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Investment Strategy

"A Wall Street Walk Through Time"

Robert Penn Warren (April 1905 – September 1989) was an American poet, novelist, and literary critic who once said, "History cannot give us a program for the future, but it can give us a fuller understanding of ourselves, and of our common humanity, so that we can better face the future." We thought of him when we received this email from a veteran Wall Streeter named David S. Mann. We like this story:

> Just want to thank you again for your ongoing insights on the market and, indeed, life in general. Your recollection this morning of the seemingly well-founded doubts that the market could continue to rise after its initial post-election blastoff last year reminded me of a few moments since I left the practice of law and joined EF Hutton in the spring of 1981. After graduating from The Training Boardroom downtown at One State Street Plaza, I moved up (literally and figuratively) to a branch office in midtown on Fifth Avenue. A veteran, cigar smoking broker named Phil had made a ton of money consistently being long puts as interest rates skyrocketed, stocks fell under that weight, WPPS Bonds went "woops!", and Paul Volcker and Henry Kaufman were the headliners of the day. In fact, one cold call recipient, in response to my suggestion that he buy shares in Ohio Edison for its 16% tax deferred dividend yield (due to its nuclear plant construction), assured me that he wasn't "stupid" and would not "lock in" 16 % since he "knew" that interest rates were going higher. Another favorite was when another gentleman counselled me (as I heard mooing in the background), saying in a long, slow southern drawl, "Son, the only stock I buy is LIVEstock"! Since I was then quite certain that just about everyone else knew more than I did, I finally placed my inbred optimism aside and bought puts in my own personal account with the very few number of shekels my wife and I had to our name. That was just a couple of days before August 12, 1982 which, if I remember correctly, was the date the DJIA bottomed [at] about 776. Thereafter, Phil continued to invest, tightly embracing his certainty that the market was wrong and he was right. My options expired worthless (unfortunately, not the last lesson it took for me to learn) and Phil was eventually out of the business.
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> The market close on October 19, 1987 found me at my desk at Lehman Brothers with my right palm tattooed to my forehead and my fingertips sporting calluses from repeatedly/vainly dialing the order room and receiving no answer. That evening, I returned to the home we'd taken on the big mortgage to buy, precisely two months prior to the day, trudged up to my bedroom with my worried wife a step behind me, sat down on our bed, and hopelessly told her, "Life is over as we know it". The DJIA had closed around 1738.
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> If 1987 was The Crash, 2008-2009 was more like The Flood associated with the Biblical Noah. It seemed to be never-ending. As luck would have it, on the September Sunday that we left for a Wachovia sponsored firm trip to Hawaii, Hank Paulsen hosted a news conference announcing Fannie Mae's problems and that the Preferred issue that clients had bought the prior May would cease paying dividends. Not good news. The other shoe dropped the next Sunday as we awaited our return flight being informed that the futures were down over 400 points due to the Lehman debacle. Not exactly the bookends to the "Pleasure In Paradise" vacation I'd hoped to enjoy. As tragedy unfolded, it led to a conversation with a client near the ultimate bottom around 6500. He owned a number of old-line quality names that had plummeted to single digits amid the fears of Financial Armageddon. Swept up in the broadening panic, I'll never forget when he softly instructed me, "Sell 'em all". He, and so many others, took quite a hit.
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> And here we are. I'm reminded that everything we look back on is something else we got through—no matter how end-of-the-world it seemed at the time and that the only thing I truly know for sure about where the market's going and when it's going to get there is that I absolutely do not, and cannot ever know, such things for sure. The best I can do is try to identify the guideposts along the way and do my best to ferret out the detours needed to be taken as the journey continues. Your models, experience, and discipline to which you often refer help me in that regard. So, thank you again. I do hope at some point we can get together if your schedule permits.

There is much wisdom in David Mann's missive. We suggest reading it again and then thinking about all of the mistakes you have made over the years of investing/trading. We too worked for EF Hutton and learned early in our career that the trading

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of options was/is a money losing operation. Using options to “lay off” risk, however, is a totally different and effective strategy. Speaking to the WPPS bonds, we bought the WPPS #3 tranche of bonds when we read that Warren Buffet had bought them. At the time, all those WPPS bonds were being “puked up” because the #1s and #2s had gone into default. But, the #3s ended up being money good and were, at the time, yielding 17% tax free and trading at $0.72 on the dollar. They ended up being redeemed at par a number of years later. Remember, as often referenced in these letters, the Japanese kanji symbol for “crisis” is composed of two characters; the first character represents “danger,” the second “opportunity.” Thus it is in the stock market, as well.

Moving on, while the world continues to be a dangerous place, there has been no real danger in the equity markets since the presidential election. Quite frankly, we should have stayed with our long-term forecast of last summer when we wrote that there was a big rally coming in the fall of 2017. Alas, our intermediate model suggested that was not going to be the case a number of months ago and adopted a more cautious approach within the construct of a secular bull market. Last week, that secular bull market continued with a number of the indices we monitor tracking out to new all-time highs. All of the broad-based Advance/Decline Lines also tagged new highs. Even the Operating Company Only Advance/Decline Line, which excludes closed-end funds, etc., made new highs. That said, Selling Pressure has been rising while the stock market has been trending mainly sideways. Indeed, back around the beginning of November, the S&P 500 (SPX/2602.42) was changing hands around 2600, and that is pretty much where it is currently. What is truly amazing to me and Andrew is that, during the post-election rally, there has not been one single 90% Upside Day. Given the nearly 25% rally by the SPX since 11-4-16, we are not really sure that has ever happened before. It certainly is not chronicled in our notes of over 50 years.

The call for this week: Plainly, the driver of this second leg of the secular bull market has been the transition to an earnings-driven secular bull market from an interest rate-driven secular bull market. The most recent earnings season confirms this once again. So as we always do at the end of earnings reporting season, we screen the Raymond James research universe of companies that are favorably rated by our fundamental analysts, have beaten earning/revenue estimates and guided forward earnings estimates higher, and screen favorably on our models. Many of these names have been on this list for over a year, but they still look great: Home Depot (HD/$172.33/Outperform); LKQ (LKQ/$38.05/Outperform); S&P Global (SPGI/$163.73/Outperform); Wal-Mart (WMT/$96.62/Strong Buy); Johnson & Johnson (JNJ/$137.17/Outperform); Becton Dickson (BDX/$226.28/Strong Buy); Praxair (PX/$152.88/Strong Buy); Equinix (EQIX/$474.07/Strong Buy); Cisco (CSCO/$36.49/Outperform); and NVIDIA (NVDA/$216.96/Outperform). As for the equity markets, we are about to enter the month of December, and we have learned the hard way it is tough to put markets away to the downside in the ebullient month of Christmas! That does not mean it can’t happen, but it is pretty rare. This morning, stocks are marginally higher as President Trump notches yet another “win” on trade as China slashes tariffs and retailers report strong sales.

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