CAPITAL MANAGEMENT

THE SQUEEZE ON SAVERS

How TTCM Can Help

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Today I read an excellent article in the WSJ regarding the fact that stocks have tripled since their March 2009 lows, but savers are still being squeezed from low interest rates. One of the primary takeaways was that retirees are increasingly investing higher amounts than they are comfortable with into equities, because the prospect of such low returns from fixed income is so unattractive. The article even highlights that many retirees are using tools such as index funds and ETFs, which are generally 100% long the stock market, to get their equity exposure.

This is a story that is unfortunately all too common, and one that I think will end very badly. When we were managing money in the years right after the Financial Crisis, all anybody talked about was that they didn't want to take risks via equities. That was the time when just about every other TV commercial was an advertisement for gold or annuities, as market participants seemed to be obsessing about a secular bear market in stocks, which was expected to last a decade or more. During that time, we were able to buy incredibly high quality franchises such as Phillip Morris (PM), Johnson & Johnson (JNJ) and United Healthcare (UNH) at 11-13 times trough earnings. Now these stocks trade in the mid-20s on earnings, which are probably closer to their peaks than their troughs.

If you own these stocks currently and are going to hold them for 15 years, you will probably do okay, but is that really realistic for most people? People say they are comfortable getting their 3.25% dividend, but is it worth the potential for 25-40% downside in a major downturn? What if you have a cash need that forces you to exit positions more quickly than your initial plan? Selling during market panics is absolute death to investment returns!

Market psychology is consistent in that you can always count on market participants going from extreme pessimism to extreme optimism, generally at the wrong times to do so.

Many current participants will say that they hate everything going on from a political perspective and think the market is expensive, yet they are still 100% long stocks, which implies an extremely optimistic outlook on equities. It is easy to keep that sort of allocation when markets continue to go higher; but when a test is faced, such as a major selloff, it is essential to understand what you are invested in and have the conviction to hold when everybody is telling you to sell.

Rough start to 2016 ended strong

For example, by the end of January of 2016 we were as long financial stocks as we have ever been, having dramatically increased our holdings in the sector during the panic to start the year. All of the news seemed to be terrible and market pundits such as Jim Cramer and Melissa Lee on CNBC said that they were simply "uninvestable." Remember that the 1st quarter of 2016 was the worst start to a year since the Great Depression. Interest rates kept dropping which pressured net interest margins, oil was in the $20's, causing many analysts to project major losses. During this time, we at TTCM did our own analysis, and it was clear that even if we entered into a major recession, the financial stocks were still way too cheap. As the year progressed we saw a recovery and then Brexit stomped it out once again. As that event didn't turn out to be as financially cataclysmic as many expected, the stocks once again began recovering, and after the election they caught fire producing massive returns.

2017 Outlook

Now as we look at the overall market, we see a mixed bag. We are bullish on the U.S. economy as exemplified by the outstanding ADP jobs numbers reported today, yet we are only mildly bullish on equities due to valuations. Some of the best investors in the world such as Warren Buffett and David Tepper are somewhat bullish on stocks, mainly due to the prospects of faster growth brought on by reduced regulatory headwinds. Being mildly bullish does not mean being 100% long stocks. For retirees, even having 70% long stocks at current prices is probably riskier than makes sense given the reward/risk potential.

The T&T value and strategy

This is where we believe our strategy at T&T Capital Management (TTCM) can offer the most value! By being value investors, we are able to focus on finding those few cheap securities where we have significant upside potential and a strong margin of safety. Most of the stocks that we are dealing with are still trading at discounts to book value and/or are trading at 10-13 times normalized earnings. While financials are still by far the cheapest sector of the market, as a sector, they aren't the sure thing that they seemed to be early last year, because the valuations are far higher as the stocks have appreciated. Rather than buying these stocks as aggressively as we have in the past, we have been selling long-term puts on them. This creates the situation where if the stocks are flat, or trend higher, we should make near double-digit returns on the puts. If the stocks drop dramatically, we will end up buying the stocks at much cheaper prices than what are available now, putting us into position for major upside.

For retirees or anyone else, this is a much safer strategy than simply being long mutual or index funds.

If our stock selection is only just as good as the overall market on the stocks that we sell puts on, we should have 10-15% minimum of downside protection before we would start taking losses assuming we hold the options till expiration. The key phrase here is holding options until expiration. On a day to day basis these option prices will change, and if volatility spikes, for instance, we are likely to show short-term losses. However, as long as we hold till expiration, the only thing that matters is where the stocks are at versus the strike prices that we have sold the puts at. You aren't going to get a really good feel for where you are at until we are very close to expiration, so more than ever you want to take a longer-term perspective when viewing your portfolio.

One of the keys to maintaining excellent long-term investment results is avoiding the terrible years, much more than having the great years. Many money managers will go from being up 25% one year, to losing 30% the next year. For those market participants that simply chase short-term performance, this is a big reason why investment returns almost always are worse than the underlying funds, as people tend to buy at highs and sell at lows

At TTCM, one of our major strengths is communicating with our clients via our newsletter. Understand that our focus is on protecting and growing the portfolio at the highest risk-adjusted rates possible. In a year like this year, we are intentionally positioning ourselves to benefit as time elapses and as our options expire. Day to day numbers will be nearly meaningless until we get closer to when most of these options expire. If the market sells off, we have a tremendous amount of protection and would be setting ourselves up to get offensive by being exercised on put options on value stocks at cheaper prices. In addition to financials, we have found considerable value in healthcare and specific out of favor companies in a myriad of various industries. This is a market where you want to hit doubles, instead of swinging for a homerun on every pitch. For retirees or any other investor, this type of contrarian approach to investing, and utilization of tools such as cash-secured puts, can be the difference between meeting your financial goals or coming up short.
As always, we will continue to keep up the communication and I fully understand that people will have questions so never hesitate to contact us directly. I personally can be reached at 805-886-8140. Thank you very much and I really look forward to speaking with you soon!

Sincerely,

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