

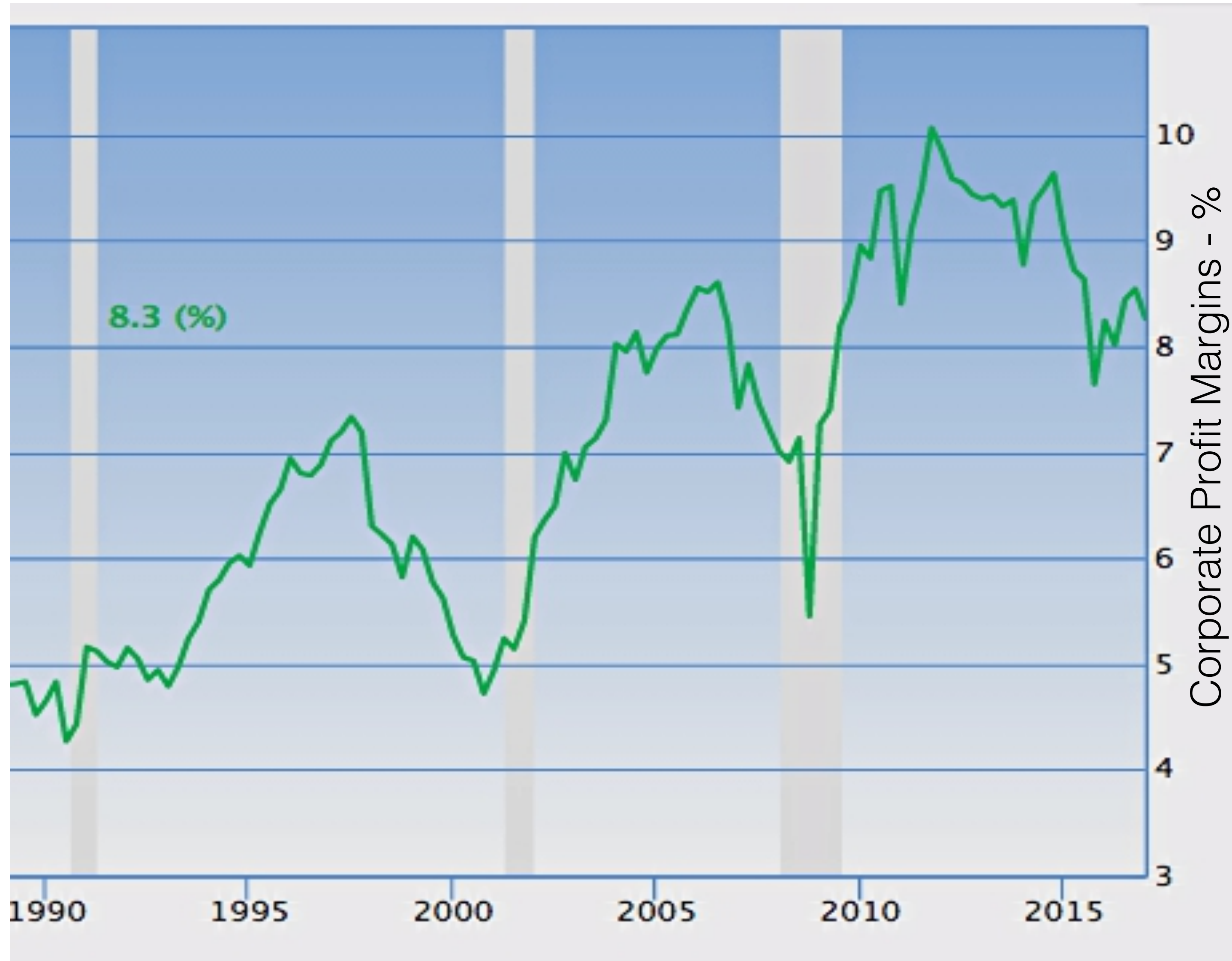


Managing a Portfolio During a Recession

New Canaan Men's Club

Presentation by: Paul A. Strassmann, Investment Club

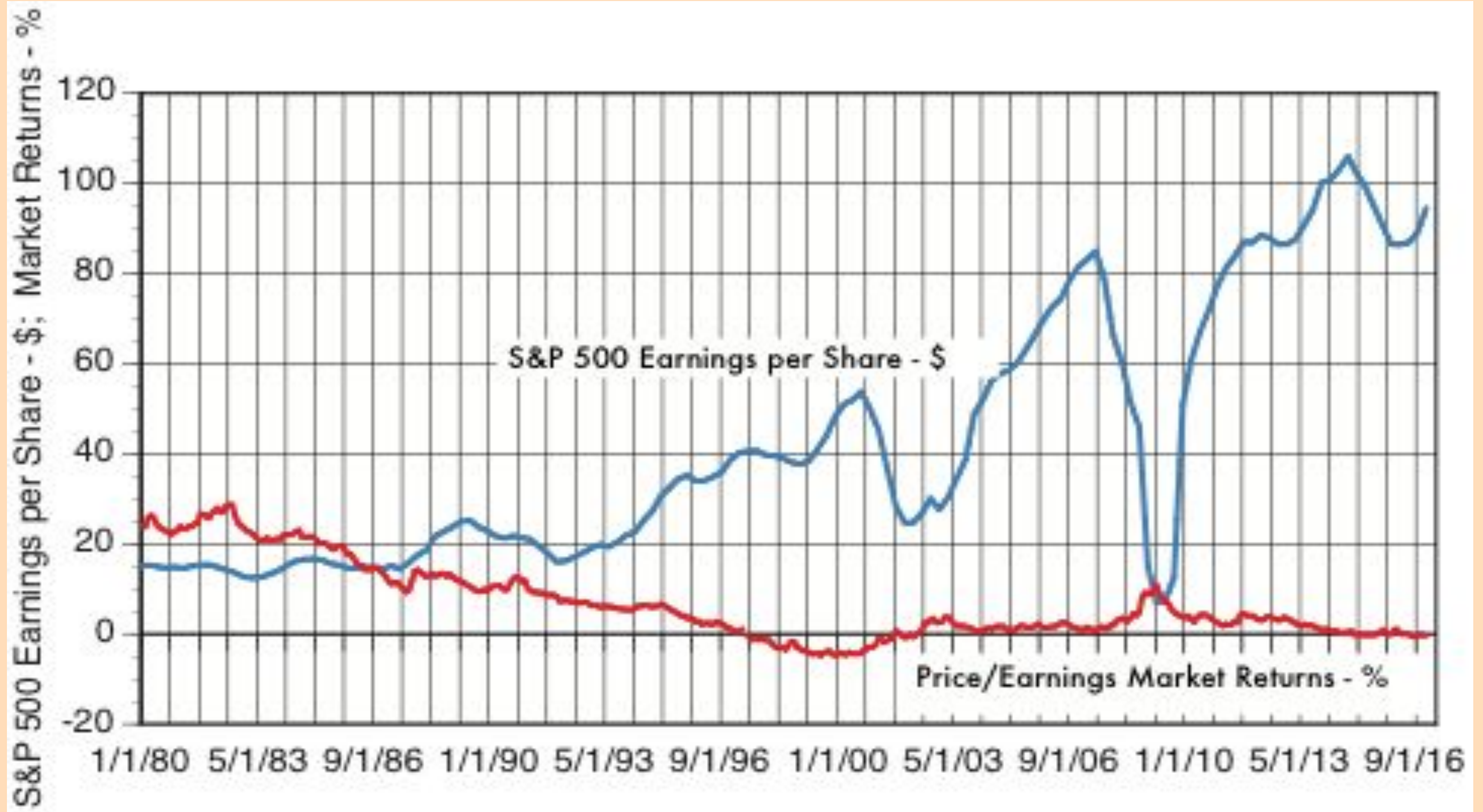
Corporate Profit Margins Are a Recession Indicator



Why are Corporate Profit Margins Recession Indicators?

- Earnings/Investments are the drivers of the stock market.
- When corporate profit margins decline to about 5% a recession occurs.
- Afterwards the Federal Reserve restores recessions to a prior peak.

As Price/Earnings Rise, S&P 500 Share Earnings Plunge



Why are Increases in Price/Earnings a Recession Indicator?

- In 2000 and in 2007 a rise in Price/Earnings % precipitated recessions.
- 2017 to 2018 S&P 500 drop could result in a large recession.

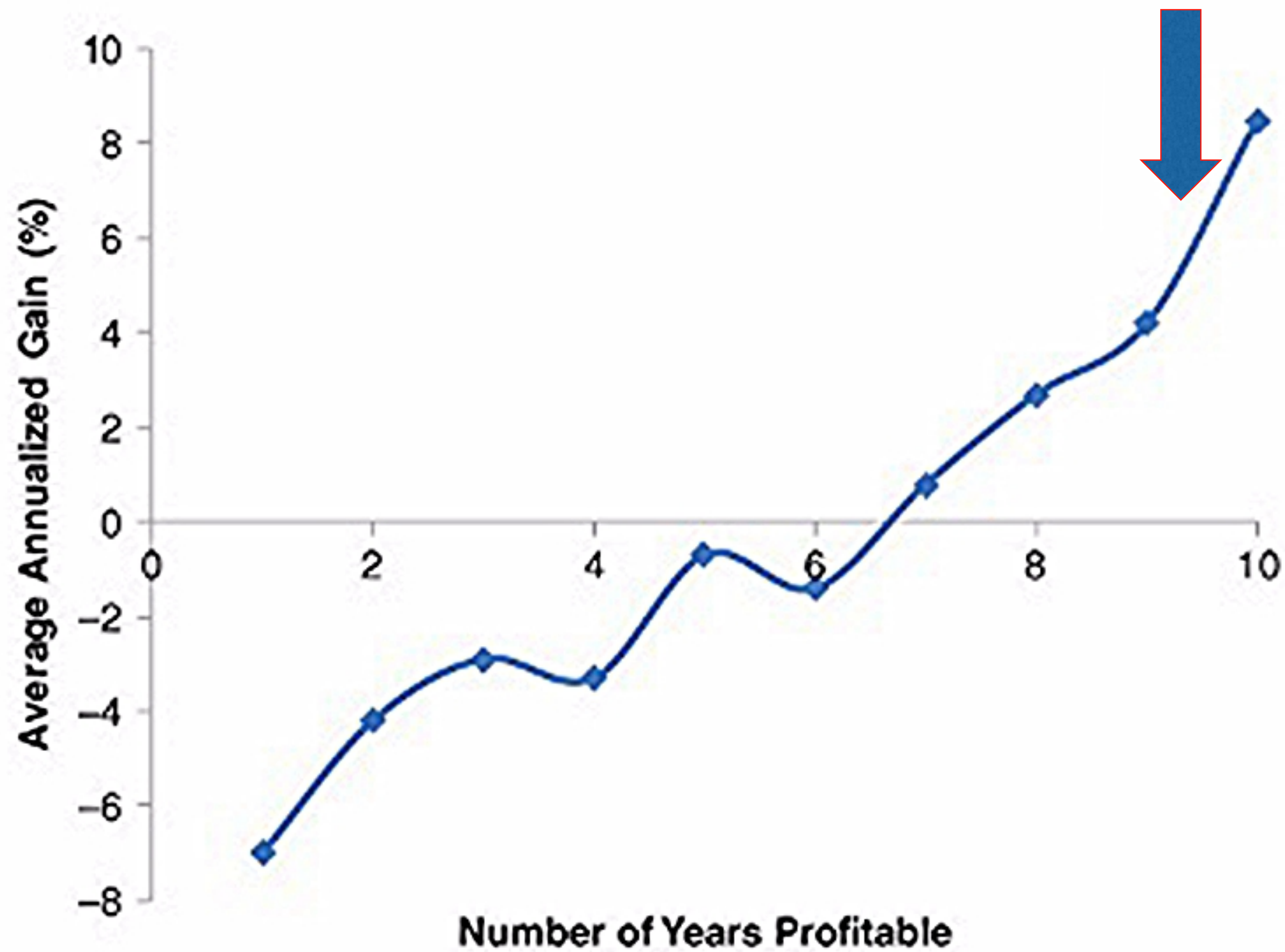
Rules for Managing a Portfolio During a Recession

- Comply with Warren Buffet rules.
- Adopt Peter Lynch choices.
- Realize High Altman Z-Scores
- Achieve High Piotrovsky F-Ratings
- Pass Beneish M-Score

Warrant Buffett Portfolio Rules

- Choose widely diversified investments.
- Pick shares with a durable competitive advantage.
- Invest in firms with low capital requirements
- Select firms with high investment returns.
- Invest in firms with long-term growth.

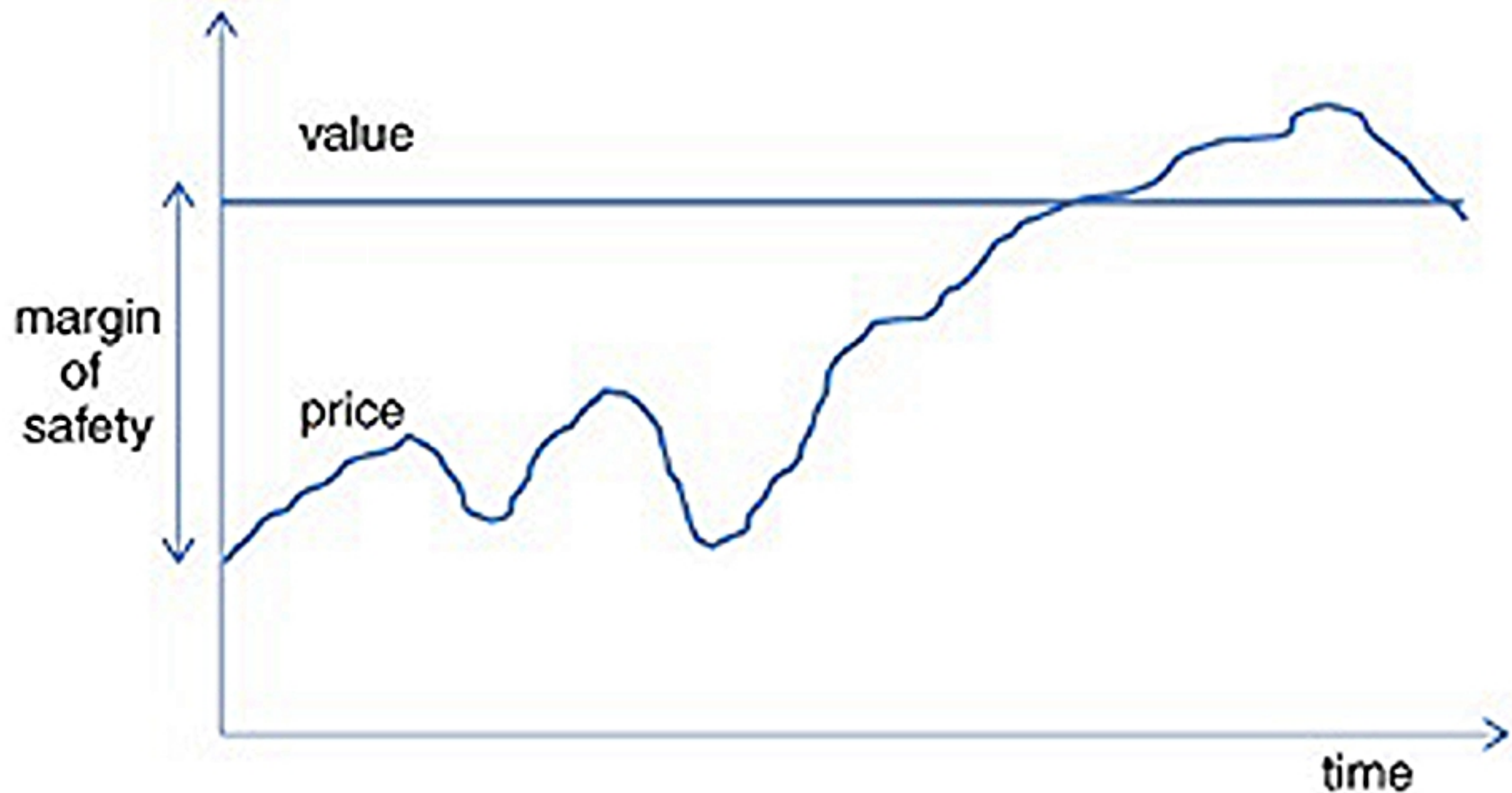
Warren Buffet Selects Shares Profitable for More than Nine Years



Peter Lynch Rules

- Show steady earnings and earnings growth.
- Deliver high earnings relative to high margins of safety.
- Pick firms with low or no debt.

Peter Lynch Selects Firms with High Margins of Safety



A Checklist for Making a Good Investment

- ✓ Meets Warrant Buffett criteria.
- ✓ Meets Peter Lynch criteria.
- ✓ Show at least 7 years of profits.
- ✓ Profitable through business cycle.
- ✓ Less than 30% of cash flow applied to capital expenses.
- ✓ Return on Equity greater than 15%.

Investment Types

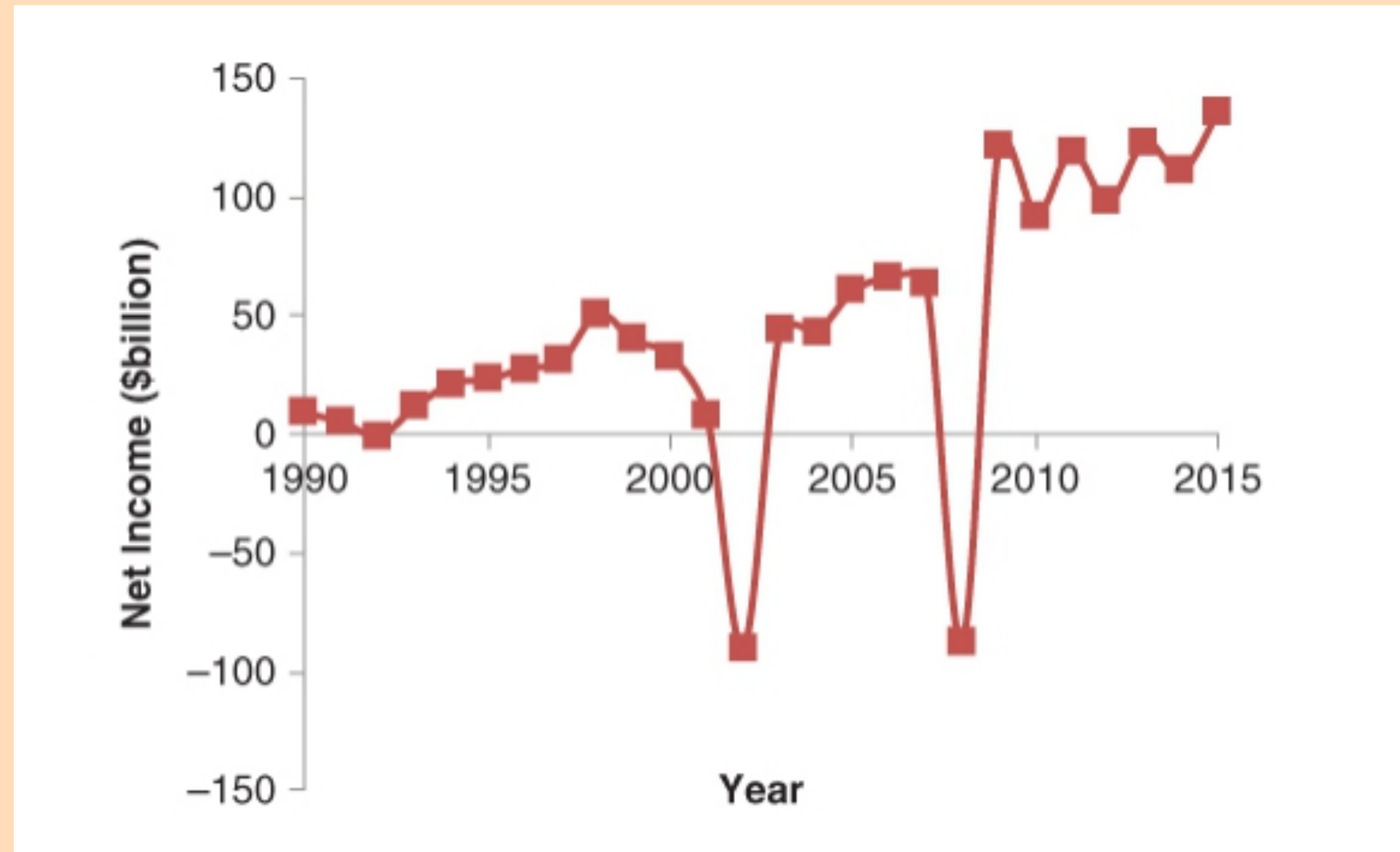
- ✗ Do not invest in slow growers.
- ✓ Profitable and predictable companies.
 - Picked by trading investors, or
 - Dividend investors.
- ✗ Do not invest in rapid growth startups.

Investment Types

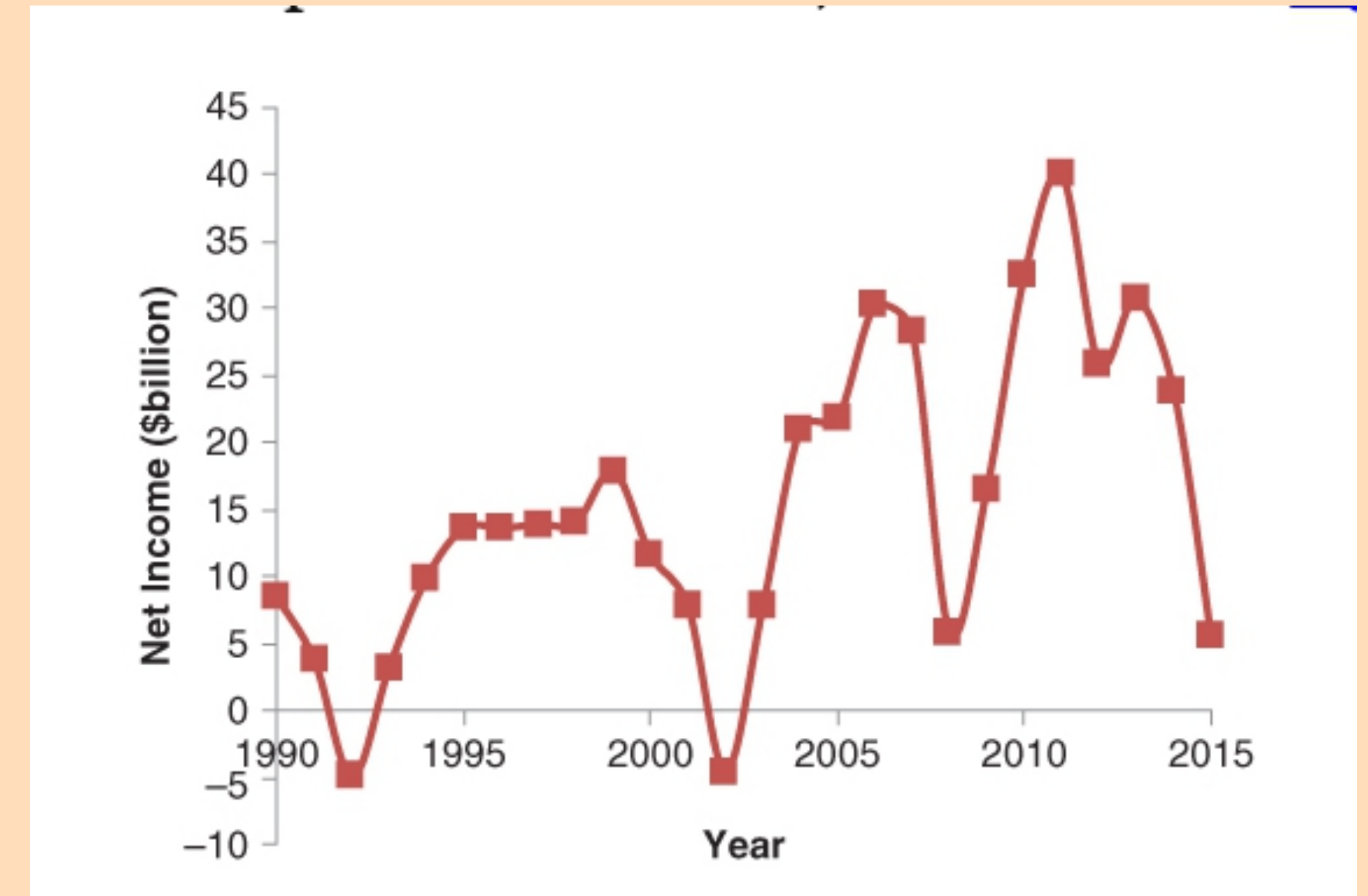
- ✗ Do not invest in asset plays.
- ✗ Do not invest in turnarounds.
- ✗ Do not invest in cyclical firms.

Avoid Cyclical Companies

{ }



Consumer Cyclical Net Income



Basic Materials Net Income

Determine and Then Concentrate on Intrinsic Values

- The intrinsic value of a share equals the discounted cash flow generated during remaining life.
- Do not diversify to reduce risks.
- Excess diversification is protection against ignorance.
- Always understand how business operations are conducted.

Buy Stable Businesses

- Avoid cyclical companies.
- Invest in firms that have brief repurchase cycles.
- Buy firms that have long product cycles, bought for cash.
- Purchase firms with low capital requirements for growth.

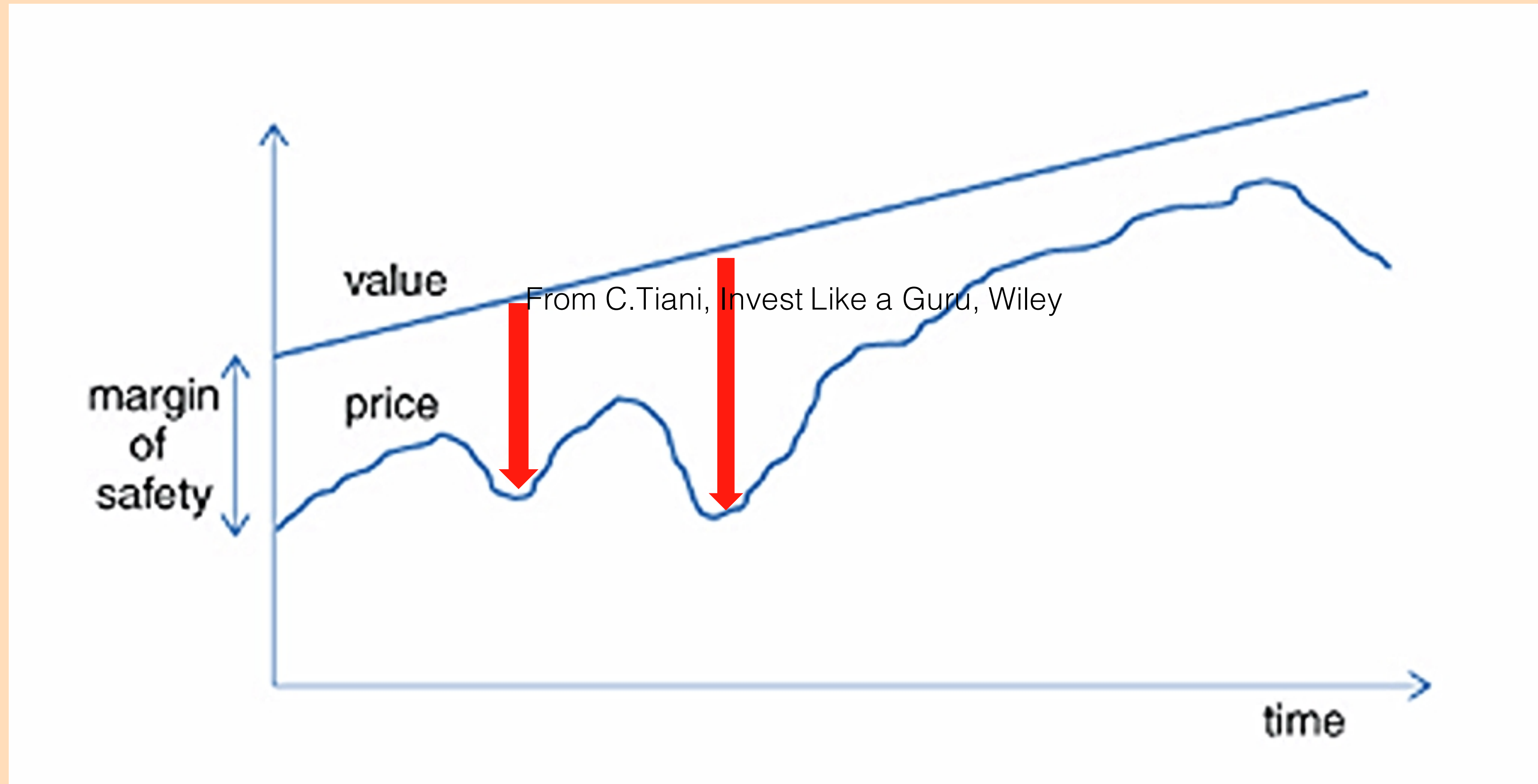
Invest in Companies With Good Management

- Management will reinvest cash back into business growth.
- Excess cash is used for acquisitions if profit criteria are met.
- Stocks are bought back if surplus cash has no other use.
- Purchase only firms with low capital requirements for growth.
- Debt will be always reduced.
- Dividends will be always increased.

Policies for Managing Recessions

- Buy when a recession is at the bottom.
- Greatest returns are realized during recovery from recession.
- Maintain high cash positions when recession peaks.
- Rate of profit during recovery from recession should exceed 20%.
- Buy \$1 bills for less than 50 cents.

Trading of Shares During Business Cycle



Test All New Investments Against Altman Z-Scores

- The Z-score equation predicts the probability that a firm will go into bankruptcy within two years.
- Variables:
 - X_1 = working capital / total assets.
 - X_2 = retained earnings / total asset
 - X_3 = earnings before interest and taxes / total assets.
 - X_4 = market value of equity / book value of total liabilities.
 - X_5 = sales / total assets.
- $Z > 2.99$ - Safe; $1.81 < Z < 2.99$ - Vulnerable; $Z < 1.81$ - Bankruptcy.

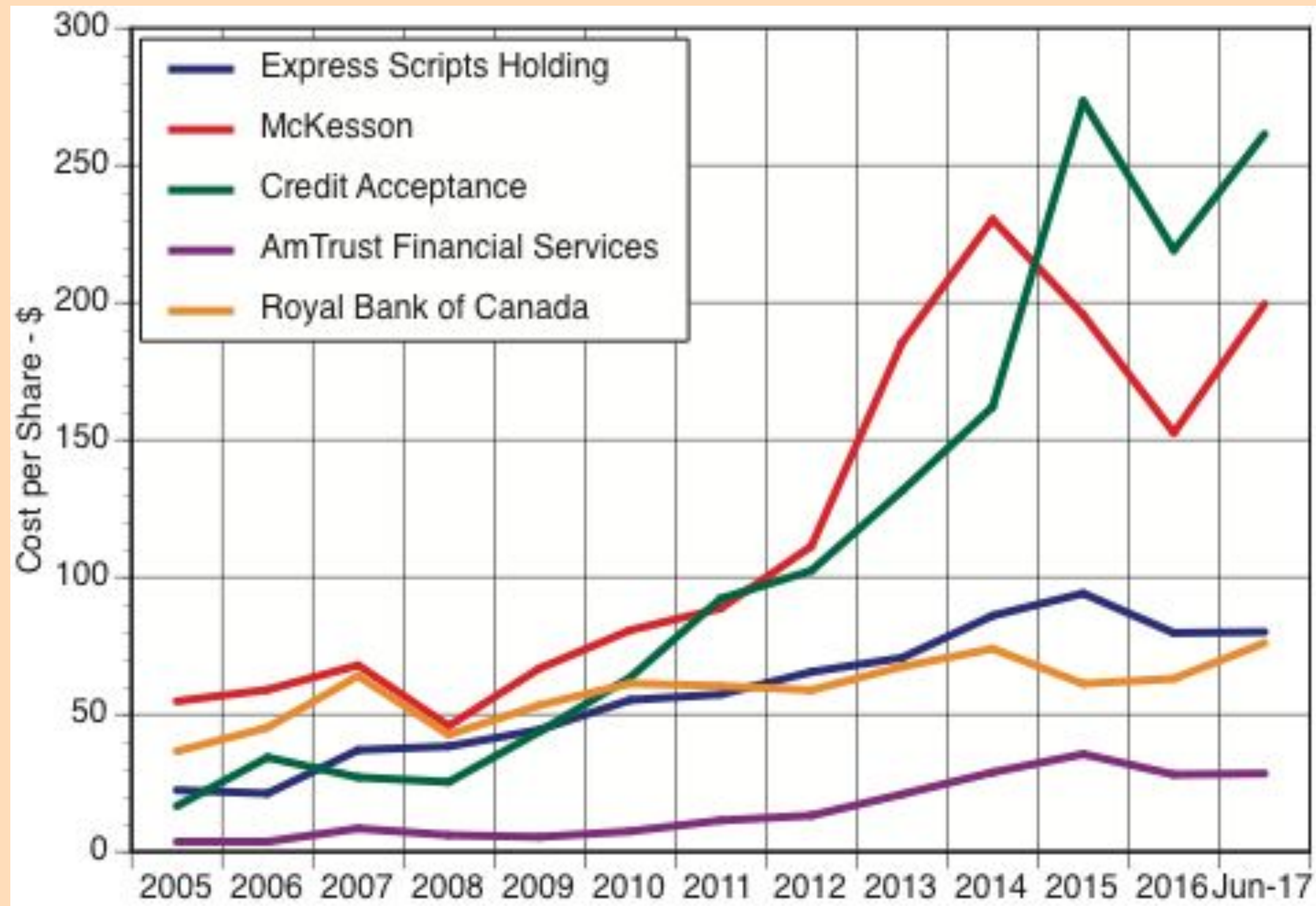
Test All New Investments Against Piotrovsky F-Scores

- Piotrovski developed a point scoring method for scoring the characteristics of companies.
- Companies that scored high (8 or 9) on a F-Score outperformed the average S&P 500 index.
- The F-scoring method covers:
 - Change in Return on Assets; Quality of Earnings; Change in Leverage;
 - Change in Working Capital; Return on Assets (ROA);
 - Cash Flow Return on Assets; Change in Shares in Issue;
 - Change in Gross Margin; Change in asset turnover.

Test All New Investments Against Beneish M-Score Ratings

- M-Score of less than -2.22 suggests that the company is not an accounting manipulator.
- M-Score of greater than -2.22 signals that the company is likely an accounting manipulator.
- The evaluation method includes:
Days Sales in Receivables; Gross Margin; Asset Quality;
Sales Growth; Depreciation; Sales, General and Administrative
expenses; Leverage; Total Accruals to Total Assets.

A View of Undervalued Companies



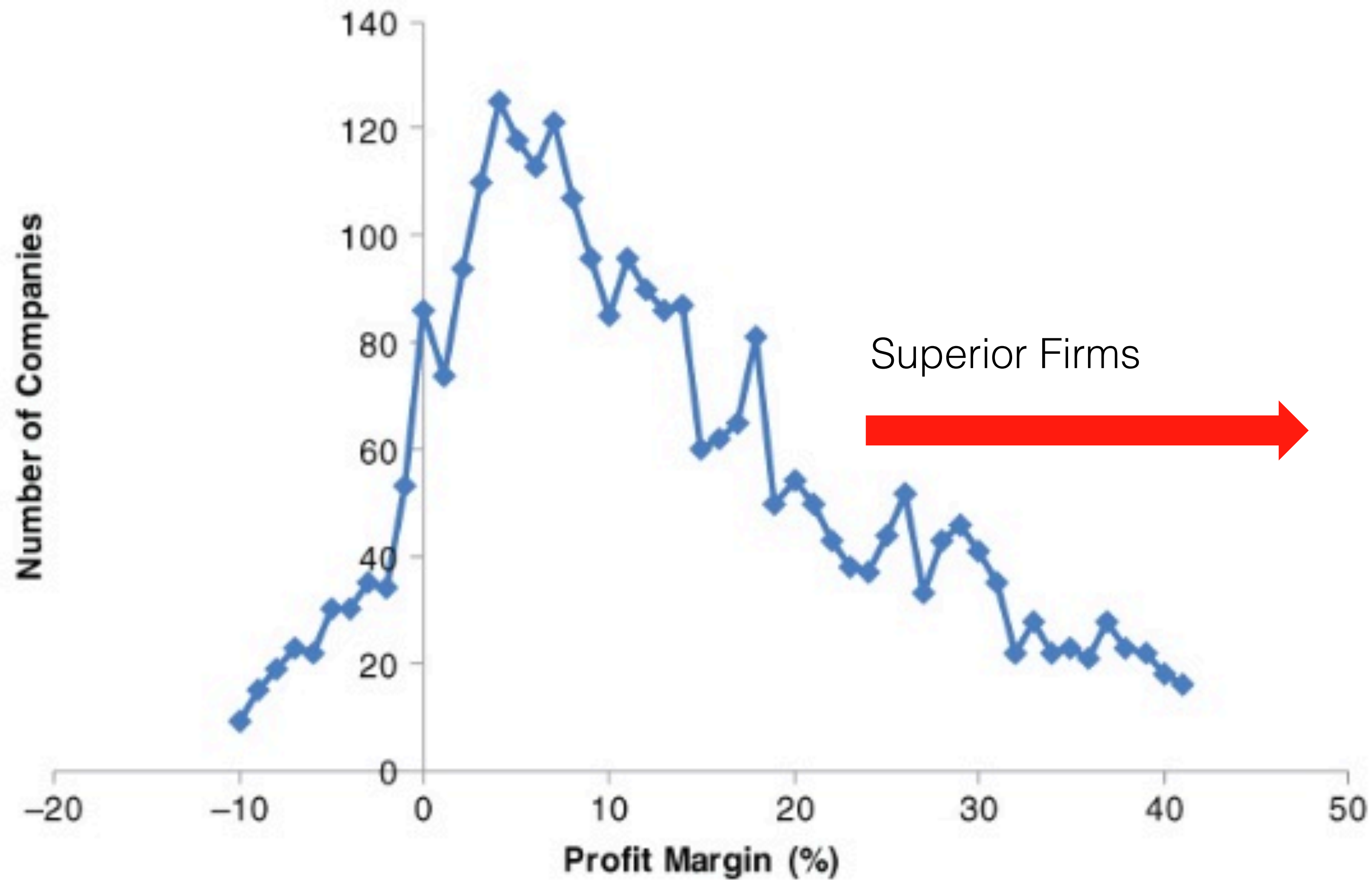
Example of Trading for Profit for McKesson Company (MCK)

MCK	Steven Cohen		2017-03-31	358,500
2012Q4	-498,245	Reduce -98.20%	9,142	\$93.3
2013Q1	+146,573	Add 1603.29%	155,715	\$104.96
2013Q2	+149,558	Add 96.05%	305,273	\$111.3
2013Q3	-19,669	Reduce -6.44%	285,604	\$122.85
2013Q4	-188,506	Reduce -66.00%	97,098	\$153.59
2014Q1	-84,103	Reduce -86.62%	12,995	\$174.74
2014Q2	+288,505		301,500	\$177.91
2014Q3	-216,400	Reduce -71.77%	85,100	\$192.49
2014Q4	-70,100	Reduce -82.37%	15,000	\$203.15
2015Q1	-7,800	Reduce -52.00%	7,200	\$221.8
2015Q2	-7,200	Sold Out	0	\$231.21
2015Q3	+4,700	New holding	4,700	\$211.95
2015Q4	-4,700	Sold Out	0	\$188.8
2016Q1	+9,200	New holding	9,200	\$161.58
2016Q2	+166,500	Add 1809.78%	175,700	\$175.42
2016Q3	-175,700	Sold Out	0	\$186.4
2016Q4	+43,100	New holding	43,100	\$147.1
2017Q1	+315,400	Add 731.79%	358,500	\$146.47

Example of Growth and Income of McKesson Company (MCK)

Fiscal Period	Revenue - \$B	Operating Income - \$B	Net Income - \$B
Mar00	\$36,708	\$110	\$724
Mar01	\$42,000	\$205	-\$48
Mar02	\$49,988	\$698	\$419
Mar03	\$57,121	\$930	\$555
Mar04	\$69,210	\$978	\$647
Mar05	\$79,096	-\$216	-\$157
Mar06	\$86,983	\$1,126	\$751
Mar07	\$92,977	\$1,264	\$913
Mar08	\$101,703	\$1,478	\$990
Mar09	\$106,632	\$1,196	\$823
Mar10	\$108,702	\$2,008	\$1,263
Mar11	\$112,084	\$1,821	\$1,202
Mar12	\$122,321	\$2,124	\$1,403
Mar13	\$122,196	\$2,347	\$1,338
Mar14	\$137,392	\$2,439	\$1,263
Mar15	\$179,045	\$2,968	\$1,476
Mar16	\$190,884	\$3,545	\$2,258
Mar17	\$198,533	\$7,109	\$5,070

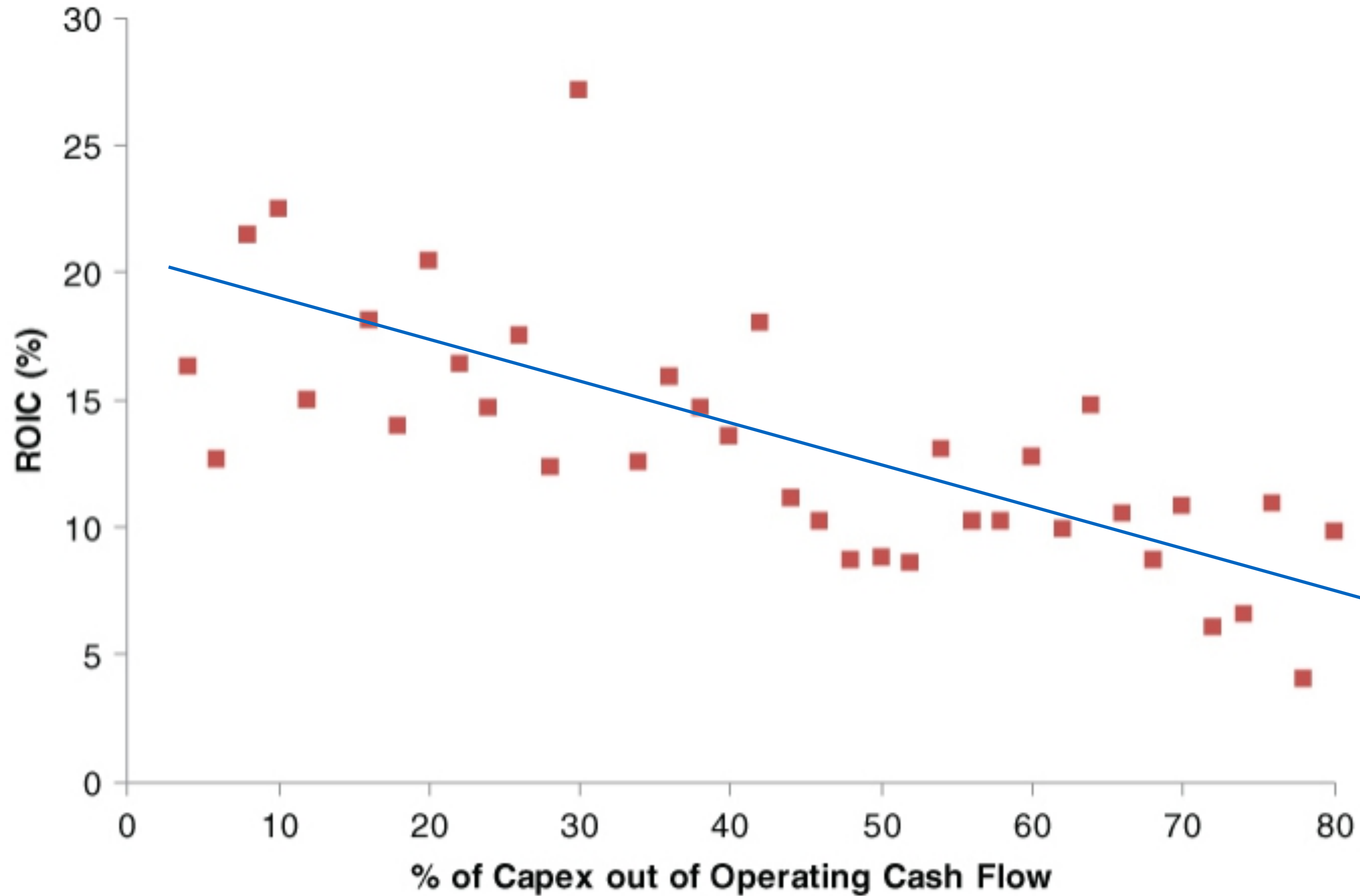
Invest in High Profit Margin Companies (Chart for 3,577 Firms)



Comments on McKesson Company

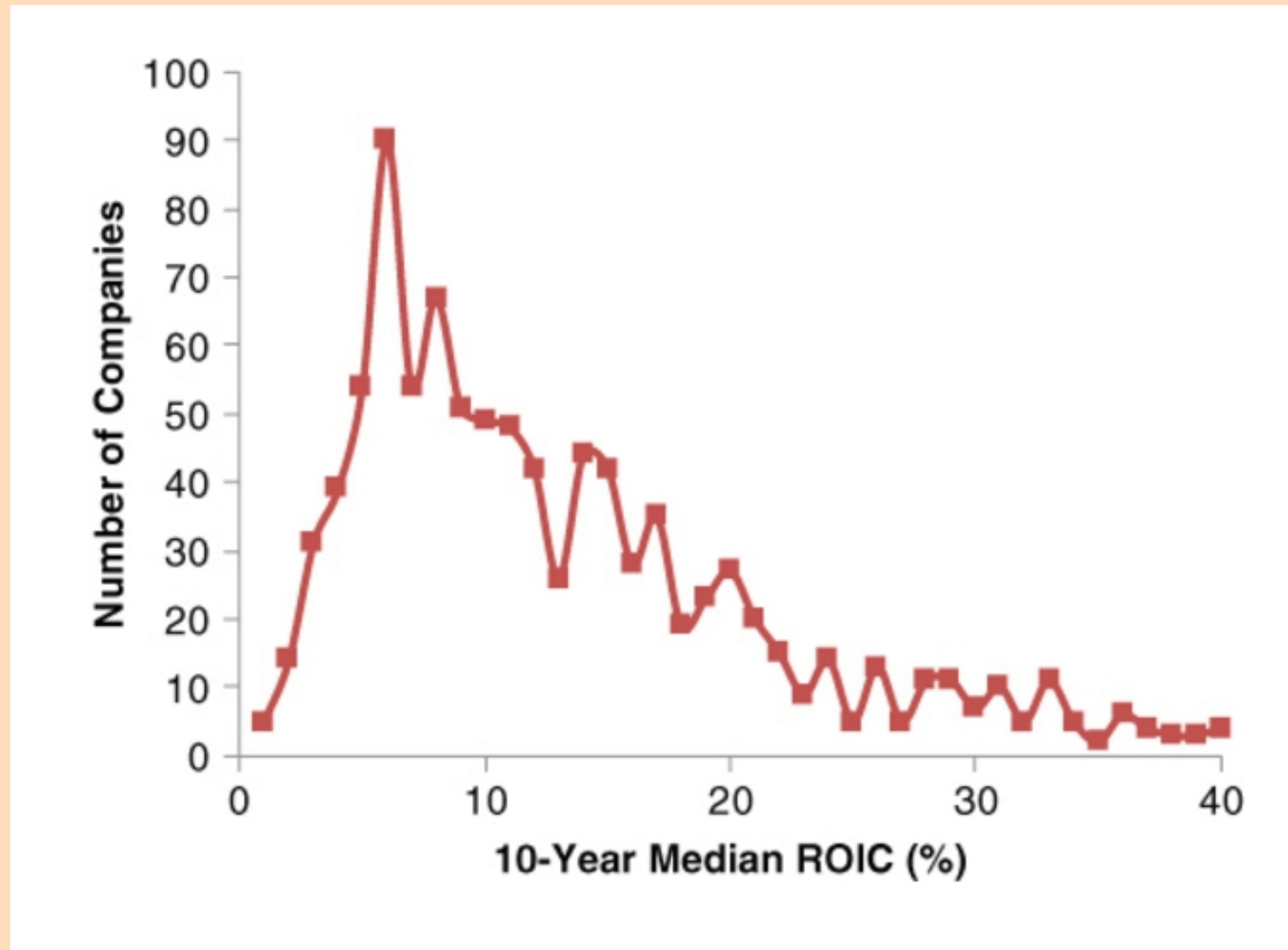
- Stock market gains realized as business cycle is ending.
- Hedge fund trading shows large gains in business cycle.
- Long-term revenue and profit gains show a good investment.
- Invest in MCK when price makes profit margins attractive.
- 12% of companies had operating margins >20% for 10 years

Return on Invested Capital Declines with Higher Assets



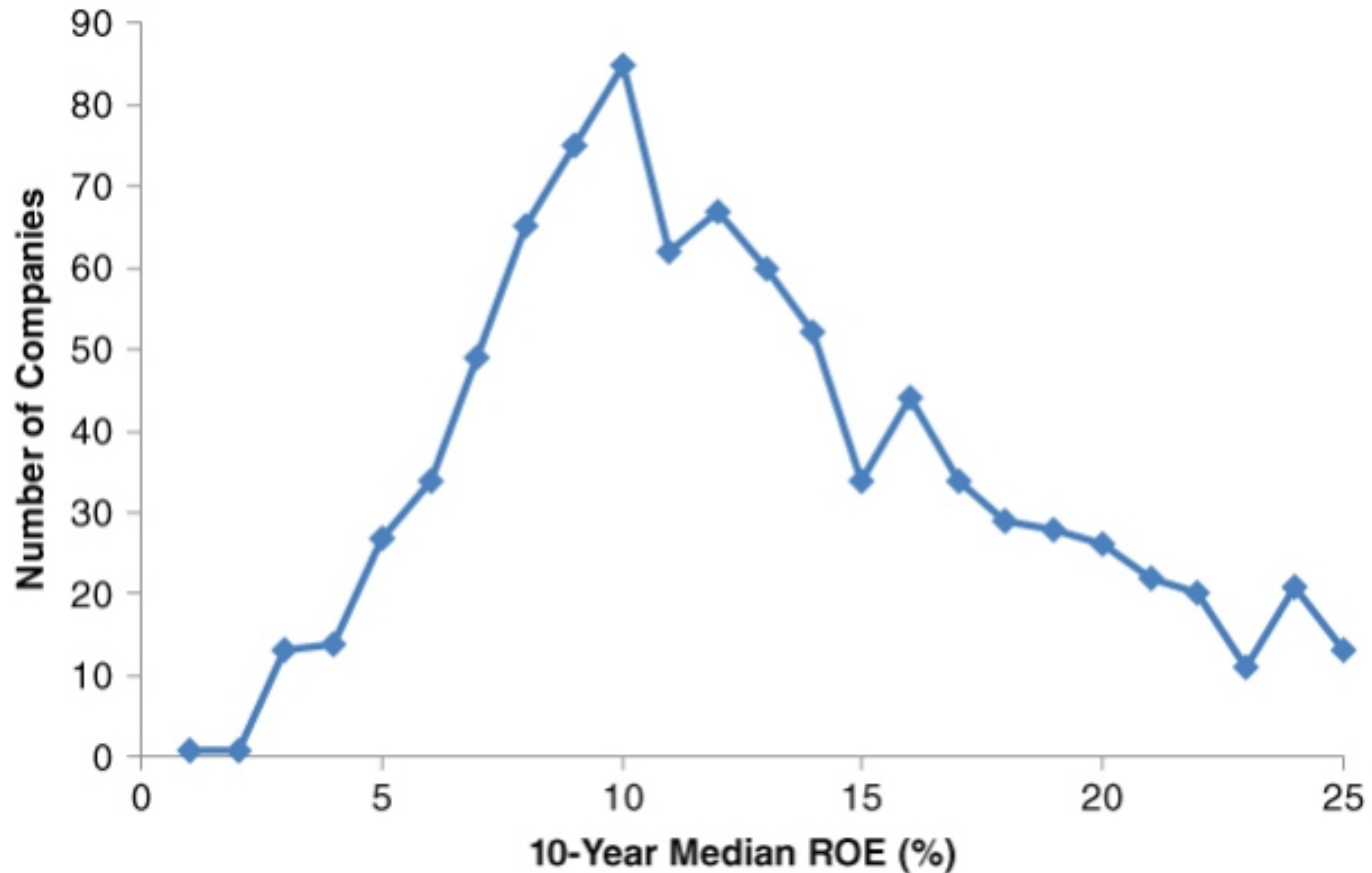
From C.Tiani, Invest Like a Guru, Wiley

Few Companies Have Long Term Return on Capital >20%



From C.Tiani, Invest Like a Guru, Wiley

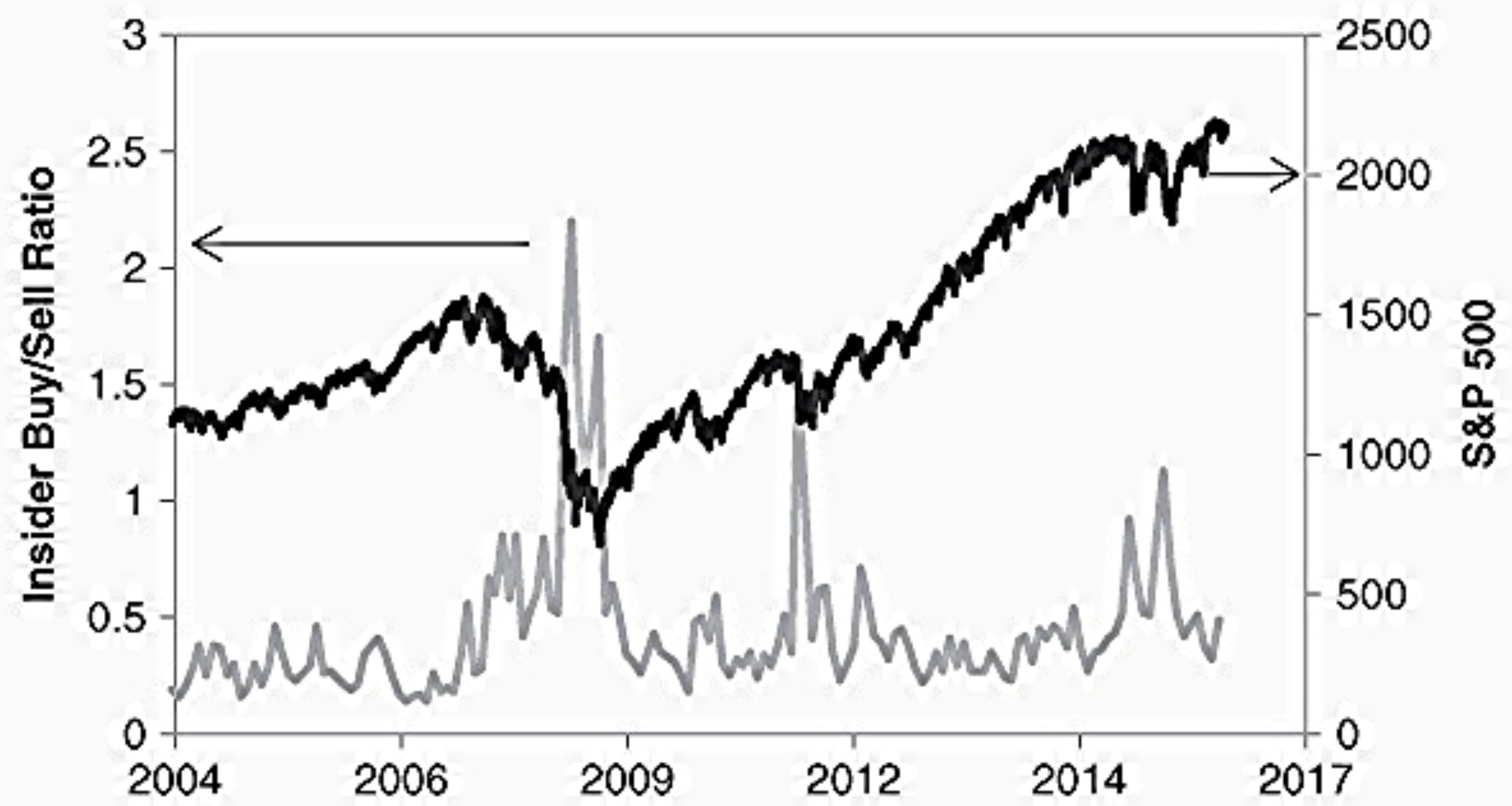
Few Companies Have a Return on Equity (ROE) Over 20%



Capital Intensity Depresses Investment Returns

- Return on Invested Capital (ROIC) declines from 20% to less than 10% as the % of Invested Capital flow rises to over 80%.
- Only 209 companies out of 1,045 have achieved ROIC over 20%.
- Very few companies have a Return on Equity over 20%,

Insiders Buy Shares As Market Declines



Insiders Purchase Shares in a Down Market, Sell as Market Rises

- The insider Buy/Sell ratio is a good indicator of a business cycle.
- As business cycle ages, investors should anticipate next decline.

Shiller P/E – A Better Measurement of Market Valuation

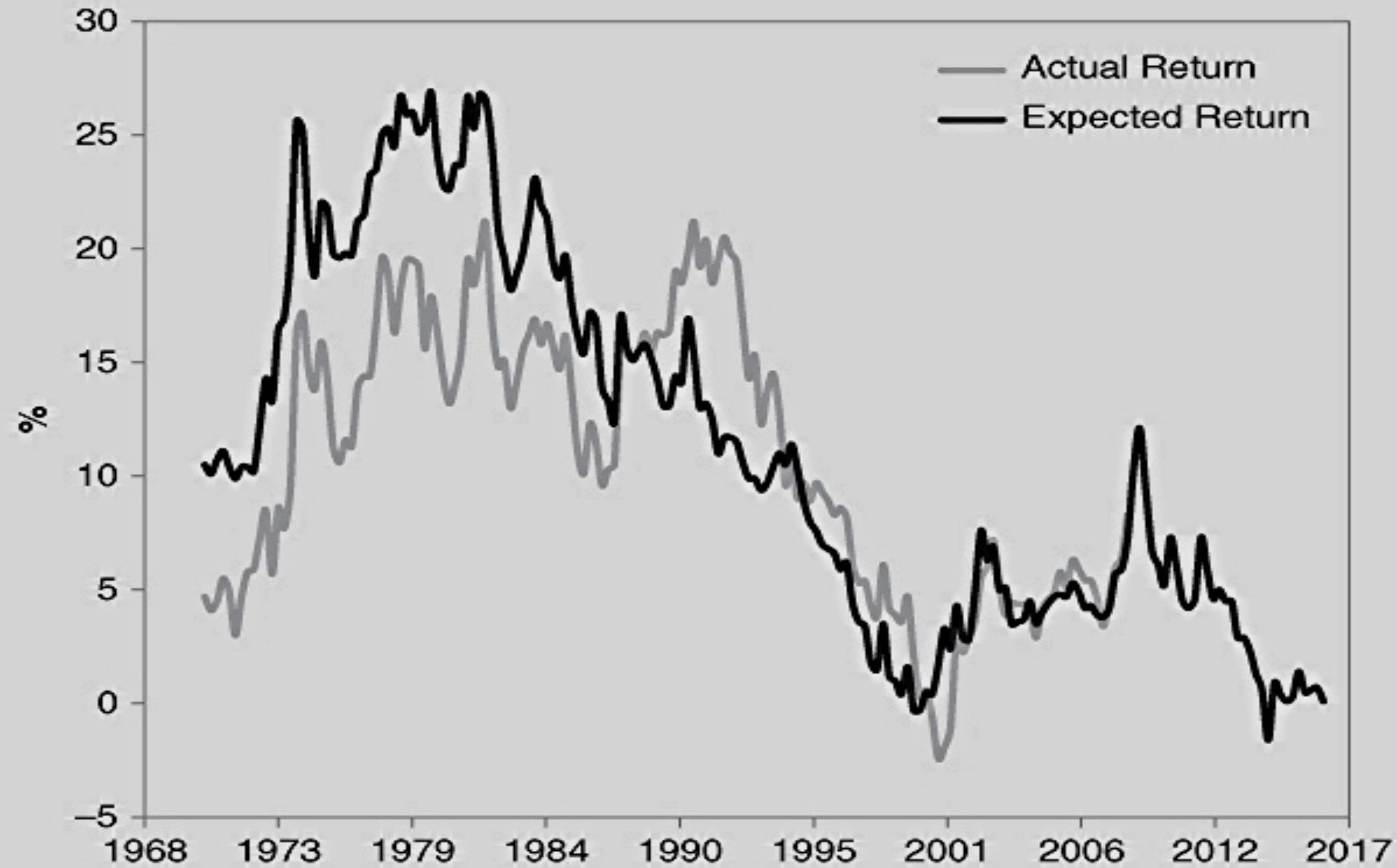


From C.Tiani, Invest Like a Guru, Wiley

Investors Should Anticipate Negative Returns

- Schiller P/E measures market's valuation.
- With current P/E levels future market returns could be -1.9% a year.

Profit Returns from Investments in US Have Declined



Investors Should not Anticipate Past Returns

- Annual returns of Wilshire 5000 Full Cap prices have declined.
- The US stock market valuations are now in an overall down cycle.
- Future market do not look promising.

Total Market Capitalization/GDP Increased with Low Interest Rates

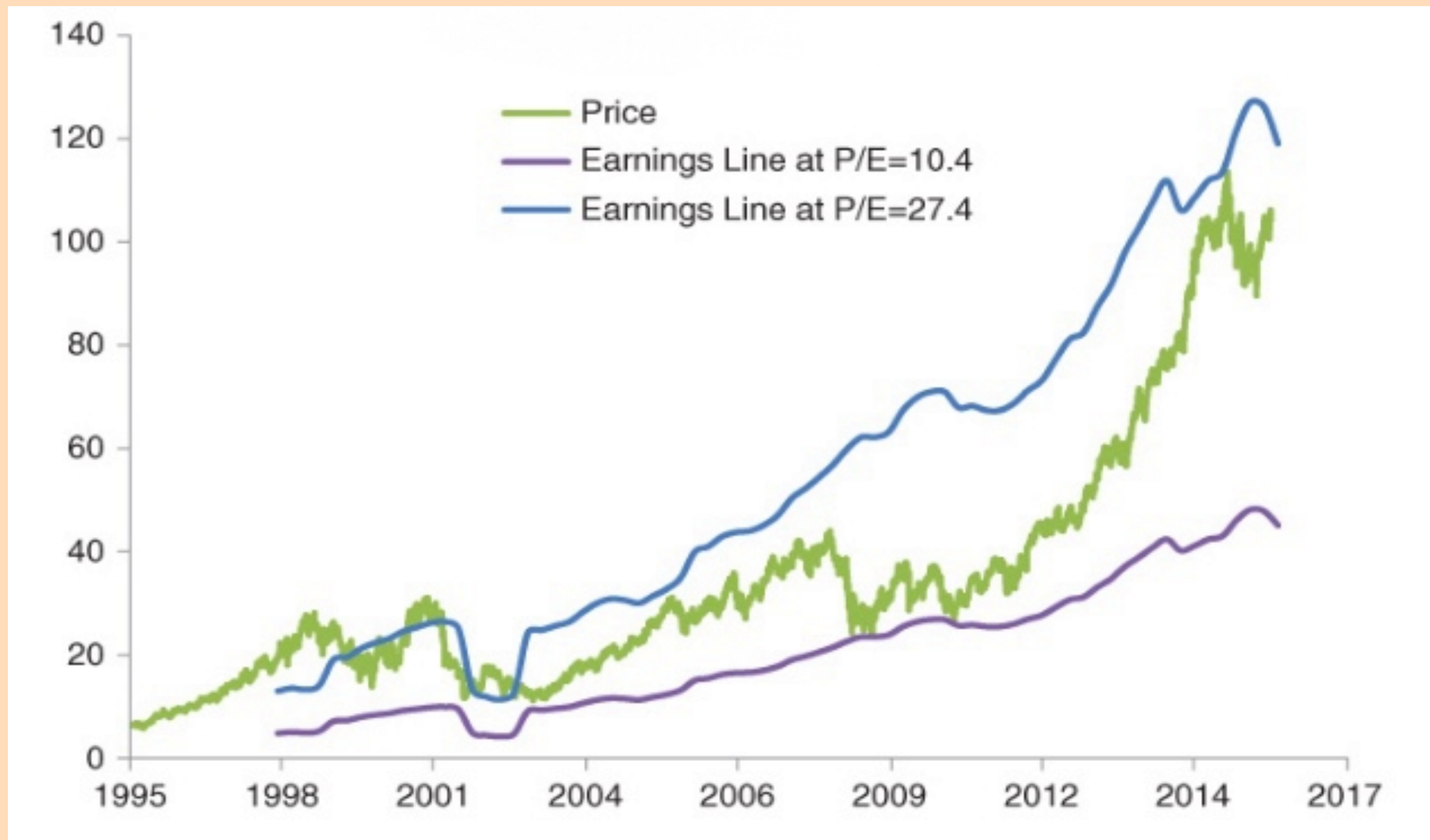


From C.Tiani, Invest Like a Guru, Wiley

Total Market Capitalization/GDP Stimulated by Low Interest Rates

- Wilshire 5000 Full Cap prices boosted by low cost of capital.
- Pending increases in interest rates will depress stock prices.
- Forecast of future market prices do not look promising.

For Traders: Buy in 2008, Sell in 2015



From C.Tiani, Invest Like a Guru, Wiley

P/E Valuations for Making Trading Decisions

- Buy for low P/E values in 2001 to 2004, and 2007 to 2011.
- Sell for high P/E values in 2006 to 2008, and 2013 to 2015.

Conclusions

- Investment in poor companies results in permanent loss of capital.
- Make investment choices on the basis of the following:
 - Consistent profitability over more than one business cycle;
 - Double digit operating margins;
 - Double digit return on invested capital;
 - Double digit revenue growth.
- Make an investment if it has a large and persistent safety margin.
- Take advantage of attractive prices at the bottom of a recession.