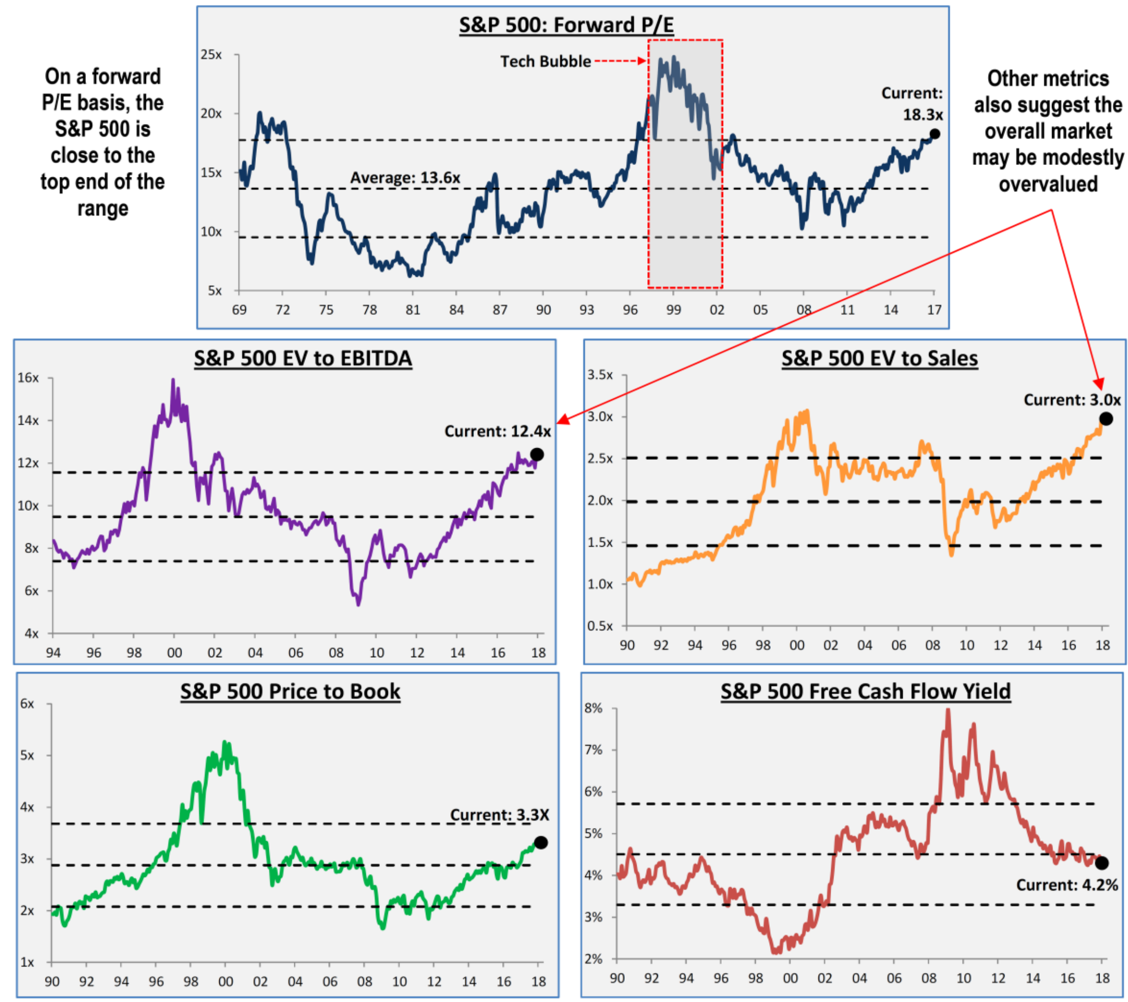
KARMIN CAPITAL

January 2018: Portfolio Check-up

With the tailwinds of tax reform, positive economic data and optimistic company outlooks, equity markets finished 2017 on strong footing and have started 2018 even stronger. Increasingly, many of our discussions with clients have focused on two potential inferences from recent market performance: (1) that the pace of gains, current valuations, strong economic data and company profit margins are all unsustainable (especially as global central banks reduce stimulus and hike interest rates) and, thus, warrants a shift to a more conservative portfolio allocation; and, conversely (2) that gains in stocks have much further to run based on positive fundamentals and, accordingly, now is the time to invest even more aggressively. Each scenario is possible and defensible, but unfortunately impossible to predict with any certainty.

To the first point on potential risks, the charts below showing S&P 500 valuations across various metrics are generally supportive of the concern that U.S. large cap stocks are approaching over-valued territory.[1] Although, on a free cash flow basis (a measure of operating cash flows minus capital investments), valuations are not particularly concerning (see bottom right chart).



Sources: Wolfe Research Portfolio Strategy, Compustat, Standard & Poor's, Thompson Reuters, Bloomberg, and FactSet.

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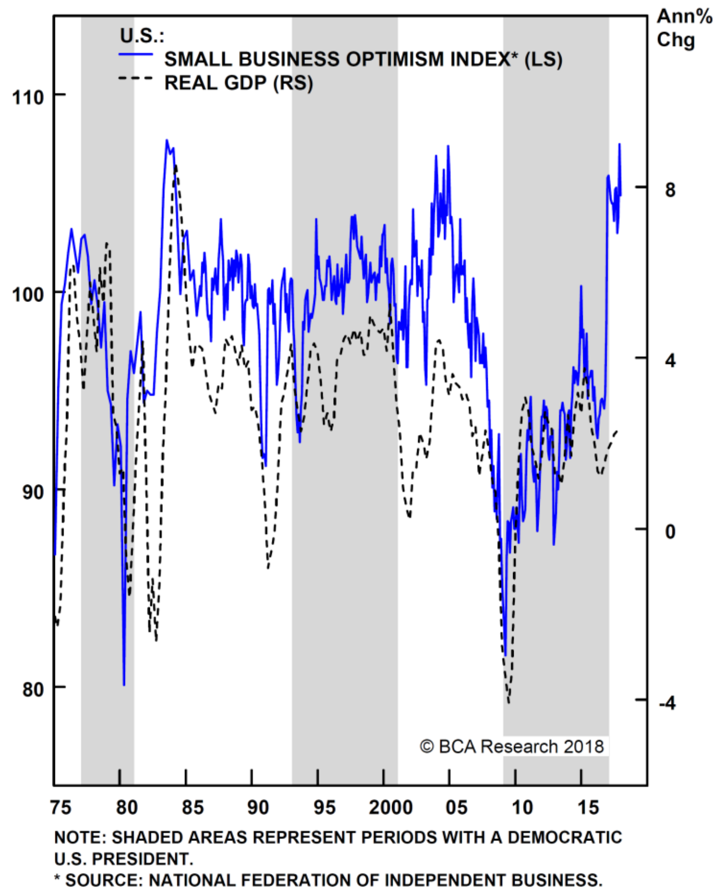
Despite elevated valuations, those with a bullish outlook can persuasively argue that the positive economic backdrop and strong company fundamentals should drive valuations even higher, especially given that interest rates on U.S. government debt are still close to their lowest levels since the founding of the country (about 2.55% on the 10-year Treasury).[2] At the same time, business owners are exhibiting extreme optimism, as evidenced by the National Federation of Independent Business survey (see below chart).[3] Such optimism should express itself in higher business spending and investment, which would be positive economic drivers.



As we have discussed with clients and as we have written in prior correspondence, our view is that U.S. stocks are likely to perform well so long as underlying earnings data continues to be strong. That being said, we believe that the most compelling opportunities right now relative to investment risk are (1) in foreign markets, where valuations are at significant discounts to those in the U.S., despite improving economic data, growing earnings and generally accommodative monetary policy; and (2) in underfollowed and/or unloved areas in U.S. and global markets that do not benefit from the constant inflow of passive funds. For example, these areas include early stage biotechnology companies working on novel cellular and genetics-based therapies, companies involved in the renewable energy and energy efficiency supply chain, small and mid-cap enterprise technology firms and even midstream energy companies, whose valuations do not reflect their improving balance sheets, cash flows and exposure to growing U.S. energy production and exports.

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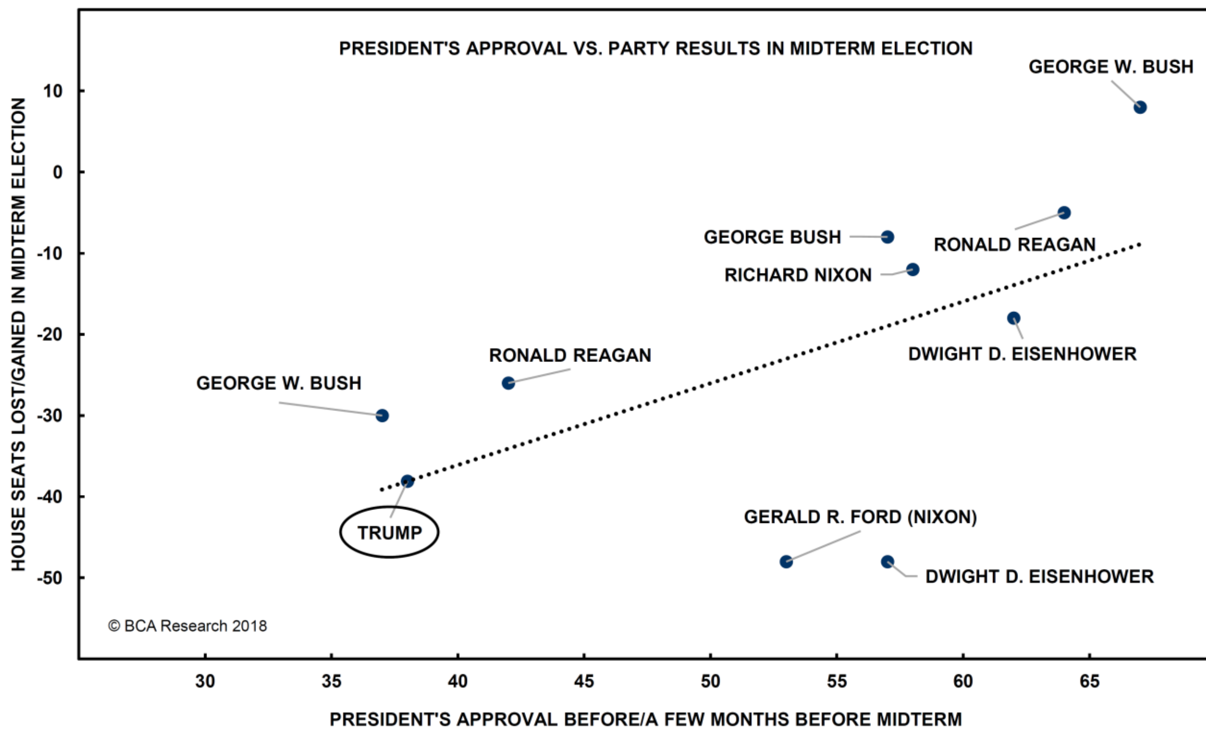
As to potential market risks, key ones worth monitoring this year include: (1) rising inflation in the U.S. that results in higher interest rates (which would pressure equity valuations); (2) a slowdown in China resulting from the implementation of reforms seeking to reduce excesses in the economy, ranging from a speculative real estate market to elevated debt (especially amongst unproductive state-owned enterprises); (3) tension in the Middle East stemming from increasing hostilities between Saudi Arabia and Iran (which could cause disorder in energy markets); (4) disruption to international trade relations, including the possibility of the U.S. withdrawing from the North American Free Trade Agreement (NAFTA) or implementing tariffs on various Chinese imports (from steel to solar panels); and (5) the U.S. midterm elections in November that could lead to a divided government – potentially focused on impeachment proceedings – should Democrats win back the House and, possibly, the Senate (based on President Trump's approval ratings, Republicans are susceptible in the upcoming elections).[4]



While we are always happy to share our views on investment opportunities and risks, what matters most is that each of your portfolios is positioned not for what you may hope or fear to be the most likely short-term path for markets, but rather in alignment with your longer-term investment objectives and risk tolerance. For those with long investment horizons who are investing for growth, it makes sense to have a higher degree of risk tolerance and, thus, a more aggressive allocation to equities. Short of another economic crisis (which we do not expect to be imminent), any near-term risk of volatility or market sell-off does not outweigh the potential upside of compounding returns over a multi-decade period. Longer-term investors who are leery of current valuations must also take timing and taxes into consideration. From a timing perspective: you are just as likely to time selling stocks so as to avoid a 10% selloff as you are likely to miss out on another 10% rally. From a tax perspective: if you are worried about a 10% pullback and sell positions with long-term gains in a taxable account, you will immediately suffer a 15-25% self-induced pullback after paying federal and state taxes.

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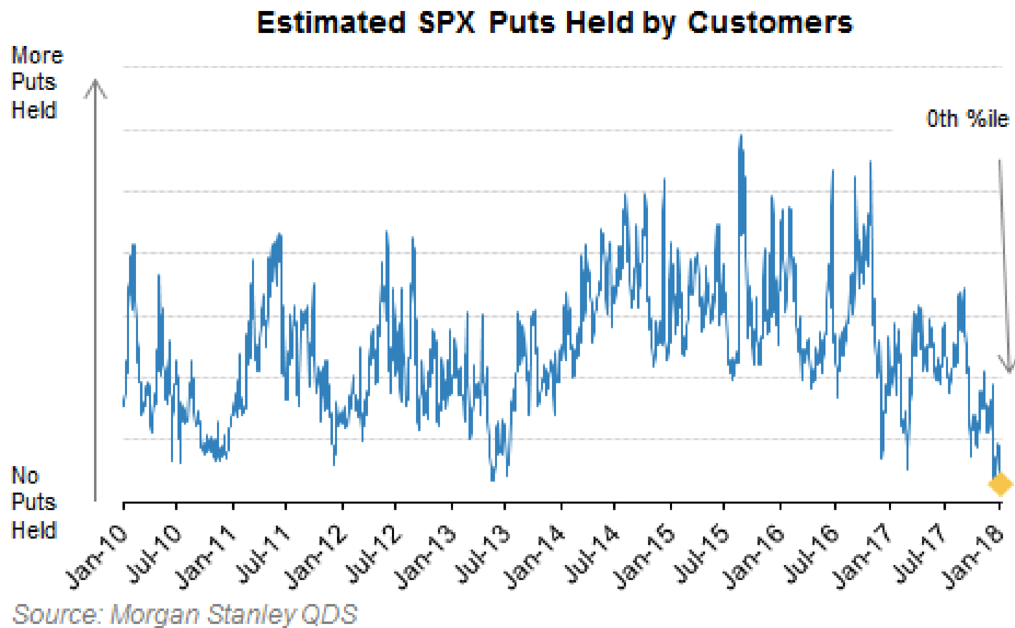
For those who have shorter investment horizons or are relying on portfolios principally for income and security, sticking to your investment goals and risk parameters is likely to lead to better outcomes than investment decisions based on the fear of missing out on the equities rally. While it is simple to compare one's performance to the S&P 500, a more useful benchmark of investment performance is against one's goals. If you can meet your financial objectives without taking substantial market risk, it may make sense to have a higher degree of cash or short duration fixed income securities at a time when valuations are elevated and interest rates are low. Your performance may not in that case mirror the returns of a bull market at full strength, but your sense of security and serenity should be strong. For those whose goals require substantial market exposure – for instance, to achieve a certain level of income – deciding to move to cash based on valuation concerns will erode the earnings and income potential of your portfolio. Regardless of one's financial condition and objectives, the achievement of long-term investment goals is more likely to suffer than benefit from short-term oriented decisions.

If you do currently have substantial equities exposure in your portfolio and are worried about the market but do not want to realize taxable gains or diminish your income potential, it may make sense to consider hedging through put options. As a reminder, buying an option contract gives one the right, but not the obligation, to buy or sell a security at an agreed upon price (the contract strike price) at an agreed upon time (the contract expiration date). Buying put options on the S&P 500 is a method to potentially profit from a market sell-off without reducing one's overall equities exposure. Subdued volatility and the lack of demand for downside option protection (see accompanying chart from Morgan Stanley)[5] has resulted in put options trading at close to their cheapest pricing since the financial crisis. For instance, the cost of a 1-month S&P 500 put struck at 2% below the current index price currently trades in the 3rd percentile of cheapness over the last 10 years. Longer-dated put options also trade at cheap prices relative to their longer-term history. While hedging through put options involves risks (including the loss of principal) and may not be suitable or necessary for every portfolio, we would be happy to discuss various hedging strategies should you be interested.



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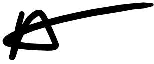
We understand that this is both an exciting and complex time to be an investor. Our goal for you this year (as it is every year) is not only to achieve excellent returns, but to do so in a way that is consistent with your definition of "excellent." As always, we look forward to working with you on making sure that your portfolio is constructed to meet your specific needs. In the absence of a crystal ball that foretells market performance, the only certainty any investor can have is in knowing his or her objectives and the only advantages are patience and informed decision making. We hope to help with the latter in order to achieve the former. Best wishes for the New Year.

Sincerely,



Peter Karmin
Managing Member

Stuart Loren
Director

Citations and Disclosures

[1] Wolfe Research (Jan. 5, 2018).
[2] Bianco Research; Bloomberg (Jan. 17, 2018).
[3] BCA Research, Geopolitical Strategy (Jan. 17, 2018).
[4] BCA Research, Geopolitical Strategy (Jan. 10, 2018).
[5] Morgan Stanley Quantitative and Derivative Strategies (Jan. 16, 2018).

Investing involves risks, including the possible loss of principal and fluctuation of value. Past performance is no guarantee of future results.

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The S&P 500® Index is a broad based unmanaged index of 500 stocks, which is widely recognized as representative of the equity market in general. You may not invest directly in an index.

Additional information about Fort Sheridan Advisors LLC is available in its current disclosure documents, Form ADV and Form ADV Part 2A Brochure, both which are available without charge by contacting Fort Sheridan toll-free at 866-559-9700. You may also request copies by email at

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info@fortllc.com, or access the documents online via the SEC's Investment Adviser Public Disclosure (IAPD) database at www.adviserinfo.sec.gov, using CRD# 151139 or SEC# 801-70517.

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