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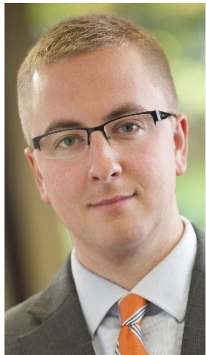

Ryan A. Kay

Global stocks started the New Year with a 10% drop. But they more than made up the loss in the second half of the quarter, with U.S. stocks returning 1.3% year-to-date versus -2.9% for foreign developed stocks and 5.7% for emerging market stocks. Despite a lot of volatility and uncertainty, U.S. stocks finished the quarter just below their all-time highs. Bonds continued to soldier on, returning 2.3% year-to-date as investors' hopes for higher interest rates were dashed once again.[1] The yield on U.S. Treasuries finished the quarter below 1.8%. As low as that sounds, it is actually quite rich compared with other developed countries, such as Germany (0.1%), Japan (-0.1%), and Switzerland (-0.4%).

During the recent Spring Break holiday, Erica and Jacob both happened to visit our nation's capital. It was an interesting time to be in the heart of our nation's political scene. Unfortunately, Erica's trip was a bit too exciting – she and her family were in the capital building preparing for a tour when a man tripped the metal detector and pulled out a gun, prompting security officers to shoot him. The next few hours were a harrowing experience as Erica and her family were rushed into several different lockdown rooms with little information about what was going on. Thankfully, no one was injured and it was an isolated incident handled expertly by the capitol's security forces. We can't explain how happy we were to have Erica back in the office upon her return! Our clients are well aware that Erica is truly one-of-a-kind.

We generally try to avoid discussing politics. When clients ask us how much an upcoming election or a change in public policy might affect the stock market, we typically respond "less than you might think." America's economy and stock market have persevered through challenges, policy blunders, and leadership miscues, and commentators often seem to attribute much more responsibility to politics' impact on markets than warranted by reality.

But this doesn't mean policy doesn't matter. Major policy mistakes can have severe long-term economic consequences. In his recent letter to shareholders, JPMorgan's CEO Jamie Dimon wrote:[2]

> [B]ad public policy, and I'm not looking at this in a partisan way, creates risk for the economies of the world and the living standards of the people on this planet – and, therefore, for the future of JPMorgan Chase – more so than credit or market risks. We have many real-life examples that demonstrate how essential good public policy is to the health and welfare of a country.

Dimon cites several historical precedents:

- "After World War II, East Germany and West Germany were in equal positions, both having been devastated by the war. After the war, West Germany flourished, creating a vibrant and healthy country for its citizens. East Germany (and, in fact, most of Eastern Europe), operating under different governance and policies, was a complete disaster. This did not have to be the case. East Germany could have been just as successful as West Germany. This is a perfect example of how important policy is and also of how economics is not a zero-sum game."

[1] As measured by the S&P 500, the Citigroup 1-10 Year Government Bond Index, and the relevant MSCI international indices.
[2] JPMorgan Chase 2015 Annual Report.

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- Singapore, South Korea, and Mexico have been economic success stories while Argentina, Venezuela, Cuba, and North Korea have floundered. These results can't be attributed to disparities in natural resources; the major difference has been policy. Dimon cites Detroit as a domestic example of misguided policy, though he speaks hopefully about recent momentum in the city.

- Fannie Mae and Freddie Mac were at the center of the financial crisis, creating material economic stress as a result of conflicted interests and a misguided regulatory structure. Yet nearly a decade after the crisis, our country has not taken any material steps towards reforming them in a sustainable and prudent way. Instead, they are stuck in political gridlock and the federal government takes every dollar of profit each company generates, leaving them with no capital buffer should another crisis occur. These organizations make the much-loved thirty-year pre-payable mortgage a reality (most countries have no such market) and they would be difficult to truly replace.

Dimon goes on to list additional challenges policymakers face today, including funding issues for long-term social programs, infrastructure planning, immigration, and tax reform. The rise of globalization makes finding solutions more difficult – policymakers cannot operate as if in a vacuum. Consider a recent example: the U.S. Treasury just announced additional rules to curb corporate tax inversions, which occur when a large U.S. company merges with a smaller foreign competitor in order to shift its headquarters overseas and thereby lower its tax rate. Americans rightfully show concern and resentment over such moves. But in a global marketplace, U.S. companies are disadvantaged when their tax rates are materially higher than their overseas competitors. Ireland, a popular tax locale, taxes corporations at just 12.5% versus the standard 35% in the U.S. The best response, *as policymakers on both sides of the aisle agree*, is overarching corporate tax reform: lower corporate tax rates and shift the tax burden elsewhere, so that our companies operate on a level playing field. But the agreement ends there, and corporate tax reform discussions are usually dead on arrival.

Another example: financial regulation enacted since the crisis has added needed safety and soundness to our nation's banking system, perhaps more so than many commentators and candidates recognize or admit. Yet as these regulations continue to mount, we risk putting our own U.S. banks at a disadvantage relative to foreign counterparts. This doesn't mean that the U.S. should adopt weak regulations in the name of competitiveness; however, overly onerous regulations relative to the rest of the globe can pose long-term competitive risks. Dimon writes:

> I do not want any American to look back in 20 years and try to figure out how and why America's banks lost the leadership position in financial services. If not us, it will be someone else and likely a Chinese bank. Today, many Chinese banks already are larger than we are, and they continue to grow rapidly. They are ambitious, they are supported by their government and they have a competitive reason to go global – the Chinese banks are following and supporting their Chinese companies with the financial services that are required to expand abroad.

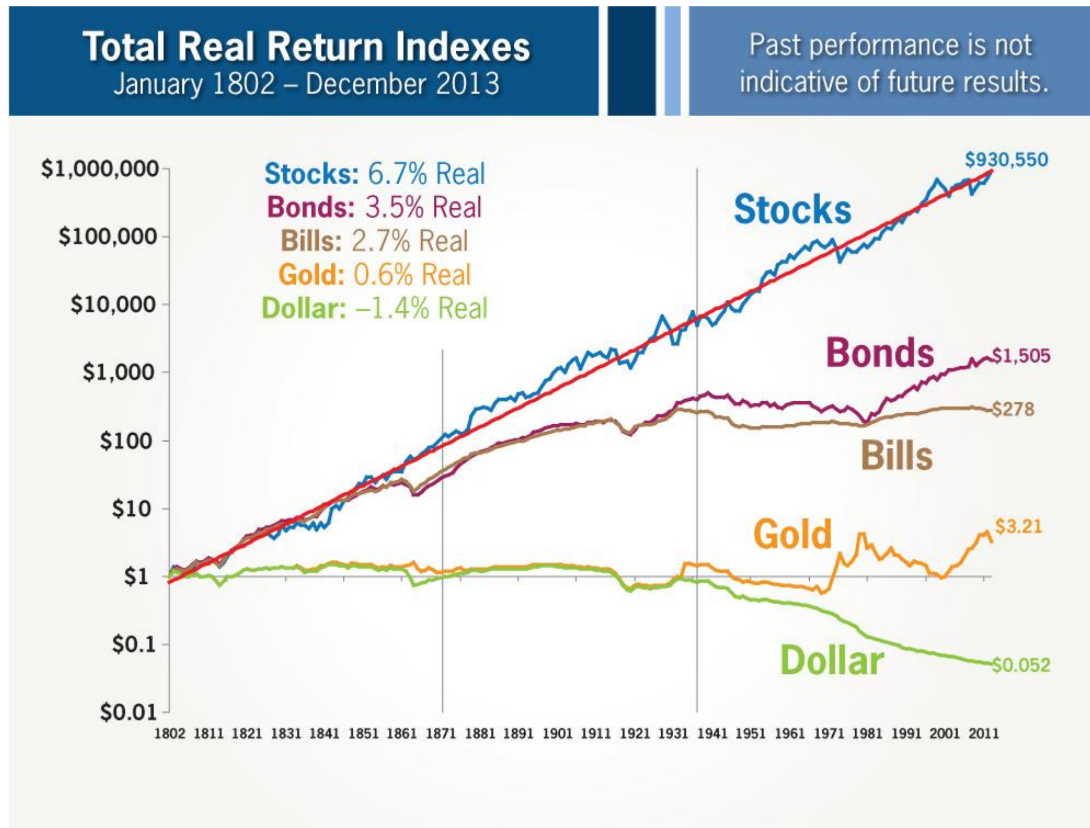
These challenges feel more acute in a world of slow-growth. Since the crisis, economic growth has been steady but modest as the world deals with the fall-out from a build-up of debt.

It is easy to look at these challenges alongside the current state of political discourse and grow discouraged. But as Warren Buffett points out and as Dimon would agree, it's rarely paid to bet against the American machine. We've faced many challenges over the past century – a Depression, two World Wars, stagflation, etc. – but the economy, and the stock market alongside it, has nonetheless persevered. Further, even 2% economic growth is enough to produce sizable long-term gains in real wealth for citizens. We agree with Buffett that America's continued success is highly likely (though never guaranteed):

> For 240 years it's been a terrible mistake to bet against America, and now is no time to start. America's golden goose of commerce and innovation will continue to lay more and larger eggs. (Emphasis added; Buffett's entire passage is reproduced in the appendix.)[3]

How expensive has this mistake been? Consider the long-term record for stocks in this country versus bonds, gold, or cash (shown *after* accounting for inflation):

[3] Berkshire Hathaway 2015 Annual Report.



Look at that chart[4] – do you think it makes sense to frequently try to jump in and out of the stock market in an attempt to avoid the occasional drop in stock prices? This kind of behavior substitutes a very difficult forecast – whether stocks will go up or down next year – for a very simple one – over time stocks are likely to do much better than the alternatives.

Now part of the reason stocks produce higher returns is that they have higher risk. Specifically, over short time periods stock prices can fall materially, sometimes by 50% or more. But over longer time periods, stocks have been *less risky* in the sense that they've done a much better job protecting and enhancing investors' wealth. Of course each investor must select the right amount of his portfolio to invest in stocks given his own circumstances, goals, and risk-tolerance. But most investors are well-served by a long-term commitment to stocks.

Our country will face many challenges in the future. But a policy of owning long-term productive assets – like high-quality businesses or income-producing real estate – should persevere over extended time periods. Much like good public policy, good investing requires the fortitude to build a sensible *long-term* plan and stick to it through the inevitable bumps and bruises.

As always, we thank you for your continued confidence.

Sincerely,

Michael D. Axel, CFA
Jacob D. Benedict, CFA
Ryan A. Kay

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[4] Jeremy Siegler and the American Association of Individual Investors.

APPENDIX: Excerpt from Warren Buffett's 2015 Letter to Shareholders[5]

It's an election year, and candidates can't stop speaking about our country's problems (which, of course, only *they* can solve). As a result of this negative drumbeat, many Americans now believe that their children will not live as well as they themselves do.

That view is dead wrong: The babies being born in America today are the luckiest crop in history.

American GDP per capita is now about $56,000. As I mentioned last year that – *in real terms* – is a staggering six times the amount in 1930, the year I was born, a leap far beyond the wildest dreams of my parents or their contemporaries. U.S. citizens are not intrinsically more intelligent today, nor do they work harder than did Americans in 1930. Rather, they work far more efficiently and thereby produce far more. This all-powerful trend is certain to continue: America's economic magic remains alive and well.

Some commentators bemoan our current 2% per year growth in real GDP – and, yes, we would all like to see a higher rate. But let's do some simple math using the much-lamented 2% figure. That rate, we will see, delivers astounding gains.

America's population is growing about .8% per year (.5% from births minus deaths and .3% from net migration). Thus 2% of *overall* growth produces about 1.2% of *per capita* growth. That may not sound impressive. But in a single generation of, say, 25 years, that rate of growth leads to a gain of 34.4% in *real* GDP per capita. (Compounding's effects produce the excess over the percentage that would result by simply multiplying 25 x 1.2%.) In turn, that 34.4% gain will produce a staggering $19,000 increase in *real GDP per capita* for the next generation. Were that to be distributed equally, the gain would be $76,000 annually for a family of four. Today's politicians need not shed tears for tomorrow's children.

Indeed, most of *today's* children are doing well. *All* families in my upper middle-class neighborhood regularly enjoy a living standard better than that achieved by John D. Rockefeller Sr. at the time of my birth. His unparalleled fortune couldn't buy what we now take for granted, whether the field is – to name just a few – transportation, entertainment, communication or medical services. Rockefeller certainly had power and fame; he could not, however, live as well as my neighbors now do.

Though the pie to be shared by the next generation will be *far* larger than today's, how it will be divided will remain fiercely contentious. Just as is now the case, there will be struggles for the increased output of goods and services between those people in their productive years and retirees, between the healthy and the infirm, between the inheritors and the Horatio Algers, between investors and workers and, in particular, between those with talents that are valued highly by the marketplace and the equally decent hard-working Americans who lack the skills the market prizes. Clashes of that sort have forever been with us – and will forever continue. Congress will be the battlefield; money and votes will be the weapons. Lobbying will remain a growth industry.

The good news, however, is that even members of the "losing" sides will almost certainly enjoy – *as they should* – far more goods and services in the future than they have in the past. The quality of their increased bounty will also dramatically improve. Nothing rivals the market system in producing what people want – nor, even more so, in delivering what people don't yet know they want. My parents, when young, could not envision a television set, nor did I, in my 50s, think I needed a personal computer. Both products, once people saw what they could do, quickly revolutionized their lives. I now spend ten hours a week playing bridge online. And, as I write this letter, "search" is invaluable to me. (I'm not ready for Tinder, however.)

For 240 years it's been a terrible mistake to bet against America, and now is no time to start. America's golden goose of commerce and innovation will continue to lay more and larger eggs. America's social security promises will be honored and perhaps made more generous. And, yes, America's kids will live far better than their parents did.

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[5] Berkshire Hathaway 2015 Annual Report.