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The Value Connection

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

O'KEEFE STEVENS
ADVISORY, INC.

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Navigating Volatile Markets

By Justin Stevens & Peter O'Keefe

The past few months were unique times. We have been mindful to stop and appreciate some of the blessings this crisis has afforded us. The silver lining is the gift of time with our loved ones and being able to spend more time doing the things we enjoy. This great pause in "normal life" will lead us to an improved version of normal. We will face challenges as we navigate the transition. Yet, our optimism remains steadfast. We want to share some of our recent activity between March and June. The goal is to explain our approach in these uncertain times and the roots for our conviction.

Examining the Value Investment Philosophy

The value approach to investing is in a challenging period. The performance gap for value investors is significant. The fear of missing out on returns is difficult for some investors to stomach. Investors are asking: why would you stay with the value style of investing? And, what makes us believe this performance gap will close?

One of Peter's initial efforts in March was to examine the Value Investment Philosophy. Peter committed to re-read the highlights from books in his investment library. The gift of time was not lost on this guy. He reviewed over 10 investment classics in March and April. The main takeaway: the volatility we are experiencing today is not unique. While the cause of each bear market is unique, the clouds will clear and reward patient investors.

It is also not unusual for the value discipline to go through periods of underperformance. Bear markets often favor value investors, but not always. Today, we see growth strategies (fueled by technology stocks) pulling away from value. Expectations remain lofty for growing technology businesses. We are witnessing that firsthand with our investments in Qualcomm and Nvidia. High expectations are an investor's friend and enemy. When real outcomes exceed expectations, investors gain. If outcomes are less than expected, investors lose. Our style thrives on identifying opportunities where expectations are dull. We look for situations where the real outcomes are likely to exceed expectations. This relationship between expectations and reality is what drives markets. Today, there are lofty expectations for many fast-growing businesses. That created a premium price environment for those companies' stocks. It is a dangerous situation to chase, and it is why we are staying the course with our strategy.

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As far as underperformance or outperformance goes, we do not spend much time thinking about it. Our main objective is to meet your income needs and long-term goals. We focus on those areas and we continue to see success across our client base. The performance of accounts compared to the indexes will vacillate over time. No strategy always outperforms. We remain confident that your investments will provide goal-reaching returns.

I have recited this story many times over the recent months, but it is worth doing it here again. If you have ever been stuck in heavy traffic, you will know what I am talking about. You are in the non-moving lane and seeing all the other cars in the lane next to you speed by. So, you put your blinker on and switch into the fast-moving lane. It never fails, that lane comes to a stop, and the lane you were in starts moving. The same thing happens in investing. The best way to get through the traffic jam is to stay in your lane. Things start moving again and you will catch up.

Examining At-Risk Holdings

The economic shutdown impacts certain companies and sectors to a greater degree. Hotels, Commercial Real Estate, Retail, and Energy investments will take years to recover. The question we ask is, "does our initial thesis still hold true" for each of our troubled holdings?" If that thesis remains intact, it is unlikely we will sell our holding. If our thesis is no longer valid, we look to exit the investment.

This was the case with Sun Hung Kai Properties. The things we loved about the business (family-operated, terrific balance sheet) still exist. But, the tensions between Hong Kong and China are too much of an unknown. Also, there is a considerable amount of office space in their portfolio. The impact that work-from-home will have on commercial landlords is tough to estimate. For these reasons, we exited our position in Sun Hung Kai.

We reexamined the at-risk positions in the portfolio and chose not to sell most of them. This may end up being an opportunity cost in the short run, but we are okay with that. We want to be intimately familiar with a business and its management. The effort that goes into this is enormous upfront. Intimacy and confidence allow us to stock up on these businesses when they go on sale. When we do it well and maintain patience, our returns increase over time.

Adding to High Conviction Investments

We moved fast to add to our favorite companies when their prices dropped in March. Seeing the price of an investment we love drop by 50% of its value in a hurry is not something we generally witness.

Being intimately familiar with our companies helps in these types of challenging times. Well-capitalized businesses with owner-operators pose fewer bankruptcy risks. If most of the management's personal wealth is in the business, they tend to avoid bankruptcy. A restructuring through bankruptcy might relieve financial stress for the corporation. It also wipes-out the owner's equity value.

In most of our Real Estate investments, the stock today trades at a discount to the value of the assets. If revenues do not recover, management can sell these assets to add cash to the balance sheet. We saw this with our Kimco Properties investment. Kimco sold over 100 open-air shopping centers in the private market last year. Most of these sales were at premiums to the value of the current stock. This improved Kimco's credit rating and provides optionality in a time of distress. Because of these dynamics, we continue to add to these positions.

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Other compelling opportunities exist in the energy space. A crisis is a catalyst for consolidation. Because the market is a function of supply and demand, excess supply yields lower prices. When the price of oil plummets, many energy-related businesses become unprofitable. These companies will halt production, choose to sell, shutdown, or restructure. This environment also creates an opportunity for the best-financed companies. When supply and demand rebalance, prices will rise again. We want to own the companies that can weather (and improve during) this kind of storm. Tidewater, Subsea 7, and Teekay LNG are all examples of these businesses. We could not have guessed that the oil industry would drop more than it already had in prior years. But, our thoroughness in understanding the balance sheet of the companies paid off. We are confident to add to these positions when investors have available reserves. And, we have already seen a significant uptick in the price for purchases made in these stocks in March and April.

We are finding the deepest discounts in Real Estate, Energy, Financials, and Media. We keep increasing our stake in our current companies: Five Point Holdings, Kimco, Tidewater, Teekay LNG, Bank of Ireland, Franklin Resources, Loews, and Discovery Communications. Write-ups on the current condition and our thought process are always available. Please let us know if you have any questions.

Looking Forward

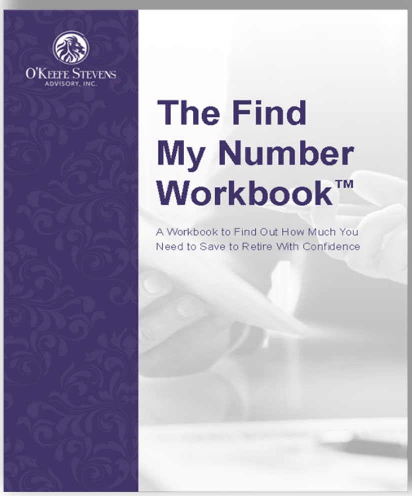
News of the reopening of the global economy changes daily. As far as we can tell, we are still in the middle of a period of great economic uncertainty. And investors hate uncertainty. Because of this, we expect volatility to continue. We learned to appreciate this uncertainty that so many investors loathe. Knowing the fair price of our investments makes us comfortable adding to them. This is especially true when the outlook is bleak in the short-term. Expectations tend to be overblown in times like these. If real-life outcomes prove better than expected, patient investors will profit.

Our biggest concern today is not volatility. It is inflation. Our government spent trillions of dollars to bolster the economy. It was necessary at the time. The unintended consequences of this decision are unknown today. We suspect the Fed will suppress interest rates as long as possible. This makes sense because the US Government is the world's largest payor of interest today. Big tax hikes are unlikely right now. Although, this could change if administration changes occur. Inflating the US Dollar makes it easier to pay off debts. These debts are less of a burden when paid with less valuable dollars in the future. This is a good thing for debt reduction, but it means you are going to experience cost increases. The cost of everyday goods and services will go up if the value of our dollar declines.

Stock ownership and real estate ownership protect against inflation. These assets adjust to higher price environments. Dividends and rents tend to provide an increasing income stream year-over-year. Cash and fixed income holdings are most susceptible to inflation pressures. Today, we see a massive imbalance of cash holdings (compared to historical averages). As these funds enter the markets for greater yield, stocks will benefit. Our advice is to stay patient. This too will pass.

Educational Workshops

By Carly Flanigan



All participants receive a fillable PDF guide to find their number.

We created an educational workshop titled "How to Figure Out How Much You Need for Retirement". Justin is presenting it monthly via web conference. Attendees will learn about the important variables that impact their retirement preparedness. Participants also receive a step-by-step workbook. This tool helps to figure out the exact financial resources needed to retire.

The webinar is suitable for participants of all ages. If you are saving for retirement, it will help to identify if you are on track. We are also opening these webinars to the public. Please contact Carly Flanigan at carly@okeefestevens.com to register.

Dates for the webinar:

Tuesday, June 28th at 12 PM EST
Monday, August 24th at 4 PM EST
Wednesday, September 16th at 12 PM EST

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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.