SYMONS® CAPITAL MANAGEMENT

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SUNSHINE, STORMS, RISK/REWARD AND DURABLE WEALTH

THE BIG PICTURE

"When the music stops, in terms of liquidity, things will get complicated. But as long as the music is still playing, you've got to get up and dance." Chuck Prince, CEO, Citigroup, July 2007.

From that statement in July 2007 to March 2009, Citigroup stock lost over 95% of its value, even though the Fed was continually easing monetary conditions. When investor psychology changes from risk indifference to risk aversion, for whatever 'unexpected' reason, Fed liquidity doesn't support stock prices because investors prefer the safety of cash over the newly perceived risk of stocks. History shows that you can't rely on the Fed, or Congress, to maintain a permanently high plateau of stock prices. History suggests risk management, where you align portfolios with the constant changes in risk/reward balance, is a creditable path to weathering storms and enjoying the sunshine. If you are prepared for dealing with the unexpected, you can enjoy the winding trip through sunshine and storm to building durable wealth.

How much equity risk do we want to take to generate the returns we want to get? For years the majority of market inflows have been going to passive investments to the point that, for the first time in history, passively managed assets now exceed actively managed assets. Because passive inflows are passively allocated, the biggest stocks get the biggest inflows, regardless of underlying valuations or risk/reward. A corollary is that when 'unexpected' selling happens, the biggest stocks will see the biggest outflows. There is no risk management in the passive flows. Stocks don't need earnings to go up; they just need the steady inflows from retirement plans and other sources — until something critical reverses those flows.

In this passive investing market, there has been a 12-year increase in equity valuations (briefly interrupted by the Covid panic downturn in 2020), a far greater increase than gains in GDP or corporate earnings. The equity gains are principally fueled by unprecedented low interest rates. Yields matter a lot in making investment choices. Low rates make bonds unattractive and incline investors to believe they have "no alternative" but to put their money into (mostly passive) equities. If interest rates rise unexpectedly, consider what might happen to the current historically high stock valuations, particularly for popular growth stocks.

In addition to passive inflows, current stock market valuations involve a considerable bet on the certainty and effectiveness of Fed supports. Interest rates affect all financial activities. The Fed has been suppressing interest rates for at least a decade and suppressing rates messes with the corrective process. The result is that the Fed has delayed and concentrated both economic and market problems, so that the risk of unexpected change is large. We are agnostic about when any such change might occur. Macroeconomic and fundamental stock data include these lurking concerns, and so they are part of our risk/reward investment process. We currently have the conditions for a storm, which doesn't mean we will get it. But it does mean that with our current portfolio setup we are reasonably well prepared. Change is constant, and we pay attention every day.

THE ECONOMY AND INVESTMENT MARKETS

It's always good to have some understanding of why things are happening in markets, because then you can better get your hands around emerging problems or opportunities on the horizon. If you know why something happened, you can better understand how it may change the path of potential investment choices. We believe there currently are a number of issues that potentially matter.

"No clear direction" describes most of the recent economic data. One example is retail sales that were better than expected, but mostly due to a downward revision for the prior month. Recent jobless claims have been a bit worse than expected. Industrial production data has looked a bit weak and there is a steady stream of negative economic news out of China. Consumer inflation data indicates an annual rate around 5% but appears to have calmed down some.

For years now we have seen economic problems on the horizon, but they've been in the distance. Today, you can make a decent case that we've seen the peak of 'Covid recovery' economic growth and perhaps the market top for the year. Call it Code Orange. For Code Red, we're going to have to see the start of a sustained downturn and more worrisome problems. There are plenty of those around, and there is a real chance that by Christmas some troubling problems will be obvious.

We are beginning to see a deterioration in the basis for GDP. For the last 18 months a big chunk of GDP has been money printed by Congress — stimulus. That temporary support likely will fade, and the economy is struggling to replace it with real economic activity. While we could allow for the possibility that stock valuations stay high for years despite a slowing economy, we don't want to rely on that view — even as many investors have been doing precisely that, principally because they believe the Fed or Congress will again save the markets from any real pain.

Here are some of the longer-term issues. First, will the Fed taper its QE asset purchases; raise interest rates; or begin to indicate that inflation may not be transitory? Then there are other issues, like the debt ceiling (Congress passed a Continuing Resolution to avert a government shutdown through December 3, but remains deadlocked on raising the debt ceiling), business issues (employee availability, supply chains, their impact on economic growth and corporate earnings), and further Congressional stimulus. The debt ceiling is likely to take a while. It always does and, with no one getting along, we may not see a quick resolution. Most of the time, the debt ceiling gets raised or suspended in various ways, but not always. Longer-term business issues ultimately tend to focus on corporate earnings. Earnings estimates tend to be optimistic until they diverge from reality, and it's starting to look like that's where we are. And every day it looks like Congressional stimulus will be smaller and take longer.

INVESTMENT STRATEGIES AND PORTFOLIO MANAGEMENT

What should we buy or hold given this economic environment? Broadly, companies that do well during risk-off periods. We already own quite a bit of that, but we may be starting to enter a period where it makes more sense to narrow our focus even further. Goldilocks-environment (steady, modest economic expansion with low interest rates and modest inflation) stocks have continued to work, but that's starting to look riskier. You can always find individual stocks that can make sense, but in general, this seems like a good time for utilities, staples, precious metals, and similar stocks — perhaps some health care. The details should become clearer in time, but for now, it looks like the speculative frenzy we've had over the last 18 months is on the way out. Retail investor participation in the market is slowing and many of their favorites have begun to struggle. Going forward, if you're going to invest in the Tesla-type stocks, you'd better do it judiciously. There had better be a path to cash flows to justify the stock's price.

Large cap growth has been doing well for several years. Thinking several years into the future, expensive growth stocks (e.g., Tesla, Peloton) are almost certainly not the place to be. Right now, with many investors focusing on "factor" investing (e.g., momentum, trend, etc.), growth is still very popular. Our judgment is that expensive growth will struggle to outperform going forward, which is why we're underweight there and recently trimmed our positions in AAPL and FB. That said, they're still an option according to many, and some even view them as bond equivalents. At some point we believe that breaks, and probably in the next year. So, we have some growth stocks, but are tilted underweight. We tend to buy selected cheap and unloved stocks, which is how many define value. That doesn't necessarily mean only industrials, financials, and energy. To us, that means things like quality defensive stocks, precious metals miners, and even cannabis.

Part of our job in managing or mitigating risk is to get in front of change before other people do. Consumer confidence has been declining, and we would not be surprised to see that trend accelerate over time. People keep hoping for a return to pre-Covid lockdown normal, but we see the long shadow of all the employment problems, supply chain issues, vaccine mandate fights, profit margin pressures, cessation of stimulus, and so on. Their impact seems likely to get worse. It may take some time to make this trend obvious to everyone, but that looks like where we're headed.

Right now, our stock portfolios have a bit of a barbell look. At the one end we have multiple opportunistic, but reasonably priced, positions in precious metals stocks along with a modest position in cannabis stocks. Precious metals stocks haven't done well in the last month or so — due to popular expectations of a stronger (Goldilocks) economy, and fear of taper pushing rates higher. On the other hand, we see long-term potential — precious metals stocks have their strongest free cash flows in decades, and they typically do well when M2 money supply is expanding and when real (net of inflation) interest rates are negative. Finally, precious metals stocks tend to do well when people start worrying more about the return **of** their capital instead of the return **on** their capital. So we see long-term value. Cannabis looks like a growth business. Generally, it has been legalized on the state level, but not yet on the federal level. We are seeing a lot of top line revenue growth, but valuations are still modest. Along with a few other holdings, these stocks are the "aggressive opportunities" end of the barbell.

At the other end of the barbell are the quality/safe stocks. In a weakening economy we are overweight in utilities and consumer staples stocks, and about equal weight in health care. Good quality companies are part of risk management — companies that can withstand economic storms, unlike companies that are fragile to the next change in the economy or rise in interest rates.

CONCLUSION

'Career risk' causes many investment managers to favor the passive portfolio path. It is safer being part of the herd because it is OK to fail conventionally when bad things happen. As we heard in both 2000 and 2008, "No one could have seen it coming."

We have our own money at risk, and we believe that risk management plays a central role in building durable wealth — not over a year, but over a lifetime, because that is the investment time horizon that really matters. Risk management may not appear to matter for years, but if risk management can limit the impact of material downturns, then risk-managed portfolios should have lower volatility and safer long-term compounded annual rates of return, because then the compounding process is not materially interrupted by a portfolio going over a cliff, as happened in 2000 and 2008.

When the market is dominated by Fed interventions and passive flows, it is evident that stock prices do not reflect the growth in economic value typically generated by growth in company cash flows and earnings. When there is no crash, it stands to reason that you would be better off with no risk mitigation. But that's not the point. The point is that the passive, non-crash path does not favor long-term success. You can't assume away downturns. Managing risk is how you get returns. Never lose sight of the whole cycle.

When something unexpected happens and investors begin to reduce risk and make withdrawals, fundamental valuation metrics will matter. Stock prices are likely to be judged, not on the basis of market capitalization size, but on the different paradigm of sustainable cash flows and earnings that provide a margin of safety against downside risk. We prefer to manage risk by looking at macroeconomic data plus individual company cash flows and earnings performance to decide what has sustainable value and a margin of safety.

Compounding of returns is a very powerful force on the upside; but it is a very destructive force on the downside. Every big loss stays with you forever. That is why Warren Buffett says that Rule #1 is — Don't lose money. And Rule #2 is — Don't forget Rule #1. Through risk management we can weather the storms and do just fine when there is sunshine.

Yours sincerely,

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