Summary of September 2016 Conference Call

NORA: Good evening everyone. Welcome to tonight's Conference Call. We have a very informative and up-to-date assessment for you since Steve just got back from Oxford and he has been talking with his colleagues at BCA. I hope you will find tonight's call informative, but I assure you, it won't be quite as entertaining as last night's presidential debate. As you might know, Steve teaches at UCLA and for the past 21 years, has taught two popular investing classes: Security Analysis and Advanced Security Analysis. We thought it might be a good idea to bring the classroom into your living room by having 3 of Steve's top students interview him. Wen, Nat and Cassidy are interns with Steve and work with him on competitive strategy, equity analysis and looking at stocks.

Cassidy: Professor, how was your trip to Oxford and can you share any insights with us about your trip and what you learned?

> **Steve:** Just by looking at what is going on in the U.K. when I was there, it looks like Brexit was a non-event. It seems like business is better after the vote than before it, and that Scotland is not making noise about another referendum vote. My Oxford colleagues and Professors also don't believe there has been an impact yet, but they don't rule out a down turn. Too many things could happen in the exit period, which is about two years.

Cassidy: You taught us about a Black Swan event. Could you explain what that is and how that formed your opinion about Brexit?

> **Steve:** Sure Cassidy, A black swan event essentially is about formulating an investment strategy on what is most likely improbable; not the probable. What it does is it gets you to think about different risk scenarios and have a plan of action.
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> With the commentators loudly claiming that the UK was going to vote for staying, the evidence pointed out that there was a good possibility that they would.
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> Speaking of a black swan event, Donald Trump could actually win since many investors and others are assigning low odds to such an event. Time to take a contrarian bet.

Wen: Professor, didn't you short the UK pound in YYR?

> **Steve:** Yes I did and the pound went from $1.47 to $1.29. We made a good amount of money in YYR. A funny story though: I was driving up to San Francisco and I called Robert our trader to see how much of a losing position YYR had. It was a good amount and I was thinking about closing my position at a smaller loss than if I kept my position open. However, I stuck with my black swan plan and by the time I reached Knob Hill, my fortunes reversed and I was in the money because Britain voted to leave.

Wen: I recall you mentioned that many of your clients were calling you before the Brexit vote encouraging you to sell the stocks in their portfolios. What did you do?

> **Steve:** Absolutely nothing. We don't invest when the wind blows in one direction and then change course when the wind changes. We manage risk by paying attention to the asset allocation (Stocks vs. bonds) and I had reduced the risk in the portfolio earlier last January by reducing stocks.

Nat: Professor, we are still learning about economics. I hear you talk about liquidity conditions. Could you please further educate us on this concept?

Steve: Nat, to do justice with that sub set of economics would take a whole quarter so I will be extremely brief. Think of it this way: When interest rates go down, liquidity goes up. When interest rates go up, liquidity goes down. When no one wants to borrow but the bank wants to lend, that is a liquidity trap.

Nat: Where are we now?

Steve: The rising US Dollar is an effective way to raise interest rates without actually having to do it. So with a rising dollar, some liquidity has gone away. We are now facing an interest rate increase sometime by December unless the Federal Reserve Bank chickens out or something catastrophic happens. Even if they raise interest rates by December, the increase won't be so much that it would affect the stock market. It would take a series of interest rates to do that. Maybe in 2017?

Cassidy: Professor, you always talk about earnings. What do you think the earnings coming in now tells us?

Steve: Despite easy liquidity, earnings are unlikely to meet expectations. Therefore, stocks are vulnerable, especially in an overvalued expensive stock market.

Cassidy: Professor, you always talk about finding beauty in an investment-ugly contest. What do you mean by that? I find it strange.

Steve: Everyone remembers John Maynard Keyes as the brilliant economist/mathematician. Hardly anyone knows that he was one of the greatest speculators of all times. He made and lost several fortunes. Maybe because he went to Cambridge instead of Oxford. He equated a beauty contest to stock picking. He essentially asked the question, "Which woman would win the beauty contest?" Each respondent said, "The most beautiful woman in the room." Keynes responded, "No, the woman who was perceived to be most beautiful." In stocks, this means the Facebooks, Amazons and Tesla's of the world.

Wen: Why don't you buy those?

Steve: Wen, you should know better. You have taken my classes and heard me lecture about it, but I suppose our audience would like to hear why.

In the late 1990's and early 2000's, many colleagues and clients were pushing me towards the stocks of that hay day: Enron, Cisco, Siebel, dot-coms, and etc. I resisted. And why? First of all, it is hard to distinguish between a fad stock and The Real McCoy. For example, in the early 1980's there were PC makers like Apple, IBM, Vector Graphics, Osborne, Radio Shack, Commodore, and Compaq. The only one left is Apple. So there is no sure fire method in which to select the perfect company. Let's take Tesla. I think they make a great product and were first to market albeit with a $125,000 electric car for rich men. GM, Ford and Toyota are quickly catching up and will make an electric car for the masses at a lower cost than Tesla. Elon Musk is a genius and also a financial wizard. Both Tesla and Solar City are essentially broke and he has to merge the two to save Solar City. However, Solar City may drag Tesla down into the debt rat hole. Tesla only makes money by selling carbon credits to polluters, not their cars. They have no economies of scale and the stock is priced for perfection to boot. And for Amazon, they consistently don't make a profit and they are empire builders as far as I can tell. No thanks. Give me a company like Oil Dri, which makes self-absorbent cleaning materials, diapers and other industrial goods; a company that has consistent earnings and little debt. Or the new Cisco, or Elbit, or, Cyber Ark.

Going back to Keynes, I think in this structure of low long term interest rates, investors are going to be very unhappy if they buy and hold broad index funds. As such, investors need to as

Captain Kirk once said, "Go boldly where no man has gone before." They need to capture a wider net and buy stocks that they think will win the next beauty contest.

Wen: Professor, speaking of beauty, don't you like Shiseido and L'Oreal?

Steve: Yes, we own L'Oreal and as you know we are considering Shiseido. We also are thinking about Inditex (Zara). You did the research report on that one.

Cassidy: What else do you like?

Steve: We like homebuilders, which are doing well, and our cyber security stocks.

Nat: You have spoken about a bubble before. Are we in one now?

Steve: Let's face it, stocks are where they are today because of easy money. If the Federal Reserve had a normal interest policy, the market most likely would be lower. Just as easy money fueled the 2000 tech boom and crash, and the 2007 real estate boom and crash, this easy money policy is fueling another bubble.

Nat: Should we sell all of our stocks?

Steve: Market timing is impossible. What if I sold all of our stocks in early March, after the market was down by approximately 10% over two months? Where would we be today? Besides, the bubble is not happening in stocks, although the market is clearly not cheap. The bubble is in bonds, especially high yield and foreign bonds. However, I'm not too worried about our bond portfolio because we have them laddered and we usually hold them to maturity.

Cassidy: Now I understand! That is why you have an asset allocation portfolio. What is the typical asset allocation right now for a balanced account?

Steve: 50% to 55% stocks (although the % may vary from account to account). 30% to 35% Bonds. Balance cash.

Nat: What risk to the portfolio do you see in the near future?

Steve: The biggest threat is a large rise in interest rates in 2017. That could spoil the party. I am watching this very carefully and I will adjust my thinking accordingly as events unfold.

Wen: Any last thoughts?

Steve: I keep going back to what Benjamin Graham used to write about. Here are some key points:

- Focus on holding your stocks long term and don't turn what can be an advantage into a disadvantage by short term trading.
- Don't chase fad stocks because they are here today and gone tomorrow.
- Neither have an all stock nor all bond portfolio. Keep it diversified.
- Approach stock selection like you would if you were a businessman buying a whole business even though you are buying a fraction of one.
- What would a prudent man do?
- Good returns are not measured by the risk you take but how much effort you put into the process

Cassidy: Thanks for an informative evening.

Nora: We are opening the audience up for questions.