Vol. 7 Issue No. 4 October 2020

O'KEEFE STEVENS
ADVISORY, INC.

The Value Connection

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

Fall Review 2020

By Justin Stevens & Peter O'Keefe

This year was full of fear, uncertainty, volatility, and change. Families are suffering from the loss of loved ones. Workers are suffering from the loss of jobs. Retirees lost precious time to travel and enjoy life. And we all lost the personal connection with other people during the time in quarantine. These losses are terrible and very real to us. Our first thoughts are for the safety and well-being of you and your families.

Markets are recovering, indicating a sign of hope for our future. Yet, the toll from Covid-19 continues to rise. The economy is improving but still struggling. The election is weighing on the minds of the American public and the implications for our future. And the vaccine that should help speed up the return to normal is still a way off. This year is unlike any other for many reasons.

As stewards of your wealth, we remain committed to keeping your focus on the long-term. Years like this one can make that work more challenging. We are thankful because our clients have remained invested. Those of you who can add to your portfolios have continued doing so. This will prove to be a good decision when we review your plans in future years. Our commitment remains to helping our clients achieve their goals. We thank you for the continued trust you place in our team.

It goes against human nature to embrace times of panic and fear. Yet, it is these exact emotions that produce the bargain prices we look for when making investments. The market's steep decline in March provided outstanding opportunities. Today, the rebound and recovery still has many investors feeling confused and uncertain. Panicking and getting out of the market proved to be an expensive opportunity cost. The reality is short-term price movements of the stock market are unpredictable. We do not know where the market will be six months to a year from now, in any circumstance. The best thing we can do, is prepare for the uncertainty when times are good. When we face uncertainty, the best option is to act according to the long-term plan we established.

We have the benefit of decades of successful investing. There is always some crisis, or "apocalypse du jour" facing investors. We avoid making short-term predictions and stay focused on long-term wealth building. The best way to do this is to own stakes in companies with durable and profitable business models. Today, there are countless opportunities in these types of businesses. We can buy many of them at reasonable or even bargain prices.

The market's recovery is attributable to 30 or less technology related businesses. You would recognize many of the US based company names: Amazon, Microsoft, Nvidia, Apple, and Advance Micro Devices. The price of these companies appears stratospheric by our valuation methods. It is a tale of two markets today. One in which recovery is slow and firmly attached to economic reality. The other, which is fast and predicated on continued improvement and unceasing optimism. We have seen this story before, and we know it does not end well.

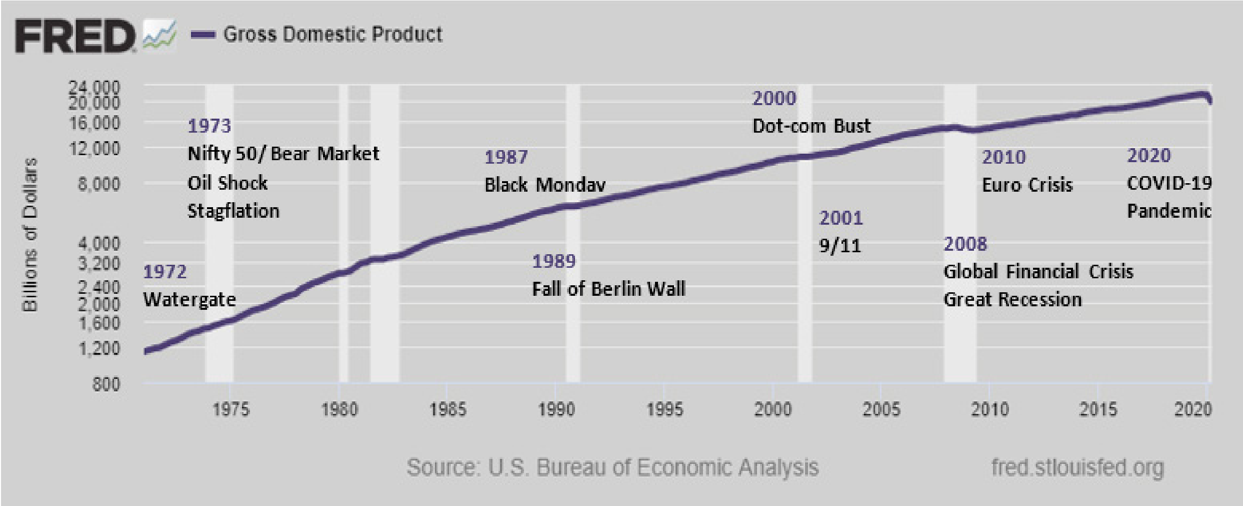
We remain convicted about the positions we own in your portfolio. This pause in the normal routine provided us with time to think, to analyze, and to invest with discipline. This process has proven successful at building the long-term wealth our clients seek. It requires a detachment from the relative performance of other investors. It requires patience and fortitude to stay the course. We know it is not always easy.

The election is a concern weighing on the minds of many investors. We featured an overview of the impact elections on markets in our recent Quarterly Call. This call and all previous calls are available for replay on our website. If you need help locating them, please reach out to our team. They're located in the Resource tab on our website, www.okeefestevens.com.

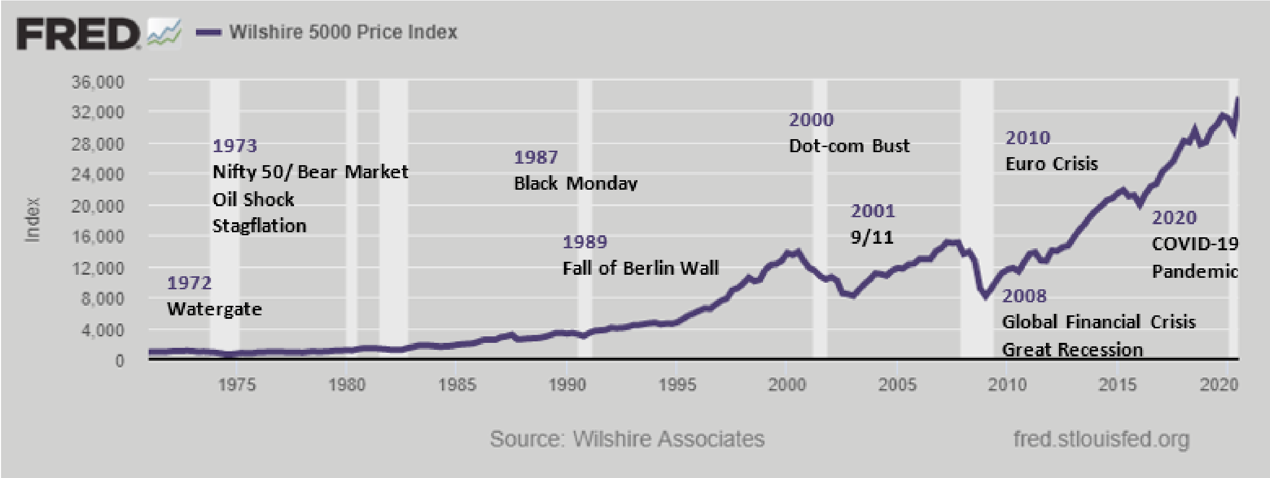
Investing through crises and uncertain times

Today we face unprecedented circumstances. It is hard to compare our current situation with past crises and market corrections. But the reality is these shocks to our economy and the markets are not new or different. We have experienced dozens of disturbances to the steady growth of our world and economy. Sometimes they relate to politics or geopolitical tensions. Other times its economic crises or stock market crashes. Yet, we have a history of enduring these disruptions.

This chart shows our nation's growth of economic activity since 1970. It illustrates some of the more pronounced events during the last 50 years. Each was scary and serious in its own way. As a nation, we survived these events and continued to make progress. We are resilient and we know how to adapt to changing circumstances. Our economy is flexible and adaptable. Despite these dramatic events, we continue to experience growth as a nation.



The businesses we own are full of talented people who stand ready to adjust, if necessary. And we benefit by learning through the crises as they occur. This ensures we will be stronger the next time something like this happens. The next chart shows the growth of the Wilshire 5000 stock index. The growth of the great companies in the United States continued to progress in value despite these unsettling events. This time is not going to be different. We will continue to improve, adjust, and adapt to the changes in the world. We will continue to make progress as a nation and so will with great businesses around the world.



Value investing in today's world

Our mission is to be responsible stewards in our clients' financial lives. We do this by seeking long-term growth of their capital through value investing. Many of you have trusted us for decades and we have achieved this goal over longer-term periods. Yet, in recent years our performance has lagged, both on a relative and on an absolute basis. Newer clients may second-guess the approach. Market indexes have rallied in the current climate and value returns are sluggish. It can be frustrating. But our discipline and patience are what provide us an advantage over time.

Value investing goes through periods where it is out of favor for many years. In 1999, Barron's magazine published an article about Warren Buffett. The article claimed he lost his touch. He and many other value investors avoided the high-flying technology sector. And, in the end, they benefited from their patience. That period was not much different from the market we see today. Momentum investing has taken hold of the investing public. The more an investment rises in price, the more attractive it becomes to buyers. The process continues to self-reinforce. More and more investors become attracted to buy the investment. Soon enough, people are buying because they fear missing out on the great returns. Tesla is, in our opinion, an excellent example of this self-reinforcing momentum.

There is no telling when the momentum will stop. It may continue for years and we are okay with that. We follow our disciplined approach because it makes sense to us. We do not understand the momentum model. It lacks the fundamental substance we need to act with confidence. The stocks we own are stakes in real businesses. These companies provide valuable goods or services to the world. They produce earnings and have well-formed plans to grow those earnings in the future. We recognize value investing has fallen out of favor. Yet, it is logical and has worked throughout history. Trying to follow the fad is a losing proposition.

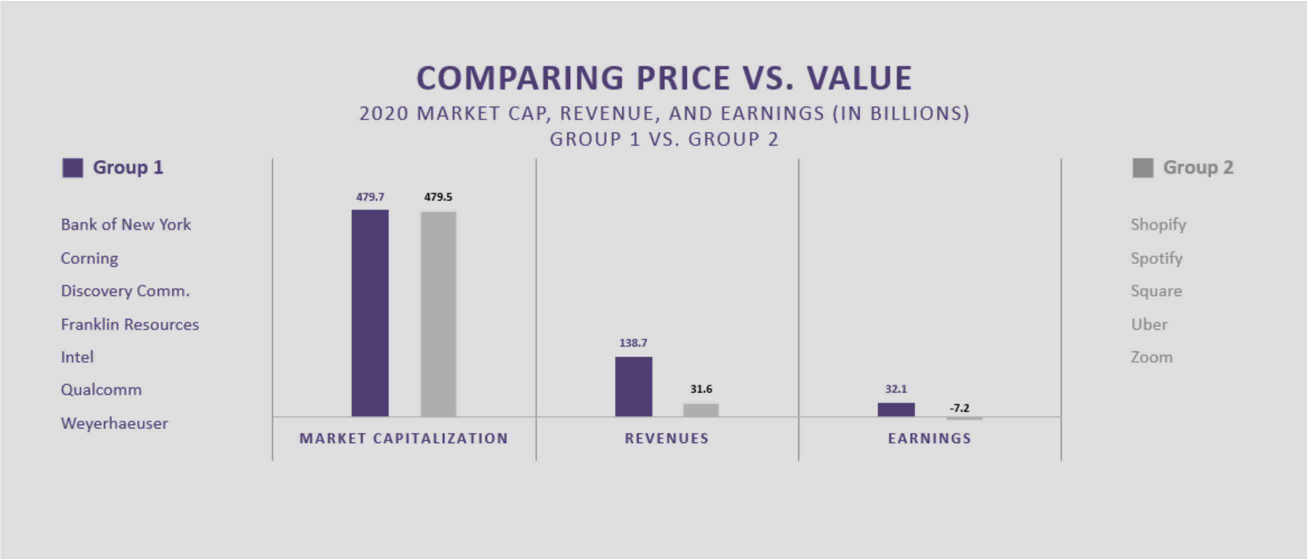
Our portfolio is a well-balanced mix of durable, well-managed businesses. We hunt for companies with the right set of characteristics. Businesses with low or no debt relative to the owner's equity in the business. Significant cash assets and free cash flows from operations. These companies are far more likely to survive difficult times. Also, companies with unique, valuable, or irreplaceable assets are attractive to us. And we like it when we can buy them at reasonable or discount prices. This tends to happen when these businesses face some near-term uncertainty. For that reason, other investors avoid their stocks. Today, we see more of these opportunities than we have in many years. This storyline is the perfect backdrop for a successful value investment recovery.

We have several examples of these types of investments in our current portfolio. Discovery Communications had revenues of $5.2 billion generated $1.1 billion in free cash during the first 6 months of 2020. Discovery plans to reduce the debt from the Scripps Network acquisition in 2018. The company is also repurchasing its common stock. The stock trades near its book value of $18/share, and at about a 50% discount from its high value in 2013. Franklin Resources had $1.3 billion of debt on June 30th, 2020. This represented only 12% of the total capital of the business. This conservative financing allowed the company to buy Legg Mason in July. Five Point owns California real estate assets in Irvine, Valencia, and San Francisco. We expect decades of development opportunities from these valuable properties. And we are seeing a massive shift out of the major cities as a by-product from COVID-19.

Companies with competitive positions in their industry are also attractive to us. Corning is the industry leader in glass technologies for a variety of industries. Teekay is a leading provider of marine transportation services for liquified natural gas. Weyerhaeuser is one of the world's largest forest products companies. We bought each of these quality businesses when others were avoiding them. They became unloved and unwanted by the investment community because of short-term uncertainty. When these issues resolve, the prices of these stocks will recover. Our charge is to be patient for the resolution of these issues.

Today, stocks fall into two distinct groups. On one side of the market, we have a basket of new and exciting technology companies leading us into the future. These companies trade at astronomical multiples to their revenues, profits, and cash flows. Investors can justify the extreme valuations. These businesses are spending to develop new products and expand their market share. The pandemic environment is favoring e-commerce, virtual meetings, and cloud computing. Their markets are larger than ever. Almost two-thirds of the world's population now has access to the internet via a smartphone.

On the other side, the majority of companies are lagging during the recovery. Their business results suffered during the global pandemic. Revenues, profits, and cash flows experienced a severe interruption. Their stocks sold off and their management teams had to make tough decisions. It is in this space that we find some of the greatest opportunities today. The short-term uncertainty is clouding investors ability to see the long-term opportunity. But the businesses are recovering. The management teams are skillful and prudent. They have a solid history of producing profits. But the market is not yet comfortable with allocating capital to these sectors.



We thought it would be helpful to illustrate this separation. We created two portfolios, each consisting of a small handful of companies. Group 1 includes seven companies in our portfolio. Each is a leader in their marketplace. All seven have conservative balance sheets and long-term competitive advantages. These companies include:

- **Corning,** the global leader in glass technologies;
- **Weyerhaeuser,** one of the largest timber landowners in the world;
- **Franklin Resources,** a global asset manager with 1.5 trillion dollars under management;
- **Discovery Communications,** a global media company with distribution in over 220 countries;
- **Intel,** the world's largest manufacturer of microprocessors;
- **Bank of New York Mellon,** the world's leading custody bank, established in 1785; and
- **Qualcomm,** the leader in mobile device technologies for network connectivity.

It costs $479 billion to buy these seven companies today. In return, you would generate $138 billion in revenues, and $32 billion in earnings. You would collect $9.75 billion in dividends. Their businesses are continuing to operate despite the pandemic. And their market-leading positions create a certainty of ongoing operations. While the near-term remains cloudy, these companies are going to endure.

Group 2 includes 5 exciting, but unproven technology start-ups. These businesses garnered a lot of excitement from the investment community. In our opinion, they have less than certain long-term futures. For the same $479 billion, you could buy a five-stock technology portfolio. It includes Shopify, Spotify, Square, Zoom, and Uber. These technology businesses generate less than one quarter the revenue of Group 1. They are also generating losses of $7.2 billion per year. There is no doubt these technologies are innovating our world. Yet, there is no proof these companies will endure and generate profits in the future.

Conclusion

The prevailing risk dynamic for technology stocks is not one that appeals to us. A comparison of the fundamentals shows that these stocks are riding high on enthusiasm. A shift in momentum or a loss of competitive advantage poses a serious risk to shareholders of these companies. Investors could see large scale reversion to more modest prices. Again, patience is a prerequisite for success in this type of market. While its challenging to see others making quick money, it does not pay to chase their results.

We will continue to own industry leaders with proven track records. And more important, current profits that meet our requirements. Our businesses will continue to grow and improve their competitive advantages. Even if they deteriorate, we remain protected because we have not overpaid for our stake in the business. This view is countercultural today. But it is our conviction this style of investing has worked best throughout history. We advise buying and holding stocks of well-financed, well-managed, and well-diversified businesses. This is how wealth is reliably built over the long-term.

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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.