WHITE PAPER

So we beat on, boats against the current, borne back ceaselessly into the past.

— THE GREAT GATSBY

BY **BILL SPITZ,** PRINCIPAL

Imagine the Unimaginable

The Federal Reserve recently announced with some satisfaction that inflation has finally *risen* to its target level of 2%. This was a particularly poignant moment for me because I am unfortunately old enough to remember the days in the early 1980's when inflation was running at double digit rates and seemed likely to remain at those or even higher levels indefinitely. The realization of this tectonic shift motivated me to think about other earthshaking changes in the financial world that have occurred during my career, and I was able to come up with a list of some twenty-five items.

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This list is by no means exhaustive, but it is long enough to remind us how much the world can change over the course of four decades. The final step was the hard part; trying to make sense of my list, and more important, attempting to draw any lessons that could aid us in the ongoing battle to manage money in an uncertain and ever evolving world. I don't know that I have identified any monumental insights or fundamental truths, but this paper will jolt memories of those of a certain age, some of which may not be all that pleasant. But, I hope it also provides a measure of optimism as well as a smidgen of perspective. I have organized the discussion into five observations and then a section on their implications for investing. Each contains the relevant entries from my list as well as some commentary.

Observations

01 "INTRACTABLE" PROBLEMS FREQUENTLY HAVE A WAY OF GETTING SOLVED

THEN NOW Inflation for the year ending March 1980 was 14.6%. **For the year ending in March of 2018, it was 2.4%.**

THEN NOW In June of 1981, the FED Funds rate was 19.1%. **Today, it is 1.7%.**

THEN NOW In September of 1981, the yield on the 10 year US Treasury bond was 15.8%. **Today, it is 3%.**

THEN NOW Oil imports were 6 million barrels per day in 1975. **Today, we import 3.7 million despite the fact that the US economy is eleven times larger.**

This is one of those "you had to be there" stories in that, unless you experienced it, one cannot easily imagine the pervasive sense of helplessness and doom that accompanied these economic problems. But, a combination of effective government policies, technology, and a bit of luck, saved the day.

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02 UNFORTUNATELY, NEW CONCERNS APPEAR REGULARLY

THEN NOW The personal savings rate in 1975 was 13%. **Today, it is 3.1%**

THEN NOW The ratio of Federal debt to GDP was 34% in 1970. **Today, it is 103.7%**

THEN NOW Household debt to GDP was 41% in 1976. **Today, it is 77%.**

THEN NOW Manufacturing employment was 18 million in 1970. **Today, it is 12 million.**

THEN NOW Productivity grew at a 3.1% annual rate from 1999-2005. **For the past five years, it has grown at a .9% annual rate.**

These statistics give rise to sensational headlines such as "The American people are profligate and addicted to debt." Or, "because companies have not been investing in new plant and equipment, we are experiencing low productivity growth which will necessarily lead to modest overall economic growth." Or, "where will the jobs come from to replace lost manufacturing jobs as well as other positions that are being eliminated by technology?" Yes, these are legitimate concerns, but as Warren Buffett has said, "it has never paid to bet against America. We come through things, but it's not always a smooth ride."

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03 WE ALSO OCCASIONALLY ENJOY POSITIVE CHANGES IN ECONOMIC FUNDAMENTALS
that were largely unexpected.

THEN NOW For the past twenty years, the volatility or fluctuation in U.S. economic output **has been 37% lower than the long term average.**

THEN NOW Since 2005, U.S. corporations have earned an average profit margin of **9.3% versus the long term level of 6.6%.**

Translating this economic speak into English, we are enjoying an unusual period of economic stability and corporate profitability. Economists argue about the reasons for this good fortune, but the list generally includes effective monetary and fiscal policy, technology, better business practices such as inventory management, capital investment, low interest rates, and modest wage growth. (The latter two involve both winners and losers) There is also the interesting question of whether these changes are permanent or likely to regress toward long term averages.

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04 THE INVESTMENT INDUSTRY HAS CHANGED SIGNIFICANTLY OVER TIME,

and the general direction has been toward ever more complexity and competition.

THEN NOW

There were approximately 450 mutual funds in 1975. **Today, there are roughly 9,000 plus 2000 exchange traded funds.**

THEN NOW

The number of hedge funds increased by 3 times in the past twenty years and **private equity capital has grown by four times.**

THEN NOW

In 1975, individuals directly owned 70% of all stocks. **Today, they own 30%. Institutions control the rest.**

THEN NOW

The average stock trading commission per share was 80 cents in 1974. **Today, it is 2.5 cents.**

THEN NOW

There were 6,000 Chartered Financial Analysts in 1979. **Today, there are 145,000.**

THEN NOW

New York Stock Exchange average daily trading volume was 15 million shares in 1975. **Today, it is 1.2 billion.**

THEN NOW

The first index fund was created in 1975. **Today, more than 30% of equity dollars are invested in passive vehicles and that statistic is expected to cross 50% in the next five or six years.**

THEN NOW

Annual stock turnover in equity mutual funds (purchases and sales) was 80% in 1980. **Today, it exceeds 130%.**

THEN NOW

Defined benefit retirement plans have been replaced by 401K and other defined contribution plans **resulting in intense competition, declining fees, and pressure on the profit margins of financial firms.**

THEN NOW

In 1989, 94% of the average large endowment fund was invested in ‘traditional” assets. (Stocks, bonds, and cash) **Today, the comparable figure is 43%.**

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I could go on but you get the picture. The good news is that investors have a huge array of choices. In addition to longstanding vehicles such as mutual funds, there are now target date funds, passive vehicles, automated rebalancing, and other services that take most of the work out of investing. Second, the general direction of fees and expenses is down, and there are lots of free or low cost information sources for those who want do-it-yourself investing. The bad news is that the variety and complexity of investment vehicles can be overwhelming and the overall pace of Wall Street is dizzying.

05 CORPORATE AMERICA IS SUBJECT TO "CREATIVE DESTRUCTION"

Top Ten Stocks in the S&P 500

THEN		NOW
IBM	1	
AT&T	2	Microsoft
EXXON	3	Google
STANDARD OIL COMPANY SERVICE (INDIANA)	4	amazon
Schlumberger	5	BERKSHIRE HATHAWAY HomeServices
	6	facebook
Mobil 1	7	JPMorganChase
Standard Oil of California	8	Johnson & Johnson
ARCO	9	EXXON
	10	Bank of America

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S&P 500
Sector Weights

	1980	TODAY
ENERGY	25.1%	6.1%
TECHNOLOGY	12.8%	23.8%

It is fascinating that only one company (Exxon) remains on the Top Ten list in its current corporate form, and that the energy and technology sectors have basically switched places in terms of their importance in the stock market. The message is that investment analysis must be dynamic and forward looking requiring continual assessment of the economy, technology, consumer tastes, and so on.

The Ebb and Flow of the Financial World

Our Chief Investment Officer, Sam Fraundorf, is partial to nautical metaphors and he was kind enough to lend me one of his favorites which is as follows: "Most investors who look at the ocean are limited to seeing the waves. Only the most skilled and insightful see the tides." I hope you enjoyed the "then/now" factoids that were included in this paper, but in isolation, they are only waves. The trick is to connect them, to convert data points into a clear picture of the financial tide. With the benefit of hindsight, it is not too difficult to identify the tide that has been in place since 1982. But, most of us did not fully grasp it along the way as demonstrated by data from JP Morgan showing that the average investor earned an annual return of 2.6% over the past twenty years as compared to 6.4% for a simple 60% stock / 40% bond portfolio. Why, because mesmerized by the waves, investors traded in and out of the markets at just the wrong time instead of riding the long rising tide.

Of course, the big challenge is to forecast the next tide. I am appropriately humble regarding our ability to do so, but we will give it a shot. First, let's review the last thirty-five years, a period that was certainly a Golden Age for financial assets.

If you review the then/now factoids above, you will note that this period was characterized by a significant decrease in inflation, falling interest rates, low economic volatility, rising corporate profit margins, and a huge increase in the number of investment vehicles with an associated decline in the cost of investing. All of this took place within the context of generally healthy economic growth. Simply stated, this was Nirvana for the stock market with the Shiller price/earnings ratio rising from 6.6 to 32.4 today. The net result was annualized stock returns of 11.7%. Moreover, bonds joined the party earning 8.1% per annum.

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Looking ahead, we can identify three primary scenarios although there are certainly many others that we can't even imagine. Given the pace of change and competition in the financial world, we think it unlikely that the next tide will last thirty five years, so let's think in terms of the next ten years or so.

The first scenario is basically a reversal of everything that took place since 1982. This Dystopian environment would be characterized by sharply rising inflation and interest rates, increased volatility, profit margins that regress toward long term averages, and muted economic growth. In this "stagflation" scenario, price earnings ratios would regress toward their long term average, and with rising interest rates, the net result would be poor returns on both stocks and bonds. Happily, we think this scenario unlikely, perhaps a probability of 15% or so.

The next scenario might be labeled the Super Bull Case. Perhaps due to a breakthrough in technology, we enjoy a long economic boom with continued high profit margins. In the rosiest version, any increases in inflation and interest rates are manageable and both the economy and markets enjoy unusual stability. Price earnings ratios would likely remain at current elevated levels or even increase to the lofty heights that prevailed during the tech boom of the late 1990's. In this world, bonds would deliver only modest returns but equities would enjoy a sustained bull market. Unfortunately, we also think this scenario unlikely and assign perhaps a 25% probability to it.

Our most likely case (60%) has been labeled the "New Normal" by some market observers, and the fact that many prognosticators subscribe to it makes us nervous. But, in any case, it is characterized by moderate economic growth, inflation, and interest rates. Corporate profit margins likely regress part way to the mean as would price earnings ratios. When evaluating this scenario, it is important to remember that we are starting from near record valuations for both stocks and bonds. The net result would be low single digit returns on bonds and low to middle single digit returns on stocks. This is hardly a disastrous scenario, but it does present major challenges to investors wishing to protect the real value of their portfolio given normal spending rates of 4-5%.

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So, what should we do if this is likely to be the prevailing tide?

Well, we have written and spoken about all of these principles (probably ad nauseum), but here we go again:

- **Diversify**
- **Look for global investment opportunities**
- **Look for uncorrelated strategies and investments that fall out of the mainstream**
- **Try to capture the illiquidity premium in assets such as private equity and real estate**
- **Watch the cost of investing**

Regardless of the actual scenario, we doubt it will be obvious and most likely will arrive with jolts, bumps, and scares. So, the smart investor sets her portfolio for the most likely scenario with safety components for the unexpected and then focuses on the tide and not the waves.

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