SEVENS REPORT *alpha*

November 28, 2017

In Today's Issue (Part 1)

Keynote Sessions:

Can Economic Growth and Markets Remain Resilient? (Bruce Johnstone, Senior Marketing Investment Strategist, Fidelity)

- Market appreciates Trump. DJIA is up over 5,000 points since election day.
- Any decent stock market rests on a foundation of these pillars: Rising corporate profits, benign inflation, benign interest rates, plenty of dough and reasonable valuations.
- Wimpy economic recovery (weakest one of last century). Economic recovery has been poor because business confidence has been lacking and corporate profits have been soft.
- When you want the Government to come to the rescue, they bring all kinds of regulations along with all their money. And when you load up regulations on the private sector, it slows things down (staggering increase in the number of regulations the last 9 years). It causes tremendous uncertainty, hurts confidence and takes away incentive. Fidelity has taken on 900 people to deal with compliance!
- Number of regulations deleted—and not created—is extraordinary under Trump.
- US is probably the only developed country on the planet that has not reduced corporate taxes.
- Amazon putting downward pressure on prices. Good for the consumer, not good for companies that want/need to raise prices.
- Small business confidence has skyrocketed since election.
- US consumer is improving (70% of GDP). Two biggest assets (housing and stock market) on consumer balance sheet are doing well.
- The amount of money we've printed is mind-boggling. The result is you debase, debauch and devalue the value of your currency. This is what we've done. Except, people don't notice it because everyone else is doing the same thing and we compare the US dollar to foreign currencies. Fact is, in the last 83 years, the purchasing power of the dollar is down 97%.
- Tailwinds: Deregulation. Low interest rates (stocks are in the inflation sweet spot of 0% to 2%). Anticipation of tax reform. Repatriation of foreign cash. World economic growth in sync.

- Headwinds: Will monetary authorities raise rates too fast and/or remove too much monetary stimulus? Inflation (in a coma, but not dead)? Will valuations come in? How do we deal with debt (we've borrowed from the future)? What about the paralysis in Washington? Are we going to get serious trade and immigration restrictions? What happens when NAFTA gets redone? What about state and local unfunded pension liabilities (close to $2 trillion)? What will Kim Jong Un do?

- A little worried about China. They've overbuilt the place. China built two-thirds of all the mall space in the world last year. They don't need it because they're shopping online.

- Complacency in markets. There are people in the financial advisory business who have never seen a "correction."

- **Likes: Non-US. Emerging markets (India and Brazil surprise to the upside). Financials. Small caps. Natural gas ($14 Mcf in 2008... $3 Mcf now… Could be a huge win in transportation system). Natural resources for the long run. Real estate (inflation protection).**

Tom's Takeaways: Largely reinforced what we've been talking about in Sevens Report, which is always nice to hear! Worries: Rising rates, debt load (individual), China, Geo-Pol. But, for now, positives outweigh the negatives—but risks are building. Most importantly, I liked his comment on complacency—many financial advisors haven't seen a correction. That will be a big opportunity for advisors who successfully navigate that volatility!

Best Strategies & Ideas for Income and Growth (Richard Lehmann, Strategic Advisor, Lehmann, Livian, Fridson Advisors; Martin Fridson, CIO, Lehmann, Livian, Fridson Advisors; John Buckingham, CIO, AFAM Capital; John Dobosz, Editor, Forbes Dividend Investor; Taesik Yoon, Editor, Forbes Investor)

Assessment of market:

- RL: Market has run ahead of what the economy will be able to deliver in the coming years; Risks have accumulated; Be defensive in your thinking going into 2018.

- MF: Valuations are high almost anywhere you look, but they aren't triggers for bear markets; We could limp along for a little longer.

- JD: CAPE says S&P 500 is 86% overvalued; Trends can go on much longer than anticipated. All things equal, higher rates are bad for stocks; During the "taper tantrum," 10-year Treasury went from about 1.5 to 3 in 6 months and high yield, less growthy stocks took the biggest hits (dividend growth stocks did well, as a group).

- JB: Recipe for value success is the environment we're in today; Can't look at stock valuations in a vacuum; Worried about bullish sentiment, which has been a good contra-indicator; Look at alternatives.

- TY: Valuations are stretched, but not every sector or industry has participated to the same degree; There are values to be had.

Tax reform:

- JB: Whatever gets done will be watered down if it gets done at all; Not making portfolio bets based off possibilities of tax reform legislation; Take advantage of what has been beaten up due to potential impact of tax reform (i.e., housing); Likes **M.D.C. Holdings (MDC)** and **Whirlpool (WHR)**.

- MF: Still have a long way to go before the legislation comes to pass; Companies doing a lot of capital spending will benefit from the immediate write-off if it survives; Income investors should benefit with tax rates coming down; Let's see what the final bill looks like.

- TY: US corporate tax rate is so high compared to the rest of the world; Small caps that generate a large portion of their revenues here should benefit.

- JD: Marginal benefit to consumer discretionary sector because households will be getting something; Large companies will bring home trillions of dollars; Billionaires will have more money.

Energy:

- RL: Focus on MLPs; They've been pounded; They're tax-sheltered to an extent; Have sizable yields; Potential large recovery over the next 12 months.

- JD: Likes larger, quality names like **Total (TOT)** with a 5% yield, excellent earnings and a reasonable valuation; Also likes oil service companies **Halliburton (HAL)** and **Schlumberger (SLB)**.

FANG stocks:

- JD: Not many companies are producing eye-popping rates of growth like them; People chase them because they are household names.

- JB: Likes **Alphabet (GOOGL)** first—and **Facebook (FB)** second—out of the FANGs; If you're a part of new-age tech, you're in the game. For example, all of the sudden people realized that GM makes electric cars and the stock went from $33 to $44 and a 5X P/E to a 7X P/E.

- TY: They have momentum, but should revert to a mean—like all other stocks—over time.

International markets:

- JD: Europe has been on a 2-year delay from the US. Stocks are cheaper there than here.

- JB: World is becoming more interconnected—can get foreign exposure through US companies; Finding value overseas (Europe); Likes **HSBC Holdings (HSBC)**, **Sanofi (SNY)**, **Medtronic (MDT)** and **Eaton (ETN)**.

2 best picks for next 12 months:

- TY: **Mitel Networks (MITL)**. Makes unified communications solutions; Just bought ShoreTel (now, No. 2 player in space); Other pure plays are trading at 40X to 50X earnings; Stock could double or triple. **SuperValu (SVU)**. One of the largest wholesale grocers in the US; Hurt because of AmazonFresh; Sold Save-A-Lot, paid down debt and bought some regional grocers; 7X earnings; Could be much higher a year from now.

- JB: **Seagate Technology (STX)**. Disk drive maker; Good earnings in Q3; 9X earnings now; 7% yield; Voracious need to store data. **Merck (MRK)**. Extensive line-up of high-margin drugs and solid pipeline; Just went on sale—dropped 12% on earnings and Keytruda disappointment; 14X earnings (historically low); 3.4% yield.

- JD: **Steelcase (SCS)**. Furniture maker for office, healthcare, education and auto industries; Revenues rising steadily; 13.9 P/E (usually, around 14.5 P/E); P/CF 9.9 (usually, around 13.4); 3.7% yield. **Tanger Factory Outlet Centers (SKT)**. Retail apocalypse is overblown; Nobody likes to go the to mall, but they will go to discount places for bargains; Revenues continue to rise; Close to 6% yield. Bonus picks: **Andeavor Logistics (ANDX)**, **EQT Midstream Partners (EQM)** and **Emera (EMRAF)**.

- MF: **Wells Fargo 5.625% Perpetual Preferred (WFC-Y)**. Good rating; 3rd largest bank in US; Bank's capital ratio is about 200 bps more than requirement; 5.4% yield. **Arch Capital Group Preferred (ACGLO)**. Fixed rate, non-cumulative, perpetual preferred; Bermuda-based insurance company; Solid rating from all rating agencies; 5.4% yield.

- RL: Likes MLPs and REITs. **Tortoise Energy Infrastructure (TYG)**. First CEF to focus on MLPs; 10% distribution rate; 30% leverage; Not as dependent on energy prices as the industry as a whole. **Annaly Capital Management (NLY)**. Trades mortgage loans with a proprietary algorithm; Very volatile; Cheap; 10.5% yield.

Tom's Takeaways: The "Buy Housing" on any tax cut dip really caught my attention—very interesting idea there that I agree with. I also like the foreign exposure picks and energy names especially (contrarian ideas).

Finance for Normal People: How Investors and Markets Behave (Meir Statman, Glenn Klimek Professor of Finance, Santa Clara University)

- It's part of the human condition to miss and overlook things. Our eyes are not video cameras and our brains are not computers. We cannot rerun the tape and see what we might have missed in the first viewing. We are intelligent people and that means jumping to conclusions.

- One must acknowledge the full range of normal wants and what distinguishes normal wants from errors.

- Normal wants: Playing the lottery. Expressive benefits: *Being a player with a chance of winning*. Emotional benefits: *Hope of winning*. Utilitarian benefits: *Miniscule chance of winning*.

- Normal wants: Active investing—We want to play and win. Expressive benefits: *I am much smarter than mediocre index fund investors*. Emotional benefits: *I love the exhilaration of playing and winning*. Utilitarian benefits: *It provides high returns*.

- Why do we behave as we do? Because we are rational, irrational and normal. We fall victim to cognitive and emotional errors on our way to our normal wants. Our brains find patterns and jump to conclusions. We use cognitive shortcuts. Sometimes, we jump too fast, too far or in the wrong direction.

- Foundation blocks of behavioral finance explain why people think markets are easy to beat: 1. People are normal. 2. People construct portfolios as described by behavioral portfolio theory. 3. People save and spend as described by behavioral life-cycle theory. 4. Expected returns of investments are accounted for by behavioral asset pricing theory. 5. Behavioral finance distinguishes price-equal-value markets from hard-to-beat markets.

- It's very hard to beat the market, but not impossible. Insiders, hedge funds, active mutual fund managers, security analysts all stand a chance, but even their chances are low.

- Fidelity Traders Summit survey: 62% expected to beat the market over the next 12 months… 29% expected to match the market over the next 12 months… By default, 9% expected to lag the market over the next 12 months. Actual numbers are more than a reverse of that!

- Think of the stock market as a pot of stew. It has fat returns and lean returns. Index investors put their ladles into the stew and take out their average share of fat and lean. Above-average investors put their ladles in just right and get more fat than lean. What does it mean for everyone else? They get the below-average lean. Be careful because you might be that someone.

- In every trade there is an idiot. If you don't know who it is, you are in trouble.

- Lessons for individual investors: Know your wants. Know financial facts. Know human behavior.

Tom's Takeaway: If we want to outperform, we have to find structurally attractive risk/reward profiles. Over the long term, finding structural opportunities (like RSP underperforming when over 80% of the time it outperforms, targeting dividend growth because it's more reliable than just dividend investing, etc.) is the way to outperform—it takes good research—not just thinking we can do it!

Notable Breakout Sessions:

Global Market Outlook (Jeffrey Kleintop, Chief Global Investment Strategist, Charles Schwab)

- The RIAs he meets with are asking the same questions: Is this environment too good to last? Is it too late to buy? Is a recession right around the corner? Is a bubble about to burst? These things might be coming, but Schwab doesn't believe they will happen in the next 12 to 18 months.

- Across the firm, Schwab strategists are as bullish on the stock market as they have ever been.

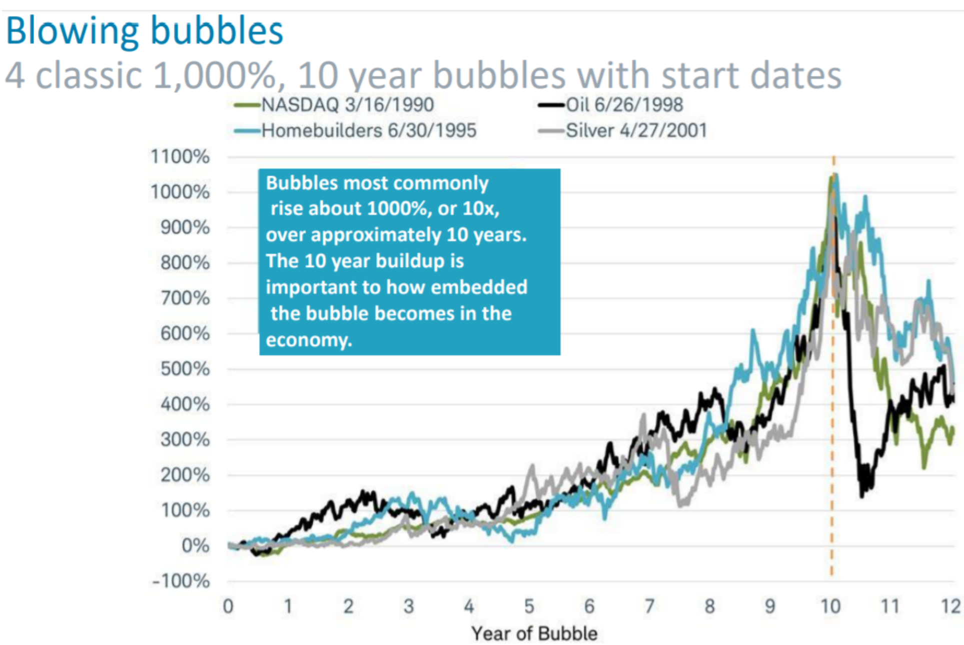
- Still a good time to put money to works (especially, globally).

- In the 30 years of the MSCI AC World Index, there's never been a calendar year where all months recorded positive returns. This year, the first 10 months recorded positive returns.

- Every major economy is growing for the first time in a decade.

- Recession risk? Watch the US Treasury yield curve (10-year yield minus 3-mo yield). Usually, about 2% on average over the last 50 years. Basically, 1 year before every bear market—and global recession—since 1967, the yield curve inverted. Amazing forecasting tool that's never been wrong. Next recession isn't imminent, but it's probably 2-3 years away.

- Bubbles? Bubbles most commonly rise about 1,000%, or 10X, over approximately 10 years. This pattern repeats itself all the time.



- Bitcoin could be the next bubble. It's up 1,000% since beginning of 2016. $1,000 of bitcoin in 2010 would be worth $58 million today. But, it doesn't have 10 years yet and its an independent thing.

- Then, there's the FANG stocks. Internet retailers went up almost 1,800% over the last eight and half years. But, there's been an offset here—brick & mortar retailers have gotten crushed. Doesn't think either are risks that would cause the next recession. Probably no major bubble about to burst in the next 12 months.

- Is the market too expensive and is it too late to buy? **No, it's not.** Valuations are critical to long-term returns, but they say nothing about the next 12 months. Thinks just about all equity markets are fairly valued relative to how they've performed and the sector(s) they represent.

- The world views the US like a big tech stock. And the US stock market behaves just like the tech sector. **Everything is tech in the US: Consumer-tech, health-tech, fintech, etc. It drives everything we do.**

- The Eurozone is made up of 19 countries. But, it behaves like 3 sectors: Financials , materials, telecom. Japan acts like financials. Denmark acts like healthcare. Germany acts like autos. Australia acts like materials. Canada acts like energy.

- **No reason to not be globally diversified right now.** Correlations across countries are the lowest they've been in 20 years. We're back to the golden years of diversification.

- It's a great environment to be invested in for the next 12 months—maybe a little longer. In the near term, focus on the positive stuff and grab double-digit returns while you still can.

Tom's Takeaways: Touched on two familiar themes: Yield curve as a recession indicator (marvelous track record), and need to diversify internationally. These were two very common themes from what I considered the sharpest speakers (Kleintop and Stovall) at the conference.

Retirement Planning: What We Know for Sure (Christine Benz, Director of Personal Finance, Morningstar)

- Secular factor unknowns: Long-term asset class returns before and during retirement… Currency swings… Tax rates… Inflation… Changes to Social

Security.

- Personal situation unknowns: Amount you can contribute to meet goal… Time horizon to retirement… Duration of retirement… Ability to stick with plan... Tax situation… Health… Large unforeseen expenses before or during retirement.

- Knowns: Longevity is increasing (while average number of years worked is declining)… Fed policy: Declining yields makes it difficult to subsist on yield alone.

- Longevity: Average life expectancy of a 65-year-old male is 19 years; Average life expectancy of a 65-year-old female is 21 years.

- **Ways to protect against longevity risk:** 1) Maximize Social Security; 2) Maintain a conservative withdrawal rate; 3) Hold healthy and diversified allocation to equities; 4) Opt for annuity option with pension; 5) Consider annuities for part of retirement cash flows (SPIAs, DIAs, QLACs).

- Finding cash flow: "Livable" yields come at a price (High yield bonds yield 4-5%/2008 down 24%; Emerging markets bonds yield 6-7%/2008 down 18%; Bank loans yield 3-4%/2008 down 17%).

- A 60/40 portfolio in March 2009 would be 83/17 today.

- Rebalancing/peeling back equities can help retirees achieve multiple goals: Reduce risk in portfolios; Tee up cash flows for the year(s) ahead; Meet RMDs; Make charitable contributions.

- Inflation is low, but it hasn't gone away. Hits older adults much harder than general populace. Consider: **TIPS, I-Bonds, bank loans, stocks, commodities and real estate.**

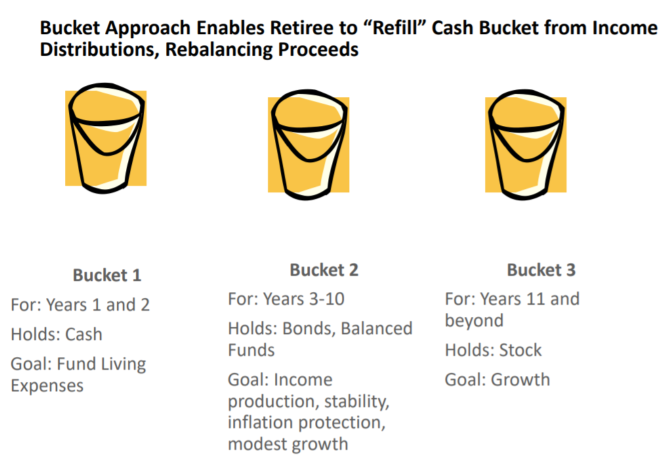
- Be cautious with withdrawal rates in early retirement. Consider: Current conditions (take less in weak markets/take more in strong ones); Time horizon (take less if horizon is long/more if it's shorter); Asset allocation (more stocks support higher withdrawal rate/more bonds/cash necessitate a lower withdrawal rate); Liquidity (maintain adequate amount so you don't have to sell securities in a trough).

- Long-term care is huge threat for many plans. 52% of people turning 65 will have a long-term care need in their lifetimes. Women have a greater need for long-term care than men. An extended long-term care need can loot a portfolio: Average nursing home care cost for a private room is $97,452 (3% to 4% annual inflation rate the last 5 years). Consider: **Insurance; Hybrid long-term care/annuity; Hybrid long-term care/life insurance policy; Self-funding using portfolio of assets and/or home equity.**

- Cognitive decline is a force to be reckoned with. It can be ruinous to a financial plan. Consider: A financial partner (CFP or CPA); Keep estate planning documents up to date; Simplify investment plan; Document as much as you can (accounts, URLs, user names and passwords).

- Bucket approach: Bucket 1: Cash to fund living expenses (duration 1-2 years); Bucket 2: Bonds and balanced funds for income production, stability, inflation protection and modest growth (duration: 3-10 years); Bucket 3: Stocks for growth (duration: 11 years and beyond).

- ETF Sample Bucket portfolio (Assumptions: 65-year-old couple with $1.5 million portfolio, 4% withdrawal rate with 3% annual inflation adjustment, time horizon of 25 years, 50/50 model portfolio)...



- Bucket 1: Liquidity portfolio for years 1 and 2 ($120,000): in CDs, MMAs/MMFs, other cash.

- Bucket 2: Intermediate portfolio for years 3-10 ($480,000): $100,000 in Vanguard Short-Term Bond ETF (BSV), $150,000 in Vanguard Total Bond Market ETF (BND), $50,000 in iShares IBoxx Investment Grade Corporate Bond ETF (LQD), $100,000 in Vanguard Short-Term Inflation-Protected Securities ETF (VTIP), $80,000 in Vanguard Dividend Appreciation ETF (VIG).

- Bucket 3: Growth portfolio for 11 years and beyond ($900,000): $350,000 in Vanguard Dividend Appreciation ETF (VIG), $200,000 in Vanguard Total Stock Market ETF (VTI), $200,000 in Vanguard Total International Stock Market ETF (VXUS), $75,000 in iShares Barclays Capital High Yield Bond (JNK), $75,000 in WisdomTree Continuous Commodity Index Fund (GCC).

Tom's Takeaway: Are older clients hedged against an uptick in inflation—because that's the "left field" risk for retirees going forward. I thought it was very interesting that was brought up. Also, very much liked the "bucket" approach—made her comments very actionable for advisors and investors.

Is It Time to Buy or Bail? (Sam Stovall, Chief Investment Strategist, CFRA)

- Second longest bull market since World War II. Also, second most expensive market (23.7 P/E ratio based on trailing GAAP EPS) since World War II.

- Every Republican President since 1901 had a recession start in their first term.

- P/E ratios are not good market timing indicators. Bull markets don't die of old age, they die of fright.

- Looks at four recession indicators: Year-over-year housing starts, percentage change in consumer sentiment, 6-month percentage change in leading indicators; yield curve (10-year Note vs. 1-year Bill). **None of these indicators are showing we're headed for a recession.**

- Stocks still look attractive compared to bonds.

- Full-year 2017 and 2018 EPS estimates have not collapsed as they did in 2015 and 2016.

- Seasonals are on stock market's side. Since 1990, S&P 500 has returned an average of 4.9% in Q4. Q4 has generated a positive return 81% of the time since 1990. Not just a US large cap phenomenon (similar results in US mid caps, US small caps and global stocks).

- Let your winners ride. Cut your losers short.

- Worries: Aging bull market; Elevated P/E ratios; Rising interest rates; Domestic & geo-political tensions.

- History & forecasts to calm the nerves: Low risk of recession; Net-negative, real-rate environment; Continued emergence from the EPS recession; Low inflation supports high P/Es; Seasonals; International participation; Speed of recovery following market declines.

- History isn't gospel, but it can be a wonderful guide.

CFRA's Industry Momentum Portfolio as of 10/31/17

SECTOR	CURRENT PORTFOLIO	TICKER	STARS
Cons. Disc.	Auto Parts & Equipment	BWA	4
	Casinos & Gaming	WYNN	3
	Computer & Electronics Retail	BBY	3
	Homebuilding	DHI	5
	Hotels, Resorts & Cruise Lines	RCL	4
Financials	Diversified Banks	BAC	4
	Investment Banking & Brokerage	SCHW	5
	Regional Banks	STI	4
Health Care	Managed Health Care	AET	5
Industrials	Aerospace & Defense	LMT	5
	Agricultural & Farm Machinery	DE	3
	Construction Machinery & Heavy Trucks	PCAR	4
	Railroads	UNP	3
Info. Tech.	Application Software	CTXS	4
	Electronic Components	APH	3
	Home Entertainment Software	ATVI	4
	Semiconductor Equipment	LRCX	4
	Technology Hardware, Storage & Peripherals	AAPL	5
Real Estate	Real Estate Services	CGB	3

- Ideas: Industry momentum portfolio; Dividend Aristocrats; High quality stocks (CFRA's top picks: **MO**, **CHD**, **FDX**, **LMT**, **ORCL**, **PEP**, **WMT**, **YUM**); Income-oriented investors need to think like landlords—focus on income stream not as much on price.

Tom's Takeaway's: I thought his recession indicators were

all very good—a bit different take on the yield curve. Importantly, while there has been deterioration, none of the recession indicators have been elected yet. It was also interesting to see CFRA's top stock picks based on both momentum and quality factors.

Thinking Differently About Diversification (Larry Swedroe, Director of Research, Buckingham Asset Management)

- All advice his firm gives is based in evidence.
- It used to be about 20% of active managers were able to beat the market. It's down to 2%.
- Most investors have insanely, incredibly short-term investment time horizons. People idolize Buffett, but do exactly the opposite of what he does. Temperament outperforms intelligence all the time.
- **Investing is about putting the odds of success in your favor.**
- World of investing has become complex. There are over 600 factors—"a zoo of factors."
- Ways to think about factors: Unique trait or characteristic; Unique explanatory power of returns; Should provide a premium.
- Factors are essentially long-short portfolios: Beta is the return of stocks *minus* the return of 1-month T-bills; Size is the return of small stocks *minus* the return of large stocks; Value is the return of value stocks *minus* the return of growth stocks.
- His factor criteria: Persistent, pervasive, robust, investable and intuitive.
- Only a small list of factors meet his test: Beta, size, value, momentum, profitability and quality (carry and term work, too).
- Odds of underperformance over 10 years: Beta (10%), size (22%), value (13%), momentum (3%), profitability (16%), quality (10%).
- Odds of underperformance over 20 years: Beta (3%), size (14%), value (6%), momentum (0%), profitability (8%), quality (3%).
- **The traditional "Larry Portfolio" of 40% DFSVX/60% VFITX has outperformed a traditional Vanguard 60/40 model (60% VTSMX/40% VFITX) over time with less risk.**
- BAM is currently investing in new, alternative asset classes: Shorting the VIX, reinsurance, alternative lending, interval structures and risk parity.

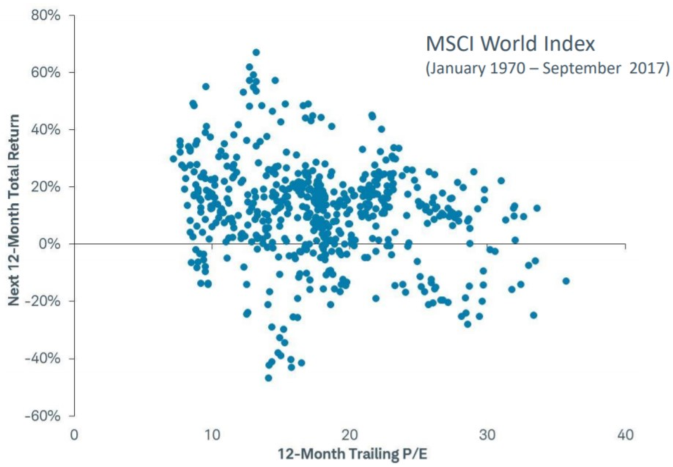
Tom's Takeaway: Keep your clients focused on the long term. Find the structurally attractive risk/reward set ups (which is what we do here in Alpha) and have a long term time horizon. This basically reinforced my entire thesis behind starting Alpha—to provide structurally attractive long term ideas that can outperform. Also, from an idea generation standpoint, it was thought-provoking to see the new investments BAM is making in "alternatives."

The Biggest Mistakes Many Investors Make & What to Do About Them (Mebane Faber, CIO, Cambria Investment Management)

- Mistake #1: Unrealistic expectations. Don't expect stocks—or bonds—to return what they have the past 10 years. Cambria's calculations show a 60/40 model returning an annualized 3.3% the next 10 years (Bogle recently predicted US stocks would do 4% per year).
- What to do? Lower expectations, spend less and save more.
- Mistake #2: US-focused portfolio. US investors have a home country bias—allocating 70% to 80% of their equity portfolios to US stocks. The problem is the US makes up about 50% of the world's market cap and roughly 25% of global GDP. Plus, it's much more expensive than international markets (CAPEs: US = 31, Foreign developed = 20, Foreign emerging = 16).
- What to do? Diversify globally. No reason to have a concentrated US portfolio. Shift some money from US equities to foreign equities. Buying cheap stocks leads to higher returns over the long haul.
- Mistake #3: Paying too much in fees. (For example, there's an S&P 500 Index fund that has an expense

ratio of 2.3%.)

- What to do? Be relentless on managing costs. For a



buy and hold asset allocation portfolio, you should pay as little as possible. If you're buying an actively-managed fund, make sure the PM has "skin in the game." As an advisor, automate portfolio management and add value elsewhere (financial planning, insurance, taxes, behavioral coaching, etc.).

- Mistake #4: Not having a plan.

- What to do? Write down your investment plan and thought process… share it with someone… and prepare for contingencies. Construct a rules-based portfolio. Evaluate progress over time and adjust as needed.

Tom's Takeaways: All of these mistakes are common, but also easily preventable. Do a self audit to make sure you're eliminating as many as possible. Getting more practical, one of the biggest will be home country bias with overallocation to the U.S., especially at such an expensive valuation. Consider diversifying internationally, even if just a little bit—it's still a start!

Have a good week,

Tom