September 9, 2019

Dear client,

As we approach our 34rd consecutive year in operation, I would like to share some insights about last week's markets that I think will be useful as a gauge to judge how we will manage your investments going forward.

Thirty-four years ago, this month, I founded Stevens First Principles Investment Advisors (now part of BFSG, LLC) to serve investors a useful framework of investing based on value. Sometimes, I like to sit back and reflect on how the investment world has changed over time. I am hoping we can learn something from this exercise.

When I began my investment practice, most investment advisors of our size and nature picked individual stocks and bonds. Although there were also mutual funds, they were actively managed instead of the index variety so common today. Today, many investment firms know little about individual stocks and bonds and farm out their investment duties to outside managers or use exchange traded funds. We are old school and we still research each and every security before we purchase it. After all, I put my own money in the same securities that I purchase for you.

Until the 1990's, a value manager such as my self could pick some good value stocks and add some bonds to construct a good performing portfolio. It was during my studies as a Visiting Scholar at UCLA, under the guidance of Professors Robert B. Andrews and Moshe F. Rubinstein, that I realized the world had changed and a new approach was needed to successfully navigate the investment world. The world's economic dynamics had changed, and the dotcom bust was a symptom of that change. Between 1998 and 2001, there was a tectonic shift in the global economy and monetary system that enabled the global stock markets to become severely overvalued and this is what I have referred to in the past as the boom-and-bust cycle.

Since 2000, we have included a global macroeconomics view in all of our asset allocation decisions. My goal has always been to preserve capital and "not to bet the ranch". I believe my clients want me to do exactly that - get a good return but not blow a hole in their pot of money.

In the beginning, my investment philosophy was and to a degree, still is, highly influenced by Benjamin Graham (value), Phillip Fisher (technology), Moshe Rubinstein (uncertainty), Murray Rothbard (trade cycle theory), Chadwick Oliver (forestry) and Marty Marshall (management). However, as all good investment managers evolve, so have I. Whereas, I used to shun investing in technology stocks, I now feel comfortable with it. I have come up the learning curve and soon I will be completing my advanced certificate in technology and innovation from the Sloan School of Management at MIT. In this three-year course I have learned about artificial intelligence, machine learning, cryptocurrencies, internet of things, and digital business strategies. All of this keeping relevant will help me adapt the portfolios to the current landscape.

What about the markets? What is the difference between 1985 and now? The stock market certainly is not cheap, the way it was in 1984, with the S&P 500 trading at more than 18 times trailing operating earnings.[1] Low interest rates are providing support, but we believe future returns are likely to be in low single figures in a world where economic growth is moderate and there is little scope for profit margins and/or multiples to expand.
Prospects for bonds are not like they were back then. Bond yields in 1984 were approximately 13%. Then, there was only one way for yields to go once the Fed's peg ended. Down! Today, yields will only fall sustainably if the economy sinks into a protracted downturn. We think we will get another recession in the next few years and yields could certainly hit new lows at that point. But the resulting policy response – both fiscal and monetary – seems almost certain to lead to higher inflation down the road. That would not bode well for the bond outlook. This is one reason why we like timber and timber stocks. As a tree grows, the wood gets more valuable and it doesn't have to be cut until the market conditions are ripe. Although stocks like Potlatch, Weyerhaeuser and Rayonier don't move

in price much, they provide dependable and stable dividend yields averaging above 5% while the trees grow and outpace inflation. This is just one component of the portfolio that we have to combat both inflation and deflation.

Concluding thoughts

If Benjamin Graham were alive today, he would be not be able to understand how investors could be so complacent with record government deficits and debt, reckless behavior by central banks and casino-type gambling by many investors. The bottom line is that he would be advising investors to be extremely cautious.

Investors currently are obsessed with the timing of the next recession as that would be the signal to significantly downgrade risk assets. I say that a recession is not imminent, and this creates a window for stocks to outperform. However, for those more concerned with absolute performance, the current upside potential seems unattractive relative to the downside risks. Therefore, we remain cautious.

Unfortunately, economists have a poor track record of forecasting recessions and bear markets therefore, often come as a complete surprise. Yes, low interest rates provide a floor under stocks, with the dividend yield comfortably above the 10-year Treasury yield. But rates are low for a reason: the economy and corporate earnings face major downside risks. This is a time to focus on capital preservation rather than taking risks to maximize returns.

At this point, I am not willing to abandon stocks and dive into bonds. Carefully chosen stocks with good dividend yields can act as bond substitutes providing a superior return of bonds. If I am correct in my assessment, that in the next recession, the Fed will drop interest rates to zero and the Federal Government will stimulate the economy fiscally. Inflation will rise once again. Therefore, at these yields purchasing long term bonds at this moment are a bad investment. We will continue to be vigilant and make portfolio changes as necessary, but we remain cautiously optimistic.

Best regards,

Steven Yamshon
Investment Counsel

1. The S&P 500 is designed to be a leading indicator of US equities and is commonly used as a proxy for the U.S. stock market.