Pittenger & Anderson, Inc.
REGISTERED INVESTMENT ADVISOR

P&A's Quarterly Letter

Q4 – December 31, 2019

January 5, 2020

Dear Friends and Clients,

This was a pretty good year by any measure. The Dow was up 25.30% while the S&P posted a 28.90% gain, both include dividends. If you average these two indexes you get a large cap return of 27.10%....once again, pretty good. Ready for another factoid? The S&P is market cap weighted while the Dow is price weighted. The two indexes revert to a common mean over time which is currently a little less than 11.00%. According to Seeking Alpha, if you were to market cap weight the price weighted Dow, it's 2019 return would have been 38.80%. In popularity contests the Dow has become a bit of a step child to the S&P because of the number of stocks in the index (30 vs. 500). As a practical matter, few people can manage a 500 position portfolio and few own as "blue chip" a portfolio as the Dow. They both have their own utility so we monitor each one. Now, let's average the two as market cap weighted…..we get a 33.85% return! I don't know anyone who market cap weights or price weights their portfolios. It would be an organizational nightmare. So perhaps that 27.10% rate works out to be a pretty lofty goal.. I think so. How about two in a row? Not likely, but not impossible either. There have been 4 runs of back-to-back Dow/S&P +20% or better during my lifetime.

Let's get the Adjectives Right…

These are not just good returns, they are great returns. Particularly when we remember to examine the "compared to whats?" The 10-year Treasury is 1.80%, the 5-year is 1.60% and cash is about 0.50%... substantially less than equity returns. So the trick through the last 10 years has been to own as many equities as you are comfortable with. Both Schwab and P&A will be sending you year-end reports. Both will describe the values in your account. Ours will provide you with performance which you can compare to the popular indexes. Both reports will have some pretty charts. Never forget you are a human and don't waste a lot of time comparing yourself to charts or tables that don't describe your asset allocation. Decide who you are and what your risk tolerance is. If we have addressed these emotions incorrectly, give us a call and we will re-evaluate with you.

When the market goes down, we will make every effort to loss trade your portfolio…haven't been able to do much of that for some time now. The losses we take for you in this manner are valuable and can be used against future gains. When the market goes up we need you to spend some money so we can ring the cash register and rebalance. Please have some fun. We have been encouraging clients to do this for a long time now. This too will end. When it does, expect us to recommend that you send more investable dollars to your accounts. Many of you complain that we are encouraging your spouse to spend when no encouragement is necessary. Nothing could be further from the truth, we are dumb like foxes and addressing the problem of diversification in a world of high-priced alternatives. When your dollars move from financial assets to use assets you are diversifying. Beating the Dow is always a target but don't frown if you miss it by a bit. Getting the direction right is always most important and holding a strong equity exposure will be a constant key to success.

Top down vs bottom up….

I am thinking you have probably heard these terms before. Top down managers study the economy, figure out growth rates, predict election results, analyze foreign exchange rates and tell you when you should have had your entire portfolio in gold. We're not very good at doing that. This approach sells a lot of newspapers, fuels the talking heads and creates a lot of finger pointing. From our point of view the top down guys have a much more difficult job than we do. The emotional elements that help to generate their opinions reverse themselves frequently, making their lives a balance beam act that is the envy of every troop of Chinese acrobats. The investment companies that use this management approach are high profile and call themselves value managers, growth managers, quant types, and lots of other cookie cutter descriptions. If you watch the pundits on financial TV you will notice they provide the fuel which fires this group. That cast is made up of economists, strategists, political observers and macro managers. Hearing this TV-ga-ga is inescapable, especially when you have dollars invested in securities, real estate, precious metals, whatever. The collective media creates noise designed to shake confidence and addict viewers.

Harsh? Not really. The truth is we admire this bunch individually but not often collectively. They eventually become victimized by self-inflicted wounds. We tried the top down approach early in our brokerage days and it did not work well for us. Our bosses, however, liked it. Looking back, it is clear their objectives were different than ours. Brokerage firm management does not trust brokers and brokers view management as lower life forms. From time to time, brokers went rogue and when they did so they cost the firm money. Individual brokers had to be controlled by branch managers who lived distantly from the home office. Tiring of this game, the home office adopted an affection for top down portfolio management. They created model portfolios that could be monitored and dispensed to the branch offices. This also lead to the employment of economists and strategists that could answer questions like "what are your people saying about interest rates?" or "what do you guys think about the next election?" You can bet the big-wigs at Dean Witter wanted intelligent answers to those questions as well as slide shows to make their case. Consistent with this, they had no interest in allowing route stepping brokers to pick their own stocks in a bottom up format. Instead of mastering the flip-charts and company lines we became comfortable with saying "beats me" or "I don't know," concentrating on the stocks and bonds we knew best.

In order to make all this work the brokerage houses needed strong compliance departments…also called business avoidance departments by the brokers. Doing the right thing was always a challenge for these rascals. Part and parcel to all of this was the advent of "managed accounts." Often described as individual mutual funds, this approach delivered professional management to the individual portfolio level. The concept was good, but the brokers wanted to be paid on full commission schedules and there were too many hogs at the trough. Most of these products carried 3.00%+ fees and once again, the self-inflicted wounds took their toll. Managed accounts perpetuated the retail brokerage dependence on top down thinking and the business schools turned out legions of economists and strategists.

Frequent readers of these letters know that there were a number of reasons behind our 25-year old departure from Dean Witter. This was one of them and occurred about the time we got off the merry-go-round. Being able to manage custom portfolios for our clients was high on our list and we knew we were bottom up guys. Looking back, it is clear to me that a number of the arguments on both sides of the top down/bottom conflict were integrated and the antiquation of the industry hid many of those connections. The advent of the internet and the dot com revolution dropped prices significantly in the financial services industry. Modern Portfolio Theory became popular and the practitioners tried to teach the industry that stock picking was a fool's game. We did not buy into that argument and continue to reject it. Since no one told us we couldn't mix disciplines we did so by dividing our portfolios into two sections, one populated by individual stocks and the other holding ETFs and mutual funds. We were surprised to learn that what we called our "asset class" model had a national following called "core and satellite." The whole affair was parallel discovery but two rubes from Nebraska without pedigrees weren't going to lead the charge, so we adopted the name the heavy thinkers liked and have been core and satellite practitioners ever since.

Results…

I must admit we were surprised when our P&A success became somewhat self-fulfilling. On the day our business was born we were vexed by not being able to afford the hardware, software and staff necessary to manage portfolios the way we wanted to. Clients may not have known it at the time but they got behind us and pushed. Our business plan was unique, our role as a fiduciary was singular and the transparency we delivered continued to attract assets. As our business expanded, we used the incremental profits to buy a Bloomberg machine, larger servers, more powerful software, smarter staff (not hard), larger quarters, cloud applications, consultants, seminars, etc. Few of our competitors took pride in nor were able to manage custom portfolios in a bottom up fashion. They used partnerships and created their own mutual funds.

The core and satellite approach helped us a lot. We employed growth and value stocks across a variety of market caps as well as geographic origins. For a few of those early years we spent more time than we should have divorcing ourselves from the top down thinking that dominated portfolio management. We're over that now. Although we care when current events rock the boat, we don't rush from port to starboard any more. We shed the last remnants by 2006, just in time for the financial disaster of 2008. We survived.

One more anecdote before I finish these thoughts. Dan left the National Bank of Commerce to work with me at Dean Witter in 1985, he has been a great partner ever since. He hit the deck a running. Within a half hour of his arrival he had opened several new accounts and sold some muni bonds…which was our principal endeavor in those days. Eventually he drew a breath and asked, "how do I buy stocks?" I handed him a stack of equity tickets and asked "Why?" Tax exempt bonds offered double-digit returns at the time and max tax brackets were 70%...a layup. "Because, I want to own Cat Tractor, it's a great company and I think it's cheap." I thank my lucky stars for having a partner that has pushed my thought processes all these years. We agree, disagree and fight like dogs and cats. In the end we are healthier for our relationship. The same thing has happened with all the staff (many are now partners) hired over the years. They rarely cut us any slack. The group has maintained their individuality but all have the same "lunch pail" approach. Each of them want to be stock pickers but see the value of MPT. No one on our trading floor ever has to be reminded that the client comes first…that's our glue.

The World According to Pitt & Dan….

We would expect 2020 to be a difficult year for a lot of investors. It is an election year for an incumbent President…historically good. An impeachment year for the same President (a jump ball in anyone's book), and potentially a war year...we'll see how that works out but deem it a negative. The market knows all this and will discount it. Benjamin Graham taught us that over the short-term the market is a voting machine (popularity) and over the long-term it is a weighing machine (substance.) There will always be plenty of opportunities to vote and weigh, in the end weighing wins.

US equities are a very cheap asset class at the current time. Gold doesn't pay a dividend and does not generate earnings. The real yield on bonds…after inflation (2.10%…. Is basically zero. The real yield on cash is worse. The Dow and S&P currently have a similar dividend yield, we'll use 2.125%. Let's figure an 8.00% growth rate. Annual buyback rates can vary widely with market and economic conditions, for this example we will use 3.50%. These assumptions make the Dow and S&P real shareholder yield a little better than 3.50% (dividend yield + plus buyback - minus inflation 2.125 + 3.50 – 2.10.) Both indexes have averaged total returns (growth + dividends) of about 10.50% over the last 50+ years. There are a lot of numbers to consider here. Notice the fixed income numbers I have quoted are "hard" while the equity numbers are "approximate." Those of us willing to accept approximate will probably earn more…particularly over the long run.

Our equity disposition will remain at "Like." We will predict 2020 to deliver about 10.50%, the historic average. If we are correct it will cost you $10,000 per $100,000 to hold your liquidity in cash (10.50% - 0.50% = 10.00%.). Stocks can do anything bonds can do better.

Last but not Least….

During the 4th quarter of 2019 we were informed that our firm was ranked by CNBC as one of their top 100 financial advisory firms. This was a head scratcher for us since we had no idea we were even under consideration for the honor. Accolades like this are often delivered in exchange for advertising dollars or commissions generated. We maintain a low profile in this regard and have vetted the intentions of our benefactor. We were number 71 on a list that could have included as many as 13,000 firms. Hardly the spot where you would expect to find bribery and coercion. In the end we were flattered and humbled. Click on www.pittand.com if you would like to share our surprise.

On behalf of the entire P&A team,

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