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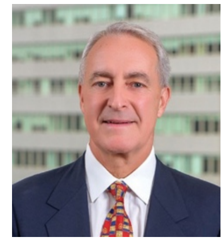

Thoughts for Investors

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Summer 2020 newsletter – The "Great Housecleaning of 2020" and the "New Economy"

June 2020

"If past history was all there was to the game, the richest people would be librarians"

-legendary investor Warren Buffett

Like it or not (and many people don't), the challenge of making money in stocks requires risking time and money on the future and uncertainty. The past has passed. What worked in the past is unlikely to work the same way in the future.

"The essence of investment management is the management of risks, not the management of returns"

-legendary investor Benjamin Graham (Warren Buffett's teacher)

Investors are discovering "passive investing", buying the whole stock market via an index fund in an effort to "manage returns", is no ticket to automatic wealth creation. Instead, it is like "driving through the rearview mirror". In a recent CNBC segment, Jim Cramer noted that passive investing "forces investors to take the high-performing holdings with the laggards". In my opinion, there have never been 500 stocks in the S&P 500 worth owning. Why dilute the effect of the good ones? Studies have shown that mathematically, 30 stocks give you 85% of the S&P 500's diversification (1. Fisher and Loire study). Barron's recently wrote that thanks to the "recent economic disruption and market volatility…the committee overseeing the (S&P 500) index could have to replace more than 30 companies this year".

"Nothing so undermines your financial judgement as the sight of your neighbor getting rich"

-JP Morgan

With decades of "low cost" passive investing and apps eager to help with "asset allocation" and "rebalancing", I ask, "Where is your yacht?" If you are a passive investor without one, maybe it's time to question how you have been investing, time for a portfolio "housecleaning" and time for investing in the "New Economy". Before you say you don't have time or the knowledge to find great stocks, keep in mind if you inherited any, it seems your parents were capable.

"This time is different' are perhaps the four costliest words in investment history"

-legendary investor Sir John Templeton

Let me outline three steps to get you there. The first step in the transition is having the correct mindset. The above is a very strong statement from one of the greatest investors ever. If you are walking around with the mindset "This time is different", beware! This commentary is everywhere, as it is after every crisis. Circumstances do change. Yet human reaction is probably the same since mankind was first chased by a wild beast, RUN AWAY! Templeton perceived investors might justify their actions through "confirmation bias", the "tendency to interpret new evidence as confirmation of one's existing beliefs or theories". Investors "confirm" their investment decisions based on popular opinions at the time. There are a lot of negative opinions today confirming the best course of action is to RUN AWAY from the stock market! A better mindset starts with thinking about how to take advantage of the opportunities created by those who are panicking.

"You make most of your money in bear markets. You just don't realize it at the time"

-legendary investor Shelby Davis

Pervasive pessimism is easily confirmed in the midst of a crisis and "raising a little cash until the dust settles" seems "prudent" at the time. Is it wise in the long run? According to great investors such as Templeton and Davis, you should be doing the opposite.

"Never bet on the end of the world. It only happens once"

-Art Cashin, director of floor operations for UBS

When this latest crisis subsides, and the mood changes, more than a few investors will also confirm they knew all along we would recover. Remember the aftermath of 9/11 when investors worried about terrorist "sleeper cells" in major US cities, diverted flights and the color-coded terrorism threat advisory scale. There was even talk of shutting down Reagan Airport because it was too close to the government. At the time, Psychology Today magazine noted, "A plastic knife is no longer a utensil packed for a picnic, but a means to mass murder." Today these are distant memories and plastic knives are back.

The second step is to clean out your portfolio. Is your portfolio filled with "innovative" financial "products"? "Innovation" and "financial services" is not always a good mix. If you don't understand the investments you own, how they make money and how much they cost, get rid of them. Need I say if it's too good to be true….? Beware the shiny packages of investment products. It's what's inside that counts. Too many layers just add costs. Furthermore, great wealth today will not be created with "Old Economy" stocks. The people who really made money on P&G invested with William Proctor and James Gamble.

"The computer is a bicycle for the mind"

-Steve Jobs, Apple founder

Which leads to the third step, invest in the New Economy. The phenomenon of WFH/WFA (work from home/away) is just the latest example. Are you aware of the plethora of others? Gig economy, "Cloud", AI, telemedicine, drones, digital transformation and data analytics. Technology, broadly defined, is affecting healthcare and vice-versa. Broadband communications is linking them both, though beware of jumping on the bandwagon after a big rise in these stocks. The computer truly is a "bicycle" allowing us to go further and faster, though we still have to pedal and steer! The "Old Economy" can no longer survive by changing the "packaging", shrinking the size and raising the price. No one retains "pricing power" forever. Beware of companies that depend on it for too long. That goes as much for packaged goods companies as airlines. In fact, saving the Old Economy is likely to involve help from New Economy companies.

"Diversification is protection against ignorance"

-Warren Buffett

"If you spend more than 13 minutes analyzing economic and market forecasts, you've wasted 10 minutes."

-legendary investor Peter Lynch

Do you suffer from the 3-D's of over-diversification, duplication and dilution? Do you own too little of any one stock to make a difference? Do you spend more time "analyzing market forecasts" or "asset allocating" and "rebalancing", instead of finding great stocks? If so, here are the 6 characteristics we look for in a company whose stock we might own.

1.What is the market opportunity? Is it a large addressable market with room for many competitors, a small but fast growing market, a consolidating market or is the company able to gain market share of the existing market?

2.Do they have superior products and execution, proven market acceptance or a strategy for new product development? Do they have a proven business model and potential for scale?

3.What are the barriers to entry by competitors? Is it "first-mover" advantage, capital intensity, infrastructure, patents or the moat of a "network"?

4.What are their financials? Do they have "unit volume growth" not just total revenue growth? Increasing revenue can come from raising prices, yet no one retains pricing power forever. Technology has handed consumers new, unfettered access to information about costs that was previously guarded by producers. How much debt do they have? Sadly, due to low interest rates, many companies piled on lots of debt and are now in trouble.

5. Do they have strong management? Have management done it before? What is the turnover of management? "Bet on the jockey not the horse".

6. There will always be "unknown unknowns", i.e., uncertainty. Does the company have tools to deal with instability, doubt and unpredictable external risk?

"Man's mind, stretched to a new idea, never goes back to its original dimensions"

-Oliver Wendell Holmes

A recent WSJ article proclaimed, "Uncertainty Emerges as a New Enemy". Uncertainty is always the enemy as investors prefer the comfort of the "knowns". Eventually, solutions are discovered and the uncertainty of the future becomes the certainty of the past, accompanied by "confirmations" like "I knew all along we would get over this". Don't worry about the future if you believe, as I do, that mankind has not exhausted the capacity of the human brain.

In summary, don't wait! Now is the time for a portfolio housecleaning of Old Economy stocks and an introduction of New Economy stocks (if you haven't already done that). Nature abhors a vacuum. I believe the decline of the Old Economy will be replaced by the rise of the New Economy. In the words of Amazon founder Jeff Bezos, "Being wrong might hurt you a bit, but being slow will kill you". Some Old Economy stocks are listening to Bezos and, helped along by the technology of the New Economy, may survive.

"Nothing in life is to be feared, it is only to be understood"

-Marie Curie

Sources:

1. Fisher and Loire study (1970s)
http://ppca-inc.com/Articles/DiversByNumbers.pdf

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