J.V. Bruni and Company

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Thinking Ahead

Let's start with the obvious: The first quarter of 2020 saw the largest quarterly stock market decline in over 30 years and one of the largest quarterly falls ever. Traditionally, a bear market is defined by a stock market decline of 20% or more. This year's bear market took only 19 days to reach the 20% threshold—the fastest in history. Daily volatility has been very high in this era of rapid communications and 24-hour news media, combined with people's herding instincts. During the first quarter, medium-sized and smaller companies saw their stock prices fall more than the large-cap S&P 500 index, which is normal during bear markets. If history is any guide, medium-sized and smaller company stocks will likely outperform larger company stocks in the next bull market. Our managed portfolios include large, medium and small companies.

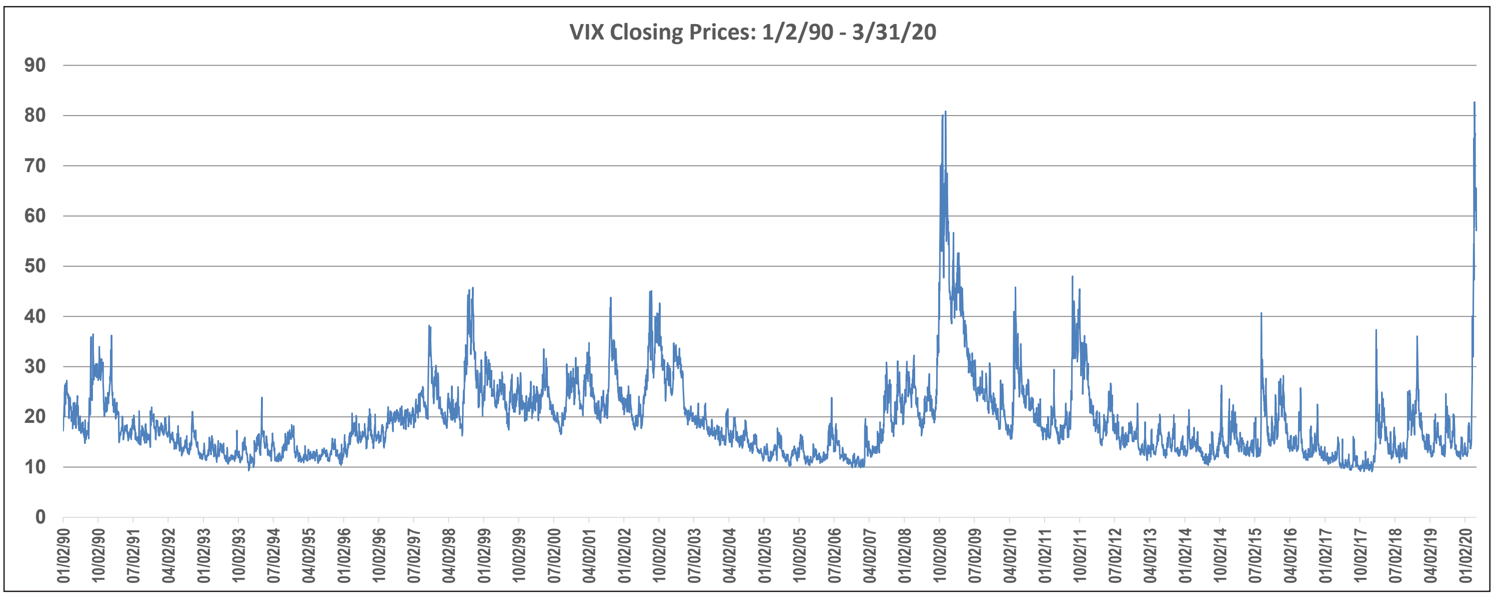
Thinking Ahead. We know that a rapid change in the status of the coronavirus pandemic, or in the measures taken to fight it, could significantly affect next week's outlook by the time you receive this letter. A week seems to be the new quarter. Therefore, rather than spend much time looking at this week or next—as interesting as they may be—we'll use this letter to address the coming two or three months. Although that's still a short-term time frame, we think the coming months will more clearly reflect the results of some major healthcare and economic developments already in action. Before we get to that, however, if events require us to share important information with you on relatively short notice, we'll use the home page of our website, ***www.jvbruni.com***, to do so. Indeed, we've already started posting brief updates there. We suggest you bookmark our website for future reference.

The Twilight Zone. As we suggested in a mid-month update in March, current stock prices reflect, as they always do, equilibrium levels that balance the desires of buyers and sellers. What seems different recently is the profound impact of motivated sellers driven by fear, uncertainty, margin calls and other short-term influences. Given the relatively low volume of stocks normally traded for ***economic*** reasons—as opposed to the volumes attributable to index funds and robotic quantitative strategies—a temporary imbalance between buyers and sellers can move stock prices ***very*** significantly. In recent weeks, a number of stocks have seen daily price moves of 20+% up ***and*** down—sometimes on consecutive days. If such dramatic moves don't seem crazy, they should. (See below.) Let us repeat: In times like this, we think steep declines in stock prices primarily reflect the resolution of temporary imbalances between buyers and sellers. Most of today's stock prices, in our view, don't come close to reflecting long-term economic value. This is nothing new. Stock prices that temporarily disconnect from economic reality have been fixtures of many bear markets.

Stock Pricing. The long-term economic value of most stocks doesn't really change much from day to day. For example, suppose you owned a business that stood to earn $1.9 million in 2020, $2 million in 2021, $2.1 million in 2022 and then about 4 – 5% more each year through year 20 (and perhaps beyond). Given that cumulative earnings over the next 20 years are apt to be about $60 million, we'd say that a reasonable price ***today*** might be approximately $25 – 30 million. (In previous letters we've referred to this as "the present value of forever.") Now suppose that due to a steep recession this year, earnings are apt to be virtually zero in 2020, $2.2 million in 2021 (a bounce back), $2.1 million in 2022 and then about 4 – 5% more each year through year 20. What's the present value of forever in this scenario, where 20-year earnings will total about $58.6 million? We think a reasonable value might be about $24 – 28 million. Cumulative 20-year earnings dropped only about 2.4%, even though they fell sharply in the first year. A company's value comes from much more than its earnings ***this year.*** When you own a stock, you indirectly own its earnings forever. Recessions come and go, and so do periods of above-average economic growth. This begs a logical question: If recessions produce only slight changes in long-term earnings, why do stock prices typically fall so much in a recession? There are two primary answers: (1) Some investors mistakenly focus intently on current year results, almost to the exclusion of the future, and (2)

When investors are gripped with fear, they sometimes do things they'll later regret—like selling more on emotion than reason. Although ***every*** bear market in the U.S. has ended at some point, and ***all*** ensuing bull markets have ultimately reached new all-time highs, the force of emotion can be very strong, especially to those who haven't experienced bear markets before. When ***other*** investors act emotionally, the conditions are ripe for patient investors (that should be us) to take advantage of the bargains presented in a bear market.

Fear. Last month, we introduced the VIX Volatility Index as a measure of the amount of fear in the stock market. The chart below has been updated through March. As you can see, recent levels of fear have existed only once before in the last 30 years—and that proved to be an excellent time to buy stocks. If the world doesn't end—and we really don't think it will—we see remarkable bargains for long-term investors nowadays. While we take the necessary time to complete our intensive research before we buy, and we maintain money fund positions to satisfy foreseen withdrawals, this is not the time to be unduly cautious in making long-term investments. Intelligent investors need to rationally assess both risks and rewards, as always. This should be every investor's *modus operandi*.



The Coming Months. Let's start with our outlook for the COVID-19 pandemic, because it's at the root of the worldwide disruptions in healthcare and economics. Simplistically, pandemics can produce exponential growth in the number of people infected when each infected person spreads the illness to more than one additional person—perhaps two or three, on average. This is not sustainable indefinitely, because ultimately everyone would be infected—thereby eliminating future infection growth. Moreover, as social distancing reduces in-person human interactions, the rate of infection growth will necessarily diminish. This is beginning to play out ***now*** around the world. What's being reported in the media on a daily basis is not the total number of infections, but rather the number of ***confirmed*** infections. You have to be tested to count as confirmed. According to estimates from various medical authorities, the total number of undiagnosed infections around the world is a significant multiple of the number of confirmed cases. Therefore, given the rapid expansion of testing around the world, which is good, part of the increase in total ***confirmed*** cases simply reflects the impact of greater levels of testing. Yes, part of the number of new confirmed cases may be due to the spread of the virus, but without further data, it's impossible to discern how much daily growth in confirmed cases is due to a spreading infection and how much is due to more testing. If, hypothetically speaking, the total number of worldwide infections remained absolutely constant, we'd still see reports of increasing confirmed cases for some time, given additional testing. If the experiences of early-infected countries like China and South Korea are relevant, and if medical models of infection contagion are reasonable, then sometime in the next month the rate of infection growth will slow (if it hasn't already) and then actually decrease. We just won't know it by looking at reports of confirmed cases. Ultimately, the total number of actual infections will turn downward, and although the long-term battle against the virus will not be over, it will feel a bit like one of the turning points of World War II. For example, the Battle of Midway occurred in 1942, yet the war in the Pacific didn't end until 1945. Still, Midway was a key inflection point. Experts don't think it will take three years to meaningfully control the coronavirus.

W*aiting Can be Costly.* A recent report in *The Wall Street Journal* looked at what happened to stock prices near the end of major economic recessions. To nobody's surprise, stock prices typically bottomed ***before*** the economy did. For example, in the 2007 – 09 financial crisis, U.S. GDP bottomed in June of 2009. If you had known the economy was bottoming ***exactly*** at that time (a very unlikely possibility, given the time it takes to gather and report economic statistics), you would have missed the bottom in stock prices (in March of 2009) by three full months. During that three-month period in which stocks were rising, but the economy was still falling, stocks rose at an annualized rate of over 90%. Looking at eight other steep recessions, on average stocks gained at an annualized rate of about 65% between the stock market's bottom and the eventual end of the recessions. As you can see, it can be quite costly to wait for clear evidence of economic improvement before investing.

R*isks.* There are ***always*** risks for investors, whether they seem obvious or not. Stocks, the historically best-performing asset class, have experienced many bear markets, though they have all been temporary. Bond prices, especially for longer-maturity bonds, can decline significantly when inflation and interest rates climb. Very short-term bonds may provide inadequate returns—or lose purchasing power—even in good times. When obvious risks seem absent, prices for most investments can rise to unrealistic levels—and ***that*** is its own risk. In the current environment, we're not too worried about excessive prices. Indeed, we see many bargains. The future of the coronavirus pandemic is a risk, although we think this risk will be overcome through the dedication of health professionals and the ingenuity of medical researchers. Interestingly, the ***responses*** to the pandemic may represent their own risks. Shutting down large portions of the travel, hotel, restaurant, entertainment, sports, personal services and other industries is not sustainable for long without disproportionate human and economic consequences. Millions of workers have already lost jobs, hopefully temporarily. In addition, there is a reasonable likelihood that thousands who have poured their lives into building and maintaining their own businesses will lose their life savings, and there won't be a bailout for them. Losing entrepreneurs—risk takers—isn't a good thing.

C*orporate Insiders.* Insiders (corporate officers, members of boards of directors, etc.) are the most knowledgeable and informed investors in their own companies. Indeed, in the interest of full disclosure, insiders are required to report their stock transactions to the SEC within 48 hours. Although even insiders can be wrong, we make it a point to keep an eye on their trading. Many insiders aren't waiting to buy, according to reported research from the Washington Service, which tracks trading activity by corporate executives and their board members. Over the last month, more than 2,800 insiders have purchased almost $1.2 billion in their companies' stocks, the third highest level in over 30 years—and we suspect their buying isn't over. Indeed, a number of insiders of the companies we own have already made significant open-market purchases of their stocks. We like that. Moreover, while a good number of smaller and mid-sized company insiders have been buying, we've seen very little insider buying in Amazon, Apple, Microsoft or Google, for example. This is consistent with where we see—and don't see—bargains.

V*irus Therapies.* The likelihood of a slowing coronavirus infection rate in the coming months reflects basic math and some degree of success in social distancing, but there's likely to be additional good news. The odds of finding at least partially effective therapies within a few months are arguably pretty good, judging from history and by today's very advanced medical research methods. If a somewhat effective therapy were announced today, we'd expect a strong rise in stock prices. If this happened next week or next month or by summer—which we think is likely—the results should be the same. Experts aren't counting on a vaccine until next year.

K*eeping Calm … and Carrying On.* As we've mentioned a number of times over the years, successful investing—from the perspectives of portfolio managers and their clients—requires a degree of calmness and clear thinking, even in stressful times. I don't know how each of you manages stress, but I like to listen to some music from my youth. (Do you remember Judith Durham?) Maintaining physical activity can be very helpful, too. In addition, many people find it useful to limit news watching to reasonable amounts of time. Most of us can learn what we need to know about the coronavirus situation in 30 minutes or less each day. Whatever else I do, I try to avoid overtly politicized "news." As *Barron's* associate editor Jack Hough put it:

> The least-productive thing I hear smart people doing most days is arguing politics. Right now, it feels like a second pandemic. I'm hearing stock market and public health opinions that seem to spring from a starting point of loving or loathing the president.

B*usy Times.* As you might imagine, account custodians like Charles Schwab & Co. have been laboring under the load of increased operational requirements while simultaneously implementing social distancing directives. We've been monitoring our custodians, and we have not seen any meaningful disruption to their essential services, although some administrative requests may take an extra day or so. At J. V. Bruni and Company, we have been able to perform our portfolio management functions without delay.

Sarah's Sidebar. Sarah offered to forgo her sidebar article this month, so we could have more room to cover more topics of interest in this environment. Look for an article from her soon in a coming letter.

Form ADV, Part 2. There has been no material change to our SEC disclosure "brochure" in the last year. Indeed, there have been no material changes since our disclosure form/brochure was first produced in response to new SEC regulations in 2010 – 2011. Our Form ADV, Part 2 has previously been provided to all of our clients; nevertheless, if you want another copy, give us a call.

Required Distributions from Retirement Accounts. ***The following may be very important to retirees:*** Recently, the CARES Act was enacted, and we have seen reports that required minimum distributions (RMDs) from some retirement accounts have been waived for 2020. If this could affect your plans for retirement account distributions, you may want to consult your tax adviser soon.

Realized Gains and Losses. It takes a sale to realize a capital gain or loss for income tax purposes. We didn't do much selling in the first quarter, for obvious reasons, so only a small minority of our managed accounts have any capital gains or losses to report so far in 2020. If you had sales in a taxable account, a report is enclosed. Looking ahead, there will be buys and sells in the normal course of portfolio management, especially as our companies report first quarter results.

Water Still Flows Downhill. Sometimes it's hard to envision the specific path to recoveries from economic setbacks. That's understandable, since we live in a very complex and dynamic world. However, it isn't necessary to see specific details in advance when we have a useful vision of how market economies function. For example, imagine standing with a running garden hose in your hand. The exact path of the water won't necessarily be easy to determine without information regarding the precise contours of the surrounding land and the presence of even the tiniest obstacles. However, we all know water will move inexorably downhill, choosing its own path. We know where the water is going, and likewise we know where market economies are going, because they are good at making thousands of adaptations to fulfill people's needs and desires. Indeed, both individuals and companies are continuously guided in their actions by Adam Smith's "invisible hand" so as to promote human advancement. It's a beautiful thing.

Jerome V. Bruni
President

Widespread fear is your <u>friend</u> as an investor, because it serves up bargain purchases. <u>Personal</u> fear is your enemy.

Warren Buffett

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