QUARTERLY INVESTMENT LETTER
THIRD QUARTER 2018

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THE BIG PICTURE

How does Symons® Capital go about its intellectually independent research work, as we look for the best risk-adjusted opportunities in order to build durable wealth? We read, think and build considered judgments about future economic, market and individual stock probabilities. We use discipline and patience as we follow our developed path to the goal of building durable wealth through differentiated risk management. This means our portfolios are different from the market, and so they can both underperform and outperform the market at times. We steer portfolios away from risks we see on the horizon, even if we are not expecting those risks to come tomorrow. We currently don't see an imminent downturn, but we do think a sector rotation is likely. Because almost no one else is preparing for either risk event, it matters that we are. As we have discussed before in different ways, much of our risk management judgments are based on a basic knowledge of human nature — investors are most confident after a long stretch of smooth sailing, and that is when the odds of something going wrong are highest. As long as human beings are involved in financial markets, notable differences between rational prices and herd-like behavior will occur. It is our job to steer portfolios through the resulting risks and opportunities.

Big market events matter greatly when you are trying to build durable wealth. Twenty years ago, in August-September 1998, we had a financial crisis when Russia defaulted on its bonds and devalued its currency, which caused massive losses and the Fed/Wall Street bailout of Long Term Capital Management. In March 2000 we had a market crisis when the dotcom bubble burst, again causing massive losses. In September 2008 we had a financial/market crisis when the subprime lending bubble burst, causing massive losses of what, once again, turned out to be temporary wealth. In every case the "unexpected" financial/market crisis had been brewing for years, but few investors paid attention. Investors had ample time to change risky portfolio positions, but they didn't. Most investors didn't want to miss out, and were confident they could get out when the market started to reverse, but they didn't. After each of these big market events there were bargains galore for those who had managed risk and built durable wealth.

What has happened before will happen again. Simple behavioral biases will inhibit investors from taking sensible risk management actions almost every time. Are markets again telling us that another big event is on the horizon? No one knows, but the warning signs are there: high U.S. stock and bond valuations, both of which suggest below average future returns; huge consumer, corporate and government debt burdens; weak or no growth of consumer disposable income; trade/tariff tensions; economic problems becoming evident around the world — China, Italy, Turkey, Argentina, Indonesia, and others. Should these real-world concerns be ignored until something actually happens, or should they be factored in as part of sensible risk management? The question is not whether to take an all-or-nothing approach, but whether to adjust portfolios to limit the possibilities of downside risk, rather than waiting until reality catches up before trying to take action.

In general, it is hard to know whether the market will respond to a problem before, during, or after it becomes evident. Thus, when we see a problem on the horizon we're comfortable with being earlier than most in addressing it. For instance, in this go-around it seems likely to us that economic and stock valuation problems may begin to appear in the fourth quarter, but to some extent that was getting priced in during the summer as we started to see some sector rotation.

While many investors at this point may not feel optimistic, they continue to choose to take optimistic-type actions due to their fear of "missing out." Even though the stocks that have won in the recent past (FAANG) are unlikely to be what wins in the future, that is how people are largely positioned. We have chosen not to abandon our usual risk management approach. Perhaps the most specific aspect of the current risk environment is the FAANG-type stocks, whose prices continue to be based on what we view as unattainable future revenue and profit expectations. We prefer to focus on stocks with more sensible future expectations.

THE ECONOMY AND INVESTMENT MARKETS

Since the Global Financial Crisis ten years ago, the Fed has managed to shift risks from the Wall Street financial institutions to the other 99% of Americans, but none of the underlying problems of massive debt and too-big-to-fail banks have been resolved. Rather than Adam Smith's (author of *The Wealth of Nations*) "invisible hand" of millions of people making economic decisions that they deem best for themselves based on information relevant to their particular circumstances, the actions of the Fed and other central banks, through their ZIRP and QE policies, have been setting prices around the world for stocks, bonds, and money (interest rates). It would be preferable if the daily decisions of millions of human actions determined such prices. But we have to deal with, and adjust to, the prices as impacted by central bank actions. The Fed may be well-meaning, but they are not all-knowing or all-powerful.

Central banks around the world have purchased trillions of dollars of sovereign debt, keeping interest rates low, and allowing governments to issue more and more debt as the cost of borrowing steadily declined. Some central banks even purchased corporate stocks and bonds. How might these novel central bank actions affect the economy and financial markets? Will the Fed's actions of bailing out poorly run financial institutions, suppressing interests rates and purchasing financial assets cause a deflationary decline in the value of the mountains of debt added, or will the massive increase in the money supply chasing a more limited supply of goods and services result in serious inflation?

The Fed may be starting to worry about these issues. Back in the 1970s, massive inflation was only resolved when interest rates moved above 15%. Today, we are seeing a yield curve that struggles to maintain a positive slope. Either road can create economic stress and often recession. Recession typically brings lower rates. We don't know what path the Fed and the economy will take, but it is clear than any path can have negative market impacts. There are risks, and it is our job to manage them. All forms of government economic stimulus have created market risks. Too much money chasing too few stocks causes prices to rise to a point where the prices are not very attractive.

We don't know what future investor confidence levels will be. But we do know that investor confidence levels change and are not permanent. Since the last market peak in 2007, annual S&P 500® earnings growth has averaged less than 3% annually, and much of that has come as the result of profit margin expansion. Revenue growth has averaged less than 2% annually. Dividends are now below 2% annually[1]. Despite all the weak growth numbers, most investors only see the fact that the index has been growing at double digits annually. Is it reasonable to expect that disconnect will continue for the next decade?

EQUITY STRATEGIES AND PORTFOLIO MANAGEMENT

We do not believe that the old rules of stock valuation no longer matter. We do not believe that stock prices will always go up if you hold them for long enough. We do not believe that all current debt can be refinanced. We do not believe that central bank money printing creates value. And, we do not believe that central banks can support financial markets indefinitely. Do you want to trust your future financial wellbeing to the Fed and other central banks?

The value of a stock is independent of its price; its value is intrinsic to its enterprise. But today it is evident that many people disagree with that view. Rather, they believe that price does represent a stock's value. The price of Netflix will keep going up, and no one should care why. Rather, investors have confidence in a quantitative investment factor — say six months price momentum — regardless of whether it makes sense. This view of investing is dominating institutional asset flows in the form of passive index investing. Passive investing can build wealth; it's just not some magic answer. It has a tendency to overinvest in what is popular, and thus generate runs of good and bad performance with lots of volatility. With this approach, what comes at supposedly low cost also comes at great expense in the long run because they have purchased an illusion of value. How do corporate managements view these two paths to building wealth? Insider selling is now at the fastest pace in the last decade.

We believe that stock market risk can be managed, and that durable wealth can be built with constant attention to risk management. We believe that the time of peak GDP growth is coming. Perhaps in 2018; probably in 2019. In the meantime, we will continue to build durable wealth, but will not chase the happy momentum stocks over a cliff. Events rarely turn out as expected. Early in the year investor flows poured out of safe assets and into tech. Economic data generally continued to be strong, but we did begin to see some cracks. We have seen narrowing leadership, increased divergence among individual stock movements, and weakness in corporate bonds. Perhaps that is why the market tide started to turn (not dramatically), getting better for our safe, generally defensive and high quality stock stance. At this point it looks highly likely that forward economic results will be solidly in favor of our portfolio positioning. On the one hand, the year is 75% done. But on the other hand, quite a lot can happen in a short period in either a market rotation or a downturn. While we don't expect this time to be so dramatic, we always like to point out the example of 2000. From March 10, 2000 to March 31, we went from tech, media, and telecom massively outperforming to underperforming. Those ugly value stocks looked a lot better on March 31 than they did March 10. Again, we'd bet we never see a rotation that violent again in our lifetime, but we wouldn't be surprised to see an echo of that over the next year or so. Further, we expect our basic current portfolio positioning could serve us well for years to come.

CONCLUSION

At this point in 2018, the US is the only developed country in the world that has generated a positive year-to-date stock market return. Europe, China, Japan, Canada, Mexico and all the rest are in negative territory.

It is fair to say that we have more economic and market uncertainties than usual. With our constant goal of building durable wealth through continuous risk management, we prefer to turn away from seeking full participation in hoped-for gains, and turn towards seeking risk/reward opportunities that allow us to build durable gains while limiting downside risk should a decline happen. While investors would like to have it both ways, that wish is unrealistic. Market conditions make this a time for caution. It is important to pay attention to risk indicators and to have a plan.

We do not expect a major downturn in 2018. Virtually the entire wall of money created by the central banks is still there. Nor do we see any sustainable upside to the current stock market. While corporations have benefited materially from federal tax reform, that is a one-time boost. All the other concerns noted above remain with us.

When might the current optimistic investor psychology end? When investors stop believing that economic growth can be created simply by creating more money and more debt. While other investors still believe, we doubt, and so we are ready for the eventuality of change. We are prepared for uncertainty, change, and some hard truths about sensible investing and the importance of risk management in building durable wealth.

Yours sincerely,

Ed Symons, JD
Chairman & Founder

Colin Symons, CFA
Chief Investment Officer

[1] (John P. Hussman, "Eternal Sunshine of the Spotless Mind," *Hussman Market Comment*, September 2018).

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