BFSG, LLC January 7, 2020 Conference Call

Summary of January 2020 Conference Call

Welcome to tonight's conference call, the first of the new year. From looking at all of the accounts, it looks like we had a real rewarding year in 2019. Hopefully, 2020 will be the same.

Tonight, we are going to talk about several interesting topics: The effect of the U.S.-Iran confrontation on the U.S. stock market, investing themes for the next decade, and some interesting things about some of the recent stock buys and sells in accounts.

First, let me begin by talking about the Iran-U.S. confrontation. Iran has been egging on the United States for some time through its proxies in Lebanon, Yemen, Iraq, and Syria. In other words, these proxies do the dirty work for Iran and allow them to look like they have had no hand in any sort of violent action. However, the world knows differently. The tensions escalated last when Commander Soleimani was killed in a drone attack. However, the stock market, although initially rattled, didn't move much to the downside, especially after a huge runup like it did October through December. In this environment where we believe a retaliation by Iran is a 60% probability, I think it is wise that we remain with our target asset allocation of approximately 60% stocks, 5% gold, 30% bonds, and 5% cash. Fixed accounts will remain at 35% stocks and the balance in bonds. As a reminder to those who think stock markets go straight up and stay there, let me walk you through some history. In 2000, the market significantly declined due to the withdrawal of liquidity by the U.S. Federal Reserve that caused the dot-com bubble to burst. The market also significantly declined in 2003 and bumbled along until 2007. Of course, I think almost everyone remembers the 2008 great financial recession and again in 2018 when the S&P 500 declined by 13%. Putting 2018 into perspective means that the stock market only increased by approximately 17% in 2019 because it lost 13% in December of the previous year. One reason why we have bonds, in addition to collecting interest, is that bonds and gold act as a cushion when the markets slide. Although we have to give something up on the upside, we don't have to give a lot of it back on the downside. And, over time, a balanced portfolio, in my opinion, is a better way to achieve risk-adjusted returns.

Corporate earnings have been lukewarm, and the Chinese-U.S. trade spat has been going on for over 1 ½ years. Thankfully, the U.S. and China have come to a trade truce, not a long-term arrangement, but a short term one. It simply pushes any real trade resolutions down the road. Let me say with conviction, that the autumn rally was largely due to the easing of trade tensions with China and the easy money supplied by the U.S. Federal Reserve. Without that two-punch hit, the market most likely would have not gone up too far, too fast. Anytime easy money gets easier and by that, I mean, the lowering of interest rates and a renewal of quantitative easing (basically printing money), the market will respond. If we take a walk down memory lane, we would find ourselves in a similar situation in 1999. Back then, the Federal reserve lowered interest rates to put at bay the financial crisis that was occurring in emerging markets. In addition, the Federal reserve injected a lot of cash into the banking system in case Y2K blew up all the ATM's and bank tellers. Nothing happened except that the Federal Reserve withdrew liquidity in the spring of 2000 to mop up the excess cash and the dot come bubble burst. The stocks that are most overvalued, get hit the worst and this time around it was the dot-com stocks, in 1973-1974, it was the Nifty Fifty and in 2021, I believe some of the momentum stocks like Facebook, Apple, Amazon, Netflix, and Microsoft will get hit hard. On the other hand, we believe the boring stuff we buy, and some of it includes technology, will get hit less. However, the bonds and gold should help cushion any downside. The difference between 1999 and 2020 is that there was no Iran to spoil the party back then. Now is different. As I said in Spring 2019, the "black swan" or low probability event that can raise havoc would be a confrontation with Iran.

I suspect that the Iranians don't want a major war. After all, their economy can't sustain it. Without saying, I don't know what the White House will do next. A prolonged major, and I mean major confrontation, would likely put the economy into a recession and that would mean a major market decline. For 2020, I believe this to be a low probability. Therefore, we are keeping our current asset allocations where they are until I see something that convinces me otherwise. After all, we are balanced and have downside protection in the form of bonds and gold.

Every decade it seems that there is a dominant theme that captures the imagination of investors. In my book, *Human Action and the Securities Markets,* I wrote that markets move from pessimism to optimism, swinging back and forth trying to find an equilibrium. The result being that speculators move an asset class like stocks skyward, believing that good times will never end. Then the assets fall from the stratosphere back down to earth and crash. We have seen this in the past.

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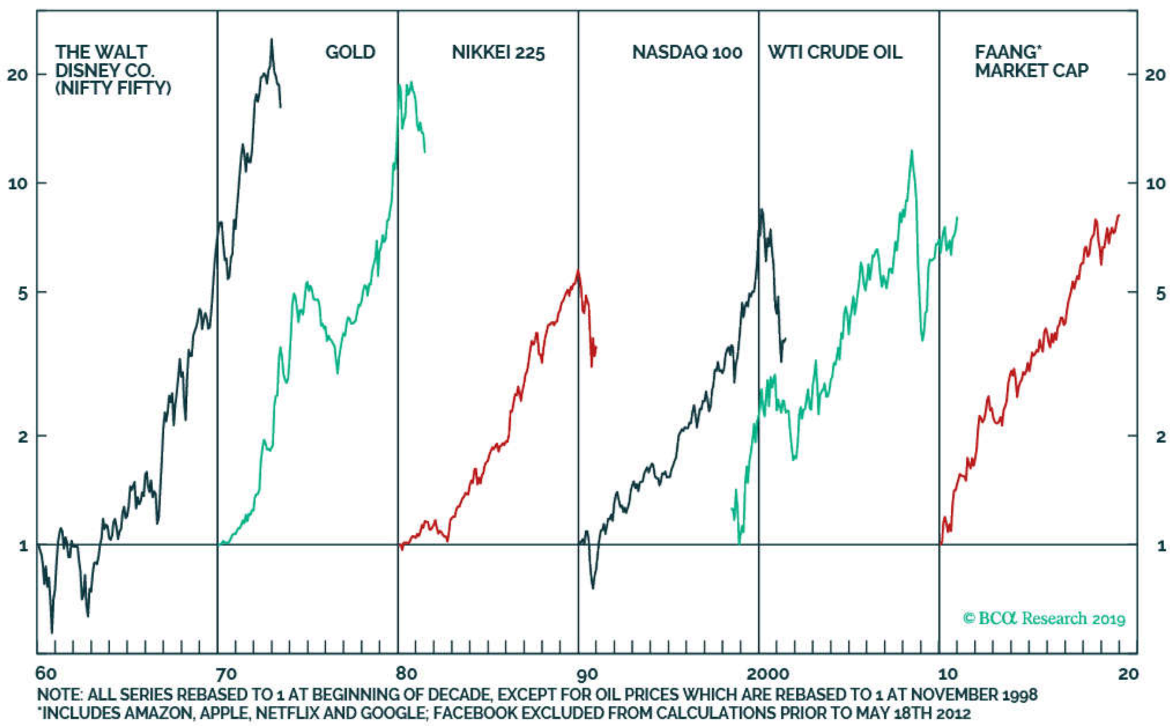
Chart 1 – Manias: A Historical Roadmap



If we look at chart 1, we can see that between 1960 and 1970, the major theme was the Nifty Fifty, followed by gold, then the Japanese stock market, dot-com stocks, crude oil and finally this decade.

I can't predict which asset class will be the favored winner in the 2020 decade, but I do think I have a good idea where some of the next investment themes will be. According to BCA Research:

1. Theme 1 - Deglobalization
   Odds are that countries will continue to look inward and concentrate on their domestic economies, as the U.S. adopts an aggressive approach to trade, global growth slows, China and European trade tensions increase.

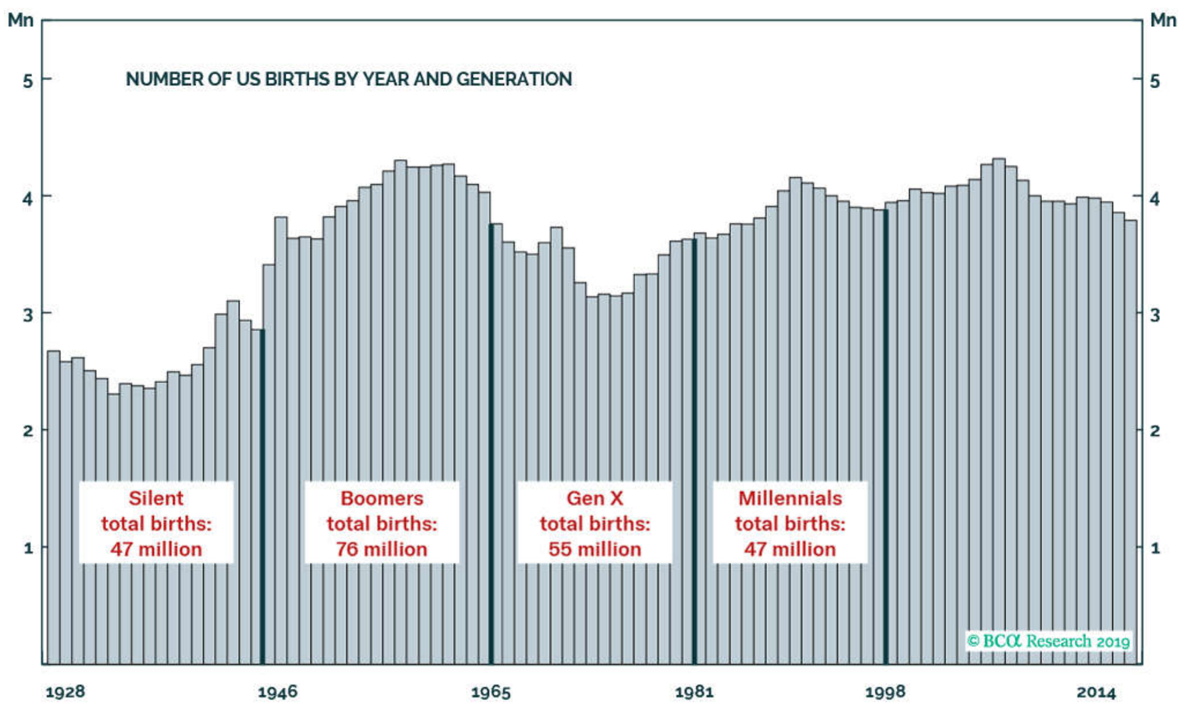
   The investment implication is that many of the companies in the S&P 500 are export oriented and that their profit margins may be squeezed as trade growth slows. In this type of environment, small-cap stocks should outperform large ones because they are more domestically focused. Value over growth stocks and due to heightened political tensions, defense stocks. In the defense arena, we like MOOG, General Dynamics, Hexcel, and Textron.

2. Theme 2 - Tech Sector Regulation
   The tech sector will be regulated as the United States implements privacy laws similar to the ones that Europe passed in 2018 and in California in 2020. This will hit companies such as Apple, Google, and Facebook, who use private information to collect data analytics in order to sell ads. This will severely impact the above-mentioned companies and most likely affect Amazon and Netflix too. In fact, any website that uses customer information will be affected. Many people will opt-out in allowing social media and others to distribute, sell or use private information.

3. Theme 3 - Software as a Service (SAAS), Artificial Intelligence (AI) Augmented Reality (AR) and Autonomous Driving (AD) are not fads.
   The world is awash in software and almost everything now depends on it. From your car to your TV, to making your flight reservation on airlines, these companies enhance productivity and will should prove to be recession proof. Software is leading the world. In this space, we like Palo Alto Networks and CyberArk software.

4. Theme 4 – Millennials are already the largest demographic group and will dominate spending.
   The millennials represent a huge shift in economic power, especially considering that they will most likely be the beneficiaries of baby boomer inheritances. The millennials differ from the baby boomers and Gen-X, in that they prefer social media (Snapchat and Instagram versus Facebook), online shopping, and live on their smart phones. This is a global phenomenon. For example, when I was in Cartagena for the holidays, we stayed at the Hotel Caribe which is an all-inclusive hotel at the beach. At breakfast, lunch, and dinner, the millennials were seated with their parents eating their meal. However, the millennials were not talking with one another, but looking at their smartphone. The same thing was going on at the beach and airport too. I have developed a millennial index that I plan on using in the investment accounts once a correction of a 10% to 15% magnitude occurs.

Chart 2 – Millennials Are the Largest Cohort



5. Theme 5 - ESG (environmental, social governance) becomes mainstream.
   Like it or not, believe it or not, that doesn't matter. However, climate change is important to the millennials and they are conscious of it. Second, the Europeans have passed legislation towards advancing their own version of a new green deal. Like it or not, I think it is only a matter of time that the United States follows suit. Third, institutions are being pressured by their beneficiaries to go green and are shunning stocks that are detrimental to the environment. In such a scenario, stocks that have a lack of demand will not increase in price. For example, we own Exxon and Total and if it weren't for the dividends, we would have sold them a long time ago. However, they are paying dividend yields of 5% or more and trade in a tight range. The dividend yield is much better than what I can get in a bond, and I have a chance for appreciation. In general, bonds don't appreciate. I'm digressing here. One of the reasons why I am of the opinion that oil stocks have not moved up while crude oil has, is that many investors are shunning oil stocks. This is a contrary indicator that may prove that ESG is taking hold. The investment implication is that fossil fuels, gambling, alcohol, steel mills, mining companies and tobacco stocks among others should be avoided.
   Of course, nothing is absolute, but I think that looking at these five investing themes deserve my attention.

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Mobile is the fastest growing segment in the gaming industry, and we continue to believe that Activision is differentiated, thanks to its ability, which it is now ramping, to port existing IP over to the mobile platform. Mobile growth and Activision's ability to exploit this is the key to our analysis. Engagement is key and Activision's more streamlined business is resulting in improved engagement trends. Activision's IP portfolio of strong content with proven, reliable franchises with loyal followings is a strategic advantage.

Viacom is a stock that I know well because I have been in and out of Viacom since 1988, before Viacom bought Paramount. This is the cheapest I have ever seen the stock. It is trading at an unheard of 8 times consensus earnings. I think the merger of CBS and Viacom will make a stronger platform in which Viacom can sell content and advertising. They have taken an "arms dealer" approach by selling content to the highest bidder instead of being a "Me-too streaming platform." For example, Viacom recently sold the rights to SouthPark for $750,000,000. In addition to Paramount, Viacom has other valuable properties such as TV Land, Nickelodeon, BET, Sci Fi Channel, MTV, and CBS which includes Showtime. We believe this stock is too cheap to ignore.

Don't forget to look for Katie's emails on Fridays to link you to our weekly commentary on Coffee with Dr. Steve. Again, I would like to thank you for your confidence is us and I wish very one a happy and safe new year.