



The Exceptional Decade

Harold Hallstein IV

The close of the decade was uniquely memorable and gratifying for us. This year we celebrate our 10th anniversary in business as an independent advisory firm. As of December, advised funds stood at \$59.5 million USD, with accounts under direct management of \$42.3 million USD. While we welcomed a few new clients in 2019, a great deal of our business's growth was generated through investment returns, which was satisfying.

I count our lucky stars every day. Very few investment companies have seen their first 10 years spared from bear markets. While hanging our shingle in 2010 may look prescient in retrospect, it was actually fraught with both personal and economic fears. Frankly, one of the main reasons it all worked was my age and ability to live a frugal lifestyle at the time. Without diminishing the hard work and care, a larger factor may have been perseverance. According to the Bureau of Labor, 70% of all new businesses fail in the first 10 years. I think that is less about talent, and

more about grit. My father told me it takes five years for people to simply accept you're not going away. He was right about that.

As we enter our 10th year, I'm more confident than ever that we have decades of great work ahead of us. Our talents have grown with broader practical experience. Our information network has expanded with each new client. We are better attuned to the landscape. Despite our luck and those blessings, we also plan to hold fast to the values of simplicity, conservation and patience that are at our foundation. *I suppose you never forget how it all felt when you got started.*

During 2019 there were important structural changes in our industry that deserve discussion. Most notably, the competition for brokerage business reached a new level as Charles Schwab, Fidelity Investments and TD Ameritrade dropped most commission rates to zero. While this immediately benefits our clients, we have concerns that such moves will ultimately cause declines in customer service levels as those firms seek to make up for lost revenue with added client volumes. Saving \$4.95 is well and good, but if it results in materially more time on the phone for simple transactions, we don't always consider that a win as your fiduciary.

We've also been hearing clients wonder how these brokerages make money if they don't charge commissions—a valid question. In fact, they still have many ways of generating revenue including, but not limited to: lending money, lending securities, sponsoring investment funds, and paying extremely low interest rates on unvested cash. The latter impacts us materially. We have never seen worse conditions for unattended cash balances, and that requires ongoing vigilance. We want to maintain reasonable yields, but we also don't want to be sucked into riskier investments we think aren't attractively priced. This requires more incremental time and thought on cash and bond management.

All the competition has also led to casualties in the industry. For example, we had some investment assets with TD Ameritrade, but Schwab recently announced they are acquiring TD, so those accounts are coming right back to Schwab. This type of activity makes us nervous because maintaining a broad selection of options for vendor relationships ensures our ability to negotiate better incentives and outcomes. We don't want to find ourselves being dictated by our vendors, and much prefer setting the terms of engagement in a robust multi-party bidding process.

We worry survivor brokerage firms will eventually use the less diverse landscape to exploit markets they have effectively cornered, even if getting to that position required lowering prices to essentially zero—for now. Needless to say, we will continue to monitor the situation and explore new entrants into the space while placing emphasis on our expectations for customer service and processing times. We plan to push continually on behalf of clients for the efficient

and effective service they deserve. We don't plan to let our vendor's ambitions for scale undermine the high-service fiduciary model that is our core approach to business.

Turning quickly to 2019 investment results, nearly every major asset class had positive performance last year. In fact, most assets classes produced double digit returns, including domestic stocks, international stocks, preferred stocks, longer dated bonds, gold, real estate trusts, and volatility risk premium strategies. Even crypto-currencies staged a recovery and most closed the year higher. Underlying these bull markets was a U.S. dollar that churned upward through the year.

As value oriented investors, this circumstance is interesting. It means precious little stands out as newly cheap or undervalued. It even makes the portfolio rebalancing process feel a bit strange. If everything performs strongly and similarly, no significant and material rebalancing actually happens, or at least what happens feels small and non-committal. Further, we are forced to wonder, if all assets can gain largely and simultaneously in one year, might they also fall together in tandem? This would clearly present a material problem even for our "diversified" portfolios.

In industry speak we call this worry "correlation convergence." As we build portfolios we try to combine investments that have good expected returns but which also show statistical non-correlation to each other. This generally results in a portfolio with higher returns for each unit of risk/volatility, as certain parts of the portfolio zig while others zag. The problem is that often at the exact moment you want such non-correlation (i.e. during stock market declines) previously existing non-correlation starts to disappear. Essentially, while the theory is helpful, in practice, assets that are uncorrelated while markets are rising become the victim of human fear. Otherwise strong quantitative relationships break down.

We looked into this phenomenon more closely during Q4 and have a few observations to share. First, it is clear that within equities, even such disparate investments as frontier markets and companies trading at deep value, do indeed tend to converge and become more correlated under pressure. The same is also true about real estate investments—both traded and private real estate. Many investors put forward gold as a potential solution to this correlation problem, believing it is a reliable safe haven. But over the last 45 years, gold's average 12-month rolling correlation with the S&P 500 has actually been zero. That means that while it *sometimes* moves inversely to stocks, it cannot be relied upon to rise during stock sell-offs. While it does tend to rally during serious crisis periods, gold often moves for long periods in the same direction as equities:

Fortunately, there is one asset that consistently moves both strongly and inversely to stocks, and only very rarely travels in the same direction. These are the highest rated and longer-dated sovereign bonds. Only *once* since 1945 have such bonds and stocks fallen together, and that was in 1969, when both fell somewhat marginally. In all other years when the S&P 500 declined, high-quality bonds rallied:

When Stocks Are Down Bonds Do Well

| Year | Stocks | Bonds |
|------|--------|-------|
| 2008 | -36.6% | 20.1% |
| 1974 | -25.9% | 2.0% |
| 2002 | -22.0% | 15.1% |
| 1973 | -14.3% | 3.7% |
| 2001 | -11.9% | 5.6% |
| 1957 | -10.5% | 6.8% |
| 1966 | -10.0% | 2.9% |
| 2000 | -9.0% | 16.7% |
| 1962 | -8.8% | 5.7% |
| 1946 | -8.4% | 3.1% |
| 1969 | -8.2% | -5.0% |
| 1977 | -7.0% | 1.3% |
| 1981 | -4.7% | 8.2% |
| 2018 | -4.2% | 0.0% |
| 1990 | -3.1% | 6.2% |
| 1953 | -1.2% | 4.1% |

S&P 500 & 10 Year Treasuries from 1945-2018

FORTUNE

As we enter 2020, we stand in the 11th year of the current bull market in U.S. stocks. While we are grateful for the exceptional conditions of the last decade, we will continue to review portfolios with an eye towards historical realism. While many commentators suggest AAA sovereign debts have too low of interest rates to make a decent investment, we plan to hold tight to our research outlined in the previous letter titled [The Trillion Dollar Question](#). The one asset with the proven ability to move in the opposite direction as stocks will end up very desirable when any correction occurs. Such bonds will be bought by investors no matter how low interest payments go, provided the principle remains negatively correlated. Why? Because these are the only time tested “safe havens.” Europe has demonstrated this reality to us in recent years.

Additionally, we also note the fact that such safe haven bonds are available in less quantity than they have been for the last two years due to net asset purchases by the European Central Bank and the Fed’s reserve activities, which can be seen below. For triangulation, the periods of

low supply seen in 2014-2016 corresponded with material capital gains for longer dated bonds. The Vanguard Extended Duration Treasury ETF (EDV), an index fund in this space, gained more than 50% from 2014 through mid-year 2016.



(Heisenberg Data, 2020 Estimates - TD Securities) CB Purchases = Central Bank Buying.

Finally, in keeping with annual tradition, I also attach below our internal long-term S&P 500 valuation model. We find this document to be very helpful in maintaining a broad historic view on asset allocation decisions. If I could only keep a single piece of paper on my desk, this page would be it.

Closing Note: A client shared an interesting observation with us recently. We should all sign documents “/2020” this year, not simply “/20”, so documents are not vulnerable to back and forward dating by others.

We wish all our readers a wonderful New Year in 2020!

Best,

A handwritten signature in black ink, appearing to read 'Harold A. Hallstein', with a stylized flourish at the end.

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| Year | S&P 500 Price | (EBIT) Operating | | (EBIT) Operating | | Current P/E Ratio | 10 Year Cyclical P/E Ratio | Avg. 10 Year Treasury Yield | EBIT/10Y Yield Spread | Graham Dodd Modified (Value) | 15x Operating Earnings (Fair Price) | Dividend Payout Ratio | Notes: |
|-----------------|------------------|------------------|-----------|------------------|----------------|-------------------|----------------------------|-----------------------------|-----------------------|------------------------------|-------------------------------------|-----------------------|--------------------------|
| | | Earnings | Dividends | Earnings Yield | Dividend Yield | | | | | | | | |
| 1974 | \$69 | \$9.35 | \$3.72 | 13.64% | 5.43% | 7 | 11 | 7.56% | 6.1% | \$44 | \$140 | 40% | Historic Opportunity |
| 1975 | \$90 | \$7.71 | \$3.73 | 8.55% | 4.14% | 12 | 14 | 7.99% | 0.6% | \$43 | \$116 | 48% | |
| 1976 | \$107 | \$9.75 | \$4.22 | 9.07% | 3.93% | 11 | 16 | 7.61% | 1.5% | \$49 | \$146 | 43% | |
| 1977 | \$95 | \$10.87 | \$4.86 | 11.43% | 5.11% | 9 | 13 | 7.42% | 4.0% | \$55 | \$163 | 45% | |
| 1978 | \$96 | \$11.64 | \$5.18 | 12.11% | 5.39% | 8 | 12 | 8.41% | 3.7% | \$54 | \$175 | 45% | |
| 1979 | \$108 | \$14.55 | \$5.97 | 13.48% | 5.53% | 7 | 12 | 9.43% | 4.1% | \$54 | \$218 | 41% | |
| 1980 | \$136 | \$14.99 | \$6.44 | 11.04% | 4.74% | 9 | 14 | 11.43% | -0.4% | \$49 | \$225 | 43% | |
| 1981 | \$123 | \$15.18 | \$6.83 | 12.39% | 5.57% | 8 | 11 | 13.92% | -1.5% | \$43 | \$228 | 45% | |
| 1982 | \$141 | \$13.82 | \$6.93 | 9.83% | 4.93% | 10 | 12 | 13.01% | -3.2% | \$50 | \$207 | 50% | |
| 1983 | \$165 | \$13.29 | \$7.12 | 8.06% | 4.32% | 12 | 14 | 11.10% | -3.0% | \$61 | \$199 | 54% | |
| 1984 | \$167 | \$16.84 | \$7.83 | 10.07% | 4.68% | 10 | 13 | 12.46% | -2.4% | \$58 | \$253 | 46% | |
| 1985 | \$211 | \$15.68 | \$8.20 | 7.42% | 3.88% | 13 | 15 | 10.62% | -3.2% | \$70 | \$235 | 52% | |
| 1986 | \$242 | \$14.43 | \$8.19 | 5.96% | 3.38% | 17 | 17 | 7.67% | -1.7% | \$97 | \$216 | 57% | |
| 1987 | \$247 | \$16.04 | \$9.17 | 6.49% | 3.71% | 15 | 17 | 8.39% | -1.9% | \$90 | \$241 | 57% | |
| 1988 | \$278 | \$24.12 | \$10.22 | 8.69% | 3.68% | 12 | 17 | 8.85% | -0.2% | \$92 | \$362 | 42% | |
| 1989 | \$353 | \$24.32 | \$11.73 | 6.88% | 3.32% | 15 | 21 | 8.49% | -1.6% | \$105 | \$365 | 48% | |
| 1990 | \$330 | \$22.65 | \$12.35 | 6.86% | 3.74% | 15 | 19 | 8.55% | -1.7% | \$112 | \$340 | 55% | |
| 1991 | \$417 | \$19.30 | \$12.97 | 4.63% | 3.11% | 22 | 23 | 7.86% | -3.2% | \$124 | \$290 | 67% | |
| 1992 | \$436 | \$20.87 | \$12.64 | 4.79% | 2.90% | 21 | 23 | 7.01% | -2.2% | \$144 | \$313 | 61% | |
| 1993 | \$466 | \$26.90 | \$12.69 | 5.77% | 2.72% | 17 | 23 | 5.87% | -0.1% | \$188 | \$404 | 47% | |
| 1994 | \$459 | \$31.75 | \$13.36 | 6.91% | 2.91% | 14 | 21 | 7.09% | -0.2% | \$171 | \$476 | 42% | |
| 1995 | \$616 | \$37.70 | \$14.17 | 6.12% | 2.30% | 16 | 26 | 6.57% | -0.5% | \$199 | \$566 | 38% | |
| 1996 | \$741 | \$40.63 | \$14.89 | 5.49% | 2.01% | 18 | 28 | 6.44% | -1.0% | \$222 | \$609 | 37% | |
| 1997 | \$970 | \$44.09 | \$15.52 | 4.54% | 1.60% | 22 | 33 | 6.35% | -1.8% | \$249 | \$661 | 35% | |
| 1998 | \$1,229 | \$44.27 | \$16.20 | 3.60% | 1.32% | 28 | 39 | 5.26% | -1.7% | \$334 | \$664 | 37% | |
| 1999 | \$1,469 | \$51.68 | \$16.71 | 3.52% | 1.14% | 28 | 43 | 5.65% | -2.1% | \$350 | \$775 | 32% | |
| 2000 | \$1,320 | \$56.13 | \$16.27 | 4.25% | 1.23% | 24 | 35 | 6.03% | -1.8% | \$363 | \$842 | 29% | |
| 2001 | \$1,148 | \$38.85 | \$15.74 | 3.38% | 1.37% | 30 | 29 | 5.02% | -1.6% | \$446 | \$583 | 41% | |
| 2002 | \$880 | \$46.04 | \$16.08 | 5.23% | 1.83% | 19 | 21 | 4.61% | 0.6% | \$498 | \$691 | 35% | Historic Opportunity |
| 2003 | \$1,112 | \$54.69 | \$17.88 | 4.92% | 1.61% | 20 | 25 | 4.01% | 0.9% | \$598 | \$820 | 33% | |
| 2004 | \$1,212 | \$67.68 | \$19.41 | 5.58% | 1.60% | 18 | 25 | 4.27% | 1.3% | \$601 | \$1,015 | 29% | |
| 2005 | \$1,248 | \$76.45 | \$22.38 | 6.12% | 1.79% | 16 | 24 | 4.29% | 1.8% | \$652 | \$1,147 | 29% | |
| 2006 | \$1,418 | \$87.72 | \$25.05 | 6.18% | 1.77% | 16 | 25 | 4.80% | 1.4% | \$636 | \$1,316 | 29% | |
| 2007 | \$1,468 | \$82.54 | \$27.73 | 5.62% | 1.89% | 18 | 24 | 4.63% | 1.0% | \$700 | \$1,238 | 34% | |
| 2008 | \$903 | \$49.51 | \$28.05 | 7.24% | 3.11% | 18 | 15 | 3.66% | 3.6% | \$907 | \$743 | 57% | Historic Opportunity |
| 2009 | \$1,115 | \$56.86 | \$22.31 | 5.45% | 2.00% | 20 | 18 | 3.26% | 2.2% | \$1,042 | \$853 | 39% | |
| 2010 | \$1,258 | \$83.77 | \$23.12 | 6.65% | 1.84% | 15 | 20 | 3.22% | 3.4% | \$1,119 | \$1,257 | 28% | Sankala Group Founded |
| 2011 | \$1,258 | \$96.44 | \$26.43 | 7.67% | 2.10% | 13 | 18 | 2.79% | 4.9% | \$1,365 | \$1,447 | 27% | Bullish |
| 2012 | \$1,426 | \$96.83 | \$31.25 | 6.79% | 2.19% | 15 | 19 | 1.76% | 5.0% | \$2,247 | \$1,452 | 32% | Bullish |
| 2013 | \$1,848 | \$107.07 | \$34.99 | 5.79% | 1.89% | 17 | 23 | 2.34% | 3.5% | \$1,749 | \$1,606 | 33% | Still Bullish / Cautious |
| 2014 | \$2,091 | \$113.01 | \$39.44 | 5.40% | 1.89% | 19 | 25 | 2.52% | 2.9% | \$1,711 | \$1,695 | 35% | Still Bullish / Cautious |
| 2015 | \$2,044 | \$100.44 | \$43.39 | 4.91% | 2.12% | 20 | 23 | 2.13% | 2.8% | \$2,195 | \$1,507 | 43% | Cautious |
| 2016 | \$2,238 | \$106.26 | \$45.70 | 4.75% | 2.04% | 21 | 25 | 2.10% | 2.6% | \$2,394 | \$1,594 | 43% | Cautious |
| 2017 | \$2,688 | \$124.51 | \$48.93 | 4.63% | 1.82% | 22 | 29 | 2.32% | 2.3% | \$2,292 | \$1,868 | 39% | Bullish - Tax Outlook |
| 2018 | \$2,507 | \$151.60 | \$53.75 | 6.05% | 2.14% | 17 | 24 | 2.91% | 3.1% | \$1,963 | \$2,274 | 35% | Still Bullish / Cautious |
| 2019 est. | \$3,231 | \$154.54 | \$56.08 | 4.78% | 1.74% | 21 | 28 | 2.15% | 2.6% | \$2,849 | \$2,318 | 36% | Cautious |
| Averages | 59 Years: | | | 6.68% | 2.97% | 17 | 21 | 6.12% | 1% | | | 45% | |

Source: Standard & Poor's Financial Services LLC

| | | | |
|--------------|-----|-----|-----|
| 10Y Compound | 11% | 11% | 10% |
| 30Y Compound | 8% | 6% | 5% |