

the Connection

A Quarterly Review

4th Quarter 2019

THE OVERWHELMING CASE FOR EQUITIES

In this article we are going to make the argument that public equity, known as common stock, is the best available investment for capital today. We will do so by comparing public equity to other assets including fixed income, precious metals, private equity and real estate. The decision to buy /own stock should be evaluated from a comparative valuation perspective, along with a macro overview toward what is working in favor of stocks in the long run regardless of current market valuations.

Interest rates drive the economic bus, because they determine the cost of money. Currently borrowing money is dirt cheap, with ten year treasuries less than 2%, and ten year German bunds at less than 0%. If you were borrowing in Euro's, you would pay back in the future less than what you borrowed today. Borrowing in dollars, as anyone with a mortgage knows, is extremely affordable. If you are a company, like Ford, borrowing costs are really low. When borrowing costs are low, profitability goes up. On the flip side as a bond investor (lender) the return (yield) that you get in treasuries is low, so you are willing to take more risk – thus supporting higher valuations in equities. If we only make 2% in treasuries, why wouldn't we own a stable stock paying a 4% dividend; or buy a stock reinvesting capital at above 6%? The likelihood that a stock is worth less in ten years than it is today is minimal, so if we compare time frames, and take the best available option, we buy stocks, not treasuries or other bonds.

Gold – the boogeyman of all rational investors. People buy gold because they don't trust anyone or anything. They believe markets will fail, governments will fail, and they will be left with six ounces of gold and a shotgun. For our younger clients, please insert Bitcoin here when we say gold. Gold has a legitimate use. There are times of hyper-inflation. There have been failed governments. Venezuela and Argentina come to mind immediately. Gold is a great way to protect against those events. But for those countries, U.S. Dollars also worked just as well. Gold is a more appropriate fear gauge than volatility. Gold is the fear of anything, inflation, war, famine disease, capitalism, communism – doesn't matter, if you are scared, owning gold makes you feel better. But is it a sound investment? We need to look at recent history. From September 1st to November 1st, 2008 – the worst market anyone alive has lived through, Gold was actually down?!? It started to rise as stocks started to rise in 2009, and ended up doubling in value roughly from 2008 – 2011. That was in direct correlation to inflationary fears, when the Fed balance sheet

blew up, and they were printing money to cover it. Government spending went crazy, and Gold reacted because people were worried about inflation. Well, today, we can't even get inflation started. We keep trying, by printing money, providing stimulus etc. but it just doesn't happen. The two main areas inflation is visible are in technology and healthcare services costs. This has resulted in benefits for investors who own those stocks. Inflation hawks don't understand why we don't have-inflation across the board. The main reason is because global competition continues to drive prices down on goods. As necessities become cheaper, and if we find a solution for healthcare costs, inflation will remain tame. We don't see a massive spike in inflation coming, thus we don't see gold as a great investment.

Private Equity versus Public Equity is the most complex argument, because they are essentially the same thing, with different access points. Any way that you can directly invest in a productive, profitable growing business is a good investment. The same factors that hold true for public equity also hold true for private equity. Private equity is simply ownership in a corporation that doesn't have a public listing on an exchange. However, if you access private equity like most people, through an illiquid fund, there may be some reckoning in that marketplace in the near future. Masayoshi Sun, the founder and CEO of Softbank, Japan's largest telecom carrier, just lost half of his companies' value in private equity deals gone south. WeWork and Uber did not do him any favors.

Private equity firms charge enormous fees for access to companies in their early stages. That worked for a long time, and these guys made a lot of money bringing private companies public. However, now we increasingly see public companies acting as their own private bank, funding new tech and healthcare companies for direct purchase. Microsoft may spin out a division, give the new CEO some capital and some leeway, with a contract to buy the company back if it hits certain hurdles. Microsoft's ability to raise capital and invest far outstrips a private equity fund. They also don't need as high a return, because they aren't charging themselves a large fee to invest. We think public companies are going to put increased pressure on private equity funds to revise their forward return to shareholder assumptions, and thus their fees. It's cheaper and more efficient today to access public markets than private markets, and in our opinion the return in private markets does not pay enough to take the risks associated with it.

The last asset to discuss would be direct real estate ownership. This isn't necessarily a great argument either way. Real estate is valued on cash flow and opportunity. There is a defined scarcity to real estate, so that factors in as well. If interest rates and inflation stay tame, direct real estate ownership will do fine, and will not be appreciably better or worse than equities. You can't sell a building in three days like you can a stock, so stocks have that going for them. You also don't get the direct tax benefits and cash flow from a stock that you do from real estate. This is more of a preference and allocation issue than anything else.

Now with these arguments made, all of the types of assets we just talked about still have their place in an overall allocation. There is still a real need to own bonds, and real estate. That is not the argument that we are trying to make. We think equities will continue to tumble around, and have good years and bad years. The argument really is that the best return available right now, by percentage, is in public equity markets. Not by a little, by a lot. More importantly investment capital seeks the highest return. Today and for the foreseeable future that is in equities.

THE ACT OF GIVING

Below is an updated list of some organizations our clients are helping today.

All Local Food Banks

www.sfmfoodbank.org

www.shfb.org

www.foodbankcccs.org

www.refb.org

Bloom Marin

www.bloom.org

Maya's Music Therapy

www.mayasmusic.org

Friends of the Urban Forest

www.fuf.net

Guide Dogs for the Blind

www.guidedogs.com

Doctors without Borders

www.doctorswithoutborders.org

The Nature Conservancy

www.nature.org

National Kidney Foundation

www.kidney.org

Guide Dogs of America

www.guidedogsofamerica.com

Golden Gate National Parks Conservancy

www.parkconservancy.org

Fine Arts Museums of San Francisco

www.famsf.org

Canine Companions for Independence
www.cci.org

Alzheimer's Association
www.alz.org

The Foundation for Rotary International
www.therotaryfoundation.org

Wildcare
www.wildcarebayarea.org

Homeward Bound of Marin
www.hbofm.org

Whistlestop
www.whistlestop.org

FINCA
www.finca.org

Sonoma Land Trust
www.sonomalandtrust.org

Friends of the Earth
www.foe.org

The American Friends Service Committee
www.afsc.org

Amnesty International
www.amnestyusa.org

Eastside College Prep
www.eastside.org

Northern Sierra Partnership
www.nothernsierrapartnership.org

American Bird Conservancy
www.abcbirds.org

The Cornell Lab of Ornithology
www.birds.cornell.edu

Mono Lake Committee
www.monolake.org

California Trout
www.caltrout.org

Tahoe Rim Trail
www.tahoerimtrail.org

Ocean Conservancy
www.oceanconservancy.org

Global Fund for Women
www.globalfundforwomen.org

Marine Applied Research & Exploration
www.maregroup.org

Marin Agricultural Land Trust
www.malt.org

Walk to End Alzheimer's – San Francisco, CA
www.act.alz.org/sanfrancisco2019



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Barbara 415-797-6003 or bcorley@gencappm.com**