Quarterly Client Newsletter

3rd QUARTER 2017 REFLECTION

BY ALEC BETHURUM
SR. PORTFOLIO MANAGER

One of my favorite Warren Buffet quotes is that "investing is simple, but not easy". What does this mean? This means that it is very SIMPLE to look at long-term returns in the stock and bond markets and realize that the price at which you acquire the underlying asset is the most important determinant in what the future LONG-TERM returns will be. In fact, as we have emphasized on several occasions, the difference in long-term returns of Value vs. Growth is not small, it is an average of 3-5% per year over rolling ten and twenty-year periods.

Buying based on value is the simple part, but owning these "cheap" assets is not EASY. This is because the reason assets become cheap is most often a result of negative news regarding the company or the industry. Generally, the mainstream press is disparaging the company/industry on television and in the papers. Often, analysts from the major investment banks, not wanting to be seen supporting stocks which are getting beaten up, will downgrade the stocks hoping people will quickly forget they had rated the company a "Strong Buy" when it was 30% or 40% higher. It is also very difficult to time the exact bottom of these stocks as they are subject to negative momentum and prices that appear to be very low can be pushed lower in the short-term. This "HARD" part of value investing is in fact why the "SIMPLE" part of long-term outsized returns occurs. This "HARD" element drives prices to levels where the risk-to-reward is heavily weighted in the investors' favor and we can greedily acquire shares as others panic.

One excellent way for investors to avoid this panic and take advantage of the cheap prices they provide is to mentally separate the "stock" they own from what the stock represents,- an actual ownership interest in an operating business. While the value of the "stock", driven by fear and greed associated supply and demand, may fluctuate wildly on an intraday, week or monthly basis, it is highly unlikely the actual value of the underlying business would fluctuate so wildly. As an example, Proctor and Gamble, a company with nearly 200 years of operating experience and $83 Billion in sales in products such as Bounty Paper Towels and Crest Toothpaste, declined by nearly 50% in value in 2008 and over 30% again in 2015. Did 30% of the country suddenly decide to stop brushing their teeth? Did messy kitchen counters suddenly clean themselves? Of course not, which is why following both those drops the stock quickly bounced back. This variance that occurs between the traded market value of a security and the intrinsic long-term value of the underlying business, is what a value investor exploits over the long-term to generate those outsized rewards.

The hard part of exploiting this is not the realization that a company's true value is greater than its "stock market" value. The hard part is the mental conviction and the patience required to acquire the asset when its perception is poor and to then hold it through a period of potential negative momentum to then achieve the rewards of the outsized returns.

I address this issue this quarter because one or two "Companies" we own had "stock prices" which did not perform well in the quarter and experienced negative media reports and analyst downgrades. For us, given that we have done extensive analysis on long-term viability of these companies, the short-term downside in price is not something to fear but often an opportunity to be embraced and increase our position. Our primary concern, when we buy a stock, is the question of whether the issue confronting the company is cyclical. In the example of Proctor and Gamble, will less people brush their teeth or clean their kitchen? As long as the issue is cyclical, then short-term stock price movement, even substantial movement, is opportunity, not a reason for fear.

The last thing we want to address is the difference between volatility and loss. In conversations with clients, some will say "XYZ stock is down, I lost Y dollars." While nobody likes to see a negative number on their statement, there is a significant difference between a permanent loss, which occurs when a company goes bankrupt or a bond goes into default, and a paper loss resulting from short-term price volatility. The first type is to be avoided at all costs as it is crippling to long-term returns. The second type is more often to be embraced as it is often an opportunity. The Chinese symbol for "crisis" is the combination of two characters, one which means danger, and a second which means opportunity. We have found that when it comes to investment opportunities, the latter is more often the case then the former.

As always, we appreciate your business and encourage questions and comments.

WEATHERING THE STORM: REINSURANCE AS AN INVESTMENT

BY REGAN ERVIN, CHIEF OPERATING OFFICER

One of the non-correlated asset classes that we have exposure to is the reinsurance sector. The returns in these securities are derived from the premiums paid to insurers by those looking to insure their property in the event of natural disasters and other singular event.

We know as a function of owning this type of investment, from time-to-time there will be significant events which will lead to large payouts by the insurers and large losses to the investors. We also know that following these events, significant rate increases are imposed as policies are renewed. This rate increase is no different than an increase in your auto insurance rate after you have an accident. The insurance companies are regulated in a manner in which they are required to increase rates to ensure their profitability; after all, the availability of insurance is what sustains our homes, cars and businesses in times of peril.

We expect, over time, 'reinsurance as an investment' will generate mid-to-high single-digit returns, with no correlation to stocks or bonds. To generate these returns, we must be willing to add to our exposure following events. This is the point in which risk premiums become more favorable to investor. In other words, the return potential improves while the underlying risk remains constant.

IDENTITY PROTECTION

For tips and resources regarding identity protection, visit our Sept. 20th post titled *Credit Report Self-Monitoring* found on sterneckcapital.com, under News & Resources.

QUARTERLY INVESTOR CALLS

Tuesday, October 24th @ 10am CST
Tuesday, January 23, 2018 @ 10am CST

To register: 816-531-2254 or *info@sterneckcapital.com*

COMMUNITY STEWARDSHIP

This past quarter SCM was honored to support:

- Shawnee Mission Health: Living In Vitality (LIV) -- empowering Kansas City women to live healthier lives physically, mentally and spiritually.
- Callyn's Course benefiting Braden's Hope -- creating awareness and increased funding for researching cures of childhood cancers.
- Grief's Journey -- offering compassionate grief support programs in Nebraska, free of charge, so no one has to walk their grief journey alone.

PLANNING FOR THE UNEXPECTED

BY FRANK STERNECK, CO-FOUNDER & CHIEF INVESTMENT OFFICER

In a past newsletter, I cited a frequent quote of my father, “when you least expect it, expect it”. The memory of this quote proved very real to me after my parents visited me in KC two weeks ago. Two days upon leaving KC, my father had a ruptured aneurism and left us forever a few days later.

Besides the emotional trauma of such a sudden and shocking event, there are the practical and financial issues and implications that must be dealt with. While my father was compulsively organized, the fact that he handled most of the financial tasks, such as paying bills, left an instant void. It took me two days just to find his checks. In notifying social security, my mother’s payment will be increased to my father’s amount, but the net effect is that the “household” income will be reduced by approximately 35%. This is simply one example of the many tasks and implications resulting from my father’s passing.

I share this with you as a reminder of the value of surrounding yourself with people and professionals that you can trust to help navigate some of life’s financial surprises and challenges. Just as Sterneck Capital will help navigate the administrative and asset management responsibilities for my mother, we are here to help plan and protect you and your family. It is never too soon to plan for the future.