July 13, 2017

Dear Friends and Clients,

The beat goes on for both stocks and bonds. The Dow and S&P were up about 3.5% during the second quarter and 9.5% for the first half of the year. While interest rates seem to be working higher, the 10-year Treasury actually moved lower in yield year-to-date…from 2.44% to 2.15%. Measured annually, equities trade higher roughly 70% of the time. Stocks also trade within 5% of their all-time highs 35-40% of the time. The nattering nabobs of negativity tend to get pretty noisy when indexes challenge cardinal numbers…Dow 20,000 (past) or S&P 2,500 (future). New highs don't bother us; we expect them. I'll let the cat out of the bag….we still Really Like equities, but are taking steps to make our portfolios a notch less volatile. You'll learn more if you read to the end.

They, them and the other guys…

A client asked me this week about getting nervous, what would change our minds, or did we ever recommend bonds. Those that have met us in the last 10 years might think we are perma-bulls. Au contraire, there was a time when Dan and I only sold bonds. We worked for banks early on and fixed income was our only product. However, when we graduated to the brokerage community we were able to sell from a full wagon. In the late '70s and early '80s, interest rates encroached on 20% and the risk coefficient of equities did not measure up. Our peers continued to sell equities and counseled us, "Don't lock up that money for 20 years, you'll never earn another commission on it." Or, as W.C. Fields adroitly put it, "never give a sucker an even break." No remorse here, we actually encouraged clients to use longer maturities, however, the inverted yield curve made that a pretty difficult sell. During our late brokerage and early P&A years, we recommended balanced portfolios and found ourselves content as long as we could present clients with a 5x5 offering…a 5% return coupled to a maturity of 5 years or less…a working wage if you will.

So we have recommended bonds, we do change our minds, but we really don't get very nervous. The reason is less complex than you would think. First of all, our time horizons are long term and we frame decisions in the context of a full economic cycle (5-7 years). Think of that as a "rolling" economic cycle, 5-7 years from each decision date. Our stock selections are restricted to quality companies, favoring best of breed whenever possible. We try to keep P&A portfolios fully invested at all times, and we eat our own cooking. We insist on a positive relationship with all the companies in our portfolios and think of these companies as partners. When something happens to dampen those emotions, we vote with our feet.

Last but not least is a noise filter we call portfolio science. The markets and the media launch daily attacks on investors who come to the party armed with little more than a garbage can lid. Traders have their own vocabulary, with duplicitous definitions and crescent wrench like utility. Instead of referring to a dimension, a "long" implies ownership, a fully paid for position, with the expectation of a profit from a rising price. A "short," instead of being a comparison to a "long," is instead the polar opposite. All of this makes sense as long as you know it is okay to be short…oh well.

Portfolio science…

In our October 2012 letter, we created the term "cashology." If you Google that term today, you will find two articles from P&A, an Urban Dictionary definition, the creation of a Cashology Academy, and several YouTube videos. Imitation is the highest form of flattery and apparently this concept has not fallen on deaf ears. In an effort to simplify, and at the risk of creating more new language, this month's letter offers the concept of "portfolio science."

With our very first quarterly letter in September 1995, it has been our intention to educate in an entertaining fashion. Since that time, the market has had a plethora of bull market rallies and bear market retreats. The number of households we work for has increased from 100 to 200 to 300, up to the current head count of around 600. Logic would tell you that our emotional client calls would have increased as those numbers grew, but that's not the case. It has always been our conviction that education overcomes emotions and as the client learns our processes they become more comfortable with the highs and lows of the marketplace. Portfolio science is a study of the mechanical events occurring within a portfolio on a daily basis. The rest of this letter will concentrate on three of these mechanical events. We would present more but they really aren't very interesting and you should get the drift of things after these examples.

Whose money is it?

Our first topic will be float, of which there are several types. If you understand float you understand that it is possible to make money using other people's money…"OPM" if you will. In this case, we will examine your money and the government's share of it…capital gains. The following example will assume an after-tax account (traditional retirement accounts are before-tax), a max tax bracket investor and no state income tax. We'll introduce retirement accounts later in the letter. Our first example describes a growth oriented investor who does not require dividend income. He or she is interested in earning capital gains.

A capital gain is an increase in the value of a capital asset (investment or real estate) that gives it a higher worth than the purchase price. The gain is not realized until the asset is sold. A capital gain may be short-term (if held one year or less) or long-term (held more than one year) and must be claimed on income taxes. Long term capital gains (LTCG) are taxed at preferential rates set at 20% for max tax bracket payers. Income generated from wages, salaries, tips, commissions, and bonuses are considered ordinary and can be subject to the max tax rate of 39.6%. Like LTCGs, qualified dividends (paid by American companies, ex-REITS and MLPs) are taxed at the preferential 20% rate for higher income tax payers. Dividend income is generally paid on a quarterly schedule beyond the control of investors. Capital gains are triggered by the sale of an investment asset and therefore controlled by the investor. The following table describes the portfolio math generated by a stock that most investors are familiar with, Berkshire Hathaway:

Date	Shares	Descr.	Dividend Rate	Market Value	Before-Tax Book Value	Gain/Loss	After-Tax Dividend	Total Return	Tax Rate	After-Tax Book Value	Float
6/29/2012	100	BRK/B	0.0%	$83.33	$8,333	-	$0	-	20%	$8,333	-
6/30/2017	100	BRK/B	0.0%	$171.51	$17,151	$8,818	$0	$8,818	20%	$15,387	$1,764

Berkshire Hathaway does not pay a dividend and it is unlikely to initiate one in Warren Buffett's lifetime. That means a growth oriented investor could own this stock for the foreseeable future and never expect to receive any cash compensation for doing so. The offset, of course, is its healthy record of growth. Using the trailing 5-year period, a holder of 100 shares of Berkshire would have generated a gain of $8,818. Since no dividends were paid, the total return is the same number. This gain was “deferred” until sale, at which time the LTCG tax of $1,764 would have become due and payable on the investor’s next tax date. Assuming the stock generated straight line growth, this tax bill was growing throughout the investment period. The ultimate tax bill of $1,764 can be considered “float” and continues to accumulate for the benefit of the investor during this time period. As an investor, you can hold on to this float as long as your patience will allow. When your patience runs out, or if liquidity needs arise, the security gets sold and the float becomes tax…that portion of the market value is no longer owned by the investor, as the government takes their bite.

Depending upon account size, a typical P&A stock portfolio is built with 28 to 33 names (3% to 3.5% a position). Using our Berkshire example and a 30-name portfolio that would mean float of about $52,920 in a 5-year-old portfolio ($1,764 x 30 = $52,920). Granted, not all companies are run by Warren Buffett, but if you add a year or two and own some high quality companies along the way, this assumption is not far-fetched. The point here is that the timing of a portfolio’s LTCG tax burden is in the hands of the investor. Through the end of 2016, the market has returned an average of 11.56% over the last 50 years. In order to be conservative we’ll use 10% to value this float…. $52,920 x 10% x 5 = $26,460. So the take away is this type of deferred return is naturally generated by an equity portfolio. If you participate, you will be a beneficiary, if you constantly interrupt these engines, your returns generated by float will diminish.

Stocks grow in random patterns and we’re not perfect…we buy some gems and some clunkers. It is our style to let winners run and to stem losses using down 20% as a trigger. When we trim winning positions we call tax bills home (float) but stay cognizant of the affect this has on float as we proceed.

Better make it 4, I can’t eat 8…

Mechanical event #2 might seem rather mundane, it is the portfolio math and the subsequent science of dividend payments. I used to work for a guy who became one of many father figures to me. I loved my own father but must have been a bit of a problem child because lots of these guys put me under their wings. Milton was pretty good at investing in real estate but lacked sophistication when it came to financial assets. Didn’t bother him a bit, he collected stocks like stamps and was a perpetual buyer…never sold anything. Like Bing Crosby, he accentuated the positives, eliminated the negatives and never messed with Mr. In-Between. If he had a loser he never told me about it. The boss liked dividends and didn’t take profits because he didn’t want to pay tax. My guess is he would argue with the next factoid I’m about to lay down, but so be it…this is how things work. The math surrounding a dividend payment:

Shares	Descr	Price	Value	Div./Sh	Total Dividend	Tax	Net Dividend	Ex-Dvd Price	Ex Dvd Val	Total Value
100	Stock A	$100.00	$10,000	$1.00	$100	20.0%	$ 80.00	$99	$9,900	$9,980

For some reason, a host of individual investors hold the opinion that the value of a company’s shares do not go down in price after the dividend is paid, but they do. This process is called going “ex-dividend,” and it has been going on ever since the original 24 signed the Buttonwood agreement in 1792. Somehow, someway, individual investors started to think that their dividends were delivered with an “ok to spend" note attached…also a misconception. The reality is that qualified dividends are a cash flow generated by a public company and owned by the stockholders. Total return is the sum of price appreciation and dividend income. Spending dividend income is no different than spending the proceeds of a share sale.

Shares	Descr	Mkt Px	Value	Sale of 1 share	Gross Proceeds	Tax	Net Proceeds	New Shares	Ex-sale Price	Ex-sale Share Value	Total Value
100	Stock A	$100.00	$10,000	$100.00	$100	20.0%	$ 80.00	99	100	$9,900	$9,980

Misconceptions die hard and several have needed assassination during my career in order for investors to draw a clear focus on the relationship of dividends and capital gains. First of all, the reduction in commission rates has virtually eliminated the concept of churning. You can sell shares at a minimal fee and there is no odd-lot differential. Second, the tax rate on LTCGs has fallen almost as much as commission rates. Third, access to transparent management has blossomed and is readily available to investors. Fourth, in 2003, the Jobs and Growth Tax Relief Reconciliation Act equalized the rate at which qualified dividends and long-term capital gains were taxed…no difference.

What does make the dividend payment process worthy of consideration by a portfolio scientist is the corporate thinking that surrounds the event. The consistent payment of a dividend is a reflection of balance sheet strength and a point of pride amongst corporate boards; they are collectively loathe to reduce or eliminate a dividend. In the same vein, companies that generate dividend growth are quickly included in an elite category that attracts a significant group of investors. Likewise, these increases are financial-speak telling analysts that the board considers the company's future to be bright enough to increase this cash flow.

Dividends are declared during quarterly earnings announcements along with shareholder re-org events (stock splits and buy-back programs). With the exception of earnings, these events tend to be shareholder neutral but often affect investor categories that the stock will appeal to, as well as the preference of some to hold larger share positions. As the beneficiary of a 2-for-1 stock split, the owner of 100 shares of a $200 stock will become the post-split owner of 200 shares of a $100 stock…no financial difference. Nonetheless, splits hold a strong attraction for a large number of investors and prices do seem to react favorably to the news of a split. In an effort to explain the effect of a split, Warren Buffett tells the story of a kid ordering pizza. The waitress asks him how many pieces he would like his pie cut into…4 or 8? After a pensive moment the young man replies, "Better make it 4, I can't eat 8."

So what?

Maybe all this stuff is the long way around the middle but it should offer you some insight into how we think. The tax deferment and float generated by a common stock as well as the cumulative effect of growing dividends is almost too boring a subject for this letter. We refrain from making the case that a common stock is a better tax deferral investment than a variable annuity…but we hold that opinion. Interrupting this process is not good for investor health. A stock that declares and grows dividends rewards investors beyond the cash-on-cash received. Splits have no mathematical benefits but work to the long term advantage of shareholders. There are other unexciting events that occur consistently in a portfolio that receive less press coverage….insider accumulation events, balance sheet/fixed income restructuring, cash accumulation, etc. The knowledge of all of these and related events can be lumped into portfolio science. Knowing that the management of the companies we hold are ever vigilant in this regard allows us to triumph over mechanical event #3, ignoring "noise" and maintain a long term point of view. Long term is the only term.

We still Really Like equities…

The Yellen Fed has been very forthcoming and told the marketplace they would raise Fed Fund rates two or three times in 2017. In June, they tacked on another 0.25%, moving the Fed Funds target to 1%-1.25%. Please notice that the interest rate changes we are about to talk about occur to the "right" of the decimal point. We manage fully invested portfolios and like to spend as much time as possible working on investments that generate returns "left" of the decimal point. That being said, it is clear to us that a somewhat higher interest rate complex is healthy for the financial institutions we depend upon and will eventually put the Fed back in position to stimulate the economy with interest rate cuts, a posture they have not enjoyed since the Great Recession of 2007-08.

Will increasing interest rates stifle the economy? Probably not. These are "demand-pull" changes as opposed to the inflation-fighting "cost-push" rate hikes we experienced in the '80s and '90s. If you can't successfully run a company with 1% to 2% Fed Fund rates, that enterprise is probably not well conceived. Actually, the same analysis probably holds true with 4% to 5% rates. Expect the Fed to increase rates in December and the economy to prosper. These guys have a better handle on business health in America than any of the pundits who are constantly pundit-ing about it (noise). We have learned not to fight the Fed over the years. The current activity, however, strikes us as more of a discipline restructuring than a tightening. "Helicopter Ben" Bernanke and "Hammerin' Hank" Paulsen did not have tools designed to rescue institutions deemed too big to fail, so they had to rely on 0% Fed Funds and quantitative easing. We are now on the other side of that mountain.

Twenty-eighteen will undoubtedly bring incremental rate hikes until the Fed feels they have attained stimulative equilibrium (pretty good expression, eh? I made it up). Dan and I have felt the government should have been selling 30-year bonds all the way through this low rate environment, but what do we know? Doing so would have taken advantage of extremely low cost money for an extended period of time. Instead they have been buying and selling 10-year bonds to fund quantitative easing. Since the Fed is actually a large owner of Treasury bonds and mortgages, they will become a net sell going forward. This, and a higher Fed Funds target will cause the interest rate complex to rise.

As mentioned earlier, the Fed currently has a target rate of 1% to 1.25%. This is the rate at which member banks borrow from each other. It also provides a benchmark for position-traded money market funds, which in late May hovered between 0.50% – 0.75%, crawling towards 1% in early July. Sweep funds pay 0.375% – 0.50% less. Interest rates are going up and if you have an adjustable rate loan it will no doubt be going up as well. Pay attention, your debt should all be fixed rate at this point….call if you would like some help.

We continue to Really Like equities but find ourselves reducing the number of stock positions we hold in favor of owning large, mid and small cap ETFs. This is old news as we started doing it in Q1 and the strategy has worked pretty well for our accounts. We haven't changed any allocations but we reduced our single stock exposure and feel our portfolios will be a little less vulnerable during correction. Here comes the "spend some money" pitch. Have some fun (a repeat request from last quarter and last year). If you are planning a trip, take it, or at least fund it. If a lake or beach home is on your bucket list, start shopping. How about a nice RV? Maybe a cruise is in the offing or perhaps a new car? Move some assets from the investment category to the use category. Reduce your P&A management fee by spending some of that hard earned. We are at all-time highs so philanthropy has never been cheaper…contributing to a donor-advised fund might just scratch the itch. Who knows, maybe this is our mojo, whenever we recommend spending money the market seems to trade higher.

One more thing, a client of ours recently shared a great article from the Wall Street Journal, which we have linked to here.* As I read it, I felt like I was listening to myself, however, the guy had some great ideas, is a good writer and, at the least, offers validation to our point of view.

As Always,

James S. Pittenger, Jr, Chairman/CEO CFP®	Dan Anderson President CFP®

* - full link to the WSJ article is
http://pittand.com/v2/wp-content/uploads/2017/07/wsj.com-The-Mental-Mistakes-We-Make-With-Retirement-Spending.pdf