is a lot of optimism baked into the prices of the overall U.S. market. In such a rich market by many measurements, we 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 use a formula based on several valuation inputs to decide what percentage of cash to hold.

The Best Part...

...Stocks we Like

Recently I wrote an article for Seeking Alpha titled: 4 REITS: 1 Buy, 2 Sells and a Hold. The one "Buy" recommended in the article is Care Capital Properties, Inc (NYSE: CCP). The company owns 340+ senior care facilities, primarily senior nursing facilities, and leases the properties to their operator partners through a triple net lease structure. REIT ownership in this sector is relatively small 2,300 properties compared to a 15,000 total, so there is a major tail wind for REITs such as CCP to acquire more properties. The company also has solid organic growth opportunities by improving existing facilities. Supply and demand is another growth driver for this REIT as there will be more senior citizens in the U.S. needing care, yet there is a stagnant supply of senior nursing facilities. The company has a manageable level of fixed rate debt, and valuations are very compelling at a 9% dividend yield, and 11% adjusted free cash flow yield, which represents good coverage of the dividend.

Every stock has it's negatives. For CCP there is government pay risk to CCP's operator partners as the U.S. attempts to find ways to cut Medicare and Medicaid payments. CCP has had a major operator request rent concessions as a result of increased regulatory and labor costs. Another risk to keep a close eye on is consistent impairment charges to existing properties.

To us, the reward outweighs the risk for CCP, at lease in relation to other U.S. stocks. Knowing when to sell it will be as important as the purchase conviction.

Our 3 Strategies and Year End Performance

Fortunato 1 - Growth and Value Strategy. Invests in 10 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 stocks.

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. 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 Clients:

Fortunato 1 – No Management Fee, Performance Fee is 25% over a 6% per annum return. On the first 6% return, no fee.
Fortunato 2 - No Management Fee, Performance Fee is 20% over a 4% per annum return. On the first 4% return, 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 for Fortunato clients.

My family has a substantial percentage of our personal 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 and we wish you a Happy New Year! It's a pleasure to serve you. No matter what the future holds, there will be excellent opportunities to invest in great companies.