ASSESSING THE INVESTMENT CLIMATE - APR 26,2019

First off, lets wish all our religious friends belated holiday wishes, and our vacationers with happy vacation wishes! The traffic coming into downtown Buffalo this week is exceptionally light. With spring break from schools, and folks on vacation, my door-to-door commute time is down to 20 minutes!

One thing that has not changed while "spring has sprung" is the upward trajectory of the US equity markets. The week of April 22nd saw the NASDAQ hit record highs. We likely would have also hit new highs on the DOW Industrials (DJIA) if it wasn't for Boeing, which is putting a drag on the DJIA.

So the bull rages on, apparently looking to 2020 as a continuation of the slow growth trajectory of the U.S. economy. Cautiously, however, as the bond markets are sending mixed signals about future economic growth. In fact we've seen interest rates available to investors back up here in the 1st quarter. For example, the short term 3% CDs that were available in December have disappeared. Now, 2.45% is the best we can muster near term in a risk free investment.

By the way, that shows what the next market downturn will likely feel like, just like December. The dynamic is stocks take it on the chin, all while bonds are also repricing to higher yields. (Which, of course, means bonds are also losing value – just like they did in December.) In fact, like December, we expect bonds gaining yield (by losing value), may be enough to trigger a more sustained correction in the stock market. Yet, we can't "see" the future that far ahead.

That dynamic DOES HOWEVER lead us to be much more cautious in "chasing yield" by going long term, or by dropping credit quality standards too much in our bond holdings.

On the stock side, bad investments won't be "lifted by a rising tide", as much as in the past, so stock picking, if you choose to do so, will need to be more precise. Broad diversified investments, like index funds, should pull back to mid-single digit returns. It should also create a period wherein good stock pickers, and their mutual funds, ought continue to shine. How long that outperformance of "active" versus "passive" stock selection works, is anyone's guess.

It should be repeated that for LONG TERM INVESTORS, who can accept the full risk of the stock market, LOW COST, DIVERSIFED INVESTMENTS WIN THE DAY! This is the core philosophy of Vanguard and so called - "Bogle-heads", i.e., increase the likelihood of success by cutting expenses to the bone, and effecting as much diversification as possible. It is the model we use on all 401(k) advice.

Yet for those who prefer less risk than the market, attempt to achieve better-than-market returns, or seek higher than average income, active funds still have a role to play in individuals portfolios. The trouble with active funds is, that they are active, they make "active bets" not in line with the market. For example, in our portfolios right now, we have a few active growth-focused funds that are handsomely beating the market. On the other hand, we also have a few active value-focused funds which have lagged, and are just catching up to the market as we type this missive.

The other issue is, is their skill at beating the market permanent or was it just "luck"? That is indeed a proper question to be asked. Once again, here is the reason folks like Warren Buffet say that for the "average investor" buying a passive index fund is the way to go. It is much simpler than trying to find those funds that perennially outperform. I would hope that Mr. Buffet, who grew Berkshire Hathaway into an investing monolith starting with an ordinary insurance company, would admit that his own investment acumen did not include buying passive investments. He was very "active in his bets". With some professionalism and discipline one can also become a "better than average" investor.

We know some of those "better than average" investors, and they have names like Wellington, Eventide, Champlain and Artisan. And there are many, many more. Even Vanguard chooses to use "better than average investors" when it comes to managing their bond funds. Yet, the old adage that 90% of funds cannot beat the market is essentially true, as they are weighed down with fees.

Why are we highlighting active vs passive investing? By the book, so to speak, active investing ought to start paying dividends over the next phase of the market cycle, particularly if the market starts to trend sideways. So if you've held a fund that has been disappointing, be it domestic or foreign, it ought to be poised to have its "day in the sun". This is where patience pays its own dividends.

As much as we've adopted passive strategies, and factor-based strategies through ETFs, we here at Delaware Avenue Advisors still maintain a deep due diligence research effort on mutual funds and have a complete "buy recommendation" list at all times. We believe we have been able to identify those funds that show skill, not fleeting luck, over long period of time. And we agree with Mr. Buffet, the average investor may be better off simply buying the market.

It's no secret that we have an aging client base; in fact we became experts in producing yield from retirement portfolios over a decade ago. In our last missive, we discussed why we preferred CBD oil investments to weed investments; clearly a topic for a younger more aggressive investor. This week we will focus on something for the more conservative among us, yield from infrastructure.

The word infrastructure has been popularized by politicians, a breed that is usually wrong about everything. Let's define infrastructure very simply for our investors – infrastructure encompasses investments that essentially extract "tolls" for essential services. If you're thinking of toll roads, yes, correct! Also think about gas pipelines, storage facilities, sea ports, utilities, data centers AND toll roads.

Many infrastructure investments are regulated, like utilities. You may think this causes it to be a poor investment. Not really. What is does is cause it to be a more CONSERVATIVE investment, wherein the downside is somewhat protected (most utilities aren't allowed to go out of business for example) and where forecasted future cash flows don't have the same volatility as unregulated business cash flows do. Additionally, most infrastructure investments are essential services such as energy, roads, shipping deliveries, and yes, even data has become an essential service these days.

At most periods over the last twenty years, our income producing portfolio all where a little "greasy" with oil stocks. Why not? Oil was a perfect income investment showing good yield and the potential for yield increases as energy prices escalated, i.e., an inflation hedge on our income. Recently however, not so much!

While many investment advisors and sovereign funds have moved away from oil investments to be more "green", we moved away from them because the world changed. The US becoming a net exporter, ongoing energy efficiency programs, ride sharing, all have conspired to make oil a much less relevant economic input. And therefore, a less relevant investment.

What we've never given up on, are the gas pipelines. Infrastructure. "keep your oil and gas, I only wants dibs on the transport of same". Pipelines are still the "greenest" way to move energy. This doesn't imply that pipelines aren't without risk. Ask any of our clients who've owned Kinder Morgan over the last few years. Kinder is a buy product of Enron, and is one of the US largest pipeline operators next to Enterprise Products (which we also own). We are finally starting to make money on Kinder after sitting on shares at a loss for years. The good news is, not only is our capital back to normal, but Kinder looks poised to continue to ramp up their dividend over the next few years. They just gave us a 50% dividend increase!

Yet, we're not recommending Kinder Morgan here. We'd prefer to focus on a company that has a much, much longer operating history, and encompasses all facets of infrastructure, not just gas pipelines – Brookfield Asset Management, located right across the border in Toronto. www.brookfield.com One of their funds is our focus investment this month, Brookfield Infrastructure Partners, ticker symbol BIP. Full information can be found here: https://bip.brookfield.com/

Brookfield Infrastructure Partners summarizes easily…. Through a Master Limited Partnership structure (there are tax issues, so we prefer to hold BIP in IRAs) we earn approximately a 5% dividend yield, which has historically grown at an 11% COMPOUND GROWTH RATE. It is not what we consider a high yield investment – sort of in line with what many electric utilities pay – around 5%. The BIG part of that is the ability of BIP to grow that dividend. At an 11% compound growth rate, in a few years we'll be earning 7% on our original shares, then 10%, then 12%, and so on.

"Historical results do not guarantee future returns". We've all seen that in investment ads, and it's no different here. We cannot assume that dividends will continue at that growth rate. However, our research shows two important issues; 1.) BIP has just reinvested significantly in operations, which usually gives a concomitant increase in future income and 2.) relative to other valuations such as US stock, US real estate, US bonds, infrastructure assets are relatively inexpensive to their historical levels. This is unlike US stocks, bonds, or real estate which are getting on the expensive side of their historical valuations.

So we have a bit of protection by decent valuations. Another layer of protections arise from infrastructure being an essential business. A third layer of protections by the extraction of fixed tolls, regardless of commodity prices, so the businesses are cash flow stable. And the last layer of protection is the general partner expertise, Brookfield itself.

So 5% doesn't seem exciting, I know. Yet, in the investment universe, a decent dividend of 5% of capital that can potentially grow at double digit rates consistently into the future becomes…well….sort of exciting to an income investor!

Remember bonds hardly ever increase their interest rates. That's why we call them FIXED INCOME. And long run, fixed income can play havoc with a client's purchasing power if there is inflation at hand. This is why having sources of increasing cash flows in income portfolios becomes so critical. Infrastructure provides investors with the potential of increasing cash flows, without taking the risk of investing in pure stocks, one of the only sources of rising dividends.

Brookfield isn't the only good fund in the infrastructure space to be sure. Yet, caveat emptor… there are a lot of poor funds in the space as well. So, as this is an ACTIVE type investment, good due diligence and research are very important.

If anyone would like our full research on Brookfield Infrastructure Partners delivered to their mailbox, send your request to info@delawareaveadvisors.com with BIP in the subject field.

With warmest spring regards,

Gene Chaas, CFA
Managing Director