

Fortunato Asset Management
Q3 2017 Newsletter

Market Outlook

Average analyst earnings growth predictions of around 10% for the S&P 500 looks strong for the remainder of 2017. Volatility has been extremely low, potentially leading many to a dangerous conclusion that the stock market is a less risky harbor for spare funds than it really is. Good values are hard to find. The S&P 500 is trading at 19X this years earnings estimates vs. 15X the long term average. It's pricey. I don't know about you, but I like getting at least a solid value on purchases whether it's a car, a vacation, clothing, anything. I can never get excited about overpaying for something. Stocks are no different. There are good values out there, but they are difficult to find. But high prices alone do not warrant a correction. As long as earnings and economic growth remain in an uptrend, and global liquidity is net increasing, the bull market rally will likely continue.

I've mentioned before in this newsletter some thoughts on the business cycle and I still believe we are somewhere along in the late stage of the cycle. It's difficult to nail down where, but caution is warranted regarding our allocation to equities in this late stage of the cycle. Valuations are high and interest rates here in the U.S. are rising. Therefore, we are focusing our attention on certain types of investments that tend to do well in the late stage which include opportunities in the materials, energy, and health care sectors.

The ETF Threat

I believe that ETFs (exchange traded funds) have an underestimated potential to exacerbate a downturn. ETFs are baskets of stocks, sometimes representing a sector, sometimes representing the entire market. Some of the most popular ETFs exist in the whole stock market space (S&P 500 ETF for instance), and the dividend income investing space. When I research a stock, I always take a thorough look at who owns it. These days I try to limit my investments in stocks with high ETF ownership. Why? Because ETF ownership has increased exponentially since 2009. Successful investment strategies often sow the seeds of their own destruction. It's incredible to see how much money has flowed into ETFs and their corresponding stocks. For example Simon Property Group (NYSE:SPG) a large mall REIT is 30% owned by ETFs as is a stock I recently sold that was held in Fortunato 1 - Ventas (NYSE:VTR) a senior nursing facility healthcare REIT. These two stocks are held prominently by specialty REIT ETFs (no

doubt for dividend income), as well as whole market ETFs. I would estimate the average ownership in a U.S. mid or large cap stock at around 18%, up from around 6% five years ago.

Why does high ETF ownership bother me? ETFs are by definition passive investments. ETFs are agnostic about the fundamentals of the basket of companies in which they own stock. Therefore, their investors are passive investors. I simply believe many ETF investors will lack the conviction to hold their investments through downturns due to having no idea about the underlying fundamentals of the stocks they own. The resultant panic selling will lead to a cascade effect in the prices of stocks prominently held in the ETFs - as they liquidate their positions to cover redemptions.

A Stock We Like

Viper Energy Partners, LP (VNOM)

I mentioned above that energy companies could do well in the late cycle. Viper Energy has some enviable assets in the Permian basin, one of the lowest production cost basins in North America. The company is structured as a master limited partnership (MLP) which was spun off from Diamondback Energy in 2014. As solely a mineral rights holder, it derives its income from royalties charged to exploration and production companies that drill its property. It has no operating or capital expenditures, little debt and a solid balance sheet. The company issues shares periodically when it needs capital to acquire an asset. It pays out a hefty portion of distributable cash flow (DCF) with a current distribution around 7% and a goal to pay out 100% of DCF every quarter. There is no substantial ETF ownership of the stock, and insiders bought the stock aggressively in May and July of this year. Viper is somewhat dependent on oil prices for growth but not entirely, it can also grow by increased production on its acreage. The stock is up a bit since we acquired. Buying this stock at the right price level is important. As with all the stocks we own, we have a written sell discipline to know when to sell it.

Recent Articles/News



We first brought Ubiquiti Networks to your attention in the first quarter 2016 Fortunato newsletter. I believe the company still sells at a significant discount when considering the

opportunities ahead and I recently wrote an article for Seeking Alpha explaining why I believe that is the case. It's titled, "7 Reasons Ubiquiti Networks Remains Undervalued."

https://seekingalpha.com/article/4101521-7-reasons-ubiquiti-networks-remains-undervalued

http://www.fortunatofunds.com/newsletters/Q1%202016%20Fortunato%20Newsletter%202.pdf

Our Strategies, Fees, Costs and Alignment

We manage separate accounts for clients with three fund strategies. Our 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, Performance Fee is 25% over a 6% per annum return. On the first 6% return, no fee. Goal is a 15% 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. On the first 4% return, no fee. Goal is a 15% 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. Goal is a 6% average annual return.

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.

My 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 and technology.

Thank you for investing with Fortunato. It's a pleasure to serve you. No matter what the future holds, there will be excellent opportunities to invest in great companies.