



INVESTMENT COMMENTARY

WHAT'S IN YOUR..... PREFRONTAL CORTEX?

The prefrontal cortex may be as good a friend to man as dogs are, and after reading this letter, I am sure you will agree with me.

The 401(k) plan that I manage at our firm, and every other account in which I have an interest, hold the same common stocks that you have in the portfolio that we manage for you. Also, every other account, besides the 401(k) plan I manage for myself, has the same positions. We are all in this together.

Since February, we have endured intense, unforgiving stretches of volatility. Volatility is tough enough. But when it comes to high percentage net losses, even if they are on paper, times such as February and March can be unsettling. You do not have to be gifted with an above-average quotient of empathy or other facets

The table below shows that the common stock of [Nike, Inc. \(NYSE: NKE\)](#) achieved from January 1, 2015 through March 26, 2020 an average price return of 17.9 percent versus an average price return of the Standard & Poor 500 of 7.7 percent. As I hope to show you below, there is a good reason for this difference.

2015	2016	2017	2018	2019	2020		5Yr Avg
30.0	-18.7	23.1	18.5	36.6	-19.2	Price Change (%)	17.9%
30.7	-28.2	3.6	24.8	7.8	2.2	+/- S&P 500(%)	7.7%

So, I am confident that many of the paper losses we have suffered in February and March will be replaced by gains, gains that I intend to be unrealized or untaxed gains for many years as [Nike](#), and other companies of which we own parts of, will maintain and likely improve the power of their brands, and will provide what all serious investors prize the most: a multi-year unrealized, that is untaxed capital gain with annual dividend increases many multiples of the inflation rate.

I opened the doors to our firm in late October of 1987, just a week after the market had fallen 22.7 percent on October 19, 1987, a rout that was

of emotional intelligence to understand how deeply disquieting the market activity of February, and March has been, especially for some of the firm's clients who did not weather the tough period of 2008-2009.

Nevertheless, the companies in your portfolio, such as [Nike, Inc. \(NYSE: NKE\)](#), with its number one global position in virtually every sports category, enjoy significant competitive advantages, putting them in the driver's seat or if you are a race car fan and like to follow such events as the NASCAR 500, the pole position, making it likely that these firms will do well under any conditions and, when it comes to such tough periods, periods marked by events such as the coronavirus crisis or situation, will gain market share at the expense of their weaker competitors.

intensified by a concept, sold by Wall Street marketers, known as portfolio insurance, a strategy of dubious value and shaky logic that dictated the following: when prices fell a certain percentage, it was time to sell. Those money managers who subscribed to portfolio insurance programmed their computers to execute massive selling of stocks when prices fell to certain points and to execute buying when prices rose to a certain programmed or preset level. Hence, portfolio insurance and programmed trading --- two concepts whose logic escaped me---became known as interchangeable terms. With such thinking, there was no attempt on the part of

these investment managers to consider any reasonable or intrinsic value of the securities for which they had a fiduciary responsibility.

Portfolio insurance seemed to me to be diametrically opposed to what I had thought was the purpose of insurance, which is to reduce or narrow the likelihood and cost of negative outcomes.

The battleground on October 19, 1987 was bloody, even shocking. When I spoke with potential clients after October 19 ---most of whom I had worked with when I had managed the common stock funds in the trust department of Fourth National Bank of Tulsa---it was interesting to note that most of these people---despite the fact that I had produced a record in the stock market well above average---were cautious and nervous. But the most experienced, successful business people who had created first-generation wealth for themselves and their children were excited.

At first, looking at the market battlefield after October 19, I was cautious. After all, I had never experienced anything close to the debacle of October 19, 1987. Now, not only did I have to decide which companies to select for investment amidst the carnage, but I had another challenge: to convince potential clients to remain calm and to draw upon the very large potential enclosed in their respective prefrontal cortexes, brain matter with which all of us are endowed, to understand the enormous opportunity in front of us, as we put aside any purposeless emotion and let logic and correct conceptual thinking, powered by the prefrontal cortex, work for us.

My job was to listen and understand them, particularly to examine their fears gently. Doing so, I had some success in convincing them to be clients. Listening to them also helped me: it was a constructive way to challenge my own optimism, which was based on my view---a view exactly conforming to my view today about the prospects for common stocks---that the market decline of October 19, 1987 was excessively punitive, and one that incorrectly foretold an economy much weaker than reality.

On October 19, 1987, one selling wave had dictated another wave and so on until bargain

hunting and decisions backed by research, logic, and common sense, all functions of the powerful prefrontal cortex, intervened. Then shares were bought at bargain prices, purchased from people throwing in the towel, share prices stabilized, and then quickly rallied as programmed trading kicked in on the plus side. And, as you guessed, after the bottom was reached and prices began to recover, sentiment turned positive, and investment managers called on the prefrontal cortex of their brains to seize the opportunities that the programmed trading (and other factors, of course) had provided, we saw sizeable price gains, with programmed trading (not investing) goosing the gains. This is what happened on many days in February and March of this year.

From February 20 of this year, we have experienced the same effects of portfolio insurance or programmed trading that investors experienced on October 19, 1987.

Unless a company suffers a critical blow, such as a food company admitting that it had knowingly inserted rotting ingredients in a candy bar, it would be hard to believe that any company's value could go up by ten percent in one hour, down by fifteen percent in one hour, up twenty percent in the next hour and so on. (Because of real estate's poor liquidity, when compared to common stocks, especially common stocks with multibillion-dollar share counts and great market liquidity such as Coca-Cola (NYSE: KO) or Union Pacific (NYSE: UNP) or when real estate's liquidity is compared to the market for United States treasury obligations, one of the largest and most liquid markets in the world, we do not see rapid gyration, turnover or volatility. Perhaps, the mature investor, understanding his temptation to be impulsive and to be influenced by volatility, and having a very good understanding of his strengths and weaknesses, chooses real estate as a means of enforced discipline. She cannot succumb to rapid price changes because there are none, and there are none because real estate is not fungible.

February and March of this year have been a time of frenzied activity, great price swings, with net declines. Very unpleasant. The reason: is fear of

what the unknown could do. The fear of the economic damage that the coronavirus could cloud of uncertainty. But the powerful compound of experience mixed with logic, pioneered by the prefrontal cortex, suggested that the markets would turn around, as they have and will continue to do so.

Merriam-Webster defines a crisis as "...a time of intense difficulty, trouble, or danger." That is its first definition. Interestingly it does not include uncertainty in its many definitions. But that is what we have today. In fact, you could say that a crisis is only as big as its uncertainty. Our uncertainty arises from our inexperience with the coronavirus or COVID-19. We do not know how long it will last, the extent of its virulence, how people will respond to it, and perhaps most importantly, how leadership will respond to it. We also did not know whether we had enough critical battle gear---items such as masks, tubing, ventilators, and gloves---to tame the coronavirus. So, a great deal of uncertainty existed and exists. In sum, there was and is much uncertainty about what we would face and how and when we would vanquish it, that is, how long and how much money, work, and sacrifice it would take to vanquish the virus.

As we see the first signs of some control of the COVID-19 virus, we may see the same kind of frenzied buying to offset the frenzied; some call irrational, some call panicked, selling that we have dealt with, and successfully. Most of the firm's clients have experienced the tough days of 2007-2009 and the great returns that followed as the economy regained its feet. Of course, there is no guarantee of such recovery now. Still, I am sure that such recovery will begin this year and will be dramatic, given the dramatic fall in prices since February 20 and the strength of the American economy, buttressed by exceptionally low-interest rates.

We are invested in a small number of companies, usually twenty. These companies have unusually powerful competitive strengths. Maybe a way to understand the market position and other dynamics of these companies would be to take a small detour into literature, a detour that I promise will be rewarding.

inflict, linked with the toll it could take on our population, created a horribly menacing Animal Farm, first published on August 17, 1945, reflected George Orwell's distaste for communism, which he believed promised equal rewards and equal power for all citizens, a promise that was impossible to achieve. An allegory, Animal Farm tells a story of disillusionment and misperception. Orwell says that communism has it all wrong. Communism's promise that everyone would be equal is insincere, and even if it were sincere, it is impossible to achieve and may not be desirable in any case.

The reader may now ask themselves what an allegory, attacking the logic, the platform, and the promise of communism, has to do with investment management? This a very legitimate question. All I can do is ask the reader for more patience and understanding.

Animal Farm is about the Soviet Union's early years. At the story's beginning, Old Major inspires his fellow farm animals to revolt against their human master, Mr. Jones, owner of Manor Farm. Leaders of the animal revolt include two pigs, Napoleon and Snowball.

Ultimately, however, the rebellion is betrayed, and the farm ends up in a state as bad as it was before, under the dictatorship of a pig named Napoleon. It turns out, sadly, that the leaders betrayed the other animals who had believed that everyone would have equal power and privileges. Disillusioned, most animals under the new regime now bitterly understand that there is no true equality. They now know, after the revolution, that yes, all animals are equal, but some are more equal than others. In fact, Napoleon declares himself the ruler and has inscribed on the side of the farm's barn the following: all animals are equal except that some are more equal than others. (Some of this can be credited to Wikipedia).

ALL COMPANIES ARE EQUAL, BUT SOME ARE MORE EQUAL THAN OTHERS

Likewise, in business, and from our point of view, it is not true that all companies are equal in power, competitive advantage, and other dimensions. Some companies are more efficient. Their software has fewer bugs because they have better

software engineers. Their factories have less downtime because their factory managers are better trained. Their marketing is more skilled. More on point and more persuasive because they have the cash to spend on developing the most sophisticated websites and online shopping experiences. Some companies have more powerful brands. In sum, some companies are more equal than other companies.

Orwell wanted to tell the world that it was not realistic to believe that all citizens and all people were equal and that communism's promise of such a state could not be achieved and, by implication, would not be ideal in any case. After all, we are not born with equal aptitudes or given

equal opportunities; we do not have equally constructive environments in childhood, grade school, or afterward. We may be equal in some ways, but we may be just as likely to be more equal than others in many ways.

There is no such thing when it comes to business or, most likely, anything in life--- if I could succumb to jargon---as a level playing field.

Our job is to find companies that are more equal than the other companies. Our job is to find the companies that love an unequal playing field. One of these companies is [Nike \(NYSE: NKE\)](#).

If George Orwell were a professor of marketing at Harvard Business School, Stanford Business School, or Washington University, where I earned an MBA, dutifully learning to compute every financial ratio known to man, he might have remarked that all companies are equal, but some are more equal than others. (In the MBA program, I learned—not very well—to do some computer programming. In one class, we were required to write a program for a mortgage. The professor did not specify how long the mortgage ought to be. He merely told us to follow banking conventions, which would place the mortgage at a maximum at that time of thirty years. My software program produced a mortgage that would be paid or satisfied over two thousand five hundred years. The professor sardonically remarked that I had created a kind of reverse mortgage. Maybe I was ahead of my time; reverse mortgages became popular long after I had earned my MBA, along with other exotics such as the subprime one.

[Nike](#) is one of those companies that is more equal than others.

Adidas, New Balance, and Sketchers do not have the global brand name that [Nike](#) enjoys. In fact, no athletic sportswear company has the global distribution and brand name [Nike](#) has. The numbers show it. What do I mean by that?

Consider this if all companies were equally endowed, then all companies would have the same return on equity, and the same market share, all of the ideal characteristics clash ferociously with reality. Few companies have a high return on assets and equity and the high margins that [Nike](#) enjoys. The power of the [Nike](#) brand makes such numbers possible. Sometimes the [Nike](#) basketball shoe is actually more ergonomically sound than one priced twenty percent lower than another brand might offer. But the teenager living in a city-run housing project in Bedford-Stuyvesant in

New York City, or the teenager living in the squalid housing projects in New Orleans, or the teenager with the privileged upbringing in Greenwich, Connecticut, wants to have the basketball shoes that Michael Jordan or LeBron James endorses and wears, no matter that it does not make economic sense.

Owning these shoes---the shoes worn by superstars—unnaturally gifted athletes with charismatic presence and stupendous earning power, superstars, if lucky enough not to be exploited by the hordes of hangers-on, superstars who and can keep their cash and build a net worth that would be the envy of anyone but Warren Buffett, Jeff Bezos, and Jeff Bezos's ex-wife, and a small group of overpaid chief executive officers, can make these teenagers feel powerful, respected, and give them a sense of belonging and identification. For [Nike](#), these demographic

groups make the company's gross margins as fat as a sumo wrestler.

Nike is one of the world's great brands. Sure--- there is no denying the fact--- when Nike is told by governments around the world not to open their stores or when Nike voluntarily closes their stores---it is going to have a powerful; impact on the company's earnings and revenue for the present quarter, and probably for the next quarter. But two quarters, even three quarters, is a short time in the life of any company. And when a company has significant durable competitive advantages that Nike enjoys, a few months is a very short time.

Nike has a super global brand, and it will survive well. The share price decline of February and March assumes a permanent decline in Nike's sales. And a compromise of the brand. I believe that neither will take place.

Investors have the right to do what they want to do with their money and many either view the secular outlook for Nike in much different terms than I do or are unaware that the decline in the share price of the last three months does not signal a permanent, irreversible decline in Nike's fortunes.

I respectfully disagree.

I am sincere in the word respectfully as I look back at Nike's price action and see that its price has been much higher than where it was today when earnings were much lower than I believe they will be when the world gets past this coronavirus development. Of course, nothing about the arena and the game of common stock investing is highly predictable and easily forecasted. If that were true, we would see treasury investors switch their portfolios into common stocks so they could have the best of

both worlds: they could have a portfolio with little volatility as they do know when the volatility of their portfolios is measured against the volatility of a common stock portfolio, and they could have average annual returns much better than treasuries afford. We, a common stock investors, must put up with volatility. Sometimes, however, when investors---and particularly acute examples of this behavior were on display this month in the shares of Nike (NYSE: NKE), United Technologies (NYSE: UTX), and ResMed, Inc. (NYSE: RMD)

Let's take a closer look at Nike.

The table at the end reveals a dynamic, healthy company with a strong increase in sales, earnings, and every other important indicator, measurement, sign, and expression of health over the last seven years.

Especially outstanding: is Nike's EBIT. EBIT stands for earnings before interest and tax expense.¹

In 2019 we see that Nike's EBIT was \$4,772 million; its net income was \$4,301, which means it paid \$47 million in interest expense, but its net income was \$4301. This was coverage of 4301 divided by 475 or 9.05 times. When you look at two other figures, you get a feel for the strength and durability of Nike and its ability to survive and prosper in tough times as we now experience. In 2019 Nike returned 17.9 percent on its assets, a very productive figure, a number much higher than the average weighted return on assets of the composite Standard & Poor 500.

Nike's return on equity was outstanding, an almost unparalleled 50.9 percent which tells us that its modest use of debt produced extraordinary returns. In the meantime, from 2014 through

purposes, the company may estimate the useful life to be five years, giving it a depreciation expense or write-off of twenty million dollars instead of ten million dollars, the difference producing a reduction in taxes payable of ten million dollars and if the company has an average effective federal tax rate of thirty percent, that means a tax savings (a tax avoidance, not tax evasion) of three million dollars, not counting any savings on the state level.

¹ The dollar amount of tax expense is rarely the same as taxes owed or taxes payable and taxes paid because the tax code permits companies to use accelerated methods of depreciation and other conventionally accepted and perfectly legal methods of accounting to measure the expiring life or useful life of its assets. For its internal books, a company might report, for example, a depreciation charge on its factories, estimating a useful life of ten years, on a cost of one hundred or ten million dollars a year. For Internal Revenue Service

2019, Nike raised its per share dividend from \$.54 per share to \$.94 per share, an average annual compound rate of 13.1 percent.

This makes sense. With its powerful brand, reaching around the globe, its efficient but disciplined use of debt, and its vast global unparalleled distribution system (a distribution system that touches virtually everyone in the world, the Nike brand is omnipresent, omnipotent, and universally loved and respected.

I think that Nike will emerge in better shape than ever after we have seen the peak of the coronavirus crisis. Why? Before the crisis, Nike had already begun to take a constructive but introspective look at itself, attempting to determine what it was doing right and what it might be doing wrong, or at least where it might improve. This audit covered marketing, finance, logistics, and everything else that a multinational giant would undertake. For example, it began to see that with a more online presence, it could be even more profitable, it would not close its stores, but it would make its online proposition more attractive.

Nike, the largest athletic footwear brand in all major categories and in all major markets, dominates categories like running (\$5 billion in annual sales) and basketball (\$4 billion in annual sales) with well-known brands like Jordan, Air, and Pegasus.

At Nordstrom, for example, Nike operates its own shops with its own salespeople, allowing it to control the brand message. Nike's consumer plan is led by its Triple Double strategy to double innovation, speed, and direct connections to consumers. Triple Double includes cutting product creation times in half, increasing membership in Nike's mobile apps, and improving the selection of key franchises while reducing its styles by 25%

Nike has a great opportunity for growth in China and other emerging markets. Nike has experienced double-digit growth in each of the last four fiscal years in China, and I expect it will continue to do so for many years. Nike should benefit from heavy investment in sports by the Chinese government.

Moreover, Nike, with worldwide distribution and \$3.8 billion in fiscal 2019 digital sales, should benefit as more people in China, India, Latin America, and other emerging countries move into the middle class and gain broadband access.

In China, while people were isolated at home, Nike said weekly active users on its activity apps were up 80% by the end of the quarter versus the beginning. Digital business in China grew by 30%. Nearly 80% of the stores in China are back in operation.

More than 70% of Nike's growth over the next five years may come from outside North America. Nike's Triple Double strategy of increased innovation, direct-to-consumer sales, and speed may improve margins and share. Membership growth in its digital channel has exceeded expectations. Nike's gross margins may expand by a few dozen basis points per year through automation, e-commerce, and higher prices.

We know that when we buy shares in a company, we are buying part of a company, part of a business. If we owned a business that suddenly faced a difficult period but a period that in all likelihood would be conquered, a problem that would be challenging but that could be solved, based on the history and market position of this business—would we agree to sell it just because a buyer, understanding that the business faced a difficult three month period. For example, the company had suffered an interruption in the supply chain, a kind of interruption that it had fixed before—but that the company had faced difficult periods before and done well—offered a price that was five times annual earnings when the company for the last ten years refused offers for ten times earnings many times and the company was fully capable of resuming the earnings pattern that had persisted for ten years? That is when we buy common stocks; we buy parts of a company. If a share price fluctuates by twenty-five percent in one day, does that mean that the business underwent a change in value by twenty-five percent in one day? Of course, if it turned out that hundreds of studies indicating that the ResMed

sleep machines engineered to fight sleep apnea had been falsified and that these machines were permanent decline in the demand for these products because a commodity part---tubing---was in scarce supply as it was being rerouted for

not effective, ResMed would be in trouble. But to attribute a ventilators used in the fight against coronavirus would be absurd.

Nike: Important Relationships

Nike, Inc. Class B
(NYSE: NKE)

\$ 82.36

Top 10 Relationships (out of 201)

Relationship Type	Company	Country	Industry	Mkt Cap (\$)
Customer	JD Sports Fashion	Great Britain	Apparel Retail	6,099
Customer, Partner	PVH	USA	Apparel and Footwear Production	2,848
Supplier, Customer, Partner	Pou Chen	Taiwan	Apparel and Footwear Production	2,507
Customer	Foot Locker	USA	Footwear Retail	2,448
Customer	Shoe Carnival	USA	Footwear Retail	355
Supplier, Customer, Partner	Delta Galil Industries	Israel	Apparel and Footwear Production	282
Supplier	SL Green Realty	USA	Equity REITs (Real Estate Investment Trust)	3,845
Supplier	Las Vegas Sands	USA	Arts, Entertainment, and Recreation Providers	36,932
Customer	Hibbett Sports	USA	Entertainment Retail	190
Supplier	Tanger Factory Outlet	USA	Equity REITs (Real Estate Investment Trust)	627

Millions, Sources: FactSet Revere, FactSet Fundamentals, FactSet Prices, FactSet Mergerstat, FactSet Estimates, and the World Bank

Sincerely,

Fredric E. Russell

Crystal Isaacs and Kristen Jabbour made important contributions to the research, fact-checking, and proofreading of this INVESTMENT COMMENTARY. Any

erroneous conclusions, dull interpretations, misreading of the obvious, passive acceptance of dubious assumptions, and any other writing or

logic shortcomings are solely the work of Fredric
E. Russell.