BFSG, LLC June 3, 2020 Conference Call

Summary of June 2020 Conference Call

Tonight, we are going to talk about some stocks and our process for selecting them, but first an update on the securities markets.

Last January and February, I thought the U.S. stock market had begun to get a bit over stretched. To me there didn't seem like much value was there. In response, I started to reduce the amount of stocks in the majority of the portfolios. Along comes COVID-19 and the stock market declines between 35% and 40% within a short period of time, starting in late February and going into the third week of March. At that point, the market became undervalued. However, if we look at past experiences, we might see that the market could have gone down further like it did between 2008-2009 and 1929-1932. I chose those instances because I studied them in detail, but I am assured that there have been other similar episodes when the markets had severe downdrafts like the ones I mentioned. At that time, many clients were terrified about losing more money and I had to field numerous phone calls. Of course, I care about my clients, so it was fine by me. I like talking to all of you and those who have been with me for a while know that I am always available to you 24/7. However, remember when the markets are relentlessly going down and people are frightened, it is almost impossible to convince anyone to buy more stocks. So, we didn't, but the simple reason was that it could have gone down a lot further. This brings us to today.

The world is learning to deal with COVID-19 and it is my feeling that it won't disappear overnight, nor will there be a magic vaccine that will keep us all safe right now. I am confident with over 100 pharmaceutical companies working on a vaccine or first line of defense, the problem will be solved, but it may take a while. Adding to the stock market confusion is the fact that we are in an election year. Along with the politicking comes a looming trade war once again with China. Not only is the President on the China bashing trade wagon, but his political appointments are with him too. To add further insult, the Chinese are playing games with issues too, making false claims and stirring the pot. Then comes along the George Floyd killing, and believe me, I am not making light of that horrible situation. With the protests, there has come violence and looting. Some politicians, academics, community leaders, newscasters and other people have even justified the destruction of property in the name of justice. To be fair, others have condemned it. I am not making a political statement here, but when you have a pandemic, possible trade war, and the potential for protests to spiral out of control, how can that be constructive for the stock market?

At this moment, I am of the opinion that the stock market is detached from reality. The "real" world is going in one direction while the stock market goes in another. In my view, at some point, they have to line up. Let's face it, the stock market was overvalued in February and the pandemic was just one of many excuses that the market needed to self-correct. However, nobody thought it would self-correct that deep. At this point in time, the valuations are getting stretched once again.

What have we done?

During the darkest weeks, we held pretty steady. Only two clients, out approximately 220, told me to sell. One instructed me to sell right when COVID-19 was happening while the other one told me to sell pretty close to the bottom. I tried to talk them out of selling, but to my disappointment, no avail. Still I have to consider it a success that I convinced 218 clients to stay the course. As it turns out, the markets have largely recovered and even with COVID-19, trade issues and civil unrest, the world has not come to an end. During the market downdraft, we pretty much held steady trimming a few stocks here and there and buying some too. Lately, we have been buying a few stocks but keeping the stock allocation largely in the ranges that I feel is appropriate, given the circumstances today. I think this is important, we may lag in performance because we are under our usual allocation in stocks at this time. As I said before, I would rather miss an opportunity than lose a lot of money and I feel there is a disconnect between reality and the markets. This leads me into the next segment of our discussion tonight. How do we view markets and how do we pick stocks?

How do we view markets and how do we pick stocks?

I had the fortunate circumstances to learn security analysis at the Anderson Graduate School of Management at UCLA. At UCLA, I had a teacher named Jack Shelton who, in the mid 1980's, taught the Security Analysis class. Ironically, it was the same class that Benjamin Graham taught at UCLA from 1956-1965. In case you have never heard of Benjamin Graham, he was the father of fundamental analysis in the 1930's and the mentor to Warren Buffett. Lucky for me, I was taught the art and science of fundamental analysis. Without going into the details, Graham's philosophy is built around financial soundness and value. Financial soundness means that the company isn't so overextended in debt that they couldn't survive if some bad years came along. Value means not overpaying for a stock or bond. In the 1990's, I had discovered through my studies, that deep value wasn't working. Therefore, I had to adapt Graham's fundamental analysis to the changing environment. I still have to tweak it here and there, but the two fundamentals remain the same, financial soundness and value. Today, many companies are horrendously in debt while many other companies are grossly overvalued. Some friends and colleagues have asked me why I don't become a momentum investor like one of my partners at BFSG or become a technical chartist like my colleague and trader, Robert Verdugo. My answer to them is that there are many ways you can invest in the stock market, but you have to pick the method that fits a person's personality, temperament, style and suitability. In all of my academic studies, real world experience, and examination of the greatest investors of all time, I am of the opinion that the path that I have chosen works best. For me, I am well suited for the modified value investment style because I feel more comfortable in knowing as much about a company as I can. I want to know what makes a company successful or not. All of this involves analysis of a company's financial statements, competitive position in an industry, evaluation of any disruptive effects and an evaluation of a company's management.

Many on Wall Street are focused on a great leap in quarter-to quarter earnings. I think earnings are important, for sure, but there are other important considerations an analyst must take into consideration. For example, what is the value of the content in Viacom's vast library. As many of you know, I have had a love-hate relationship with Viacom over the years. I have put up with the nonsense between Sumner Redstone, his daughter Sheri, and the sexual harassment drama of ex-CBS President, Les Moonves. Why would I put up with all of that? Because Viacom is one of the last independent content producers who has a vast library of TV shows, films, and strong brands. CBS has been the number one TV network for over 12 years and a leader in sports programming. Viacom has channels like BET, Comedy Central, TV Land, Nick-at-Nite, Spike TV and the Paramount Studios which includes Star Trek, Mission Impossible, Titanic, and Indiana Jones. To me, their streaming service, CBS All ACCESS, makes sense at $9.99 per month. I believe the stock is worth approximately $60 per share and it's trading at $22. I don't see the Redstones (majority shareholders) selling any shares. Why should I? What I look for is a margin of safety - the difference between what a stock is selling for and what it is worth. Of course, there are a lot of other variables one must consider like financial soundness. To boot, Viacom is paying a 4.4% dividend. Are you going to get that with a U.S. government bond today? Emphatically no! And with Viacom, you get some growth prospects.

Recently, we bought Alibaba. Some clients asked me why we didn't buy it when the company went public in 2014. First of all, Chinese accounting standards are always suspect. We learned that lesson with Luckin Coffee. Luckily, that turned out ok in the long-run. Second, the company was unseasoned, and we had no idea what they were really about. I felt there was no margin of safety. Today, I feel differently. To address the accounting standard, Baba stated very clearly that they already comply with U.S. accounting standards and they have no problem in complying with the newly adopted U.S. regulations that require the PCAOB to audit companies annually. Third, Baba is big in financial transaction services like PayPal, is here in the U.S. and, the company is heading big into the cloud. At the price we paid for Baba, I feel that this grown mature company is worth twice the amount of money that we paid for it. This is my margin of safety. We're not interested in Alibaba for a week, month, or even a year, but we like long term hauls and I believe Alibaba is a good stock for that purpose.

Keeping with the margin of safety principles, we like stocks that have competitive advantage others cannot duplicate. Our railroad stocks, CSX and Norfolk Southern, fit this bill. They can haul freight cheaper than trucks and more of it at one time. When do you think the government and activists will let a transcontinental railroad ever be built again? Of course, PayPal fits this description as well as it would be very hard for any company including Mastercard, Visa, or Square to duplicate PayPal's distribution network.

Lately, we bought Keurig Dr Pepper (KDP) for their ecosystem. In my opinion, that phrase has been overused in the investing world. Leave it to business to come up with its own vernacular. KDP sells Snapple (I'm a big fan), Dr Pepper, Canada Dry, Orange Crush, Dad's Root Beer and Keurig Coffee. Interestingly enough, the ecosystem for KDP comes into play when you keep buying the coffee pods, not the machines. Again, in addition to the other important factors of KDP, there is a margin of safety.

In the next one to three years, I don't believe that we have to worry about inflation. However, shortly past that point, we will. All of this stimulus will have to be paid for and if the country needs to increase social spending to quell the masses, then inflation and taxes should rise. I would be surprised if they did not. Using our gold component of the portfolio protector idea that I have implemented almost 2 years ago, we plan to increase the gold exposure by another 3 to 4 percent when the opportunity arises. After looking at gold prices today, the time may be near to buy more. Another tactic we will use is to purchase inflation protected bonds. We have, in the past, purchased U.S. Treasury Inflation Protected Bonds known as TIPS, but they are too expensive now. However, we have been buying a TIPS closed end fund that currently pays a 4% dividend. So, we are starting to pivot.

I want to leave you with this quote from the philosopher Horace, "Many shall be restored that are now fallen and many shall fall that are now in honor." I wish I could say that I was a lover of philosophy and poetry, but I lifted that quote from the 4th edition of Graham's Security Analysis. To me, this means that ZOOM, Teledoc and others will fall from grace. You may stay by them now and enjoy the ride. Easier said than done. When do you get in and more importantly, due to human greed, when do you get out? Me, I'm sticking to margin of safety.

remember to contact BFSG, in writing, if there are any changes in your personal/financial situation or investment objectives for the purpose of reviewing/evaluating/revising our previous recommendations and/or services, or if you would like to impose, add, or to modify any reasonable restrictions to our investment advisory services. BFSG shall continue to rely on the accuracy of information that you have provided.