Pittenger & Anderson, Inc.
REGISTERED INVESTMENT ADVISOR

P&A's Quarterly Letter

Quarter 3 – September 30, 2019

Dear Friends and Clients,

We love to talk about our company and love opportunities to go one-on-one with our clients. Most of our clients are big picture types, they want to see the value of their accounts rising, when they do happiness quickly sets in. From time to time, they have questions which are typically insightful. Whose research do you use? Does Schwab tell you when to buy and when to sell? Why is the market going up (or down)? How do you control risk? How do you monitor success (and failure)? These are all good questions and for this letter we thought we would try and answer a few that have not been asked.

"Why does the market go up in spite of bad news?"
"There are a lot of factors that affect my account. Name a couple that P&A considers bellwether."

Climbing the wall of worry….

On the day I was born, the Dow Jones Industrial Average closed at 182.09. The day I graduated from junior high…701.34, and the day I went to work at the First National Bank…804.28. None of these were high water marks, but it was working its way higher. Today, the index weighs in at 27,048. Like the other waypoints, not an all time high, but significantly higher than the 182.09 on my date of birth. Success can breed strange bedfellows and the stock market is pretty good at that. Is the market too high? Is there a recession coming? Shouldn't we book some of these profits? When is the next crash coming? All of these emotions form bricks in the "wall of worry."

Stocks climb the wall of worry, investors don't. However, investors and pundits need to know this phenomena exists. The wall is built with single economic events, political chicanery, geopolitical upheavals, and sorted and sundry natural crises. Single economic events would include the bursting of financial bubbles, stock market crashes, sovereign defaults and currency crises. These things usually start in the banking and financial world then spread throughout the economy. While they are not fun, there are enough of us that have lived through them to provide guidance. Most of the time (emphasize most) these events provide loss trading as well as buying opportunities that we don't like to miss.

You don't have to look far to experience political chicanery; it's a constant and lives right outside your window. When President Obama was elected, we had several clients who headed for the hills. Nebraska is overwhelmingly Republican, so we were not particularly surprised. However, the Democrats hung in there and, despite passing the controversial Affordable Care Act, found a way to increase investor net worth. When Donald Trump took office in 2017, we had a number of clients who headed for the hills. Sound familiar? The technique was different this time, brash and unapologetic, he set about fulfilling campaign promises. There have been tariffs, border wall talks, tax cuts and tweets for us to become accustomed to. Once again, the party in charge has found a way of increasing investor net worth.

I can't tell you when our most recent geopolitical crisis began but it appears to be continuing. I might be joining this discussion in the middle, but what the heck. North Korea agreed to suspend its nuclear arms testing program during the Hanoi Summit February of 2019 and then Kim Jong-un proceeded with short range tests, launching on 5/09, 7/25, 7/31 8/02, 8/24 and 9/10. I thought that was a bit "in your face" but the markets traded higher. Only a few weeks ago Iran, using drones and cruise missiles, sponsored an attack on three oil refineries in Saudi Arabia. Surprisingly enough, the refineries were back on line two days later and the markets shook things off in another 48 hours. On the day I wrote this, Trump spoke to the United Nations, promoting sovereignty over globalism. He took a hard line against Iran and encouraged western governments to join the US sanctions. We didn't know how well that was going to be received, but Nancy Pelosi changed the game on the same day. She supported a formal impeachment inquiry in the House and the Dow traded in a 400-point range finishing lower, a long day for the Donald but the major indexes finished higher that week.

A natural crisis is delivered to us on the Weather Channel, evening news, or by word of mouth daily. These events almost always include loss of life, destruction of infrastructure, and widespread economic upheaval. We're talking about earthquakes, tornados, hurricanes, tsunamis, volcanic eruptions, pestilence, etc. Not living in Puerto Rico would be a good way to avoid many of the items on this list. The results of a natural disaster run the gamut between waterlogged and scorched earth, the only people that stand a chance of benefiting are the contractors that find employment in the resurrection process. As the regions affected by these events recover, the markets treat the new construction as growth and they trundle higher.

Long term readers of these letters know that it is our opinion that securities are constantly moving from weak hands to strong hands. As that process unfolds, intermediate and short-term bottoms are formed and eventually the sellers punch themselves out. Slowly but surely buyers benefit from their "sixth sense," the bargains are scooped up and the price of shares move higher. Think of the economic environment as prevailing weather with interest rates as headwinds and inflation as precipitation and taxes as temperature. For the last 10 years, these forces have been benign at the best. That means that other elements in the environment can gain significance. Real returns tend to increase as growth and/or income prospects improve. Highly liquid financial investments reduce the traditional advantage held by private and non-marketable transactions. Income deferral becomes less interesting and thinking in the long-term becomes more popular. As these changes take place, equities climb the wall of worry…. yesterday's threats which have become today's wisdom.

Is there a complement to the wall of worry?

While bull markets gain from climbing the wall of worry, a bear market accelerates lower as it slides down a "slope of hope." For us, both events are painted on a canvas of exhaustion populated by investors that are spent by acting out their own misconceptions. The wall of worry causes stocks to trade higher because all the weak hands that want out of their positions have liquidated and presented the bulls with buying opportunities. Contrarily, the followers and chasers create the slope of hope by buying stocks on weak premises that create prices high enough to persuade traders to ring the cash register and exit stage left, like Snagglepuss.

As bad news is triumphed over it becomes support, while the price at which stocks quit working becomes resistance. This churning process will typically cause the market to move sideways, bouncing between support and resistance until it generates enough momentum to move to a new trading range. Market technicians will tell you they can predict these moves based on history and algorithms…we can't. We are, however, able to observe that markets mover higher roughly 65% of the time (paragraph 3 describing the Dow during my lifetime). In addition, the current market is and has been supported by Republicans and Democrats that can't seem to work toward a common good. Gridlock is like 3-in-1 oil for the stock market and generates fewer reasons for it not to trade higher. Long term investors benefit from this situation since it allows the earning power of well-run corporations to shine like a beacon in the night, making it easier and easier for stock prices to make new highs.

Allocation and attribution

These two terms are key to portfolio performance. Asset allocation is the optimal distribution of asset classes across portfolio investments. The mix can be fixed or variable depending upon economic and market conditions. Building a diversified portfolio of assets using an efficient frontier is the core of Modern Portfolio Theory, a discipline made popular by the work of Harry Markowitz in the 1950s. Examples would include but are not limited to: fixed income, equities, cash, commodities, real estate, foreign securities, precious metals, small cap, mid cap, etc.

Attribution is an assessment of the value added by the actions of a portfolio manager. This starts by determining which asset classes are employed, then a measure of investment style and finally the impact of market timing.   Next an appropriate benchmark is chosen, and the amount of alpha generated by the manager can be calculated.

While asset allocation is straightforward and easy to break down, attribution is very difficult to analyze. In the allocation realm, P&A focuses on equities, fixed income and cash. We have history with commodities and precious metals but do not see significant opportunity there at the current time.   We include REITS, foreign, small and mid-cap in our equity allocation. Cash is generally minimal, representing client liquidity needs. We encourage clients to size their fixed income in a manner that will make them comfortable with their equity allocation.

Example 75/25: if the client is uncomfortable with a 100% equity allocation, a 75% equity & 25% fixed income allocation should be discussed.
Example 50/50: if the client is uncomfortable with 75/25, a 50% equity & 50% fixed becomes our next recommendation.
Example 25/75: if the client is finds 50/50 too threatening, a 25% equity & 75% fixed should be discussed.
We manage all allocations to +/- 10%, that means 75/25 stretches to 85/15 or contracts to 65/35, etc.

At every change in allocation we use the appropriate risk modeling tools, historical results, standard deviations, Monte Carlo projections and financial planning tools necessary to unlock the proper decision with the client. These decisions are then monitored and reviewed on a schedule that matches the client’s risk tolerance.

Attribution analysis is extremely complicated. Once an allocation is determined attribution can begin. It includes stock picking, sector selection, market timing, skill and luck. We have made a couple of passes at constructing our own tools to conquer these problems…. they have not performed very well. At the current time we do this work by hand after breaking down our portfolios into sectors and industry groups.   Tamarac, our portfolio management software vendor has promised us an attribution tool for a couple of years. A well-engineered program in this area will assist in the execution of our bottoms up approach, and help deliver well managed, best of breed companies to our portfolios. We believe this tool will be forthcoming. Additions like this to our technology efforts tend to be meaningful for our clients. We are always looking for solutions that have a big bang for the buck while running seamlessly in the background. As per usual, our thoughts are in the future and we look forward to our first attribution shakedown cruise.

The World According to Pitt & Dan….

About 20 years ago we responded to client requests by disclosing our short-term market affection. While many of our peers favored a multiple factor grading system, we decided to use a simple 3-tiered approach…. like, really like and love. We come from a deep fixed income background which has taught us indelible lessons about the superiority of equities over the long-term…. the only term. In January we liked equities, changing to really like before February. The belly of the year was actually pretty flat and this month we have fallen back to like. We re-emphasize, this is our short-term demeanor, not our long-term posture. Our bottoms up process has kept us fully invested since March of 2009 and we are pleased about that. Surprisingly enough, it is very difficult to remain fully invested over any ten-year period. Our discipline is akin to planting flowers and pulling weeds without creating cash balances. It was certainly not our prediction, but still looks like 2019 could be a high teens equity year. We are happy for our clients. Since money market returns are still fractional, that equity advantage is considerable. We don't know what the balance of the year has in store for us nor are we ready to predict returns for 2020. However, we learned a long time ago that double digit returns are gravy.

We have a new associate; his name is John Dannenbring and he is a very nice young man. Since we now have a Jon and a John, we are in the process of refining his nickname. Some of us have taken to calling him Johnny or Johnny D. I favor Johnny-behind-the -H with a nod to the legend of Wyatt Earp. Don't know what will stick. Our new guy has an institutional real estate background and seems to be picking up stocks and bonds quite quickly. You will eventually meet him over the phone or the next time you visit the office.

Breaking news from Schwab, their commission schedule goes to zero for U.S. stocks, ETFs and options on 10/07/19. That's 0, nada, nothing or free. This is a price war between Schwab, TD Ameritrade, E*TRADE and Interactive Brokers. All other market participants will get swept up in it as well and it is not even close to being over. May 1, 1975 is called May Day in our business and marks the initiation of negotiated commissions. Ever since that date these tariffs have been negotiated lower and are probably near a bottom.

This change will not be without dislocation, expect ancillary fees to change as well. Some will go lower, while a handful will probably go up. It's hard for a business to work for nothing. Schwab expects to purloin the assets held by its competitors and may have to change their fee structure as that does or does not occur. If their expectations are fulfilled, we could skate. If not, minimums could rise, account segmentation might occur or an increase in management fees may be at hand. The changes we foresee are on the custodial side of the equation, however we thought a commission $4.95 was very attractive….as per always, expect change.

On behalf of the entire P&A team,

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