Summary of September 2017 Conference Call

NORA: Good evening! Welcome to our September Conference Call. I would like to start off by thanking all of you who attended our best ever investor forum and luncheon last month. From all the feedback we have received, it was our most successful event yet! We had over 100 participants who came from all over the country to attend. Our brilliant speakers stole the show and we would like to thank Dr. Ron Ruby, internist and endocrinologist, Chen Zhao, economist and strategist, and Gary Myer, high tech futurist, for their splendid presentations. Thank you once again.

On behalf of our SFP team, I would like to congratulate Steve on his award from Oxford University. This past June, Steve was awarded the prestigious Oxford Alumni of the Year award for his outstanding contributions to the University and for his community service. Steve is a finance and strategy graduate of Oxford SaÏd Business School with 3 masters qualifications.

Tonight, Steve has a lot of ground to cover because there has been a lot going on lately. So we ask for your patience and reserve your questions until Steve has finished. Thank you.

Steve: The economic landscape has significantly changed since our last conference call, but not enough in my opinion to change our direction. I know that many of you read the daily news with the so-called gurus predicting a crash of some sort. This is utter nonsense and just a lot of noise. It is amazing how much resilience the market has. In the face of problems in North Korea, hurricanes Harvey, Irma and Jose and their aftermath, the market bounces back. In order to have a market crash, the economy must go through one of two things: Either a sustained rise in interest rates or a market/economic imbalance. None of these are on the horizon. For one, interest rates are lower now than they were at the beginning of the year. As measured by the ten year U.S. Treasury, this bond is down to 2.08% from 2.50% in January. With a dovish Fed, it is unlikely that the Fed will raise interest rates more than one more time this year. With the hurricanes and their destruction, the weak Fed may not raise rates anymore this year. Unless inflation goes wild, then rates won't rise significantly this year or next. Not great for buying bonds, but good for the stock market. Second, the North Korea issue is just noise and the likelihood of us getting into a conflict with them is very low. Strategists at BCA are of the opinion that the risk of war is low because each side, including China, has too much to lose. Think about it, if North Korea sends a missile towards Guam or the continental United States, we would annihilate them. We are not going to strike first because there are too many people in Seoul South Korea that would be killed. The DMZ is only about 30 miles from Seoul. China doesn't want the United States to unify the Korean Peninsula because a pro-American government would be on China's backdoor and they don't want a flood of Koreans in their country. This situation is noise.

There are no economic imbalances facing us yet. The raising of the debt ceiling is politics not economics. The government will always pay its bill and not default on the debt. The bottom line is that the next recession will be triggered by the rise in interest rates, not by imbalances in the economy. This could happen late in 2018 or 2019. Stay tuned!

Katie: What a great conference this year! Chen was funny, entertaining and informative. What did you think of his presentation?

Steve: I have known Chen for about 20 years when he was at BCA. He usually was "spot on" so I pay attention to his research and what he has to say. He made the case that a stock market downturn is unlikely unless you have a recession caused by a rise in interest rates or a fiscal imbalance. Ordinary recessions are caused by the Federal Reserve raising interest rates while extraordinary recessions are caused by fiscal imbalances that overwhelm the economy like in 2008. In 2008, the imbalances were caused by speculation in real estate, while the 2000 imbalance was caused by speculation in dot com stocks. We will talk about that later. In essence, Chen believes that we have had a sub-par economic recovery since 2009 so it is unlikely that the Fed will greatly raise interest rates in 2017 or 2018. The economy has to be on "fire" in order to kill the stock market and right now the economy is "soggy." However, some sectors, like FANG stocks, are on fire and that could pose a problem.

KATIE: I read in your newsletter something about the "Minsky Moment." Could you explain that to me?

STEVE: Sure, the Minsky moment was named after Hyman Minsky, an economist. Minsky believed that a period of instability follows a period of stability because the stability encourages investors to take more and more risk. They think the party will never end. I have referred this syndrome to the "musical chair effect." Charles Prince, the ex CEO of Citibank said, right before the 2008 crash, "as long as the music is playing you have to get up and dance." I say no, you don't because what will happen when the dance is over and there are no chairs. This is exactly what happened in year 2000, and 2008 and in Japan. I refer you to chart 2 because the Japanese experience explains it best. (Steve explains chart 2.)

ARASH: Steve, you said that the risk of a recession is low, stocks are the asset class to be in but that stocks may be in a bubble. I'm confused.

STEVE: Yes, I did say the odds of a recession are low and that FANG stocks may be in a bubble. BCA estimates that in order for the stock market to get in trouble, the ten-year bond has to yield 3.25%. We are a long way from 3.25%. If unemployment drops from the current 4.2% to 3.8%, then inflation will ignite and the Fed will have to raise rates. BCA doesn't expect that to happen until late 2018. As I said earlier, the market will be killed by the Fed but not until next year.

ARASH: Is the market overvalued?

STEVE: The general market is stretched and we are finding few stocks to buy. I would say the valuations are stretched but more so in the FANG stocks. Most people really don't look at the underlying fundamentals of a stock. They buy stocks based on what their friends and others tell them, not the fundamentals. I call this the "Pied Piper" approach. Most investors blindly follow the Pied Piper down the road until they're drawn in the river. We do it differently here. We examine the economic prospects of the company and their ability to make money and pay off their debt. This is why we don't buy the Netflix at 400 times earnings or Amazon that really doesn't make any money at all. However, I like Google because they are like a venture capital investment, a pure play on technology. In the end, I think that these FANG investors who follow every rumor will have their heads handed to them in losses. I have been at this party before and I would refer you to the last newsletter I sent out in which I stated my case.

KATIE: What about index funds?

STEVE: Yes, that is a good point. As I said earlier this year, index funds look appealing because of their low expenses but underneath lies something that could be expensive to the average investor. In the 1970's, we had the "Nifty Fifty." These were fifty growth stocks that many of the stock brokers were pushing. They were telling investors that you could buy these fifty or so stocks and hold them forever. Brokers were saying "put them in your safe deposit box and don't even look at them." Of course, many market historians know that this scheme didn't work out either. The Nifty Fifty happened to be the most overvalued part of the stock market going down approximately 45% in 1973-1974 and never fully recovering. The main problem with index funds is that many investors are pouring into them without giving any thought about risk. When the Minsky moment arrives, the same investors will pour out leaving those behind holding the bag. Please refer to Chart 4. The S&P 500 index peaked in year 1998 and did not come back even until 2013. As you can see in Chart 5, the NASDAQ never has recovered to its 1998 peak. As the late "Intelligent Investor", Benjamin Graham, pointed out that there is danger in buying overpriced stocks especially those that are super popular. Graham preferred, and I do as well, to purchase stocks that are less well known but offer promise. In my opinion, this style of stock selection is less risky.

ARASH: You mentioned that BCA and you think that the U.S. market valuations are stretched. What do you think about investing in other parts of the world?

STEVE: Through our leverage with BCA and Oxford, we have built up our capabilities to scout and analyze global stocks. Two of my favorite areas in which to invest are Japan and China followed by Europe. Japan is starting to come out of its 25-year doldrums. By the way, the Japanese market peaked at 40,000 in 1989 and is now at 20,000. Luckily, we avoided the downdraft and got out of Japan in time, but this illustrates the problems that occur when you buy over popular stocks at market peaks. At this moment, everyone hates Japanese stocks, therefore, they present good value. Japan is tricky though because of the currency fluctuation of the yen. If the yen goes down, no matter how good your stock is, it is also going down. That is why we use DXJ, an ETF that hedges the currency. I also like selected stocks in China, but there again we need to be careful. We are starting to buy a couple of stocks that I believe have a bright future in China and in the rest of the world. I also like Europe, especially the UK where stocks are extraordinarily cheap because of Brexit. As U.S. stock markets become even more stretched, you will see that the portfolios will have more stocks from China, Japan and Europe as we trim some U.S. stocks. Valuations in Japan are absurdly cheap as they are in China. Europe not so much.

THE BOTTOM LINE

The good news is that a recession is not imminent. The bad news is that once inflation starts to raise, the party may come to an end. Until then, we will keep our stock allocations as they are. With U.S. valuations being stretched to say the least, we are moving into Japan, China and Europe.

KATIE: Steve you mentioned something about social investing at the investors' luncheon. Could you please go into detail about what this is?

STEVE: For about a year, I have been working on a social conscious portfolio. The portfolio is based on companies that clearly demonstrate environmental, social consciousness and good corporate governance (ESG). This process is not easy to implement because there is a whole array of variables that need to be checked and analyzed before an investment can been made. Through our partnership with Bloomberg, we have implemented a social conscious portfolio that evaluates a company's good behavior and governance. Socially responsible investing are those investments that are designed to create a positive impact beyond a financial return.

ESG Investment Criteria:

- 20 ESG Investment criteria
- Compared to non ESG investments
- Additional analysis similar to existing SFP investments
- Time consuming and research intensive

We realize that socially responsible investing is not for everyone. However, this is something some of our clients have requested and want. There is a demand for such an investing style. If you would like to discuss this further please either email or call me.

NORA: Thank you for participating in tonight's conference call and we look forward to your questions. If you have any questions about social responsible investing please direct those questions to Steve directly after the call has ended. We want to reserve all of the Q & A time this evening to other investment topics.