

Margin for Error Chapter 1: The Post Pandemic World 2021

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The post-pandemic world is visible, with vaccines slowly making their way into American's arms. What will our lives look like? Will we go back to the world we knew, or will things be strikingly different? Will new issues inform our choices in the next year and beyond? What have we learned from this once-in-a-lifetime horror? It is time to ask these and other important questions as we head into 2021.

[I would like to thank Greg Fleming, President & CEO of Rockefeller Capital Management, and Matt Shulman, CEO of The Ardent Companies, for their contribution to this discussion. They are both great friends, great leaders, and great intellects, and I appreciate both sharing their wisdom with us]

In hindsight, what will people say about 2020?

I think that 2020 will find its way into history books for decades to come. For obvious reasons, a once-in-a-century pandemic warrants historical significance. Beyond the pandemic itself, the unprecedented development of effective vaccines in under twelve months is a truly remarkable feat. By comparison, it took 14 years for the measles vaccine to be perfected after the disease was declared a U.S. pandemic in the

early 1950s.¹ While textbooks should discuss the science, technology, and ingenuity that underpinned the vaccines' creation, they should also highlight that when driven to it, bureaucracies around the world were able to get leaner and more nimble to allow for faster vaccine development and approval. Such a feat should be studied not only for its impact on the success of the vaccines but how it can also be applied to other innovations that will undoubtedly be coming in the months and years ahead, in healthcare, communications, and in different ways we will live our lives post-pandemic.

When I asked this question to Greg Fleming, he added the following insight, "...The step-function moves in productivity that technology has made possible for companies and people...created changes that will reverberate for decades. The way we work, the way we shape our day to day lives, the nature of cities and other places that have housed companies and workers since the industrial revolution, all of these things are going to experience lasting change." You can observe these lasting changes in the companies that excelled during 2020. It is no wonder that those businesses were the anchors or the architects of the

connectivity and evolution of the workplace that Greg mentions. Whether it was Microsoft or Amazon, Cisco or ServiceNow, these businesses were already contemplating how our lives would be different; the pandemic just accelerated their business plans by five to ten years!

Matt Shulman always wondered what it was like to live through the 1960s. "When I have asked people about that experience, it really depends on how you experienced the time and how it affected you short and long term. Were you in Vietnam or a protester? On a farm or city life? I think 2020 will be similar. Many gained perspective on spending time with family and slowing down. Some lost family fortunes in restaurants or hotels. Some lost loved ones. And we are only talking about the COVID-19 impact on 2020. 2020 was also the year of major socioeconomic changes and an unimaginable election regardless of who you voted for. I think most people desire to get back to some level of the previous normalcy."

What are the long-term consequences of the pandemic for American society and the American economy?

As an economics student, gross domestic product (GDP) has been a good proxy of human well-being. If GDP slows, there is socioeconomic pain, and policymakers respond. I think the pandemic confirmed that in the United States, this is no longer as good a proxy due to gaps in quality of life and education, population, and income inequality. If you look at the past 20 to 30 years, good GDP outcomes have not necessarily translated to better quality of life outcomes for all Americans. It will be interesting to see what new metrics we devise to ensure that the American dream is attainable by all. As Mr. Fleming

highlighted, "the challenges of income inequality and the severe impact of the pandemic on so many working-class Americans highlights the urgent need for us to make changes that ensure all Americans feel that the economy works for them." Mr. Shulman added, "One consequence [of the pandemic on American business] could be a heightened consideration of how businesses impact society and the environment. At the very least, there will be a greater commitment to community and an emphasis on doing well while also doing good."

That said, America remains an incredibly adaptive place, with businesses transitioning to remote work without losing productivity and momentum across many different industries. Startup and existing businesses continue to identify new trends and changes in behavior, maintaining the United States' position as the most innovative economy in the world.

How will managing a private or public company change based on the events of 2020?

Fleming is confident that "managing a company post-pandemic, public or private, American or international, just became both easier and more challenging. Easier in the sense that the ability of employees to work productively in most businesses on a remote basis is an order of magnitude beyond anything we have previously seen in our lifetimes. The scale of the remote work experiment mandated by the pandemic has created a comfort and an ease with a distributed workforce never before seen. The challenges come from how to lead a company and create a culture that binds employees together in a world where remote work is as pervasive as it is today and likely will be, at least in part, going forward."

The difficulty in creating a culture in a digital work environment could also make corporate deal-making more challenging. It could be harder to ensure a mutual affinity for teams seeking partnership or a merger when rubbing shoulders is less likely due to the exchange of business travel for video conferencing. While Microsoft Teams, Zoom, Google Meeting, and other video conferencing services were a savior during 2020, there is no substitute for a handshake and looking someone in the eye.

The overall clock-speed of life around us has inexorably changed. Companies and their management teams will have to rise to that challenge. The consumer's needs and desires will shift more fluidly than ever before, and employees will demand that the quicker pace of corporate decision-making forced by the pandemic remain intact.

The pandemic's impact has also been disparate for large corporations, which had the resources to adapt quickly, and small businesses that clearly struggled. Now that large corporations are functioning more efficiently, the ramp back up in employment for them may be less tied to the vaccine rollout. In contrast, small business employment will likely rise more in synch with "normalization."

Has the CARES Act and the Federal Reserve's unprecedented actions taught us how to avoid recessions?

"My initial reaction is not at all. This reliance on the government to bail us out of the problem does nothing to avoiding recessions, rather just lessens the blow. These actions were necessary to avoid a major disaster; however, I think it is too early to tell if the actions taken were too much or too little. The risks of

hyper-inflation, an unpayable national deficit, and funds being distributed fairly to all taxpayers are all concerns," opines Shulman.

I believe we have discovered some fundamental things about macro policy's effects through both the financial crisis and the pandemic. Has America stumbled into how to avoid recessions? Not just that, but how to prevent poverty too? The real question is, what do we want to do with that knowledge? These questions define the next great chapter in the 50-year journey of realizing the power of a fiat money system. What we will ultimately discover is that this is a political question, not a technical one. We now know how to do it (avoid recessions, prevent poverty, bailout companies), but should we do it? If so, who should we do it for? This is a generational debate that will not be easy for our democracy to deal with.

Suppose such a path is the precursor to adopting modern monetary theory (which posits that governments that control their currency can spend freely) in the United States. In that case, we must also be clear that we are treading on uncharted territory. The closest historical examples we can find all lead to inflation, currency debasement, or both. Thus, such a path may mean that the benefits of a recession-free and poverty-free economy are fleeting at best.

What will the policy priorities be for the Biden administration and the new Democratic majority in Congress?

Fleming: The Biden Administration is going to focus first on the vaccination program and eliminating the Covid-19 virus across America. As they progress on that front, they will have several policy priorities, including income inequality and getting people back to work across the country, climate change and the

investment in green technologies, and cybersecurity, including the implications of the recent Russian hacking across the U.S. federal government.

Shulman: We imagine an overall continuation of spending and supporting legacy institutions.

- Continuation or expansion of government stimulus plans to support various businesses during the pandemic-induced disruption.
- Maintain presence of the GSEs - which have historically provided financial support for housing – both single-family and multi-family
- Greater commitment to affordable housing and/or broader rollout of rental housing regulations
- COVID-19 vaccine distribution and the economic recovery
- Environment and sustainability
- Technology and Tech Regulation
- Foreign relations with U.S./China
- Equality

Merlin: When you have a crisis like this, you have the option of trying to get back to "normal," or to "build back better," as President Biden campaigned. We have recognized as the pandemic has unfolded that there are structural deficiencies in the way we have organized healthcare, global supply chains, and income distribution, among other things. Once we get past relief and onto recovery, I expect that the U.S. government will focus on investments that they believe will lead to reforms in these areas. The \$2 trillion that Biden wants to spend on climate change is both recovery and reform in his view, so that will certainly be a policy priority. Same with the \$700 billion on manufacturing, as the President feels that we must recommit to manufacturing and research and development sourced in the U.S. Lastly, there is the \$775 billion Biden has pledged to education and

healthcare reform. These investments by the U.S. government would go a reasonable distance to fundamentally transforming part of the labor market, trade, and climate. As we always say when it comes to government actions, "the devil is in the details (and policymakers aren't very good with details since that would require reading the laws they pass)." Still, with a Democratic majority in Congress, we will likely see these investments made early in the Biden administration.

What are the significant investment opportunities coming out of the pandemic?

"The biggest investment opportunities, public and private, are companies that are best positioned for the rapid changes occurring in all industries driven by technological progress. As more companies are staying private longer, the role of direct investments and different types of alternative investments, particularly for high-net-worth investors, will continue to grow," says Fleming.

Shulman said that in the real estate markets, "searching for value opportunities created by the pandemic will likely be easier than figuring out permanent changes in habits tied to the pandemic for future growth. Unlike the liquid markets, we believe in the illiquid investment arena regulations and leverage issues will likely create opportunities to purchase assets at well below true value. We are focused on places where we can combine a flexible balance sheet and access to capital with strong asset management skills to invest before markets stabilize. We are also focused on providing capital to other operators where similar situations present themselves to invest in another spot on the capital stack."

Merlin Wealth Management agrees with both of our good friends that opportunities will present themselves in public and private investments, growth stories, and (distressed) value stories. From the perspective of our asset management strategies, we are reminded of a lesson from one of our favorite books, *Good to Great*, by Jim Collins. Collins studies over 1,400 companies and settles on 11 that he feels have the characteristics of great, enduring growth businesses. One of these qualities is the "Stockdale Paradox," named for former vice-presidential candidate and war hero, James Stockdale. Stockdale attributes his survival from the capture and torture he endured as a prisoner of war to the combination of faith that he would ultimately prevail, with the discipline to confront the brutal facts of his reality. This psychological duality has perhaps never been more important to the survival of great businesses than it is today.

We continue to believe that the great companies who have confronted the challenging times we have faced and survived (and in some cases even thrived) still represent the best opportunities for long-term investors after the pandemic is over. Experiences like this only strengthen the resolve of great leaders, sharpens the focus of a great product or business plan, and makes a company grittier and more tenacious as it emerges from challenging times. Of course, it is easy to conclude that we are talking about the technology companies that have provided much-needed services during the pandemic, but we are also referring to cyclical businesses that were challenged just to survive in the last 12 months and have endured great hardship. These companies are beginning to see the light at the end of that proverbial tunnel. We talk more about the specific themes on which we are focused in our 4Q20 Market Commentary.

Margin for Error

There is a great debate whether Jack Nicklaus or Tiger Woods is the best golfer of all time, but I do not think there is much doubt that Tiger is the most exciting player ever to hit the links. Woods is a brilliant strategist navigating any course, but the thing that makes him so compelling is when faced with a near-impossible shot- no margin for error- he somehow finds a way to pull it off. Recreational golfers think about the best shot they have ever hit in a particular situation, then decide how to proceed, assuming they can replicate that outcome instead of the more probable or average result they achieved in such situations. "Once I hit this beautiful 5-iron 175 yards over water, over a bunker, and onto the green." The operative word in that memory is "once." The player is not thinking about the 100 other times they were in that situation, hit the ball in the water, bladed the 5-iron over the green, hit it right into the trees, or out-of-bounds to the left. Because of this shallow memory, most players do not allow the proper margin for error to ensure they avoid the worst outcome, even if it gives them less of a chance to achieve the perfect outcome.

The Black Swan author Nassim Taleb said, "you can be risk loving and yet completely averse to ruin." This is the essence of a "margin of error mindset" and is how we are always thinking about managing money. Room for error lets you endure a range of potential outcomes, and endurance lets you stick around long enough to allow the odds of benefiting from a low-probability outcome to fall in your favor. In the world of investments, the biggest gains occur infrequently, either because they do not "happen often or because they take time to compound. So, the person with

enough room for error in part of their strategy (cash/hedges) to let them endure hardship in another (stocks/other growth assets) has the edge over the person who gets wiped out when they are wrong.”²

Room for error does more than just widen the target around what you think might happen. It also helps protect you from things you would never imagine, which can be the most troublesome events we face. I have been managing money professionally for over 22 years. I have seen bubbles burst, currencies devalued, a terrorist attack on U.S. soil, a financial crisis, multiple bailouts, bankruptcies, and now a once-in-a-century pandemic. I promise you, no matter what people say, no one predicted that any of these events would happen before they did. While it is awfully uncomfortable to live through such painful and uncertain times, we learn one of the most critical aspects of successful investing from these experiences. Economist Daniel Kahneman best describes it, "the correct lesson to learn from surprises is that the world is surprising."

At Merlin Wealth Management, our core principle of achieving maximum risk-adjusted returns while also creating the proper margin of error to defend against those unexpected risks has never been more challenged or important than in 2020. Because we own great businesses, we were able to assess on a holding-by-holding level which of our portfolio companies would be most affected by the pandemic and which had a unique opportunity to grow because of the changing dynamics of work and life. Beyond this analysis, our ability to provide an additional margin for error through allocations to cash, hedges, and well-timed alternative investments also gave us peace of mind during the most volatile and uncertain

moments in the spring. Lastly, our strong bond with our clients, and the history we have navigating challenges together, is probably the most valuable and unique treasure that we can rely upon during the worst of times.

Business books talk about how a growth mindset versus a fixed mindset has a broad correlation to success in business and life. What we have termed as the margin for error mindset seems to have an equally powerful impact in several aspects of life, not the least of which is superior investment performance.

Final Thoughts: Farewell 2020

As 2020 starts looking smaller and smaller in our rear-view mirror, it is good to take a reflective lens and consider lessons we have “learned this year that will help us in the future. We often learn more from our struggles and failures than from our triumphs,” so there are sure to be some kernels of wisdom from this challenging year.³

As someone who believes that everything can still be improved, my least favorite phrase when inquiring about something is, "because we have always done it this way." To me, this is the most dangerous sentiment to the success of any organization. Such a mindset implies that new ideas or innovations are not welcome, even when we confront problems with the old way, or the promise of these new paths is rich.

Hopefully, we have all learned from 2020 that all boats get rocked eventually; the only question is whether that disruption comes from within or if it is forced by circumstances that catch everyone off

guard.⁴ These moments are crucial to the staying power of any organization and its leadership team. The best companies, in my opinion, seek out change before it may even be required. Bob Iger, the recently retired CEO of Disney, said that the most courageous leaders are willing to tear down their businesses and build them back, well before the outside world would think such an undertaking was warranted. In addition to Disney, which we hold in our Dynamic Growth Strategy, there are other examples throughout our MWM Equity Strategies of companies that have exhibited this kind of courage and forward-thinking. Microsoft, Wal-Mart, and Apple, just to name a few. I am also proud to add Merlin Wealth Management to that list. We underwent a platform change and transition over the last 12 months, at a period when our business was performing at its all-time best. However, we knew that to be properly positioned to advise our clients and care for them to the best of our ability going into the next decade, we needed a structural change. I am proud of our team's work and am continually humbled by the trust our clients' place in us. I am more confident than ever that we are prepared for the next chapter in this journey.

In sum, 2020 forced many individuals and businesses to re-think their entire outlook or business models. Infrastructure changes that may have been slated over the course of several years were made in a few months. In such a time of upheaval, refusing to adapt because "we have always done it this way" went from an obstructionist impulse to an existential threat. So, whether it was a restaurant that had to reinvent itself by offering scaled up takeout and delivery options to survive the crisis; or organizational leaders who previously dismissed remote working, only to find themselves running 100 percent remote

organizations and functioning well, we all learned in one way or another that if we only do what we have always done, we will only get what we have always gotten.

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¹ www.HealthNation.com, Then vs. Now: The Impressive History of the Measles Vaccine by Lauren Smith, 04/19/2019

² The Psychology of Money by Morgan Housel

³ www.robortglazer.com, Friday Forward (Old Ways \$259) by Robert Glazer, 12/17/2020

⁴ www.robortglazer.com, Friday Forward (Old Ways \$259) by Robert Glazer, 12/17/2020