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O'KEEFE STEVENS
ADVISORY, INC.

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The Value Connection

Our mission is to be responsible stewards of our clients' financial lives.

Welcoming Back Volatility

Written by Justin Stevens

The first quarter of 2018 reminded us of the "price" we pay to be equity investors. That price, called the equity risk premium, is experienced when equity prices fluctuate based on the fears or euphoria of the investing public. The year began with a surge in prices in January, followed by a correction of 10% in early February. At the end of March both of the major U.S. indexes were down slightly for the year. Our portfolios, which currently have a heavier allocation to real estate, dropped by more than the market averages. Nevertheless, income streams on most of our individual holdings continue to see high single digit increases with several of our top holdings increasing their dividends moving into 2018.

During our *Value Conversation Quarterly Call* we reviewed a chart looking at the last 38 years of S&P 500 returns. 29 of the past 38 years posted positive results, and during every single year going back to 1980 there was a point during the year where the market was in negative return territory with an average year drop of 13.8%. An investor who stuck it out during those 38 years compounded their wealth by nearly 12% with dividends being reinvested. While there was lots of volatility during that time, the disciplined investor would not look back and think, "Wow, what a risky strategy that was!"

To further emphasize this thought I've pulled a small section from Warren Buffett's 2018 Letter to Shareholders of Berkshire Hathaway:

> *Investing is an activity in which consumption today is foregone in an attempt to allow greater consumption at a later date.*
>
> *"Risk" is the possibility that this objective won't be attained. By that standard, purportedly "risk-free" long-term bonds in 2012 were a far riskier investment than a long-term investment in common stocks…*
>
> *I want to acknowledge that in any upcoming day, week or even year, stocks will be riskier – far riskier – than short-term U.S. bonds.*

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Welcoming Back Volatility Continued

As an investor's investment horizon lengthens, however, a diversified portfolio of U.S. equities becomes progressively less risky than bonds, assuming that the stocks are purchased at a sensible multiple of earnings relative to then-prevailing interest rates.

It is a terrible mistake for investors with long-term horizons – among them, pension funds, college endowments and savings-minded individuals – to measure their investment "risk" by their portfolio's ratio of bonds to stocks. Often, high-grade bonds in an investment portfolio increase its risk.

pg. 13, 2018 Berkshire Hathaway Annual Report

The investment process portion of our quarterly call focused on key attributes of shareholder-friendly companies. Increasing dividends and share repurchases made at attractive prices continue to be some of the key elements that alert us to managers who treat their role as stewards of our invested capital. We received some great questions before the call and we will continue to record and archive these lessons on our O'Keefe Stevens Resource Page on the website.

Be on the look out for changes to the portfolio this quarter. We continue to "concentrate" to our highest conviction ideas. While the changes made in your portfolio are done on a discretionary basis, we want you to be informed and feel comfortable with the positions you're owning. You're welcome to call us with your questions, and we'll continue to provide you with information in our emails, newsletters and quarterly calls.

Investing in Shareholder Friendly Companies

Written by Peter O'Keefe

It's been said, and I agree, the most important role of the chief executive officer of a company is capital allocation or simply how a business deploys its resources. Two companies with identical operating results and different approaches to capital allocation will derive two very different long-term outcomes for shareholders.

During our most recent *Value Conversation Quarterly Call,* Justin reviewed the attributes of shareholder friendly investments. These included increasing dividends and well-timed stock repurchases. These activities are examples of capital allocation and the call highlighted several of our top investments you hold in your portfolio with these attributes.

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Investing in Shareholder Friendly Companies Cont'd

To expand on that discussion, I thought it would be helpful to look at the other options for allocating capital that we analyze when looking at a business. A CEO has five choices for directing resources:

1. Pay a dividend
2. Payoff debt
3. Invest in the business
4. Acquire additional businesses, and
5. Buy back company stock

Many people consider Warren Buffett the greatest capital allocator of the 20th Century, but there are other wonderful allocators of capital in the world of business. We recommend reading the book, *The Outsiders*, which outlines eight CEOs (including Buffett) who excelled at allocating capital and ran businesses that produced off-the-charts results during their tenure as leaders. How they "pulled" these five levers, in very different ways, were what made them outstanding executive officers. We are constantly on the lookout for "outsider" CEOs, who understand capital allocation and have a track record of success.

It is not just capital allocation that a chief executive needs to succeed. CEOs need to do two things well to be successful: 1) run their operations efficiently, and 2) deploy the cash generated by those operations. Without well run operations cash flows can be unpredictable and unstable. It's important for the business to be structured efficiently and for employees at all levels of the organization to be incentivized properly.

Another aspect of capital allocation, in addition to the 5 points I outlined, is how a CEO goes about raising capital to allocate. The most obvious way is to use the funds generated from operations, but there are really 3 options for raising capital:

1. Tapping internal cash flow
2. Issuing debt, and
3. Raising equity

Companies that print money through operations are by far our favorites. Generally, we're wary of businesses that issue a lot of debt, but there are many investors who have profited tremendously from CEOs who skillfully deploy this tactic. Likewise, companies that must issue new shares and dilute the existing shareholder's value do not generally excite us, but there are many businesses that have grown exponentially when capital is raised this way at the appropriate time. As an investor, it is important to understand these different methods for raising capital and know your comfort level with each method when selecting your investments.

Investing involves looking at many aspects of a company and these are some of the most important aspects we consider. If you have any questions we are happy to answer them and we will continue to provide insights on our process in these newsletters and on our quarterly calls.

Investor Suitability Statements

Over the course of the next eight months most of you will receive and be asked to sign our Investor Suitability and Investment Policy Statement. We will be sending these out via DocuSign or regular mail. You may have already completed and signed this document. The purpose of the document is to outline the parameters for selecting investments in your portfolio. We ask you to review this document, provide any necessary information and return the document to us.

The Securities and Exchange Commission (SEC) recommends using an Investor Suitability and Investment Policy Statement to ensure full compliance with the fiduciary standard. We set up O'Keefe Stevens Advisory and our highest priority is to operate according to this standard. Our fee only, discretionary investment management model is designed to place your interests and intentions first and foremost in our working relationship. When you receive this document, please let any member of our team know if you have questions. We are always happy to assist you.

Upcoming Event

O'Keefe Stevens Advisory Value Conversation Quarterly Call

When: Wednesday, June 6th, 2018 at 4:00 PM ET
How to Join: Visit http://join.me/okeefestevens
Dial in by phone: 1 (646) 307-1990
Enter conference ID: 734-977-219

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Please be advised that our disclosure document, Form ADV, is available upon request. As a reminder, always let us know if your investment objectives have changed.

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