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Postings Restored

7/27/22 –

### Stocks

If a stock portfolio isn't to be traded frantically, it should be structured to contain offsetting industry risks, for instance utilities vs. the cyclical industrials. An example of this is the diversified S&P 500, that is hard to beat over the long-term. The reason for this is not that all its stocks are perfectly priced. The reason is that the portfolio is well-diversified among 11 different economic sectors that tend to offset each other.

As portfolio markers, we chose only two stocks with offsetting (so we thought) industry fundamentals, Verizon (VZ) and Newmont Corporation (NEM). The first is the nation's largest telecom utility; the second is the world's largest gold miner. So, are the companies dividends secure? Consider the following:

2<sup>nd</sup> Quarter 2022 Cash Flow  
(millions of dollars)

	<u>Verizon</u>	<u>Newmont</u>
EPS	Down	Down
Net Income	5,315	400
Depreciation	4,321	559
-Acquisition of Wireless Licenses <sup>1</sup>	-437	n.a.
-Capital Expenditures <sup>2</sup>	-4,670	-519
-Dividends Paid	-2,724	-437
Surplus (Deficit)	1,805	3 <sup>3</sup>

<sup>1</sup> In 2021, Verizon spent \$47,596 to acquire additional wireless licenses from the FCC, in order to ultimately extend 5G to 250 million people in homes and businesses. The Verizon network is thus positioned for the addition of many data applications, in the cloud and then eventually regarding autonomous vehicles.

<sup>2</sup> For large companies, capital expenditures approximately equal depreciation. Thus when valuing the S&P 500, we could make the crucial above assumption, resulting in operating earnings  $\sim$  EBIT, that is then used to value the company.

<sup>3</sup> Newmont has a very slight 2<sup>nd</sup> quarter surplus, that may go into deficit in subsequent quarters due to increasing inflation costs and assuming no change in the price of gold. But Newmont has, in addition, \$4,307 in cash, and no term debt due before 2029. The Board of Directors will decide future dividends.

Although reporting down earnings, both companies have ample dividend coverage. This is also why we bought both. But both have dropped in price since the beginning of the year, which is irritating although our portfolio is mostly in cash and getting invested. The common source of this is increased inflation. So far, the inflated dollar dropping in purchasing power, rather than commodities such as gold, has been the international finance hedge. For that to continue, the Fed cannot lose control of inflation; there is a lot at stake. It is to this issue that we now turn.

### Inflation

The Federal Reserve Act of 1913 gave the Fed the dual mandate to maximize employment and to stabilize prices. To stop the momentum of inflation, here defined as the positive change in the embedded CPI core rate of 5.9%, excluding food and energy, the Fed announced a large 75 basis point rate hike, bringing the Fed funds rate up to around 2.5%. Although rate changes are set meeting by meeting, Fed Chairman Jay Powell, expects the year- end Fed funds rate to be around 3-3.5%, with higher levels to come if necessary. This economy is a unprecedented mixture of previous monetary creation, some degree of deglobalization, covid plague, supply chain snarls and war in Ukraine.

Since the Fed considers price stability the, “bedrock of the economy,” that enables the ability to maintain productive medium-term employment levels, it is likely that the Fed will have to hike the short-term interest

rate until demand decreases and inflation has shown sufficient progress to the planned 2% level. The bond yield curve will then likely become highly inverted; the financial markets currently believe the Fed will be successful. So therefore, for prudential reasons, we increased our long-term bond allocation to 20% of our portfolio, with 50% the target, in spite of our belief that solving the inflation problem will be rather difficult.

The problem is inflation, itself. In previous years, we had done a study called, "The Nature of Stock Market Equilibrium." The economy is difficult to study using econometrics because it contains many trending variables. For the regression model to work, the data must have a random Gaussian (bell-shaped) distribution. Trending data can be made Gaussian by taking first differences, except as Table I shows, for inflation – which is, regardless, not well behaved.

To study the beast of inflation, we use business anecdote and history:

Ken Langone, co-founder of Home Depot. In an interview, he says that inflation is embedded in the supply chains (he should know).

(WSJ, 7/23/22)

David Solomon, Goldman Sachs, "We see inflation deeply entrenched in the economy....Our economists, meanwhile, say there are signs that inflation will move lower in the second half of the year. The answer is uncertain."

Shelley Simpson, J.B. Hunt Transport Services, "I think, not unlike what's happened in the pandemic the last two years, there is continuing to be challenges in the supply chain that are creating uncertainty in the market."

Joseph Wolk, Johnson & Johnson, "We did build in a healthy assumption to account for inflation in our January guidance, planning for increased costs in labor, energy, and transportation. We noted in April, and are doing so again today, that these pressures will continue to impact margins in the third and fourth quarters and into 2023."

"Fiat Money Inflation in France (1896)" describes what happened after the Revolution of 1789. The Revolution had impacted the productive capability of the economy. The government then needed new sources of funds, which it found by confiscating Church and noble lands and then issuing secured *assignats*. But then, the nightmare scenario: "The first result of this issue was apparently all that the most sanguine could desire: the treasury was at once greatly relieved, a portion of the public debt was paid; creditors were encouraged; credit revived; ordinary expenses were met...all difficulties seemed to vanish....But soon there came another result, times grew less easy; by the end of September, within five months after the issue of the four hundred millions in *assignats*, the government had spent them and was again in distress....The old remedy immediately and naturally recurred to the minds of men. Throughout the country began a cry for another issue of paper..."

The control of inflation is likely to be a significant problem. We might increase the remainder of the bond portfolio every two months or so.

8/11/22 –

The bond markets, but not yet the stock market, are beginning to make it possible for a 50/50 portfolio to reach a total real return of around 4%, which can either be spent or saved. We are therefore now concerned with bond interest rather than with stock market dividends, which presently refer to a different world.

The 4% rule generally applies to portfolios managed in the U.S. or the U.K., which have similar economic systems. This [article](#) from the 5/8/15 *NYT* indicates that Bill Bengen, a former financial planner and M.I.T. aerospace graduate, has worked out the implications of this rule, with the proviso that the future will be like the past. In dealing with the present, this 4/19/22 *WSJ* [article](#) writes that he is now mainly in cash.

Stock traders use a different model than stock investors:

Stock Trader's Model: Trading January 1: Return on Equity =  $D/P_0 + (P - P_0)/P_0$  This is clearly a trading model.

Stock Investor's Model: Return on Equity =  $D/P_0 + g$  Relying on company growth, this is an investment model.

where:  $D$  = yearly dividend quote

$P$  = the current price (the first model)

$P_0$  = the initial purchase price on January 1,  $P$  is the final sales price on December 31.

$g$  = the growth in dividends

Being a stock trader or a stock investor depends mainly on temperament. Being a stock investor requires a settled temperament. What if the world turns out to be very different than the above? The obvious thing to do is to adjust appropriately.

**8/19/22 –**

We have been described the S&P 500 as a diversified portfolio of stocks; that is not, however, true when the index is very overvalued. At the current level of 4228, the index according to two forms of present value model is about 63% overvalued. Between 12/31/14 and 2/28/22 only eight growth stocks: Apple, Amazon, Facebook, Google, Microsoft, Netflix, Nvidia and Tesla contributed a compounded return of 6.06% per year to the S&P 500, during a period of monetary easing. That leaves, for the remaining 492 stocks in the index, a return of only 7.18% per year, or 54% of the total. If you are currently invested in the S&P 500 as a long-term investor you are betting these eight stocks will continue to power the S&P 500 onward for the next 36+ years. The internet of everything may be the future, but. The following NASDAQ study provides the data. [click here](#)

One of the advantages of a fairly quantitative approach to the stock market is that it is possible to (provisionally) evaluate what-if. Take Microsoft (MSFT),  $P/E = 31$ . We make the key optimistic assumption that the company is so superior that its return will be 6% per year, for the next 36+ years, a level 50% above the rest of the economy (2% real and 2% inflation - we hope). In that case, using the corporate finance EBITDA method and then accounting for the company's current financial structure, we get a value of \$233

which is quite a bit below the current 8/19/22 price of \$286.

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