COVE CAPITAL
MANAGEMENT

Cove Views

November 2, 2017

The overriding theme of discussions we have with clients lately is: **Given its recent run up, is the market too high? And if it is, what should we do?** We know from experience that one client asks what most clients are thinking so we felt it was high time to share our thoughts on the matter.

Generally, we do not try to predict the direction of the markets. Having said that, the stock market has come a long way in a brief period. The S&P 500 is up more than 20% since the election last November and about 250% since the lows in early 2009. Valuations by historical comparison are high. So, are we due for a correction?

Although valuations are indeed high, if you compare p/e ratios to long term interest rates, they don't seem quite as out of whack as if you were looking at them on an absolute basis. It has been estimated that corporate tax reform has the potential to add as much as 5-10% to earnings going forward and the economy continues to improve at a sustainable pace.

The common thread we see in many markets, and the thing that has the potential to concern us is that from stocks and corporate bonds, to treasuries and real estate, the strength of almost all of these markets is predicated on long-term interest rates staying low. We believe that higher interest rates could be the catalyst to shock valuations. However, with today's anticipated announcement that Jeremy Powell will replace Janet Yellen, we foresee a continuation of Fed interest rate policy and rates are likely to remain at these low levels for the time being (the 10 year is 2.35% at the time of this writing).

Given our current situation, what are we doing to mitigate risk?

- We are gradually increasing the amount of cash in accounts as the market goes up. This gives us the opportunity to take advantage of situations when companies we follow show signs of weakness.
- We spend a lot of time, particularly at this time of year, focusing on minimizing our client's tax consequences. Many individual stocks have gone up quite dramatically; as we pare those positions back we seek to find offsetting losses when possible.
- Given our overall view of the stock market's risk profile, we generally try to buy and hold stocks with reasonable valuations (using P/E ratios and other widely followed metrics). Should a pullback occur, our view is that momentum stocks would likely suffer the most and value stocks would fare better.

- Additionally, we keep a careful eye on concentrations of individual equity names. If a position becomes a disproportionate holding, we look to sell a portion of it or hedge it in the options market, when appropriate.
- Lastly, given the entire bond market's sensitivity to interest rates, we buy and hold bonds that are situation specific and generally have low durations (a measure of their interest rate sensitivity).

As always, we are always available for further discussion regarding this newsletter, your specific financial situation or any individual security you are interested in speaking about. We hope this newsletter finds you well.

Thanks for your continued trust and support,

Dave Goldenberg, President

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