Investment Markets and the 2012 Election

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Politics and Markets

We try to avoid making a habit out of discussing politics in our investment newsletters. Their importance to the economy and the markets is often inflated and we aren't political experts. With the election just a week away, investors will likely be inundated with opinions and statistics on the impact the presidential election will have on markets and how investors should re-position their portfolios. Much of this is pure noise. Jason Zweig of the *Wall Street Journal* writes:

> Most of the answers you are likely to find are propaganda or wishful thinking; many are flat-out wrong… Since 1926, when reliable stock-market data began, the United States has had 15 presidents and nine elections in which control of the White House passed from one party to the other. That's a small sample. So you should take any statistical conclusion about the relationship between presidential election results and financial returns with a grain of salt the size of the Capitol dome.[1]

Large external forces, such as globalization, international conflict, domestic productivity gains, technological innovation and the composition of the House and the Senate, exert strong forces on markets outside of a given presidential administration's aims or abilities.

The Country's Challenges

This is not to say that the outcome of the Presidential election isn't important to the long-term health of the economy. Our country faces serious challenges and whoever is elected will have his work cut out for him. Most importantly, we would highlight the following:

- The federal budget must be placed on a long-term path towards fiscal soundness. This doesn't mean the books have to be balanced tomorrow (indeed, allowing the fiscal cliff to transpire at year-end would be decidedly negative), but policies must be enacted that assure citizens and businesses that the budget is on a glide-path towards balance (and that glide should begin sooner rather than later). This requires confronting tough choices on tax policy and non-discretionary programs, specifically Medicare, Medicaid, Social Security and Defense (discretionary programs make up just 18% of the federal budget; there simply isn't enough fat to cut here to restore fiscal integrity).
- We have to ensure that U.S. businesses compete on a level playing field. This means sensible, competitive tax rates and effective fair trade policies that don't give rise to large trading deficits. Debates on corporate tax policies should recognize the fact that corporations, unlike most individuals, can relatively easily relocate businesses to lower tax regions. Fair trade practices need to be delicately negotiated, since any path towards protectionist policies is a dangerous one (both liberal and conservative economists broadly support international trade).
- Finally, we need sensibility, certainty and clarity out of Washington. Jamie Dimon, CEO of JPMorgan Chase, has frequently pointed out that while he supported the majority of new regulations on banks, there are certain policies that are harmful to the economy and others that clearly contradict each other. There was a need for new and improved regulations after the financial crisis, but surely we didn't get it right on the first try. More broadly, the economy would no doubt benefit from certainty regarding future regulation and policy, whether those regulations and policies are conservative or liberal. Executives, entrepreneurs and investors shun new investment when uncertainty is high. The corresponding lack of capital investment holds back the economic recovery.

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[1] *The Winner for Investors Is...* Zweig, Jason, October 22, 2012.

One of us briefly worked for an economist from the University of Chicago a number of years ago who recently co-authored a paper entitled "Has Economic Policy Uncertainty Hampered the Recovery?"[4] In their work, the authors construct a measure of policy-related uncertainty and conclude that:

> Policy uncertainty stands at historically high levels in the past four years… A rise in policy uncertainty, similar in magnitude to the actual change since 2006, is associated with substantially lower levels of output and employment over the following 36 months…We think the weight of the evidence and the lessons of economic theory argue for assigning some weight to the policy uncertainty view. If U.S. policymakers can deliver a policy environment characterized by greater certainty and stability, there will likely be a positive payoff in the form of improved macroeconomic performance."

Finding Success

Unfortunately, achieving success will be difficult. Any solution will need bipartisan compromise, which has become an extreme rarity in Washington. Further, success will demand unpopular choices. Policies that restore long-term fiscal integrity are often unpopular in the short-term (indeed, this is why they aren't championed by politicians). Surveys frequently show that Americans support the broad idea of cutting the deficit, but they reject the vast majority of specific policy choices that would be required to do that.

We don't know how the saga will unfold, but we wouldn't bet against America. We have quoted the words of Winston Churchill in the past – "We can always count on the Americans to do the right thing, after they have exhausted all the other possibilities." Unfortunately, transcendent leadership is often precipitated by crises – Washington and the Revolution, Lincoln and Emancipation, Churchill and World War II, etc. Hopefully leadership will precede a crisis in this case. There are reasons to be optimistic. For instance, the Simpson-Bowles Commission established that meaningful bipartisan compromise is possible and reports recently surfaced that Erskine Bowles, co-chair of the Commission and former Chief of Staff for President Bill Clinton, is putting together a powerful coalition of business leaders across the political spectrum to push for sensible bipartisan solutions to the country's problems.

[4] *Has Economic Policy Uncertainty Hampered the Recovery?*, Baker, Scott R., Bloom, Nicholas, and Davis, Steven J. June 4, 2012.

Thoughts on Investment Markets

Regardless of the outcome of the election, we don't believe that drastic changes in portfolio allocations are sensible. Our experience and research both strongly suggest that the best protection against the unpredictable challenges of tomorrow is a portfolio diversified across different asset classes (stocks, bonds, etc.) supported by fundamental, bottom-up research.

Market timing (jumping into and out of stocks or other asset classes) is a loser's game. David Swensen, Chief Investment Officer of Yale University, writes:

> Explicit market timing lies on the opposite end of the spectrum from disciplined portfolio management. John Maynard Keynes…wrote that "the idea of wholesale shifts is for various reasons impracticable and indeed undesirable. Most of those who attempt to, sell too late and buy too late, and do both too often, incurring heavy expenses and developing too unsettled and speculative a state of mind." Deliberate short-term deviations from long-term policy targets introduce substantial risks to the investment process.[5]

As evidence of the potential risk of being out of the market, consider the following: over the past ten years, the S&P 500 has returned 5.9% per annum; if an investor missed only the best 10 days over that time period (out of over 2,500 total trading days), his return would have fallen all the way down to negative 0.7%.[6] It is impossible to know in advance which days will be good and which days will be bad.

Does this mean we would never reduce the amount we have invested in stocks? No, but we will change our allocations to stocks only when we believe that market greed and excitement have pushed *valuations* to unsustainably high (or low) levels. For instance, stock prices in Japan in 1989, technology stock prices in the U.S. in 2000 and real estate prices in the U.S. in 2005-06 were far enough away from historical valuation metrics that investors could make a prudent argument to underweight those investment classes. While current domestic stock prices aren't cheap, we don't believe valuations are far enough out of sample to call for a change in current allocations. A further rise of 15-20% or more in the near term may cause us to re-evaluate this position.

[5] *Pioneering Portfolio Management*, Swensen, David.
[6] Yahoo! Finance.

We don't foresee making large scale shifts to our investment allocations due to macroeconomic or political concerns. Such concerns will have an impact on the kinds of investments we search for and the assumptions we use in valuing investments, but we don't plan to ever "time markets" based on such information. Instead, we strive to always be conservative. This conservatism is not reflected in making large cuts to our stock allocations, but in understanding each company or strategy that we invest in and making sure to pay a price well below our estimate of intrinsic worth. Additionally, we work hard to include investments from different asset classes that respond differently to varying economic conditions. For instance, bonds do well during periods of sub-par growth and deflation while stocks of companies that produce natural resources (oil, gas, etc.) do well during periods of rising inflation.

This doesn't mean that macroeconomic and political concerns won't have an effect on investment markets (because they will), but only that we nor anyone else has an ability to accurately and consistently forecast and profit from such events. If the fiscal cliff is allowed to occur, it wouldn't surprise us to see markets trade down. Similarly, if a constructive bargain is forged to avoid the fiscal cliff and provide some policy certainty, we wouldn't be surprised to see markets trade up. Due to our inability to accurately judge the probabilities of the different outcomes, we will stick to what we know – disciplined investment research on companies and assets. Buffett put it in simpler terms in an interview last week:

> [I]f you owned a good farm and had it run by a good tenant, you wouldn't sell it because somebody says, 'Here's a news item,' you know, 'This is happening in Greece' or something of the sort. If you owned an apartment house and you got to raise the rents a little and it was well located and you had a good manager, you wouldn't dream of selling it. If you had a good business personally, a local McDonald's franchise, you wouldn't think of buying or selling it every day.
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> Now, when you own stocks, you own pieces of businesses, and they're wonderful businesses. You can pick the best businesses in the world. And to buy or sell on current news is just crazy. You're in a wonderful business. You've got people running it for you. You know you're going to do well over five to ten years. And to think news events should cause you to dance in or out of something…is a terrible mistake. So, get into a bunch of wonderful businesses and stay with them.[7]

We are hopeful that whoever is elected President will work across the aisle to confront the difficult challenges facing our country. We also hope that the country can come together in a bipartisan spirit to make the tough choices that are necessary. In the meantime, we will stick to our time-tested investment policies and strive to incorporate conservatism and rigor into all that we do.

[7] Warren Buffett interview on CNBC, October 24, 2012.