QUEENS OAK ADVISORS

"There seems to be an unwritten rule on Wall Street: If you don't understand it, then put your life savings into it. Shun the enterprise around the corner, which can at least be observed, and seek out the one that manufactures an incomprehensible product." ***- Peter Lynch***

January 4, 2019

To Queens Oak Clients and Friends,

Ten years into a raging bull market and robust economic recovery, it's not surprising that stocks declined as valuations became less attractive and volatility reemerged in 2018. Recall in 2017, the stock market advanced every single consecutive month and looked to be on a similar trajectory in early 2018 until the euphoria began to evaporate. Weakness started in the international and emerging markets that were most impacted by tariffs and currency declines vis-a-vis the U.S. The slowing international economies resulted in dramatic declines in energy prices in the second half of the year.

Market declines were further accentuated by higher interest rates as monetary policy continued to be less accommodative despite minimal signs of burgeoning inflation. As the fiscal stimulus was tapering off, the yield curve further flattened and partially inverted with five-year rates falling below three-year rates. The high-flying technology stocks, dubbed "FAANG," that previously had looked infallible, led to further market deterioration as issues surrounding privacy and data mining showed a darker side to the social media and technology industry. Additionally, the housing sector finally exhibited concern with rising mortgage rates, coupled with intensified trade confrontations with China as well as considerable drama over Brexit negotiations, resulting in a market with very few pockets of safety. Moreover, along the way there were a handful of thematic investments, including cryptocurrencies and cannabis, which proved even more disappointing to a speculative investor's well-being.

It is fair to say, most "gurus" never saw much of this coming, nor forewarned investors that bull markets simply do not rage on ad infinitum. In fact, a bull market has never lasted longer than the most recent. The U.S. stock market bottomed on March 9, 2009 and the percentage gain since then is the greatest since World War II driven by record levels of profitability and productivity gains. The prevalent saying has been that "bull markets do not die of old age." The result has been a Shiller P/E at near 30x and EPS growth that has been predominately the result of financial engineering through M&A and share repurchasing. Yet, Wall Street was still forecasting unbridled economic optimism and rosy market returns across most major risky asset classes last year including U.S. equities; few predicted the self-inflicted one-two punch of aggressive trade confrontations and a hawkish Federal Reserve.

In fairness to the tactical asset allocators who have the unenviable task of trying to time the market as well as outperform the benchmarks — in this environment there has been almost no place safe to invest. Most asset allocation strategies only subtracted from returns despite their claims of diversification. Our Queens Oak global asset allocation strategies were not left unscathed either, although our clients have benefited from our emphasis on domestic U.S. markets and large cap high quality stocks which have arguably held up the best over the past year. However, our allocations to commodities and emerging markets, albeit rather modest, proved anything but rewarding.

In the past, we have pointed out the advantages of investing with boutique firms for a better chance to outperform the markets and receive exceptional personalized client service. We have also been critical of the overdiversification of investments into too many funds and securities that result in index-like returns. We have long believed that the best predictor of success is to buy value-oriented investments. This does not eliminate down-side risk since risky assets are in fact risky because of the prospect of losing money. However, over time riskier assets like stocks generally provide a premium return over bonds, and bonds provide better returns than cash. Unfortunately, there are no "free lunches" in the investment world, but valuation has served as our guidepost to long-term investing.

The evolution of wealth management has turned many professionals into tactical asset allocators rather than stock-pickers or strategic allocators, with models trying to forecast every twist and turn in the capital markets in a timely manner—an exercise we have no illusion of trying to perform. We believe that investors unable to pursue a strategic allocation strategy should implement a predominately low-cost index-oriented approach to investing. The fees add up over time and unless the firm has some unique skill and the professionals are willing to take career and business risk to make the gut-wrenching decisions—it's best to allocate to passive investments via a simple 60/40 balanced fund or lifecycle fund with lower fees, trading commissions, taxes, and of course minimization of human error. We have always had a hefty allocation to index funds, particularly where we have no unique insights into the asset category, and I believe it's helped us save a lot of nickels and dimes along the way for clients—all of which truly compound over time.

In order, to be a good value investor, career risk and business risk are simply part of the calculation since you must have the courage to buy stocks and sectors that are out-of-favor and the conviction to sell securities that are beloved. Trust me when I say—easier said than done. The challenge is primarily a matter of timing. For example, if you sold technology stocks in 1997 or even real estate in 2005 because it looked expensive, you appeared foolish for over two years as valuations expanded and every other taxi driver in NYC was piling on. Of course, we have the benefit of knowing how this ended, but along the way it was not easy to explain to clients why you found these investments unattractive when their neighbors were still day trading tech stocks and flipping real estate for profits. I believe to be a good value investor, you should exercise patience and be willing to go to yard sales and clip coupons, rather than run to the mall and follow the lemmings.

So, at this juncture, late in the economic cycle and recovery, I believe the value sectors look attractive rather than betting on the sustainability of the high growth momentum stocks. Nearly 1/3 of small cap companies remain unprofitable, leverage has reemerged from the low interest rate environment, and new age technology stocks have wooed investors despite their recent correction. Thus, with housing softening and stock market volatility escalating, the negative wealth effect could also impact consumer spending. Consequently, our focus is on those oversold sectors that offer compelling value for the long-term investor.

Putting it all together, we primarily favor high-quality U.S. large cap value companies where skepticism is rampant, but free cash flow is highest. Outside of the U.S., only the emerging markets are appearing more attractive for the more aggressive-minded investors, while Continental Europe remains less provocative. All in all, we remain cautious on the economy, hoping to sidestep a recession but believe a value-minded approach that focuses on domestic markets is the best path forward. There is no need for complexity at this stage. Simply make sure you calibrate your risk and return expectations, know your companies and investments inside and out (or feel confident that someone does), and as famed value investor Peter Lynch once said, "The simpler it is, the better I like it."

We appreciate your continued support of our firm and look forward to sharing our perspectives with you in more detail. In the meantime, do not hesitate to contact us if you have any questions or concerns during these periods of market volatility and economic uncertainty. Finally, we wish you all a healthy and prosperous start to the new year!

Sincerely,

Eric Teal

Eric M. Teal
Managing Partner
Chief Investment Officer