Diversified Trust
Comprehensive Wealth Management

white|paper
SECOND QUARTER 2016

A Winner Take All World

BY BILL SPITZ
Director

In recent years, I have written a dozen or so white papers that were designed to explain to our clients the rationale for the investment strategies contained in their portfolios, or otherwise provide education on important concepts in finance. In every case, I intended to convey a couple of key conclusions or takeaways. This paper is very different because I am going to report on an interesting phenomenon without understanding either its root cause or likely implications for investing, or for that matter, for life in general.

The essence of the issue is that there seems to be a massive and widening gap between those at the top and the rest of the world in almost every facet of life. Increasing inequality in incomes has been widely reported, but the same phenomenon is true of corporate profitability, population growth, and real estate prices, among many others. I will report on a number of these, and then leave it to you to help me figure out what is going on!

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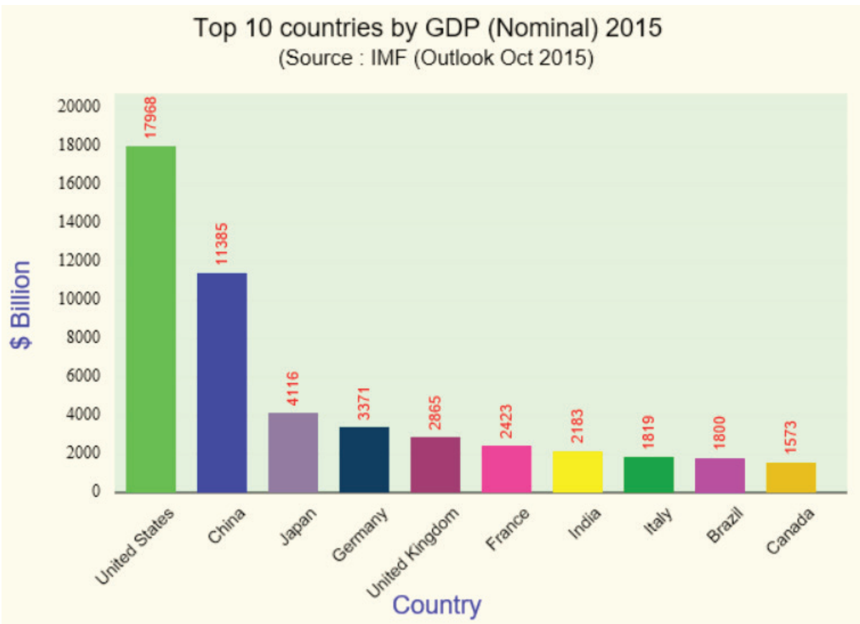
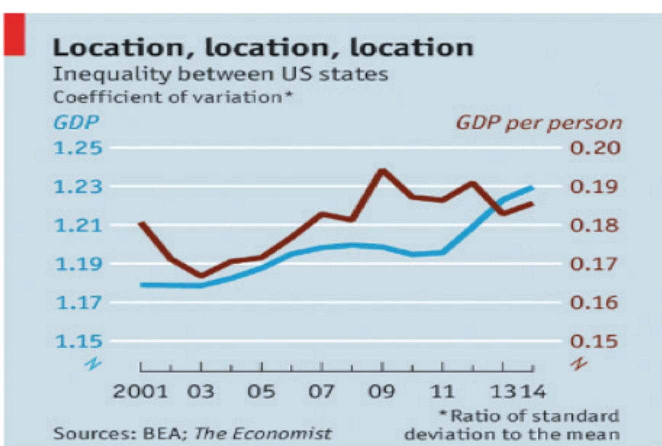
Geography

While many countries are growing at a much faster clip than the US, the following chart indicates the magnitude of the gap between the economies of the US and China as compared to the rest of the industrialized world. China's growth rate is very much open to debate but all indications are that its economy will equal that of the US in about 12 years. Currently, the US is more than four times the size of the third country, Japan, and more than seven times the size of the average of the remaining seven countries.



The same phenomenon is true within the US at the state and city level. This chart provides a statistical measure of inequality between the GDP of US states; an upward slope indicates increasing inequality:



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And, population growth varies considerably as indicated by 2014 results for select cities at the top and bottom of the heap:

Annual Change in Population

Austin	**2.9%**	**Philadelphia**	**.3%**
Denver	**2.4%**	**Chicago**	**0%**
Seattle	**2.3%**	**Cleveland**	**.4%**
Ft. Worth	**2.3%**	**Detroit**	**-.9%**
Miami	**2.1%**	**Charlotte**	**2.0%**

Source: US Census Bureau

These trends are also reflected in residential real estate prices as follows:

Average Listing Price of Homes Currently on the Market

Hawaii	**$884,055**	**Arkansas**	**$174,405**
DC	**$682,135**	**Michigan**	**$170,473**
California	**$654,009**	**Iowa**	**$170,396**
New York	**$506,353**	**Kansas**	**$166,314**
Colorado	**$504,239**	**Indiana**	**$157,701**

Source: Trulia , Inc.

As you will note, average home prices in the five leading states exceed those at the other end of the spectrum by a margin of almost four times. It seems that the winners are gateway cities on the coasts as well as urban areas with a significant cluster of high technology companies and the educational institutions that provide many of their employees. The leadership of many other cities is aware of this trend and most urban areas in the US are attempting to establish a technology corridor or footing. It will be interesting to see how many succeed and whether the current winners have built up an insurmountable lead.

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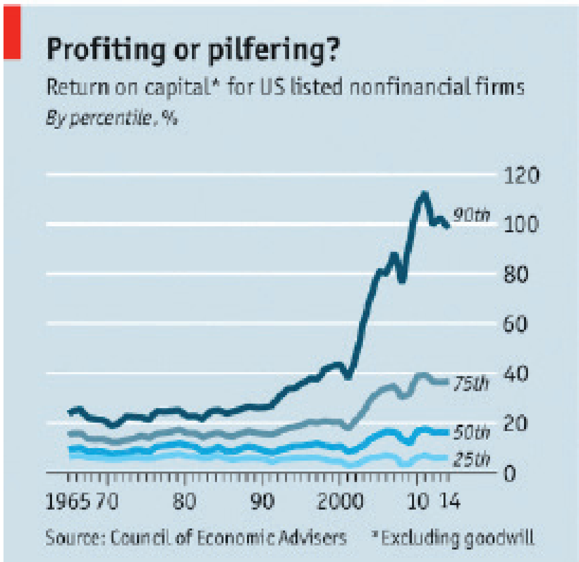
Important Notes And Disclosures

Corporations

Of course, some corporations have always been more profitable than others, but the following chart indicates that the winners and losers have diverged significantly over the past twenty five years. As you will note, the top 10% enjoy a return on capital that is around five times that of the average company.



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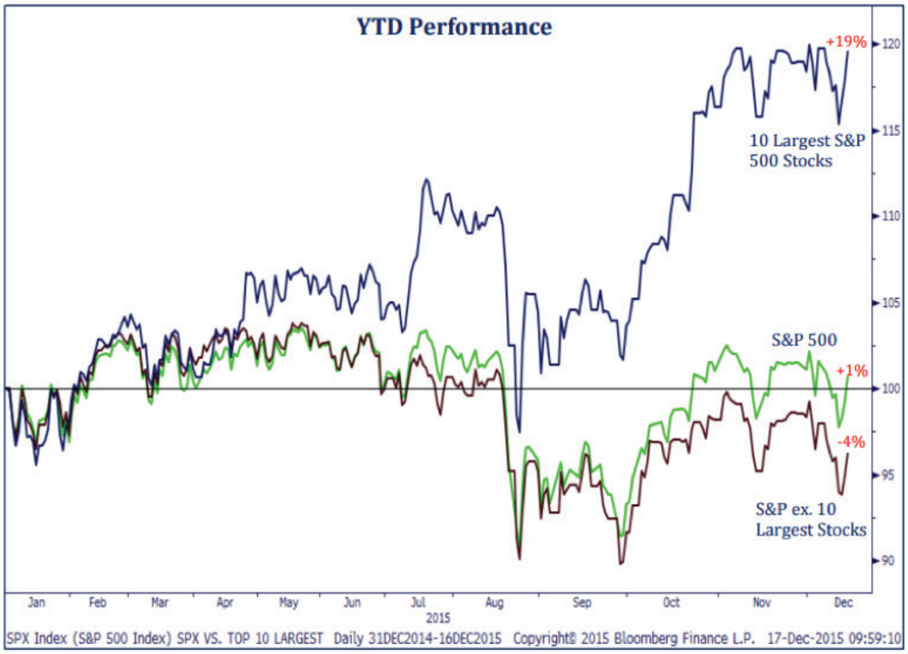
The essence of capitalism is that high profitability attracts competition which in turn causes profitability to regress toward the mean, so it will be very interesting to see whether highly profitable firms can maintain their lead or whether there will be a rotation with new combatants rising to the top.

While it may be temporary and there is not necessarily any correlation between the highly profitable firms and stock market outperformers, the next chart is fascinating. It shows that for the first eleven and one half months of 2015, the ten largest stocks in the S&P 500 Index earned a return of 19% versus negative 4% for the other four hundred and ninety stocks. Once again, the winners take all!



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College Admissions

In recent years, the advent of on-line college applications has resulted in many students significantly increasing the number of schools to which they apply. And consistent with the other areas that we have discussed, there has been a mad rush toward the leading institutions. According to U.S. News, the average university accepts 65.5% of its applicants. In contrast, here are the acceptance statistics for the most highly selective institutions:

Stanford	**5.1%**	**Columbia**	**7.0%**
Harvard	**6.0%**	**Princeton**	**7.4%**
Yale	**6.3%**	**MIT**	**7.9%**

Income Inequality

Last, I would like to focus on the most widely report divergence which is income inequality. Just for fun, I researched the salaries of baseball players and found that the average of the ten highest paid players is $27.5mm which is roughly 6.7 times that of the average player. I don't have good data, but I suspect the same is true of other professional athletes, movie stars, and so on.

More relevant to us in the financial world is the issue of CEO pay. The SEC now requires that companies report the compensation of the CEO as a multiple of that of the average worker.

FIGURE C Interactive

CEO-to-worker compensation ratio, 1965–2013

Note: CEO annual compensation is computed using the "options realized" compensation series, which includes salary, bonus, restricted stock grants, options exercised, and long-term incentive payouts for CEOs at the top 350 U.S. firms ranked by sales.

Source: Authors' analysis of data from Compustat's ExecuComp database, Current Employment Statistics program, and the Bureau of Economic Analysis NIPA tables

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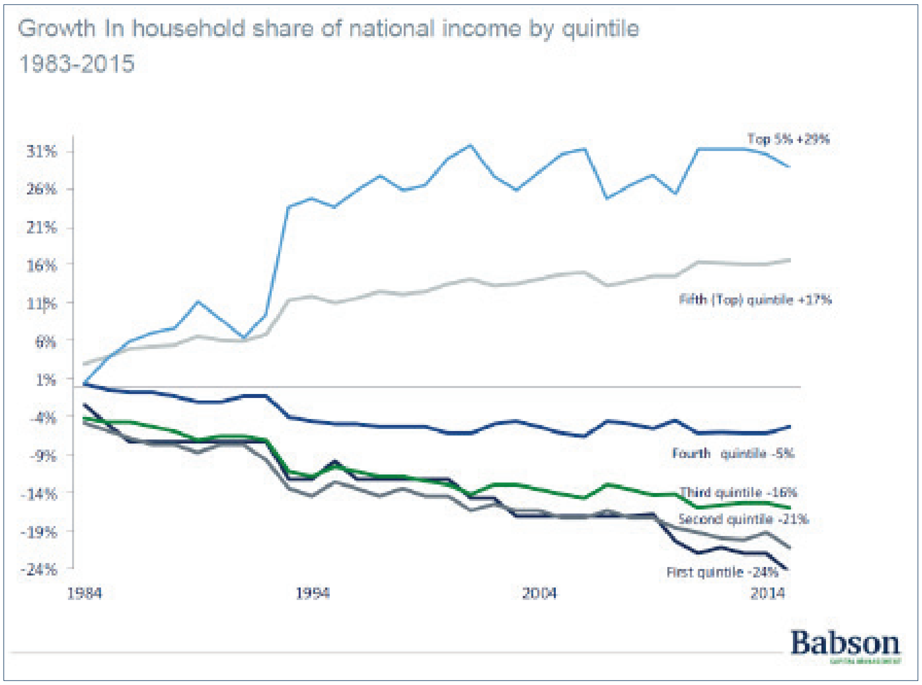
This chart shows that the pay of CEOs in 2013 was roughly 295 times that of the average worker which compares to 50 times in 1984. More recently, with a flat stock market which impacted the value of stock options, the multiple fell to 204. However, this multiple is still an order of magnitude higher than in other industrialized countries and a considerable source of populist campaign fodder.

Now, let's move to data that covers all Americans.



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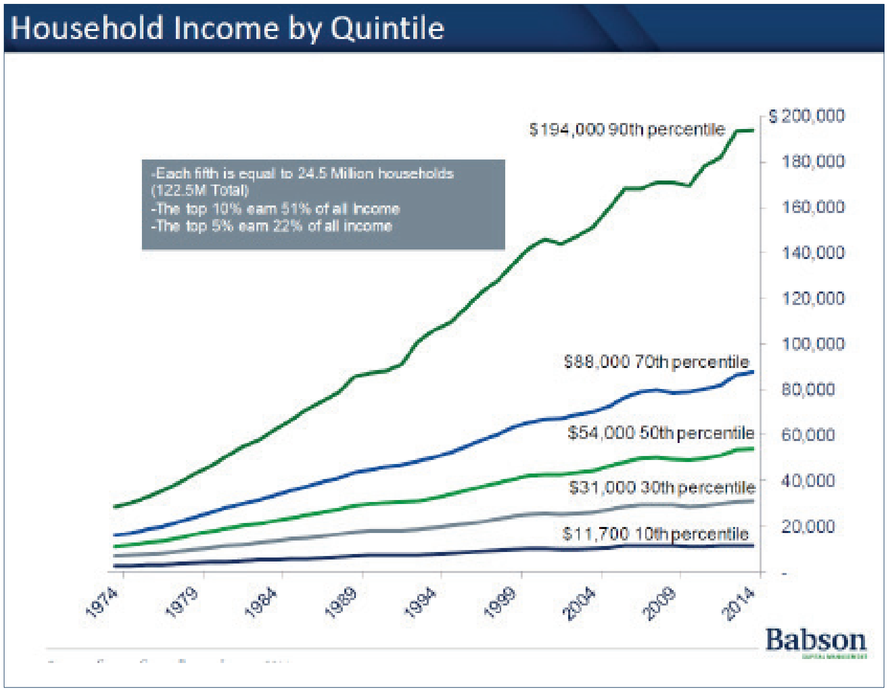
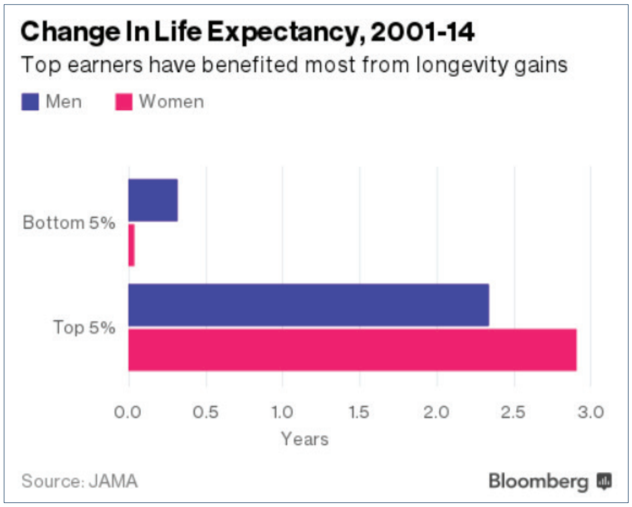
This shows that the top quintile (20%) of earners has been gaining share of national income steadily since 1984 and the remaining four quintiles have been losing ground on a relative basis. And, the following chart shows the actual distribution of income. As you will note, the top 10% of earners enjoy annual income that is 3.6 times that of the average American and those unfortunates at the bottom 10% of the distribution have seen almost no growth in their income over this forty year period.



Perhaps even more startling, the following chart summarizes a study published by the American Medical Association indicating that life expectancy has increased between two and three years for high income earners versus little gain for those at the bottom of the income spectrum.



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Discussion

Many of the areas I have discussed may not be that earthshaking but the "Aha Moment" comes when you see the same pattern across so many walks of life. Whether it is baseball players, CEOs, cities, or countries, those at the top are gaining ground versus their competition. Understanding all of these trends is way beyond my pay grade but one possible explanation for a lot of it is the dominance of technology. Highly skilled workers are commanding premium compensation and are drawn to regions with a large concentration of people with similar skills which in turn impacts regional and national economic growth, real estate markets, quality of life, and many other factors. Education is the key to joining this group so it is no surprise that the most prestigious institutions are very much in demand. And many of the most dominant and profitable corporations have a significant technology component.

Unfortunately, there are also losers in this race which raises a number of interesting questions regarding politics, public policy, and so on. Many commentators suggest that the success of non-traditional candidates in the current election cycle is an indicator of anger and frustration on the part of those that feel left behind. Is this the beginning of a new era of Populism? Will these disparities lead to social unrest? Are these trends irreversible, and, if not, what will cause them to change?

Once again, I do not have answers to these thorny questions but hope that I have given you a few things to stimulate your thinking and perhaps have a slightly better understanding of the complex world we live in. ■

ATLANTA

400 Galleria Parkway, Suite 1400
Atlanta, GA 30339
Phone: 770.226.5333

■

GREENSBORO

300 N Greene Street, Suite 2150
Greensboro, NC 27401
Phone: 336.217.0151

■

MEMPHIS

6075 Poplar Avenue, Suite 900
Memphis, TN 38119
Phone: 901.761.7979

■

NASHVILLE

3102 West End Avenue, Suite 600
Nashville, TN 37203
Phone: 615.386.7302