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CAPITAL

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Dear Clients and Friends,

In this letter, I'm going to answer the most common questions we are getting, including our thoughts on a potential U.S. recession, impeachment inquiry, trade wars, Trump's effect on the market, the upcoming 2020 U.S. Presidential election, and marijuana stocks. While we evaluate the ramification of these issues on our portfolios, the best course of action to grow wealth over time is to invest in a diversified portfolio of outstanding investment opportunities. Our client portfolios are concentrated in companies with great management teams, profitable advantaged businesses, low-debt balance sheets, motivated employees, trading at valuations that offer significant appreciation potential.

Before jumping into the questions, I wanted to outline why we've re-initiated an investment in online shopping retailer Stitch Fix (SFIX). While delivering 29% sales growth, 18% customer growth, and a 9% increase in revenue per customer over the past year, SFIX shares have declined significantly as concerns surrounding cost of acquiring customers and new competition from Amazon spooked investors. We think their core offering remains robust and are particularly excited about a new "direct-buy" functionality where customers can go online, browse 30-40 personally selected items, and buy directly.

SFIX recorded $1.5 billion in sales in 2019 and forecasts close to $2B in 2020. Its current earnings power is masked by their large investments in data science, new categories, and marketing. Given SFIX's superior business model, culture, and growth, we estimate 1) sales growing 20% compounded over the next few years, 2) after-tax margins reaching 8%, consistent with apparel industry leaders like TJ Maxx & Ross Stores and 3) the stock maintaining a premium earnings multiple reflecting its leadership (25x+ EPS). In such a scenario, SFIX shares would be worth roughly $50 per share in three years (EPS of $2.14 x 25x EPS), a potential 35% compounded annualized return from current levels.

On the next page, I'll dive into the most common questions we've been getting from clients. If you have any further questions, please don't hesitate to give us a call.

Sincerely,

Tom Eidelman, CFA
Managing Director

Frequently Asked Questions

Question #1: "*What's your view related to potential concerns about an economic downturn and impact to the markets? I do believe something will happen although timing is clearly a big question. What can we do to protect ourselves as much as possible?*"

We are cautiously optimistic regarding the stock market and believe we've positioned the portfolio for success under many market scenarios. We've moved towards some higher quality, well-managed, great culture, large companies like Google (GOOG) Southwest airlines (LUV), and Amazon (AMZN), that we think will continue to grow and possibly improve their positions in a downturn. Conversely, we sold off some of the smaller economically sensitive companies that weren't performing and could be knocked down further if the economy falters. We also continue to avoid many of the high-flying, overvalued faddish sectors along with acquisitive companies which are most vulnerable to a downturn.

The economy could also surprise us on the upside and our investments are poised to benefit. Given their attractive valuations, our investments, such as our bank holdings, could rise significantly from their historically low valuation levels. Given the limited downside and healthy upside, we feel confident about the portfolio from a risk/reward perspective.

Question #2: "*I have a large amount of cash outside my investment account, but I'm not comfortable putting it in the market right now. Is that ok?*"

Conventional investment advice recommends not trying to "time the market." There are studies that show that by being out of the market on just the 10 best trading days over the past 15 years, investors would have earned just a 3% compounded annual return versus 8% for buy and hold investors. Being out of the market can subject market timers to the risk of missing the upside. For this reason, as well as many others, we don't try to time the market, nor do we recommend clients attempt to do so. Our goal is to remain close to fully invested for our accounts under normal circumstances.

While we don't typically recommend keeping cash on the sidelines, each client's risk tolerance, time horizon, and ability to opportunistically react to the market is different. In many cases, keeping some extra cash on the sidelines to help a client sleep better at night or wait for a personal investment opportunity may make sense. We would be happy to discuss this with any client at any time to help make the best decision possible.

Client Question #3: "*Trump is destroying our country. His policies have to whack the stock market at some point, right?*"

The Presidency impacts individual companies much less than people realize. Conversely, the power of free markets, innovation, and productivity are much more powerful. The stock market is an amalgamation of thousands of individual companies each trying to deliver value to customers and returns to shareholders. While tax rates, trade rules, and regulation may change the rules of the game that businesses must follow, the stock market will correlate to how successful each of these companies are over the long term. Most companies can thrive no matter what political party is in power.

Question #4: *"What are the market implications of a Trump impeachment?"*

Given the Republican controlled Senate, the betting websites have the odds of the Senate convicting and removing Trump from office at 20%. Because of Trump's unpredictability and tough trade stances, especially regarding China, it is also possible that Trump's removal from office may not be seen as a negative market event. Combining these two facts with our answer to question #1, impeachment prospects are not a material factor in our current investment evaluation.

Question #5: ***"How would an Elizabeth Warren Presidency impact the markets? How should we think about the upcoming presidential elections?"***

While the political party of the White House hasn't proven significant to stock markets overall, individual sectors and companies may prove more fruitful than others depending on the presidency. President Trump has been an advocate of domestic manufacturing, defense spending, deregulation, while being critical of global supply chains and trade with other countries.

Recently, Elizabeth Warren's chances of winning the Democrat nomination have risen dramatically. Given Senator Warren's comments regarding a ban on new fossil fuel leases on public lands and fracking, breaking up Amazon, Facebook, and Google, and calling for the end of the private healthcare industry, some of these respective companies have lagged. She is also thought to be equally tough on China.

While her comments may cause some concern, she still characterizes herself as a capitalist, and major reforms would need to be approved by congress. There are also other sectors that may benefit including clean energy and infrastructure sectors. While there is still much to learn about her economic policies, we feel confident that companies will continue to innovate and grow under a Warren presidency, driving stock prices up over time.

Question #6: ***"Now that Missouri has passed a medical marijuana law, maybe we should look into marijuana growers & producers. There is a definite trend of acceptance now. Are there investment opportunities to take advantage of the legalization of marijuana?"***

While excitement and growth in Cannabis is rampant due to legalization; however, it's important to remember that cannabis is a commodity like corn and soybeans. As more growers and retailers open for business, prices are falling and margins shrinking. There is also the risk of big tobacco entering the space along with regulatory concerns that will cloud the space.

Consumers of cannabis products will surely be happy, but we think the business prospects don't look promising for many fledgling cannabis companies. While there have been a couple of successful cannabis stocks and trading opportunities, as a group, they have vastly underperformed. The largest cannabis ETF (ETFMG Alternative Harvest Ticker: MJ) with $750m in assets has declined 24% since its founding in 2015 and declined 50% in the last 12 months. While we will continue to monitor the sector, we think most cannabis stocks are best avoided at this time.