BFSG, LLC March 24, 2020 Conference Call

Summary of March 2020 Conference Call

***Please note: The text version of the conference call is edited. If you would like to hear the unedited version, please listen to the audio.**

Financial markets are in a state of shock because of the COVID-19 pandemic. There are the knowns and the unknowns.

What we don't know:

- In regard to COVID-19, the speed of its spread, the number of victims and deaths.
- Don't know when stocks will bottom.
- Don't know how much the economy will contract or how long the recession will be.
- We don't know how many people will lose their jobs, businesses go bust, or mortgages go unpaid.
- Epidemiologists don't know if social distancing will be enough to stop the spread within the U.S.
- No one knows how long a vaccine will take or how long drugs to combat the virus will take.
- No epidemiologist, doctor, Wall Street maven or anyone else knows what is going to happen, especially in times of a crisis or when an economic tsunami looms. Only the arrogant think so.

Since we base our decisions on facts and tend to be long term investors, we underestimated the global health ramifications of the Coronavirus outbreak in Wuhan and the severity of a 2020 recession. We could not foresee the safe-in-place lockdowns that would be imposed to slow COVID-19 spread.

We recognize that the recession will be quite severe, but not as severe as some pundits think.

The Federal Reserve is doing an incredible job backstopping credit markets and trying to ease liquidity roadblocks. Hopefully, Congress will pass legislative action for much needed fiscal stimulus, but in-house bickering is delaying the action and causing precious time to be wasted. It is our guess that the full effect of this stimulus won't be felt until after the pandemic recedes.

Significant unknowns are always at the center of any financial panic. This time is no different. Benjamin Graham pointed out that markets have a deeply entrenched tendency to overact. When an individual company begins to lose ground, Wall Street is quick to assume that the company is entirely worthless, should be avoided at any price, and thrown away. In contrast, Wall Street becomes too excited when a company that is entirely unproven with no track record or earnings comes to market only to see many of them crash and burn later. In times of stress, the market overreacts at the market level and radiates to each and every stock, regardless if it is warranted or not. For example, in the last month, utility stocks have declined as much or even more so than others, although utility usage may decline by a small amount due to less commercial usage. Residential rates are more favorable than commercial ones, but the market didn't take into account that more people will be staying at home and using more electric power. In my opinion, and in most cases, the high dividends of utility stocks are safe. Yet, the utility stocks declined with everything else. It makes no sense whatsoever except to note that investors were indiscriminately dumping everything to raise cash to pay off margin loans or to run scared. It seems to me that there must be many sound stocks that are thrown out with the bathwater, such as hospitality, restaurant, and travel companies. None of which we have. This puts the investors' advantage into a disadvantage.

The past week, there has been nothing short of a stampede out of bonds as investors dash for cash. According to Bloomberg, investors yanked $109 billion from investment-grade bond funds ending the week of March 18, 2020. Another record was taken out the week before and the municipal bond market had a similar pattern. Bond market liquidity has dried up. Investors have pulled more than ½ of the assets in the Mellon Bank Dreyfus Money Market Fund in less than a week necessitating Mellon to inject $1.5 billion. Goldman Sachs had to do the same thing but injecting a little less at $1 billion. If Mellon and Goldman had not done so, the funds most likely would have broken the buck in which investors would receive less than the $1, they originally put in the fund. This would have been an echo of the past if the Federal Reserve had not stepped in to backstop the commercial paper market. Until yesterday, liquidity problems applied to gold as well. Gold dropped below $1500 per ounce on Friday, March 20th. Fixed income and gold are not acting as the safe havens they are supposed to be. High yield or junk bonds have been the worst performers. The risk-parity theory has broken down because almost everybody has a sell everything mindset.

In regard to stocks, managers are forced to dump their stock holdings to accommodate redemptions setting off a reinforcing feedback loop.

Due to the passage of the Dodd-Frank regulation bill after the Great Financial Crisis, banks no longer keep large inventories of bonds in which brokers and banks act as market makers and holders of bond inventories. Banks and brokers are stepping away, forcing a liquidity squeeze that forces the sale of anything liquid. This caused a temporary spike in Treasury yields and a decline in gold prices.

As gloomy as this sounds, it might not be as bad as one might think. Over the past several days, I have been dusting off my financial history books and graduate school notes to see what parallels might be close to what we are experiencing. There is not much data in regard to

financial markets in the time around the 1918 influenzas because of the proximity to the ending of World War I, when financial markets were already in disarray.
However, there is plenty of history between 1900 and now. The major financial market downturns occurred in 1907, 1921, 1929-1932, 1937, 1941, 1964, 1973-1974, 1980, 1987, 1994, 1998, 2000-2003, 2008, 2018 (Dec) and 2020.

June 1907 to Nov 1907	-44%
Nov 1916 to Dec 1917	-39%
Nov 1919 to Aug 1921	-47%
Sept 1929 to Nov 1929	-48%

To understand what the worst possible scenario that could happen, I am focusing my research intentions on the period between 1929 and 1937. By April 17, 1930, the market had recovered 52% of the previous decline and was back at the beginning of 1929. The market was only 23% below the high of September 1929 and the decline in the Dow Jones Industrial Average (DJIA) was not abnormal. If we look at the rallies and declines between March 1929 and July 1932, the average loss would be -14%. Looking at Gross National Product (GNP), the output of national goods and services was 100 in December 1929, and one could see that the economy had not been affected. However, by December 1933, the GNP had dropped to 70.2, a decline of approximately 30%. To me, in today's panic, anything that the forecasters claim that will happen is suspect. This is because the banking system completely failed in 1932-1934 with a run on almost every bank in the country. Today, the banking system is backstopped, there is unemployment insurance and other safety nets like Medicare and Medicaid. The huge monetary impact of deposit flight and destruction, and the unwillingness of the Federal Reserve to counteract is the key reason why the US Recession of 1931 developed into the depression of 1931-1932. Banks react normally to deposit flight by selling their more liquid assets to bolster their balance sheets. This includes treasuries, gold, corporate, and municipal bonds. The Federal Reserve has made it clear that they have learned from their mistakes of the past they will do whatever it takes to stabilize the financial system. This time, they have been quick to act.

Interestingly enough, seemingly defensive sectors of the stock market, such as food stocks, offered little protection because the stock market was overvalued by September 1929. While bond prices had been declining, they significantly outperformed stocks. Overvalued equities became undervalued within three years. Today, overvalued equities became fairly valued within one month. Stock prices dropped once again by the start of 1933 but improved greatly from 1933 to 1937 when there was a mild recession. The period between July 1932 and March 1937 was one of the greatest bull markets in U.S. history. The DJIA rose 370% during this period when the best estimate of the Consumer Price Index (CPI) showed an 11% rise in price levels. Cumulatively, the DJIA declined by 89% from 1929 through 1932. However, every investor who stuck it out was way ahead by 1937. In addition, an investor who invested at the bottom of 1932, secured an average dividend yield of 10%. However, if the investor had invested all of his or her money in stocks, without having a balanced portfolio of stocks and bonds at the peak in 1929, it would have taken him or her until 1949 to get whole. If we average 20 major declines between 1900 and 2018, we would find that the average decline is approximately 40% as measured by the DJIA.

Lessons from History:

As I mentioned earlier, no one knows the extent and magnitude of this pandemic virus. It is impossible to know what the ramifications on the economy will be. However, in my opinion, it could NOT be worse than the 1929 depression. If that is the case, then the range of equity declines should be between 40% and 50%. A balanced portfolio would be significantly less. However, this estimate is not certain, just an estimate because no one knows with any certainty. The Dow Jones Industrial Average as of Monday, March 23rd was down 36%. This could possibly mean that the market is nearing a bottom or has 10% to 15% or more to reach a bottom. No one knows the exact figure. In my opinion, GDP could drop to -30% at its worst, but I suspect it would be less than that because this Coronavirus may prove to be shorter-lived than the Great Depression.

The Game Plan:

In many accounts, we have limited the stock allocation to 35% or less, while the majority of accounts we have it more balanced between 40% to 55%. If you recall in my past newsletters, I have stated that I thought the stock market valuations were stretched, overbought and overvalued. In response, I had lowered the stocks to bond ratio from approximately 65% for the TV accounts to somewhere in the 50% range. On the whole, a week or two ago, I had trimmed even further and brought the stock portion down another 5% or 6%. Each individual account will vary. So, going into the market decline, I feel we are in good shape and it would be hard for me to believe that our returns would be approaching the Dow Jones Industrial Average's even with bonds giving up approximately 5% of their gains YTD.

In the past month, I have had only 3 out of approximately 150 clients insist that I sell. One person was so scared, he even yelled at me when I told him not to panic. Otherwise, the phones and my email have been relatively quiet. I just want to let you know that I and my partners are thoughtful, deliberate, and are not panicking. As history has demonstrated, the big money is made at the bottom of markets, not the top.

We have already started to buy beaten up, but creditworthy municipal bonds. It might be too early to bottom fish for stocks, but we are not in the selling mood either. When the opportune time comes along, and it will, I will increase the stock allocation back to 65%, but slowly. Once all this stimulus kicks in after the pandemic recedes, I suspect that all of the liquidity in the system will have an upside effect on stocks. I don't know how long it will take for us to fully recover. If it is a V-shaped recovery, the time frame will be much shorter. If this pandemic persists or the economy really deteriorates it will be much longer. One thing I do know is that the stock market will not go to zero or even close to it and that it should recover nicely. If there is value, I am a buyer. Remember the laws of physics, for every action, there is a positive and equal reaction.

Having a bond and gold component, in my opinion, certainly helped lessen any loss in the total portfolio. This will continue and maybe those who insist that they have a total stock portfolio will learn the lessons of the 1930's and that of the 2020's. In my opinion, it is simply too dangerous to do so.

Once this debacle is finished, I suspect in a few years, there will be a large increase in inflation. We will need to pivot the portfolio towards those securities that will do well in such an environment. As it turns out, some of our stocks fit that very mold. We will also start to increase our positions in Treasury Inflation-Protected Securities and gold. But for right now, we are watching and waiting, building up our buy list and waiting for the right opportunity. You will be thankful that you stuck it out and if all goes right, you should be handsomely rewarded. By the way, I don't' see Warren Buffett selling anything.

To quote Benjamin Graham, whom I have studied his investing principles that guide me today, "Through chances various through all vicissitudes, we make our way." Good night.

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