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Margin for Error Chapter 3:
Change is an Investor's Only Certainty

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ABOUT THE AUTHOR

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See if you can guess what financial publication and author penned these economic and market observations:[1]

1. *An investors' wealth will soon be subjected to increased taxation. Corporations of great size and influence will be special targets, and their profits will be targeted by various means.*
2. *Labor will receive a larger percentage of corporate income in the future than in the past.*
3. *The Federal Government will attempt to subject important industries within our economy to new controls and regulations that will be restrictive and lead to less productivity and profitability.*
4. *The boom in building and construction will likely last beyond this year.*
5. *Inflation will cause the dollar's purchasing power to decline during the years ahead, with a resultant rise in the cost of living.*
6. *Bond prices have probably reached their peak levels for the current recovery cycle and are headed downward.*
7. *Stock prices will probably advance to higher levels before the recovery cycle has been completed. An intermediate correction may occur at any time, and selectivity is of far greater importance now than at any time during the past five years.*

Ring a bell? Can't remember whether it was a CNBC interview last week, a Wall Street Journal op-ed, or Barron's piece from this weekend? I will save you the googling- T. Rowe Price wrote these words in 1937, as part of his quarterly market commentary to his investors titled: "Change- The Investor's Only Certainty."

Mr. Price was distilling the incredible events of the Great Depression and their impact on the social, political, and economic outlook in the United States and our markets. He talked about how no one saw these changes coming and that an investor could only rely on the notion that the current environment was <u>un</u>reliable.

Over 80 years later, our great benefit is that we have seen many calamities, wars, recessions, and now a pandemic to add to the data set that T. Rowe Price used to synthesize his predictions about the market and economy. And, with all due respect to one of the greatest investors in history, change is not the only thing an investor can rely on. While we always attempt to remain aware of significant changes facing the companies we invest in or in macroeconomic and political conditions, we see clearly from the conclusions above, written over eight decades ago, that while things do change, some trends and themes remain the same. Investors can learn a great deal from both.

In today's world, we, too, are facing potential market headwinds from increased taxation, higher labor costs, and rising inflation. We have also witnessed in the last few weeks several court cases where our government has (so far unsuccessfully) attempted to impose restrictions on large companies that they feel have gained too much influence in our economy, squashed competition in their industries, and infringed on the privacy of Americans without their full knowledge. These concerns, many of which we know from history are common during the later stages of economic recoveries, can cause anxiety for investors. After the strong market performance our clients have experienced since the last two crises (The Great Recession and The Covid-19 Pandemic), it is natural that we hear some trepidation about the future prospects of the stock market in the face of these potential roadblocks. We all want to protect the gains and what, for many, is an all-time high in personal net worth.

We draw on the wisdom of the Merlin Wealth Management (MWM) Investment Discipline at times like this. One of the key tenants of our philosophy is to know when we are facing "noise or signal." While many of the headlines we see today seem ominous, we would contend that most of the issues the financial media are wielding today qualify as noise more than signal. For example, taxes on corporations (and wealthy individuals) will likely rise. While we have seen tax rates rise and fall for decades, we believe that a lower tax environment encourages business investment and innovation, the creation of jobs, and more economic activity on which the government can collect tax revenue (a concept our elected officials cannot seem to grasp). Yet, during periods of rising taxes, Corporate America and our country's wealthiest families seem to find a way to remain profitable, innovative, and consistent in their investment in America's economy and markets. American companies that maintain pricing power- the ability to raise prices without seeing a drop in demand- in their industries and among their competitors can better absorb a higher corporate tax rate and the specter of higher labor costs as well (most likely in the form of an increased minimum wage, which the current administration strongly supports). Lastly, we have seen governments go after large corporations many times for alleged anti-competitive practices. Microsoft was dragged from court to court throughout Europe during the 1990s in its' fight to defend the Windows operating system. In the end, the company was fined, but at no point was their business viability jeopardized by the threat of government intervention.[2] It was a painful period of management dysfunction that weighed on Microsoft during the first decade of the 21st century. The former was noise; the latter was clearly a signal.

Another of the MWM Investment Discipline principles is that the three most impactful influences on market performance are interest rates, inflation, and corporate profits. Tangible changes in the "big three" are signals to us and may require more substantive capital allocation shifts. With that in mind, we are paying close attention, as we have written about for the last two quarters, to the inflation and interest rate environment. It seems like a foregone conclusion that inflation is rising. While that can be a concern related to purchasing power, we are more focused on the degree inflation rises (or is allowed to rise) and what the Federal Reserve does to address the situation. As of today, our view is that inflation will rise but will not reach concerning levels. Talk of 1970s level inflation is nonsensical to us based on the data we are currently seeing. Additionally, the concern that the Federal Reserve will have to raise interest rates dramatically also seems overblown. We agree that interest rates will rise or that at least stimulative Federal policies will be curtailed. Still, we do not believe that Chairman Powell has much room to maneuver in the current environment. Some of that slippery slope hinges on whether the economic recovery evens out as reopening continues. The main driver of the conundrum the Fed faces in our view is the ballooning U.S. debt. With the historic levels of debt, the government took on to combat the Covid-19 pandemic, any rise in interest rates will dramatically impact the servicing of that debt (interest payments owed by the U.S. government to its' bondholders) and, therefore, on the overall federal budget. If debt service rises significantly, it could curtail the government's ability to provide or increase essential services that millions of American citizens rely upon, a dynamic that the President and the Democratic majority would not welcome.

A Word on Capital Allocation

While we remain cautiously optimistic about the U.S. economy's prospects for the remainder of this year and most likely into the beginning of 2022, that does not mean that we are standing pat. With corporations facing a higher cost structure, either from higher taxes, higher labor costs, or both, it is essential to understand which of our portfolio companies have pricing power or large profit margins that can absorb these headwinds. We already made moves inside the portfolios to address possible inflationary pressures, purchasing commodity-related names in the Sustainable Income (INC) and New Era (ERA) strategies. Our fixed income portfolios have been purposely positioned in a lower duration structure, which has shielded us greatly from the recent downward pressure on bonds. Lastly, we did execute some proactive profit taking where equity allocations reached all-time highs once again in client portfolios. We did this to be prudent and to rebalance appropriately, not because we are concerned in general about the equity markets.

With excess cash, we continue to look at non-traditional sources of income, such as private debt and private real estate. The real estate market has experienced a similar move upward to the stock market, so selectivity is just as crucial in that asset class as it is in equities at present. That said, we continue to be buyers of the tremendous growth businesses that populate our portfolios and are dollar-cost-averaging into our strategies prudently for clients that have cash to allocate to risk assets.

The Fourth Industrial Revolution

T. Rowe Price ended his quarterly letter to investors by claiming, "The greatest opportunity for profitable investment will be in new and rapidly growing industries, employing relatively few people and less subject to governmental interference."[3] It is an essential tenant of successful investing to be confident in your analysis of a company or a theme, and to invest aggressively even if it seems early to others. Many investors fear putting too much capital into a new idea, fearing that they will be disappointed by or maligned for market underperformance if it does not pan out. Peter Thiel, the famed venture capitalist, has a much different view. He poses that an investment should only be made if its' potential return could equal the size of the entire fund in which it is placed. For that to happen, opines Theil, you have to be convicted in the business, but you also have to invest enough capital to reap the reward.[4]

MWM seeks to be early in our thematic investing. Investors in our New Era Strategy (ERA) are well aware of the research we did on mRNA technology early in 2018, which led to our investment in Moderna in 2019. Because we felt like we were very early, we bought a smaller position, only to scale it up as the events of 2020 developed and accelerated the healthcare community's adoption of mRNA. Yes, we have also taken profits in the stock, and that is where we straddle the line between investing enough to matter (ala Mr. Theil) and being convicted to invest early, as our friend Mr. Price opined in his musing.

Today, we feel that the investment community struggles with these two characteristics, specifically within the technology sector. There is constant debate over the staying power of new technologies and whether the overwhelming returns that the most successful tech companies experienced over the last decade are coming to an end. There are many references to the dot com bubble in the late 90s in these conversations as well. I will not recount the explanation I gave in our year-end 2020 piece that discussed the major differences between the tech leaders of today and those of 20 years ago. What I will say is that it seems to us that the pandemic accelerated some major themes within technology that are leading us toward another technology revolution. Many of the themes that will lead to trillions of dollars of tech revenue in the next five years are not necessarily new (in fact, companies claiming to be new or disruptive may not be the winners in this case), and many of the companies carrying out these life-changing technologies are not being given credit for their growth potential.

We believe that the pandemic started what will be remembered as a historic deployment of remote work and digital access to services across every sector of our economy. Businesses of all types now focus on digitizing every aspect of their business as fast as possible. The technologies that will make this happen on a large scale include cloud computing, e-commerce, digital payments, artificial intelligence, 5G wireless, and video conferencing. These are not "new" businesses per se, but their use in this digital transformation across the enterprise and consumer world is just in the first few innings of playing out, in our view. As such, it is no surprise that company executives in a multitude of industries believe this will be the most significant tech transition in decades. IDC predicts the shift will account for $2.3 trillion in spending by 2023. UBS estimates that in cloud computing alone, the market will more than double in the next few years, touching nearly $600 billion in revenue by 2024.[5] That is up from $270 billion in 2019.[6]

Even more interesting is that we do not have to invest in a set of new, unproven companies to take advantage of this revolution. For example, the leading provider of cloud computing services is Amazon. Warren Buffett is famously quoted as saying he missed the opportunity to invest in Amazon twice. First, he did not believe that the e-commerce giant could unseat traditional retailers like Wal-Mart. Second, when he did not understand the opportunity Amazon was pursuing when it started its cloud computing business.[7] In this sense, Amazon was really two start-ups, not one. Investors have a hard time seeing this because Amazon already sported a premium valuation for its e-commerce business when it incepted the cloud services offering.[8] However, looking back, if one invested in Amazon again at the time of the cloud start-up, you still experienced an IPO-like return of 12,280%![9]

Investor's Business Daily published a survey conducted by Twilio, which polled more than 2,500 companies, and reported that about 92% of the companies surveyed were looking for new ways to engage customers digitally and called a shift in digital communications extremely or very critical to address business challenges.[10] Nike, an MWM holding, discussed its digital shift during its last earnings call. When the pandemic started over a year ago, Nike closed all its retail stores and switched to 100% online sales. The company focused its attention and resources on its apps as customers pivoted to engaging through digital commerce. Nike also had its former retail store employees receiving customer questions posed on the apps via text, so they could still provide customers with product-related information and advice.[11]

FIGURE: 1

All of this fits the picture of a revolution. It not only describes technological changes companies are pursuing to create efficiency in their businesses and a response to customer preferences, but it also defines cultural, social, and economic changes that will accompany this new way of doing business. So, while the emotional bull/bear debate on tech valuations is not going away, we believe the underlying fundamental stories and white-hot growth still paint a compelling mosaic for further tech leadership in the U.S. economy and stock market through 2021 and beyond.

ESG(R)

We wrote in this format before about the importance of a new capitalism permeating corporate mindsets in the future. Sir Richard Branson has been living and promoting this type of capitalism for over a decade. His motto, "do good, have fun, and the money will come," highlights how he runs his businesses. Branson says he puts employees first, customers second, and shareholders (a distant) third. Branson was a mentor to PayPal CEO Dan Schulman when Schulman served as CEO of Virgin Mobile from 2001-2009. Schulman has taken to heart much of what he learned from Branson, the most important of which is that a company's key stakeholder is its' employees.

The pandemic put a strong spotlight on the income inequality gap, which has forced leaders to rethink the idea that a company's sole purpose is to maximize shareholder profits.[12] "The 2020 World Economic Forum — an annual gathering of thought leaders, CEOs, economists, and heads of state — was dedicated to this exact conversation. Attendees were asked: How do economic leaders embrace stakeholder capitalism, the idea that a company should create a positive impact for all stakeholders?"[13]

In December 2020, Schulman told Business Insider that all stakeholders are important. But the way he sees it, PayPal's success stems from the success of employees. *"With happy employees, we can serve customers better, and when we serve customers better, regulators are happy, and if customers are happy and regulators are happy, then obviously shareholders over the medium term are happy as well," he said.*

"Two years after Schulman spun PayPal out of its parent company, eBay, he started hearing stories that some customer service employees were using a food bank to feed their families. Almost immediately after that, he created a $5 million employee relief fund." While Schulman expected some employees to apply for the fund to weather unexpected life events, like a car accident, or an unforeseen surgery, he was surprised to see the number of employees asking for money simply to help pay their bills. *"He decided to conduct a financial wellness survey of his employees and found out that some 60% of employees surveyed struggled to make ends meet."*

These results did not measure up to Schulman's employee-first mentality, so he decided to start a program to increase employee benefits and wages. After analyzing cost of living, transportation, housing, and other essential expenses, PayPal executives raised wages by an average of 7% and cut healthcare costs by 65%.

"In addition to heavy tech investments the company has made, Schulman said that the company's employee financial wellness program has set PayPal up for the success its' seen in 2020."

Employee productivity and customer satisfaction have jumped; staff turnover is down. "I believe all of that comes from having passionate, dedicated, caring employees. And I think that is reflective of what is happening in our share price well, and what has happened in our ability to serve customers," Schulman said.[14] It is no wonder that PayPal has been one of MWM Asset Management's best-performing companies and currently sits as our largest holding in the Dynamic Core Strategy.

The ideas behind stakeholder capitalism also permeate the widespread discussion surrounding ESG investing. Environmental, Social, and Governmental (ESG) consciousness is now front of mind with consumers, investors, and Americans as a whole. There is no doubt that companies like PayPal are seeing a positive impact on their bottom lines from their focus on being good corporate citizens and good businesses.

Judith Rodin and Saadia Madsbjerg, the authors of "Making Money Moral," and formerly with The Rockefeller Foundation (the organization that coined the phrase "Impact Investing" [15]), contend that there is a fourth element of corporate conscientiousness- Resilience. Covid-19 warned us that more crises with devastating human and economic consequences could be around the corner. This makes the need to build capacity to prepare more effectively, rebound more quickly, and even achieve transformation more urgent. Resilience is quickly making its way into corporate and investment conversations.

Rodin and Madsbjerg pose that resilient companies rest on five critical pillars that are buildable and measurable:[16]

- *"Willingness and ability to assess and absorb new information and adjust quickly using monitoring and feedback loops*
- *Diverse and redundant backups and supply chain alternatives to access if one part of the system is challenged*
- *Seamless information sharing, decision-making, and transparent communication that ensures coordinated action across their entire operations*
- *Strong self-regulating capabilities, so a failure in one part of the system can be delinked, preventing its spread, and permitting safer rather than catastrophic failure*
- *An ability to be nimble and adjust quickly to changing circumstances by developing new plans and taking new actions"*

We are very aware that our industry is overwhelmed by abbreviations, but nonetheless, we contend that ESGR should be the lens through which impact investments are viewed. With resilience considerations embedded in investment decisions, we believe the financial sector will be far better positioned to act as a catalyst for the creation of a world that is safer, stronger, more equitable, and more environmentally sustainable- in short, the kind of world in which we all want to live.

Final Thoughts

The foundation of MWM Asset Management has always been to align our clients' values and best practices in their businesses and lives with their investment holdings. That, to me, is the essence of ESGR investing, as well. So, one could say that we have been ESGR investors since the inception of the MWM Investment Strategies in 2013! There is never a reason, in our view, to sacrifice ethics, values, or convictions for the sake of profits. In a rare circumstance, one can have both in this case- the proverbial "having your cake and eating it too."

The definition we use for a great business was created from the values-based and results-based playbooks we saw so many of our entrepreneurial clients using to build their family businesses. Over the years, that definition has expanded to include new metrics that capture profitability (Return on Equity- ROE), balance sheet discipline, profit margin expansion, and market share. However, never lost in that process is the effectiveness of a company's management team, their focus on the professional development and working conditions for their employees, the positive impact they have on their communities and customers, beyond just making a good product, and the creativity and innovation to manage all the company's stakeholders (employees, customers, and shareholders) through challenging times. To us, grit has always been one of the most important factors to the success of any person or business. As Dr. Angela Duckworth, the author of the award-winning book "Grit," says, "grit is about having what some researchers call an 'ultimate concern.' A goal you care about so much that it organizes and gives meaning to everything you do. And grit is holding steadfast to that goal, even when you fall down."[17] In addition, great companies that stand the test of time are those that are also adaptable. Companies are not always going to get it right; they will fail; they will make mistakes; but those with the leadership that can own those mistakes, pivot, and continue to forge ahead, are the ones that will not only be the most successful but will also make the most significant impact on society. As Charles Darwin said, "It is not the strongest of the species that survive, nor the most intelligent, but the one most responsive to change." Therefore, we believe that a focus on ESG and the idea of doing well while doing good must include the "R."

A discussion about resilience always reminds me of this famous parable:[18]

> *"Once upon the time, there was an old farmer who had worked his crops for many years. One day his horse ran away. Upon hearing the news, his neighbors came to visit. "Such bad luck," they said sympathetically.*
>
> *"Perhaps," the farmer replied.*
>
> *The next morning the horse returned, bringing with it three other wild horses. "What great luck!" the neighbors exclaimed.*
>
> *"Perhaps," replied the old man. The following day, his son tried to ride one of the untamed horses, was thrown, and broke his leg. The neighbors again came to offer their sympathy on his misfortune.*
>
> *"Perhaps," answered the farmer.*
>
> *The day after, military officials came to the village to draft young men into the army. Seeing that the son's leg was broken, they passed him by. The neighbors congratulated the farmer on how well things had turned out.*
>
> *"Perhaps," said the farmer..."*

Like Forrest Gump said, "Life is like a box of chocolates -- you never know what you're gonna get."[19] Yet, the farmer is not delusional or apathetic but equanimous through life's ups and downs. And there is a subtle expectation that fortune will follow his misfortune.

It is important to have foundational beliefs that keep you composed, appreciate, and celebrate the good, and process trials knowing they will soon pass. This is a lesson well-served for life and business, especially for the future of today's great companies.

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