

Fortunato Asset Management
Newsletter Q4 2018

Sitting in the Catbird Seat

Bear markets typically occur when the stock market overall is overvalued – a point that we have been arguing for a couple of years now. Our sliding scale of equity to cash holdings has steadily decreased over the past few years to guard against what we believe is an overvalued market. In Fortunato 1 and 2, we went from around 75/25% equity/cash holdings in 2013 to 70/30% in 2014, to 45/55% in 2017, and all the way down to around 25/75% equity/cash entering October of 2018, which is where we stand today. This is a result of a disciplined approach to market valuation and risk. All that dry powder is like having a 3 ball, 0 strike count, and is why we are sitting pretty.

Many pundits and analysts focused on the earnings growth of the S&P 500 index for the forward year and argued that the resultant P/E ratio was reasonable. In our opinion, this is a poor way to value the market. We use a more historically sound, broad based formula that includes inputs like the market cap to GDP ratio, the Shiller P/E 10 year CAPE ratio, and the Price/Sales ratio, among others.

Even though the market is/was down nearly 20% from peak over the last 3 months of the year, it's been an all out rout for the average stock. Out of the more than 4,000 U.S. listed stocks, almost 1,000 had a decline of more than 50%. This was the worst market down draft in the month of December since 1931. Stocks have been whipsawed with extreme volatility. The most prevalent concerns seem to be the Federal Reserve continuing on its rate rise path, and slowing emerging market economies, particularly China.

Our energy and materials stock holdings have not escaped the carnage of the past three months, with some down 40 or even 50% over the three month period. They have taken a relentless beating, and now are incredibly cheap. So what are our thoughts about these issues now?

When you buy shares of a business that are a great value based on the real worth of the enterprise, often in beaten down sectors, and subsequently the price declines more, you can

realize some terrific bargains. The energy sector has been shunned for years even as the cost of producing a barrel of oil in shale formations has dropped from $85 in 2014 to $40 today for a new well. In the Permian super- basin in West Texas, break even costs have dropped to $27 per barrel. American ingenuity at work.

Time to get Wild and Loose?

We don't think so. We're not jumping in head first on this recent market dip. The overall market is still very expensive. But there are certain stocks and sectors that beckon with value. So we will be picking up some here and there or adding to the ones we already own that we feel have the best potential for appreciation. Which leads me to...

A Stock We Like

Pioneer Natural Resources (NYSE: PXD)

There are a few reasons that we believe the energy sector is of particular value right now. One, the sector was the worst performing of 2018. Energy stock prices realized little of the gain in oil prices in 2017 and the first half of 2018, only to dive in the last three months of 2018 when oil prices declined. As a result, many companies in the sector are down right cheap.

Next, there are 7 million job postings, and 6 million unemployed people in this country. Watch out for surprise inflation uptick in 2019, which makes hard assets like oil more attractive. On that same note, the government budget deficit will be exploding this year due to lower tax intake resulting from the tax cuts. That leads to a cheaper dollar which supports oil prices.

Lastly, the Federal Reserve looks to be backing off of interest rate hikes, which supports oil companies that have large debt loads, and also allows inflation to go unchecked.

Pioneer Natural Resources is a large exploration and production company in the best basin in America - the Permian in West Texas. The company has a 750,000 gross acre position in the play. Since 2016, PXD has grown its net Permian output from 171,000 BOE/d to 288,000 BOE/d with no end in sight unless they want to slow down. Lastly, the company has a majority percentage of oil that receives the favorable Brent crude pricing, due to favorable transportation to international ports.

Advantages to Fortunato

A friend asked me recently, “I hope I'm not offending you, but why invest with Fortunato, what are the advantages over other wealth managers, or funds?”

“Good question,” I replied, “and one you should ask. Here is what I think are our competitive advantages based on my research from years ago when I set up the company structure:

Small beats Large. Small funds have an advantage over large ones because the universe of available investments with ample liquidity are limited for large companies. Warren Buffett frequently cites this as the reason Berkshire returns will be lower in the future than they have

been in the past. To go along with that, large companies are normally very closely followed with plenty of analysts while small companies may not have much coverage -allowing for more price discovery.

Side by Side Investing. Studies have shown that when the fund manager invests along side the clients with their own funds, the results are superior. Common sense right? But you would be surprised at how few fund managers and wealth managers have skin in the game with you, the client.

Individual Decision Making vs. a Committee. While committees are great for some types of decisions, stock picking is not one of them according to studies. What do you get from a committee of 4 or 5 people meeting about stock position purchases? Closet indexing. Again from Buffett, "think independently, the only person I need to agree with me is the man in the mirror (paraphrased)."

Optimal Fee Structure. This perhaps took more thought research than any other area. We consider our no management fee, performance only fee structure above 6% return a competitive advantage. This structure was copied from Buffett and Monish Pabrai. The client makes a decent return of 6% before we partner with them on gains after that amount. Again, it's about alignment. In our Fortunato 3 strategy (6% return goal), we have one of the lowest fee structures (.55%) you will ever see for active management.

Interesting Fact

IMF World GDP Growth statistics
We hear frequently that emerging market growth is slowing and the economies elsewhere are not doing well. But a check with the IMF shows that, in 2018 at least, growth was pretty good. Here is the link: https://www.imf.org/external/datamapper/NGDP_RPCH@WEO/OEMDC/ADVEC/WEOWORLD

Our Strategies, Fees, Costs and Alignment

We manage separate accounts for clients by way of three fund strategies. The minimum investment is $250K. We have a low expense structure, with Fortunato paying all its own operational costs including audit, legal, accounting, administration, tax and filing fees. None are passed on to investors.

Below is a recap of each strategy and fee structure for Qualified Clients:
Fortunato 1 Growth and Value Strategy. Invests in a combination of reasonably priced growth stocks and value stocks. No Management Fee, the Performance Fee is 25% over a 6% per annum return with price breaks at $1M and $2M. On the first 6% return, no fee. Goal is a 14% average annual return over time.

Fortunato 2 Concentrated Value Strategy. Invests in a 5 to 10 value and deep value stocks (concentrated positions). No Management Fee, Performance Fee is 20% over a 4% per annum

return with price breaks at $1M and $2M. On the first 4% return, no fee. Goal is a 14% average annual return over time.

Fortunato 3 Dividend and Income Strategy. Invests in a conservative assortment of bonds, dividend paying stocks, and preferred stocks. Fee is .55% of assets under management. The goal is a 6% average annual return over time.

There are two components to beating the market indices. The first is to have low frictional costs (ie low fees and costs). And the second is to generate superior returns. Low frictional costs will assist in superior long term performance for Fortunato clients.

Our family maintains a substantial portion of our savings in the three Fortunato strategies; aligning my interests perfectly with investors. I am bullish on the long-term future of Fortunato and plan on managing fund strategies as long as I am able.

Final Thoughts

Many thanks to Brittany Rowland and Brian Jones for their valuable ongoing contributions to research, administration, and technology and thanks for reading.