Summary of January 2018 Conference Call

A Bit of This and A Bit of That

Nora: Steve! Welcome back from Cartagena. How was your trip?

Steve: Spectacular! I got to spend 10 glorious days at the beach in 85-degree weather and low humidity.

Nora: What did you do there?

Steve: Mostly I sat at the beach under an umbrella drinking my diet cokes and visiting with the family. There were 10 of us including my in-laws and nieces and nephews.

Nora: Now, Steve, I have known you for 10 years. What else did you do? I know you can't just lie around.

Steve: Good point. As usual I was thinking about and formulating the SFP investment strategy for 2018 after coming off a successful 2017.

Nora: Any conclusions?

Steve: As a matter of fact, I thought, not only about the investment strategy, but about Bitcoin and Oxford.

Nora: Oxford? I thought the program you were in was finished?

Steve: Yes, the original program is gone and what a sad day that was for me. Do you realize I have been going to Oxford for ten years now? The experience was incredible. Not only did I learn a lot and made a bunch of new friends, but it made me a much better money manager. However, a new program, run jointly with

Business School Lausanne has formed, and not only will I be going to Oxford, but Geneva as well.

Nora: Sounds exciting! Tell me about it?

Steve: As you may recall, I have been talking about social impact and sustainability investing and you may have read about the iPhone controversy in a recent Wall Street Journal article. Both of these are related to one another.

Nora: Can you explain, I am a bit confused?

Steve: Well, the Wall Street Journal reported that Jana Partners has created a fund that will invest in sustainable businesses because they think that those businesses should perform better over time than companies that have poor corporate citizenry. At the same time, the Journal reported that Apple has a social responsibility to discuss smartphone addiction with teenagers.

Nora: What?

Steve: Some researchers believe that teenagers are becoming socially dysfunctional due to their high usage of smartphones. In other words, kids are becoming depressed, socially dysfunctional and suicidal. Jana Partners and the California State Teachers Retirement Pension Fund wrote a letter to Tim Cook, CEO of Apple, to ask him to conduct research on this topic and to open a discussion.

Nora: Interesting, but what does that have to do with sustainability investing, Oxford and Investments?

Steve: Believe it or not, these are all related to one another. For one thing, I learned a long time ago that companies that practice good management usually produce superior results over time. This was reinforced to me at Oxford. Oxford is on the cutting edge of sustainability investing and over there I learned how to evaluate sustainable investments better than I ever did before. One reason why I keep going back is that I learn new tools and techniques that give our portfolio performances a competitive edge and sustainability is one of them. We have been incorporating sustainability and good corporate governance in our research methodology over the past few years, but we have now accelerated the process. Sustainability means much more than social and environmental issue. It examines what factors a company has that can make it a long term and sustainable business. This is where I think some of our investors may be confused. Good businesses are sustainable businesses and if they are good corporate citizens, then they should perform well over time. I think we have become better stock pickers because of it. Now, larger funds are picking up the idea, but we came early to the party, they are late.

Nora: Steve, it looks like Katie has a few questions?

Katie: Anything interesting happen while you were in Cartagena?

Steve: As a matter of fact, yes. Free enterprise is blossoming in Cartagena, more so than the United States. Let me give you some examples. No need for Uber in Cartagena because the taxis are cheap and there are a ton of them always available. The bus system is privately run and is efficient. Fares are cheap and busses go to most places. You don't need 50 permits to open a restaurant, just one. No hotel taxes like here in California that is approaching 25%. Street vendors don't need permits by the city council. The airport is sleek, modern and well run, all privately operated with no TSA, but private security instead. In contrast to the City of Los Angeles, where it would take 2 years and 23 permits to open a car wash.

Katie: While you were away, some clients were asking about Bitcoin again? Has your opinion changed about it?

Steve: No, it hasn't and my opinion against them has gotten even stronger. For one thing, Bitcoin isn't an investment, it is gambling. I had mentioned that fact in my special report on Bitcoin, that Bitcoins are manufactured out of thin air using block chain technology. Although the Bitcoin code will limit the number of Bitcoins to 21 million Bitcoins, other crypto currencies can manufacture as much as they want. There are no less than 120 crypto currencies competing in the marketplace. I saw a great movie called Tulip Fever on the airplane coming home. Although the movie is a love story it takes place during the time of another mania, the Tulip Mania that occurred in Holland in the mid 1600's. A long time ago, I read a book called "Extraordinary Popular Delusions and the Madness of Crowds" by Charles Mackay. In the book, it talked about the tulip mania that had occurred and how prices were being bid up to extraordinary levels by those purchasing tulip bulbs. The rare tulips, which had various colors, went for astronomical prices until the bubble burst. No exchange of the tulip was needed just like now - no exchange of the Bitcoin is required. Early trading in the CBOE futures market suggest that there is a speculative frenzy going on with one contract going for $2,000 above the spot price.

Liquidity and accurate market quotes are questionable because of the "fly-by-night" exchanges.

Katie: What else can you tell us about Bitcoin?

Steve: Recently, Bitcoin exchanges have had system failures and prices differing as much as 25% between exchanges. Hackers have stolen bit coins with the recent heist of $46 million being on the Slovenian exchange. Bitcoin and crypto currencies are highly susceptible to fraud and manipulation because they are unregulated. It is an unregulated market that depends on nothing. Yes, Bitcoin is an innovation in block chain technology, but the tulip futures innovation in 1636 did not prevent the market from crashing in 1637. Today, the Wall Street Journal reported that the Chinese Government is reducing the amount of electricity that Bitcoin miners can use. To mine Bitcoins, a miner needs lots of computer power and lots of cheap electricity. Bitcoin miners depend on cheap computer power and cheap electricity to make new Bitcoins virtually out of cyberspace.

Katie: Does this concern you?

Steve: Yes it does. As I said in my November Bitcoin report, the incredible surge in the price of crypto currencies dwarfs any previous asset price bubbles by a wide margin. Is Bitcoin a store of value? I am not sure since it is backed up by nothing. Not like gold that is backed by bullion or stocks or bonds with company assets, or currencies backed up by the government. A Bitcoin crash could impair those who borrowed to purchase Bitcoin or cause a panic so large that it affects the psychology of other investors. As is usually the case with bubbles supporters including FANG stocks, investors say this time is different. I doubt it.

Robert: Since I work with the portfolios too, I would like to hear your views on the outlook for 2018.

Steve: We have come off a great 2017. I think 2018 should be ok too although the market is getting a little stretched here. I mean the market is not cheap from a quantitative and qualitative perspective.

Robert: What do you mean stretched?

Steve: From a quantitative perspective, the market is more expensive now than at any other time since 1929 and that includes the dot com bubble of year 2000. From a qualitative perspective, the market can continue to go up from here even though the valuation is high if some conditions persist for a while.

Robert: What are those conditions?

Steve: For one if we remain in a low inflation environment with relatively low interest rates. And, if there isn't a systemic blow up like year 2008 from a Bitcoin meltdown scenario or a severe Chinese economic downturn.

Robert: What is the likelihood of any of that happening?

Steve: It could occur at anytime but I don't think any of those scenarios pose a problem with the exception of interest rates rising.

Robert: Why are you concerned if interest rates rise, because they are so low?

Steve: That's the point. Interest rates are rising from such a low point and there is only one way to go at this point and it is up. When rates are at such a low point, any rise has a magnifying effect and has more impact. In most of the past market declines, the vast majority of them have been caused by a rise in interest rates. The cause for the end of this bull market will be no different.

Robert: What is your magic number?

Steve: The Fed will most likely raise interest rates 3 times, maybe 4 times in 2018. That would put the 10-year at 3.5%. That is my number.

Robert: You have spoken of inflation; I don't see it anywhere except when I go shopping or to the baseball game. Can you explain that for us?

Steve: When most people think of inflation they think of it happening in goods and services. The things people buy and use. However, inflation also happens in asset prices and as we have seen we have had plenty of that in stocks and real estate. Lately, inflation in goods and services has heated up because of pricing pressures in commodities and materials, wages going up, and an economy that is running at full capacity. In addition, Chinese labor that manufactures so many of our goods is no longer super cheap. I think the Fed will be surprised in the next few months to see how strong inflation really is. Then they will be forced to raise interest rates higher than they thought or would expect to do. That is what will choke off the stock market.

Robert: When do think that would happen?

Steve: Late 2018 or early 2019 is my guess.

Robert: Then what is our strategy going to be?

Steve: Steady as she goes as we move in 2018. An interest rate rise shouldn't damper the stock market until the 10-year bond approaches 3.25%. Until then, the corporate earnings backdrop will remain supportive for at least the first half of the year. Nonetheless, I expect 2018 to be a transition year. If stocks and bonds have entered the late inning, then we must watch closely signs to reduce the allocation of stocks. The time is not here yet for that. Therefore, we are remaining at our current asset allocations for now.

Arash: I think you are right about Bitcoin, but what about gold. Do you like it?

Steve: Yes, I think gold is attractive at these prices but I am on the fence about buying it. For one, the US dollar has declined significantly in the past two years, but gold has not significantly gone up. Usually, gold goes up when the dollar goes down. Something is very wrong here. Second, if the US dollar rebounds and interest rates also go up, then that could be a toxic brew for gold. In the short term, gold doesn't look appealing, but if inflation breaks out or the US Dollar declines, the gold may be an option for us.

Arash: In the last newsletter, you mentioned you like Europe, Japan and China as places to invest. Since coming back from vacation, do you still feel the same way about investing in those countries?

Steve: Yes, I like Japan because the valuations are much more reasonable, but you have to hedge the currency. We like stocks like Shiseido and DXJ. I also like China, but I am a little wary of a downturn there so I am waiting and watching. I also like Europe, and we do have a decent European exposure with companies such as

Vodaphone, Glaxo, Elbit, Check Point, and Novartis. As we reduce our U.S. exposure in the coming months, we will be looking at Japan, China, and Europe.

Arash: I did notice that we do have a good number of international stocks.

Steve: Yes we do, I have always looked at borders as artificial. However, when looking at stocks outside the United States an investor must consider economic, political and currency risk, something we do consider. We have assembled a nice portfolio that is prudently managed and we don't take outsized risk.

Nora: Thank you Steve. That was very informative. We will now take any questions that you may have.