ORIGINAL THINKING

SPRING–SUMMER
2017

HANSBERGER & MERLIN
at
Morgan Stanley

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HANSBERGER & MERLIN AT MORGAN STANLEY

So don't say I didn't tell you so. In the last edition, I opened with a reference to the certainty of change, and change, indeed, is what we are experiencing across the globe in politics, financial markets, demographics, social preferences, and cultural attitudes. It is a profound ideological shift. No one can predict the future, but we know it will be different from the past.

Such a phenomenon comes along rarely, maybe only once or twice in a lifetime. Perhaps the last time was in the 1930s, and then, as today, there were elections whose winning candidates attacked the political establishment. Such populism implies voters were fed up with perceived cultural threats and with the academic and media elite. They felt government was not working for them. Simply, today and in the 1930s, it is a form of revolt against the system. The question, of course, is whether such conflict and resistance result in progress or in even more gridlock in shaping economic policy.

It is common today to hear of the *divided* states of America, and the recent election has evoked extremes in opinions and behavior. A classic example is the recent split over healthcare in the House of Representatives. You could say this was a 2-story house, representative of two stories within one House. Meanwhile, around the world, we are witnessing shifts in political leadership from the UK to France, Italy, even to the Philippines, and maybe Germany, with expectations of increased waves of populism in 2017.[i]

Change, of course, may be worrisome to many, but I suggest it is the only constant. With enough hindsight, most change morphs into the perfectly normal; indeed, unsurprising. Did you really think the world could coast along for much longer with negative interest rates? In 5,000 years of recorded history, there have never been negative bond yields.[ii] Would that ever make sense to you? Did you believe the new forces opposing business and capitalism that serve as the foundation for the United States of America, as differentiated from socialism in Europe and communism in Asia, would be permanent, combined with unnecessary regulation, government overreach, and political correctness? If so, you ignore the lessons of history from which we learn that the pendulum swings in both directions.

We cannot know the timing, but we can count on the reversals at the extremes. We do find there can be too much of a good or bad thing. Too low or high interest rates; too much or not enough public outcry (populism); too much authoritarianism (elected or unelected officials, "experts," "strategists," and celebrities telling people how and what to think). Every day, we have TV, radio, newspapers, and social media driving their opinions home, but they are *opinions*, not necessarily facts. They are not unbiased. For many years, I have experienced it in listening to reporting about our own industry and the financial markets, and I can tell you many do not know much of what they are talking about. I just wish our society would follow the message I recently saw on a bumper sticker, "Please stop making stupid people famous." Most wouldn't recognize a bull market or game changing progress in business if presented on a silver platter. Once again, I say this has been the most unloved bull market in history.

It reminds me of the story about the overzealous and brash new CEO who calls his first meeting of all employees, determined to bully the troops and establish his position. As he walks into the assembly, he notices a young man, lackadaisically leaning against the wall, and says, "Young man, you are lazy and disrespectful. How much money do you make?" The young man responds, "Oh, about $2,000 a month," to which the boss replies, peeling off twenty $100 bills, "You're fired!" The young man leaves the premises, and the CEO says, "What the hell does that guy do, anyway?" Someone in the group says, "He's just the Domino's pizza delivery guy." There are better ways to build consensus and create a spirit of unity than to state that the firings will continue until morale improves.

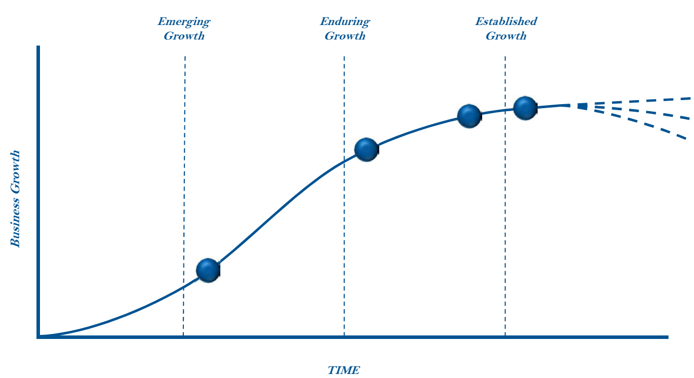
It is all so predictable, in hindsight. Today, it seems so many knew how the election of 2016 would turn out, even though no one told anyone else.

Today's populism is the backlash to the establishment, to Democrats, Republicans, the established media, and political correctness, all of which were on course to forge an end to Western civilization, as we know it, according not only to the Trump supporter, but also to much of the business community.

I am not worried about the U.S. stock market or the U.S. political system. At the end of the 1970s, investors were in shock; then came the recovery of the 1980s, but you know what? In the late 1980s, no one predicted the 1990s, which tacked on **ten more years of economic expansion** amidst a roaring bull market while far too many remained focused on the rearview mirror and the memory of the difficult 1970s. In 1999, no one predicted the dotcom recession or 9/11/2001, and no one forecasted the subprime recession and financial crisis of 2008-2009, or President Obama. Here we are, 8 years later, a market up three times, and no one predicted Donald Trump.

So what is the trusted companion to change over all these periods? It is that investing in businesses that compound earnings and dividends leads to great wealth. It is not about the President or the macro economy. It is not about short term events; it is about the big 3: interest rates, inflation, and corporate profits. All the while, every major corporation has a life cycle with three critical phases of growth - Emerging, Enduring, Established. During the **emerging** stage, younger companies are accelerating rapidly in sales and profits; the **enduring** phase represents the period when the company is proven and durable and still can reinvest the profits back into the business at high rates of return; and the **established** level in the life of a company typically is reached when the company reaches maturity and no longer can deliver internal returns equal to the past, and, hence, pays out a large part of the profits in dividends.

Life Cycle of a Major Corporation



The marketplace anticipated a Hillary Clinton victory, a continuance of Obama-like policies. Even the weekend before the election, the FBI Director officially cleared Secretary Clinton, and markets rallied on Monday, implying a form of certainty; then Trump won, resulting in an overnight selloff, only to be followed by a booming market when official trading resumed. Underperforming sectors came to life. Traders made rapid fire decisions while long term investors did nothing; history shows these investors far outperform market timers.

All of this will take time to play out. Decisions have consequences, and this recent revolt is perhaps the inevitable reaction to the decisions and frustrations from many years in the past.

We remain in an ongoing epic battle between government and business; socialism versus capitalism. I believe the business of America is business. I believe capitalism prevails. I believe the U.S. was off track for many years as government transformed business into the enemy. Today, the private sector is on its way back to new status. I believe the U.S. stock market ultimately rules and sets the course for the world.

Congress, not exactly the bedrock of successful business experience, has never fully opted to experiment with the private sector's approach. Democrats spend and *give*; Roosevelt, Johnson and Obama created massive deficits to deal with short term crises, and the Republicans *take away* in order to rein in out of control debt. It ebbs and flows over the years with most administrations indistinguishable from the others, but the U.S. economy has never been able to fully recover from the periodic extreme expansions of government, resulting in generally slow economic growth overall with the many booms (expansions) and busts (recessions).

Of course, I don't agree with certain policies of President Trump, or any President, but I do look *through* him to a cabinet of capitalists: Goldman Sachs, Exxon, and small business. It actually reminds me of President Clinton who chose Goldman Sachs CEO, Robert Rubin, as Treasury Secretary, who later joined Sandy Weill in the effort to repeal Glass-Steagall, with approval from Federal Reserve Chair, Alan Greenspan, and President Clinton, to allow the financial supermarket of today.

I believe pendulums swing far and wide, and usually too far. We could sense the extremes in 2000-2002 with dotcom valuations and the overbuilding and real estate speculation leading to 2008.

The Great Recession of 2008-2009 was a true financial crisis. Many try to cast blame upon on Wall Street, but government, ratings agencies, borrowers, and lenders were at least equal contributors. Poor public policy contributed to the recession and then held back the expansion. Ever since, there has been the predictable result of too much regulation and, again, the pendulum just swung too far.

There was certainty that change was in the air, and so we had the 2016 election. At least 60 million people today are ecstatic and relieved; at least 60 million people are angry and fearful. I remember the client calls we received in November-December of 2008 and early into 2009, fearful of President Obama. The election in 2008 was the only one in history held amidst a financial panic.[iii] So many believed he represented the opposite of capitalism; indeed, Marxism, redistribution of wealth, anti-business. How could financial markets perform well with such a dramatic change? But guess what? It did not matter!

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Now, many see in President Trump a movement in the other direction. In reality, both Obama and Trump were blank pages in their government experience, and in foreign policy. Trump has a great deal of experience in business; Obama did not. Did that information help forecast financial markets 8 years ago? Does it help forecast the next four years?

When the world, or markets, or life itself become so complex and something you cannot control, and that creates deep uncertainty, I suggest turning inward to control what you can. That's when fundamentals and a deep foundation matter. That's when the roots run deep to find water, and that's what has created excellent performance for us for so many years and since 2008 when the world was upside down with recession and crisis and with a new President who terrified the world of business and many investors.

Change is constant, but the right discipline and behavior, based on process and philosophy, serve investors well amidst and despite whatever changes develop. Time is the friend of the owner of great businesses.

We hold a certain reverence for investment management, the identification of original ideas, and the representation of our clients as we craft long term plans for the creation and maintenance of wealth. To us, such plans and portfolios are developed to provide capital gains and income, and they are to be sculpted like works of art, a rare collection of world class businesses.

Financial markets essentially were flat not only for 2016, but also throughout 2015, until the election in November, 2016, at which time the surprise of Donald Trump and the sweep of Congress caused a dramatic divergence among industry groups. The shares of banks and energy, which had been far out of favor for the past two years, and were anticipated to be under added pressure from a Clinton Administration, advanced 20% and 30%, respectively, over November–December, representing about 6% of the 7% jump in the S&P 500 over that short period. Our Growth & Income Portfolio (G&I) included such sectors due to their long and consistent growth and high dividend characteristics, while Capital Appreciation Portfolio (CAP) and Growth Opportunity Portfolio (GOP), our growth strategies, did not, due to our high requirements for both high earnings growth and returns on equity. Hence, most growth strategies, which had outperformed the markets and Growth & Income (G&I) in 2015, underperformed in 2016. Thus far in 2017, the reverse, similar to 2015, is developing, as growth portfolio strategy results to date have excelled far above the market averages.

Most importantly, our investment discipline and philosophy were enforced more than ever this past year, in that our conviction is that there are few companies that possess the characteristics to meet our standards, i.e., far above average earnings growth and returns on capital, high free cash flow, significant pricing power, pristine balance sheets, with monopolistic and dominant brand status, and such companies, through the compounding of rising earnings and dividends, dramatically outperform over time. For example, the shares of Starbucks and Google did not rise in 2016; yet have contributed greatly to the portfolio for many years, continue to excel in their businesses, and have advanced well in 2017. Even with the challenging macroeconomic headlines today and the uncertainty regarding a new administration and policy proposals, successful investment performance is always about the companies, not the economy, or government, or politics, or short term volatility.

I suggest the election was the result of, not the cause of, the need for change that was born in the aftermath of the 1970s versus the 1950s-1960s. That decade included Vietnam, Watergate, the oil embargo, and stagflation (high inflation but no economic growth), all of which served as a set up for a reversal in the 1980s and 1990s. The excesses of that twenty year period, including the dotcom era, in turn, led to the dramatic swings in the other direction, laying the foundation for two deep recessions in 2000-2002 and 2008. The horrific 9/11 attack, similar in its impact on the American psyche to Pearl Harbor in 1941, plus American investment in wars on the other side of the world, and the subprime crisis that crippled our banking system laid the foundation for an extreme racial, cultural, political, and social media environment up until November, 2016. It was all so predictable, in hindsight, of course.

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Original Thinking was inspired in the midst of the crash of 1987, which, at the time, completely confounded market seers and institutional investors who had succumbed to Modern Portfolio Theory and the foolish promises of portfolio insurance, all in search of a Holy Grail of downside protection. Ultimately, such strategies led to *increased* risk and virtually guaranteed the lack of adequate return. It may be the same with many hedge funds and traders today, and it is likely to prove the same with many areas of fixed income in the next few years. Original Thinking is all about investment advice, quite different from ordinary thinking. What is original is not consensus, but it does not have to be contrarian. It must be creative, innovative, and compelling. It must never be boring, but often inspiring; always steady, often brilliant.

It should come from passion and sometimes evoke the unimaginable. It is to be quintessentially unique and intriguing. To think, to act, originally is demanding, digging deep for the improbable, yet all the while only rising naturally from its host or author. Sometimes the solution isn't found where people would ordinarily expect it to be. Maybe you have to look in unexpected places and think in new and creative ways to find the answers. Such a devotion to Original Thinking leads to the ability to see things off in the future or around the corner that others had not even thought of.

In these writings, I always am careful to avoid any resemblance to a market commentary, a newsletter, or a forecast, and, most of all, the consensus boredom. There is already too much noise, with no real signals, a bunch of academic bull, and most constantly fall short of the most essential purpose, which should be to opine on financial markets with the goal to contribute to a real foundation on the most important principles of investing. At the heart of every serious financial advisor is a teacher.

Ernest Hemingway wrote about the keys for readable writing, saying, "All you have to do is write one sentence. Write the truest sentence you know." And mine is, "Nothing builds net worth like the ownership of a great business." It takes patience, humility, time and the control of human behavior with only limited concern about benchmarks and short term focus or, yes, elections.

In 1979 and 1980, the two nations most synonymous with liberty, the USA and the UK, had fallen into the hands of government overreach, overzealous regulation, and extreme taxation. The 1980s brought new, more conservative leaders sweeping into power, promising that free markets and smaller government would reverse the decline and restore growth and productivity. The 1990s expanded upon this theme, but the massive growth in the public sector has reappeared since 2008, leading to economic stagnation, massive debt (from private to public), and deflationary pressures.

The enthusiasm emanating today from the election stems from the hope of retaking control and reforming economic and social policy. Perhaps we are on the cusp of another 10 year reversal. In late 2008, I called for a *Decade of Equities*, at the time a forecast of a reversal of the so called "Lost Decade" (2000-2009). This may be a time for limited government and an economy in the hands of businesses while national defense is overseen by the military. Call it *The Decade of the Great American Business*. Just recognize that sea changes are only fully recognized in hindsight.

Perhaps we can grasp a sense of the future with a look into the past. In the roaring 1920s, no one forecasted the Great Depression of the 1930s. For most Americans, these were hard times for many years. The Depression included -89% decline in the Dow Jones Industrial Average and the loss of jobs all over the country. One in four, ten million people, were unemployed. In the early 1930s, almost half the mortgages in America were delinquent with a thousand foreclosures occurring every day. After the stock market crash of 1929, it wasn't long before the storm on Wall Street spread to the rural economy of the United States, with huge surpluses of food sources causing the prices of farm commodities to crash, as well.

Individual production fell by half in only a few years; millions were homeless, and in many towns, it was impossible to find a bank whose doors weren't permanently shuttered, and behind those doors the savings of countless American families had disappeared forever. Franklin D. Roosevelt formulated the New Deal for government to rescue citizens from the plight, but the political opposition called it, "An undemocratic departure from all that is distinctively American."

The New Deal was considered by many to be a radical experiment in socialist style big government spending. For some it was the lifeline that led to recovery, while others felt the policies were endangering the very foundation of American liberty.

For many of the millions of Americans who read the American Weekly every Sunday in the 1930s, they ceased to believe in themselves. There was an unrelenting uncertainty about the future. The Depression was followed by WWII in the 1940s, after which the US experienced an extraordinary boom, a baby boom, and economic expansion and stock market growth in the 1950s. From 1949-1959, the market P/E ratio expanded from 7X to 21X. Interestingly, there was widespread expectation among analysts and the business media that the expansion would end in the 1960s, with an accompanying stock market decline. It was a common phrase to say there were too many "gunslingers" in the market by 1960. Indeed, very few predicted the 1960s, which continued the strength in financial markets from the 1950s.

The quarter century from 1948-1973 was the most striking stretch of economic advance in human history. It was the first sustained period of economic growth since the 1920s. Of course, in 1973, Egypt and Syria attacked Israel, and OPEC doubled the price of oil, erupting the energy crises and busting the boom of productivity.[iv] It would be about 25 years before the unemployment rate reached such low levels, while economic growth declined from 4.9% from 1951-1973 to 3.1% for the balance of the century. The drop to 1 ½% since 2006 makes even the old lows look attractive. We have a long way to go to reach those boom times, and therein lie both the challenge and the opportunity.[v]

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What if the 2009-2016 period is similar to the 1980s? Was the dismal 2008 recession like the stagnation of the 1970s? Could the current period repeat the 1990s? For sure, most are fearful that the recovery is weak and that the stock market rise has been overdone, but **what if** we could be on our way to the longest economic expansion ever? I can clearly state that there is no euphoria in markets today; indeed, there was pessimism and doubt as the Dow Jones Industrial Average reached 20,000 late in 2016. So many fear 20,000 as a ceiling, but **what if** it was the floor?

From 1903 to 2016, there were 12 bull markets in the S&P 500; ten of the twelve had averaged gains of 15%. The average lasted 8.1 years with a total return of 387%. The average bear market lasted 1½ years and declined 35%. For this current advance since 2009 to be the longest ever, it would require a return of approximately another 665%![vi]

Business is declaring, free at last, free at last. Thank God Almighty, we are free at last. So we will see.

Over all those years to which I refer, since the Great Depression, there have been many wars, elections, booms, busts, bear markets and bull markets in stocks, bonds, gold, real estate, the US dollar, and emerging markets. We have seen negative interest rates, just as we saw rates escalating to 20% in 1980. We have seen oil prices ranging from \$20-\$150 barrel. We have morphed from nationalism to globalization back to nationalism.

So, we adapt to change, and we know there are no consistently correct forecasts and no magic formulas for successful investing, but there *are* principles, which we list in each publication of Original Thinking:

- There is a difference in market events versus economic events. Market events can but rarely do, become economic events.
- Economic events relate to the big three influences on stock market behavior- interest rates, the rate of inflation, and corporate profitability. The Federal Reserve oversees monetary policy and adjusts interest rates as it monitors economic indicators, primarily the rate of inflation. The policy of quantitative easing has driven rates low and risk assets high since 2009. By contrast, corporate profits are driven by company managements who control decisions on productivity and are measured by their balance sheets, cash flow, profit margins, earnings, treatment of shareholders, intelligent pricing power and cost control.
- Behind every stock lies a tangible, operating business, and ultimately, a stock can perform only as well as the company itself. Nothing builds net worth like the ownership of a great business.
- Volatility is not risk. Risk is the potential permanent loss of capital; volatility can be the investor's friend.
- The economy and the stock market are cousins, not twins. Peter Lynch said you should spend no more than 10 minutes a year analyzing the economy. Markets typically discount economic growth well in advance. Much of the rise in 2014 was based upon economic growth to develop in 2015.
- In times of heightened volatility, consider probabilities versus just possibilities as to the realistic outcome of the current events impacting stock prices.
- Separate the noise from the signal. Investors deal with fearful news and contrasting opinions, but they must learn to distinguish between what matters and what does not.

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Investment Strategy

Much has been written about the importance of a long term plan for investing, as opposed to the futility of market timing and short term investor behavior. At Hansberger & Merlin, we are proud to represent a stable, highly informed and disciplined high net worth client base, and we always have considered it one of our primary responsibilities to educate our investors on the value and the success of long term investing.

A little over 50 years ago, the concept of performance measurement was born, with institutions, such as pension funds and endowments, comparing and contrasting the investment records and styles of an ever growing list of managers, funds, and indices around the world as retirement funds grew into the trillions. Such analysis has led to an increase, not just in competition, but in an emphasis upon *short term* results.

Of course, we know it is inevitable that in order to create above average long term performance, investors must expect and accept periods of underperformance. Indeed, we have found we have outperformed the traditional benchmark about 70% of the years and underperformed about 30%, which ranks us well ahead of many of the world's well-known managers, including Warren Buffett and George Soros, both of whom have had more years *below* the market than above it, only to result in the totality of dramatic outperformance over their careers.

I have spent an adult lifetime in the study of financial markets and the careers of the most heralded investors. I have observed over many decades that most investors lack the courage, stamina, and patience to tolerate short term underperformance in order to reap long term rewards.

The year 2016 proved to be a classic year of below average results among growth investors with bond yields around the globe responding to stagnant or weak economic growth. Many companies paying high dividends benefitted from a surge of investment funds in the search for yield, while companies that primarily reinvest profits back into the business, rather than paying them out in dividends, lagged in performance. Some would say this is the primary difference in value versus growth investors. At Hansberger & Merlin, we are actually style-agnostic and focus less on the ever-fickle shifts in investment approaches or the market benchmarks and more on the ownership of great businesses over the life of outstanding corporations.

In 2016, net redemptions of active investment funds totaled $355billion, including many billions of dollars flowing out of some of the most admired funds. One fund underperformed its benchmark in 2016 for the first time since 2011, yet had withdrawals of over $7billion. We have found that even the very best investment managers underperform such averages about 3 of every 10 years.

Leading into yearend, 2016, we had been in a corporate profits recession for about a year and a half, and revenue growth in companies had declined for six straight quarters. The fourth quarter was when we expected a turn, carrying over into 2017. Thus far, these forecasts have proven correct.

We have seen an upturn in interest rates in December, 2016 and again in March, 2017, but we view this not as a negative. Instead, such action should be representative of economic expansion, with wage growth and a return to a more positive level of inflation. We see no recession on the horizon for some time, and this expansion is now the third longest in history.

Over 1956-2006, a full half century, the U.S. economy grew at 3.5% per year, but the last ten years (2006-2016) at only 1.5%.[vii] This economy has been steady in its recovery, but it has been weak. Due to the slow recovery, pessimism has been fairly widespread, with $350 billion flowing out of equity funds amidst macroeconomic fears regarding the recent election, Federal Reserve policy, Europe, China, the Middle East, hedge fund meltdowns, you name it. Despite it all, this expansion, this bull market, despite these occasional flat periods, has been extraordinary resilient.

Winning investment managers have not succeeded linearly. There is a certain randomness to short term returns and unpredictable results, even over the intermediate term. What we do know is that there are many investors who do outperform indices over the long term, and most of them spend roughly a third of the time looking up, not down, at the appropriate benchmark. Unfortunately, such episodes may result in investor redemptions as they chase performance elsewhere when they simply should have recognized short term under performance for what it is, a feature, not a bug, an inevitability.

Asset class performance, including equities, fixed income, commodities, and currencies will ebb and flow. What is most important to Hansberger & Merlin is our long term process, our investment discipline and our time-tested bedrock principles, revealed in our A Guide to Excellence in Investing: The 100 Most Important Principles, formulated approximately 25 years ago.

"The largest and most revered companies in the world have returned extraordinary amounts of money to their shareholders; yet all have experienced periods of significant adversity with meaningful declines in their share prices along the way, pointing out, again, that there just is no such thing as major long term investment success without enduring occasional large drawdowns. "

In thinking through this recent period of upheaval in financial markets, with so much regulation, such an oversupply of both domestic and international investment managers and funds, the introduction of more index funds and exchange traded funds, extreme turnover rates in investor portfolios, and 24/7 coverage of every hiccup in share price volatility, I am reminded of a particular reality regarding the long term success of investing in great businesses. The largest and most revered companies in the world have returned extraordinary amounts of money to their shareholders; yet all have experienced periods of significant adversity with meaningful declines in their share prices along the way, pointing out, again, that there just is no such thing as major long term investment success without enduring occasional large drawdowns.

Apple, since its IPO in 1980 to 2016, cumulatively returned over 25,000 percent, or 17% per year. **Microsoft**, since the IPO in 1986, has averaged 25% per year and cumulatively has returned over 92,000 percent! **Amazon's** returns from the IPO in 1997 through 2016 have been over 39,000 percent, or 36% per year. **Alphabet (GOOGLE)**, just since the IPO in 2004, has posted gains of 1,500 percent in total, or 26% per year. All have been extraordinary long term investment successes, but all have experienced drawdowns of well over 50% in a given year. Again, nothing builds net worth like the ownership of a great business, but it *does* require the patience, courage, and humility of both the professional investment advisor *and* the investor, in partnership, with the objective of maximum long term capital gains, net after taxes and inflation, commensurate with volatility and risk tolerance.

Perhaps the most extensive and trusted study of long term returns was conducted by DALBAR Research, a financial research firm focusing not only on investment results but also on investment behavior. DALBAR found that over the past 20 years, through 2015, stock market returns have averaged approximately 8% per year, but the average investor received only a 4.7% return. The culprit, the difference, of course, is that investors, in general, sold too soon, and often during the worst downturns.

Within that 20 year period were the major upturns in the late 1990s and 2009-2016 but also the deep recessions of the dotcom era and the financial crises of 2008. Very similar results are clear over the past 100 years. When Peter Lynch famously outperformed the index while managing the Magellan Fund from 1977 to 1990 with a result of +29% versus the benchmark +2%, Dalbar found the average investor in that fund actually had results of less than half, all because he/she exhibited the common behavioral patterns representing overconfidence or fear when buying or selling.

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About a year ago, January, 2016, Barron's published an article, "The Market Beaters,"[viii] highlighting a few fund managers who had outperformed the S&P 500 benchmark over multiple time periods. A few months ago, there was a follow up article, entitled "Top Stock Pickers Have Stumbled!" Such is the nature of investing; any given period can produce results above or below some average, but the most important time period is over the lifetime of investing. Hansberger & Merlin believes the ultimate success depends upon the identification of great businesses possessing truly rare characteristics and the purchase at attractive share prices.

Serious investment professionals often find ourselves apologizing for volatility, just as many CEOs of public companies do when addressing investors and discussing the performance of their company stock. Great companies, and outstanding investment managers, can only think long term, often anticipating trends and developments far in advance. Unfortunately, frequently, there is a disconnect between many shareholders who measure results over days, months, and quarters when the CEO, and the managers who study them, are thinking in years and decades. With such short term behavior, the number of publicly traded companies peaked in 1996 at 7,322. Today, there are only 3,671 listed companies. Since 1975, the number has declined 21% while world economies, populations, the number of investors, and the total of all invested funds have multiplied dramatically. Almost humorous is the fact that the Wilshire 5000 Total Market Index, established in the 1970s, now has 3,816 stocks![ix]

I have made the case at various times in these commentaries over the years that there has been developing a **scarcity of equities**, and, as fewer companies choose to go public, and merger and acquisition activity grows at record levels, and corporate share buybacks continue to expand, such scarcity is only increasing. Just as startling is the fact that of all the remaining public companies, and the relatively limited list of new IPOs, only a small percentage likely will turn out to be truly rewarding investments.

Consider this: the average time period for a company to be included in the S&P 500 now lasts only about 10 years. According to Yale professor, Richard Foster, in the 1920s the average life span of an S&P 500 company was 67 years, and research at the Babson School of Business finds that more than 40 percent of today's top companies will no longer exist in their current form by 2020. Foster adds, "More than three quarters of the S&P 500 will be companies we haven't heard of yet."[x] Over the last ten years, Sears has lost 96% of its value; Nordstrom -55%, Target -25%; and Walmart is nearly the same price today as 10 years ago. Over that same period, Amazon is up in price almost 2,000%. Ten years ago, there were sixty dominant pharmaceutical companies; today there are ten. We know the same trend could be applied to automobile companies, banks, and other industries.

An incredible fact is that only about 4% of all companies have been responsible for the *entire* long term stock market gain of about 9% average annual performance over the past 100 years! By now, it should be quite clear why we focus on the ownership of great businesses, disruptive growth companies that can scale to global brands or monopolistic status and gain market share in times of economic contraction, and, as stated, through our ownership, we participate in the compounding of earnings and dividends over the life cycle of those businesses.

Exponential technology refers to that which accelerates exponentially, doubling on a regular basis. The smartphone today is a million times cheaper and one thousand times more powerful than the supercomputer of the 1970s.[xi]

The world's greatest challenges today also may be the biggest business, and investment, opportunities. It is all about scale and disruption. Disruption is the innovation that creates a new market and interrupts an existing one.[xii]

Investors underestimate this concept of compounding; they underestimate the power of exponentials. They focus too much on current valuations, on short term gains and losses, too much on risk and volatility, and not enough on the opportunity that could be lost if they don't concentrate on the extraordinary possibilities of compounding.[xiii]

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We don't waste too much time thinking about the economy or the policies of the Federal Reserve. They are important, but they are not the most critical influences on market behavior or individual share prices. Nevertheless, we are very aware of the potential 3-5 increases in interest rates expected over 2017-2018, as a result of anticipated economic growth and tax reform, all of which imply a pickup in inflation. Today, this consensus forecast is known as the reflation trade, and within this forecast is the anticipation of a significant rise in corporate profits. Such enthusiasm must be measured against a severely overindebted U.S. economy, which likely could restrain growth for years to come. It is hard to find serious demand in the system, as initially all big ticket items appear exhausted; rents are falling as a result of massive apartment construction; and the auto market looks flat after a surge in the stock of new vehicles and easy credit. There just seems to be almost too much of everything from cars to homes to apartments to restaurants to TV channels to political junkies to news anchors, and yes, to include those opining on the stock market.

There is very little euphoria today and no signs to us of a stock market bubble, implying some serious doubt as to whether all this plays out in the way the markets obviously assume in the few months since the election. The earnings yield (the reverse of the P/E ratio) is about 6%, still 2 1/2X the 10 year Treasury yield, tilting in favor of equities as the preferred asset class.

If rates do rise as forecasted, it may signal the end of the greatest bond bubble in history, nearly 40 years in the making, resulting in near zero, and even negative, interest rates around the world. Such monetary policy, however noble the experiment, has not led to economic growth but surely has created a boom in asset prices. The more interest rates decline, the more asset prices rise. That is what monetary policy is all about. So, why has the world been surprised at the stock and bond bull markets since the crisis of 2008?

If rates do now reverse upward, there would appear to be significant risk in long term bonds; the longer the maturity, the more the downside risk. Simply put, government bonds have never been more expensive. The Federal Reserve controls the policy on interest rates, and central banks around the world have ballooned their balance sheets to include $15trillion currently in zero or negative rate bonds. The Federal Reserve surely does not want the stock market to decline, but the risk is that bond and stock markets decouple with this change in policy. The 30 year bond yield has exceeded the inflation rate by almost double for some time, but now if the bond yield were to rise to 4.0%, the 30 year government bond could decline 17.5%.[xiv] Obviously, normalizing interest rates will be a tricky policy and requires astute management by the Federal Reserve, just as the Administration and Congress must deliver tax reform, but such policy is not a given, as many believe rates will decline again if the economy weakens as a result of failure to enact legislation on tax reform, healthcare, and deregulation.

In our search for those exceptional opportunities, our analysis includes, but is not limited to, the following:

- **Return On Equity:** Net Income divided by stockholder's equity (total assets minus total liabilities) divided by number of shares outstanding. ROE is the single most important measurement of a company's profitability as it reveals how much profit a business generates with the money shareholders have invested.
- We project **earnings per share** out 5-10 years, using realistic, but conservative, earnings per share growth rates. To let compounding work, we must project out for periods longer than the average investor's mindset today. The goal is to find annual compounding rates of return for the next 5-10 years of at least 10%, and preferably 15%. We view the yearly per share earnings as the investor's annual return, so if a stock sells at $50 share, and earnings are $5 per share, there is a 10% average return. One then can compute earnings per share, dividend growth, and compounding returns of equity for years to come. We think of company earnings as our own. If a company earns $5 share, and we own 100 shares, we earn $500 which can be retained, reinvested or paid out in dividends. We add in corporate buybacks, thereby reducing the number shares outstanding and increasing earnings per share.
- It is an interesting question to ask: If I were willing to sell you the right to receive $1,100 in one year's time, what would you be willing to pay me for that right? $1,000 would net you a 10% return. What would you compare that to? Cash? Bonds? This is the discount process to present value.
- For our CAP (Capital Appreciation Portfolio) and GOP (Growth Opportunity Portfolio) holdings, we analyze current earnings per share and assign a growth rate in earnings for the next 5-10 year periods; then multiply that out-year estimate of earnings by the average P/E of the last 10 years; then discount that back to present to estimate an annual rate of return, and then compare it to the 10 year government bond rate.
- **Intrinsic** value is the sum of all the business' future earnings, discounted to present value, with government bonds serving as the discount rate. We believe all long term rates of return are to be measured against the rate of 10 year return of government bonds. The government's power to tax ensures the safety of bonds, and this is why the movement of interest rates affects stock prices. *Future* earnings means both earnings per share and dividends; i.e., it matters not for the sake of analysis whether the company pays out the earnings in dividends or reinvests them back into the business.
- Consumer monopolies are some of the best investments overall. Look at the long term performance of Altria/Philip Morris, an astounding +202million% over the past one hundred years. The secret is that companies that earn high rates of return can turn out to be bargains even when purchased at high P/E ratios.
- What *not* to buy helps us focus on companies that meet our criteria, and this is so different from the prevailing wisdom. Very few companies can provide 10-15% average annual return over the next 5-10 years.
- Certain companies pay no dividends because they have been able to reinvest in the business at high rates of return and grow the share price. When dividends are taxed the same as capital gains, it matters little. If not, the company should retain versus pay out. Investors are biased toward companies that pay dividends historically because stocks had to compete with bonds in many years past.
- All companies should retain the earnings per share if they can create solid rates of return. They should not buy back stock unless at attractive prices.

"While I am *very* aware of the short-term concern, I do believe we are on the cusp of the greatest reversal in government and business relations since the 1980s. I do suggest we are experiencing significant departure from the economic and social policies of the past decade or two, and I do believe people will have to learn that others may not see the world exactly the way they do."

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There has been a great deal of confidence lost in the last 10 years or so (we think it's coming back!), with recessions, unemployment, wars, and the loss of trust in so many institutions and ways of life, from the Presidency to

Congress, the electoral system, the IRS, the Federal Reserve, family values, banks, and the healthcare system, all the very fabric of America.

I suggest 2017 has the potential to mark the year of renewed confidence. The pendulum is swinging now. The stock market reflects the state of businesses, and business had been vilified for too long. You should learn to embrace that there is always opportunity in the opposite.

My study of history tells me that the average investor experiences only two true bull markets in an adult lifetime. The last two secular bull markets were the 1950s-1960s and the 1980s-1990s. Think about it; for some investors who look back upon their first secular bull market of the 1980s-1990s and the average annual return from 1982-1999 of 18%, this current upward climb since 2009 may be it!

America is on the move again, and I remind you, it is never a good idea to bet against the United States of America.

Perfect Wealth

I believe there exists an investment approach that is almost free from permanent risk, despite the bouts of extreme volatility, like a secret, magical place where investors can retreat. It is as if one could live in Shangri-La, with no aging or disease or sickness, where such limitations cease to exist. It would be the same for investors, with no time pressures, short term benchmarks or reactions to financial market reporting around the clock.

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The better investors know this place as they visit here sometimes; some too briefly. Most investors rarely ever seek to find such a haven, much less experience it. When they do, it instills in them a profound change. Assumptions for ordinary thinkers are altered. The magic of Original Thinking begins to flower and transform, and the new philosophy becomes extraordinarily liberating. To reach this place, however, requires humility, courage, and patience because it demands control by the host, similar in the way mind, body, and spirit combine to limit or eliminate stress and illness.

With so many measurement systems today, arguments over passive versus active management; regressions to the mean, Modern Portfolio Theory, the debacle of portfolio insurance in the 1980s, the question of 10 year versus 1 year P/E ratios, and 24/7 media coverage, a focus on the short term has overcome long term behavioral patterns. Such noise is not easy to avoid, but those who are grounded and rooted in a proven investment philosophy and discipline view the concept of this magical place as breakthrough thinking. It becomes disruptive and leads to Perfect Wealth.

If people think in old, familiar ways, they will achieve the same results as ever. Some may accomplish 5-10% better results by working harder, but if you seek a multiple of better results, then, I must say, well, if you want that much improvement, then you will have to approach this in an entirely different way. It demands a new attitude, a new way of thinking, a new and original perspective.

Sir John Templeton said, "If you do what everyone else does, your performance will be what everyone else's is." Bill Gates said his top ten programmers were 100x better than the average in the industry. Steve Jobs said, "Most entrepreneurs and new companies set out to be maybe 30% better than the existing competition, but I want to be 50x better!"

Investing is not to be a passive activity, or about closet indexing or your average mutual fund, or the overload of new ETFS. It is about businesses. It is about time and the long term. It requires a fundamental shift of mind, a totally different focus and paradigm from the mainstream. Some may consider it maverick, or practically radical, but you simply cannot experience significant long term gain without enduring short term volatility. Investors must understand that the best investments are in the best companies, and a stock only does as well as the business itself.

When investors grasp the fact that they own shares in tangible, operating businesses and cease to think in terms of stocks, stock markets, and broad indices, their paradigm shifts to the progress of those companies, as measured by fundamentals. The very best businesses, and investments, possess extraordinarily rare characteristics; indeed, very few consistently measure up against true standards of excellence in their returns on equity (ROE), above average earnings growth, a balance sheet with little or no debt, exceedingly high levels of free cash flow and returns on invested capital (ROIC), the ability to offset commodity and labor costs and interest expense with pricing power in their products and services, and with a proven and disciplined management team that has most of their net worth tied directly to the success of the enterprise. When such extraordinary companies are purchased at reasonable and fair share prices, time is on the side of the investor, who resides peacefully, patiently and confidently in the land of Perfect Wealth.

I was born in 1945, one year after the launch of the baby boomer generation. I came into the world on the heels of the greatest generation- the heroes, the soldiers, the families - who sacrificed and gave so much to our country and laid the roots of our freedom today.

As I was growing up, and throughout my life, I have studied and loved history. I learned of the Founding Fathers, the American Revolution, the Civil War, and the American Presidents before my time. I tried to put myself in their eras, absorbing what historians have written but knowing the times can never be fully communicated to those who didn't experience living in the midst of the opportunities and challenges of the day.

I am intrigued by the turn of the century in 1900, having experienced the new millennium of the year 2000. I am so impressed, but also saddened, by the extraordinary events that surrounded World War I & II and the Great Depression, when our great nation was wounded and broken hearted, only to eventually emerge stronger than ever on its way to a truly exceptional century, the dominant Superpower of the world- militarily, financially, spiritually- even though it was but a young nation, a mere babe compared to the historic monarchies, dictatorships, and democracies around the globe.

I marveled at the idea that FDR was elected to four administrations; that his Vice President, Harry Truman, was prepared to step aside in the election of 1948, willing to serve again as Vice President to the most popular man in the United States at the time, General Dwight "Ike" Eisenhower, who personified the great victory of our country and its allies over the forces of Nazi Germany and Japan.

As a young adult, my first President was John F. Kennedy in 1960, and I vividly recall where I was and what I was doing when I heard of his tragic assassination. What I remember most was his inaugural speech on January 20, 1961, in which he said those famous lines, "Ask not what your country can do for you, but what you can do for your country."

Throughout the recent campaign, from the very beginning; the central theme of now President Donald Trump, was to "Make America Great Again." This also was the battle cry many years ago in other elections. "Again" implies "Once was," a renewal, a return to exceptionalism, to faith, family, relationships, health, financial power, law and order, strength through power, one of the great legacies of Ronald Reagan, accountability, respect, and leadership.

Something happened along the way since that time in the past, over the course of changing demographics, overwhelming increases in productivity through technology, and globalization, the three most dominant themes of the past generation. I believe political correctness, partisanship in government, a focus on identity politics, and the influences of socialism grew to compete with capitalism and entrepreneurship and began to push our nation off course. Indeed, the vast majority of our citizens believe our country has been "on the wrong track" for some time now.

Why has the family deteriorated from the grand institution of the past? Why are we now a nation that requires such massive support of a health care system that threatens to bankrupt so many families, especially at a time when there has never been such innovation in medicine and life changing and lifesaving cures and treatments for disease and illness? We should all be on our hands and knees thanking our Creator for the highest standard of living in history, yet so many millions of our citizens live in poverty. How? Why?

So I harken back to John Kennedy's famous question, his historic call to action. I suggest today that for far too many, it is about what can this country can do for them than what they can do for the country.

Contrast this belief system with the distrust between so many nations, between our coasts, between conservatives and liberals, between our police and many in the inner cities, among races and cultures, and, so unfortunately, between so many citizens and their government.

Maybe this election was about *change*, not so much about a candidate, or a change in political parties; not a change in our Constitution, but a return to and a renewal of our core principles and values, and a restoration of and a return to our roots. There can be no *fruits* of success without a reliance on the *roots* of success. Hard work, honesty, integrity, and remember "integrity" means "wholeness," a coming together as one, such that the whole is greater than the sum of its parts.

I recently celebrated my birthday (when I came home from the hospital, my older brother asked my mother, "How long is he going to be here?"), and after all these years, what I can guarantee is that how an investor comes through any volatile period will *not* depend on the economy, the market, or the administration, but on one's own choices and foundation.

We have taken a stand with a clear investment strategy. It isn't just about service or price; it is about advice. It is what we do: We stand for distinctive ideas and points of view, and we let them be known. Our response has been to decommoditize a commodity, and I believe everything we do comes down to the original idea. Such is *our* foundation, our roots.

Finally, your life plan is more important than all the business plans and financial plans put together; hence, our belief in a holistic approach to wealth and to life and to the development of the learned behavior of finding opportunity in the midst of crisis.

I am fascinated with the metaphors that link the life of trees to human existence, and even to the financial markets. The rings of a tree tell more than just its age; they can tell the whole story of the life over 2000 years. Their thickness and thinness speak of hard years of bitter struggle intermingled with rich years of growth. The trees endure fires, lightning strikes, windstorms, infestations, and excessive heat and cold, all the while continuing to grow.

Such a metaphor can teach us about survival, and overcoming difficulties, and prevailing over adversity, leading to growth. In <u>Boys in the Boat</u>, the beautiful true story about the American rowing team and their quest for gold at the 1936 Berlin Olympics, the author teaches us about the "cedar foundations for the racing shells and what happens when the wood is put under tension and about the strength of the fibers, the resistance, and the ability of the wood to bounce bank and resume its shape. This ability to yield and to bend was a source of strength for wood, but also individuals, so long as it was helmed by inner resolve and principle."[xv]

Speaking of roots, I recall a wonderful story by Philip Gulley about trees and the foundation of deep roots. I believe such a touching tale may serve as an appropriate metaphor for my belief that, out of adversity, and uncertainty, comes growth and opportunity.

"Had an old neighbor when I was growing up named Doctor Gibbs. He didn't look like any doctor I'd ever known. Every time I saw him, he was wearing denim overalls and a straw hat, the front brim of which was green sunglass plastic. He smiled a lot, a smile that matched his hat – old and crinkly and well-worn. He never yelled at us for playing in his yard. I remember him as someone who was a lot nicer than circumstances warranted.

When Doctor Gibbs wasn't saving lives, he was planting trees. His house sat on ten acres, and his life-goal was to make it a forest. The good doctor had some interesting theories concerning plant husbandry. He came from the "No pain, no gain" school of horticulture. He never watered his new trees, which flew in the face of conventional wisdom. Once I asked why. He said that watering plants spoiled them, and that if you water them, each successive tree generation will grow weaker and weaker. So you have to make things rough for them and weed out the weenie trees early on.

He talked about how watering trees made for shallow roots, and how trees that weren't watered had to grow deep roots in search of moisture. I took him to mean that deep roots were to be treasured.

So he never watered his trees. He'd plant an oak and, instead of watering it every morning, he'd beat it with a rolled up newspaper. Smack! Slap! Pow! I asked him why he did that, and he said it was to get the tree's attention.

Doctor Gibbs went to glory a couple years after I left home. Every now and again, I walk by his house and look at the trees that I'd watched him plant some twenty-five years ago. They're granite strong now. Big and robust. Those trees wake up in the morning and beat their chests and drink their coffee black.

I planted a couple trees a few years back. Carried water to them for a solid summer. Sprayed them. Prayed over them. The *whole nine yards. Two years of coddling has resulted in trees that expect to be waited on hand and foot. Whenever a cold wind blows in, they tremble and chatter their branches. Sissy trees.*

Funny thing about those trees of Doctor Gibbs. Adversity and deprivation seemed to benefit them in ways comfort and ease never could.

Every night before I go to bed, I go check on my two sons. I stand over them and watch their little bodies, the rising and falling of life within. I often pray for them. Mostly I pray that their lives will be easy. "Lord, spare them from hardship." But lately I've been thinking that it's time to change my prayer.

Has to do with the inevitability of cold winds that hit us at the core. I know my children are going to encounter hardship, and my praying they won't is naïve. There's always a cold wind blowing somewhere.

So I'm changing my eventide prayer. Because life is tough, whether we want it to be or not. Instead, I'm going to pray that my sons' roots grow deep, so they can draw strength from the hidden sources of the eternal God.

Too many times we pray for ease, but that's a prayer seldom met. What we need to do is pray for roots that reach deep into the Eternal, so when the rains fall and the winds blow, we won't be swept asunder." [xvi]

i. *Bridgewater Daily Observations*, March 22, 2017
ii. *Wall Street Journal*, September 1, 2016
iii. *Wall Street Journal*, January 14-15, 2017
iv. *Wall Street Journal*, October 15-16, 2016
v. *Wall Street Journal*, October 15-16, 2016
vi. *Newfound Research*, February 13, 2017
vii. *RBC Capital Markets*, September 8, 2016
viii. *Barrons*, January, 2016
ix. *Credit Suisse*, March 22, 2017
x. Bold: How to Go Big, Create Wealth and Impact the World by Peter Diamandis and Steven Kotler
xi. Bold: How to Go Big, Create Wealth and Impact the World by Peter Diamandis and Steven Kotler
xii. Bold: How to Go Big, Create Wealth and Impact the World by Peter Diamandis and Steven Kotler
xiii. Bold: How to Go Big, Create Wealth and Impact the World by Peter Diamandis and Steven Kotler
xiv. *Bloomberg*
xv. The Boys in the Boat: Nine Americans and Their Epic Quest for Gold at the 1936 Berlin Olympics by Daniel James Brown.
xvi. *Front Porch Tales* by Philip Gulley

HANSBERGER & MERLIN AT MORGAN STANLEY

Hansberger & Merlin at Morgan Stanley has represented the high net worth marketplace for over three decades, assisting our clients in the creation and maintenance of significant net worth. It all comes down to Original Thinking, our mantra for over 30 years, a disruptive growth strategy that decommoditizes a commodity business. We compete on the power of our investment discipline and original ideas. In a time of an overload of advice today, what is still in short supply are insights and real innovation in investment management.

"If we can find companies with high historical and sustainable returns on equity with consistent above average earnings growth, we will have found purchase candidates for the substantial increase in net worth. Add in a healthy balance sheet, heavy insider ownership of the shares, and a management team that focuses on the successful deployment of cash flow (stock repurchases, debt reduction, dividend increases, and when appropriate, focused acquisitions that are accretive to earnings) and we will have identified great businesses. Great businesses purchased at attractive valuations should lead to significant capital appreciation over time." —Jim Hansberger

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