

## Margin for Error Chapter 4: Unintended Consequences

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Movies can stimulate, they can provoke, and they can cause people to react in several different ways. These reactions are, in many instances, unintended consequences, as some movies happen to affect people in ways that are hard to predict. There are a host of wide-ranging reactions that have come from film, from the ridiculous and insane to the heartfelt, and genuine emotional trauma that some feel when watching war movies. When *Saving Private Ryan*<sup>1</sup>, starring Tom Hanks, was released, WWII veterans flocked to the theaters to see this movie, but many had to leave within the first hour or less. They did not go because they were insulted but because the movie's realism brought back the trauma of their days in battle. The realistic gun battles, the beach landing, and the quick-moving camera angles depicting the action were enough to unnerve many individuals that had actually been there and experienced these horrifying times. At one point, the Veterans Administration fielded well over a hundred calls from those experiencing severe anxiety from watching the movie.<sup>2</sup> On the one hand, the movie's creators should be praised for the precise and impactful way they recreated one of history's most haunting times. Yet, the unintended consequences took some of the luster off of their accomplishments.

While not nearly as traumatic as war, many individuals and businesses are starting to experience similar unintended consequences from the Federal Reserve's actions to support the U.S. economy through the Covid-19 pandemic.

Federal Reserve Chairman Jerome Powell did a commendable job when faced with the COVID-19 crisis. As financial markets froze in March 2020, which affected even the most liquid and safest fixed income markets, the Fed lived up to its role as the bank of last resort. By simply stating its plan to purchase assets from municipal bonds to even high-yield securities, the Fed was able to soothe

markets and investors alike. The Fed enlarged its balance sheet by nearly \$3 trillion from March through May 2020.<sup>3</sup> This massive liquidity injection combined with timely fiscal stimulus wound up creating the strongest bull market opening since the Great Depression.

However, these ultra-loose monetary policies encouraged speculation and produced some classic asset bubbles. On December 16, 2020, the day the Fed announced its \$120 billion per month QE plan, Bitcoin surged to above \$20,000 for the first time.<sup>4</sup> Coincidence? I think not! About a month later, the surprising short squeeze of GameStop launched the meme stock craze that struck fear in the hearts of professional short sellers. "Stock and crypto trading is so in vogue now that there are numerous anecdotes of people quitting their jobs to become day traders, contributing to the labor shortage issue."<sup>5</sup>

These unintended consequences have led to widening inequality, as the rapid asset price appreciation has disproportionately benefited the investor class. First-time home buyers must compete with institutional capital targeting houses for rental income. Less affluent retirees cannot access traditional sources to generate interest income for their hard-earned savings, while their constrained resources must contend with soaring food and rental prices. However, according to inflation statisticians, it is not a problem since their substitution effect could model retirees riding to work on Bird scooters instead of driving cars!

Ironically, most free-market champions and economists would object to price controls by governments or business cartels yet readily accept central banks' manipulation of interest rates. "With the risk-free rate being one of the most important variables in our modern economy, central banks' unconventional policies might have created far



### By Michael Merlin, Founder of Merlin Wealth Management

Michael's focus has always been on demystifying financial, estate, investment, and philanthropic planning for his clients. With extensive experience in multi-generational planning and advisory techniques, as well as asset management, Michael leads MWM and its clients to partner together and create customized wealth plans that are steeped in the values and best practices of each family. Having built an institutional-quality asset management practice inside MWM, Michael and his team can even align their clients' investment plans with these same best practices.

more distortion in society than many run-of-the-mill government interventions. The proof is that more than \$13 trillion of bonds worldwide still have negative yields, and most developed market sovereign bonds currently carry negative real yields. In a world of less blatant intervention by central banks, rational investors would shun negative-yielding bonds and at least demand sufficient income to cover the expected inflation rate. As Chairman Bernanke said in 2012, even a CD should compensate for inflation, right?"<sup>6</sup>

The Fed's successful crisis management and ensuing dovishness in the face of rising inflation have also elevated the market's moral hazard – a lack of concern for risk on the assumption that the Fed would always provide a backstop. Investors have concluded that since the Fed was able to limit the duration of a bear market caused by the pandemic to under 40 days, a garden variety recession in the future would barely hurt the market. "Indeed, the co-CIO of a leading hedge fund has recently said that a recession would not be a problem for the market because we know what the policy playbook will be – more easing and deficit-financed spending."<sup>7</sup>

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The cost of this easy money-fueled prosperity is, of course, the risk of unchecked inflation. Can the Fed still pursue ultra-loose policies to reflate the economy if we are faced with an imminent recession while inflation remains elevated? Further easing in the face of elevated inflation would run the risk of tanking the U.S. dollar and fueling even higher inflation.

At the end of a recent "Fed Listens" virtual roundtable where Chairman Powell heard an earful from small business owners on the real-life challenges in running a business these days, he acknowledged, "We are really living in unique times... I've never seen these kinds of supply-chain issues, never seen an economy that combines drastic labor shortages with lots of unemployed people." Indeed, COVID-19 has been so disruptive that no one knows for sure how things will play out."<sup>8</sup> Adam Compton, Head of Asset Management and Portfolio Manager for MWM, will expand on these concepts in his upcoming Market Corner.

### **Irrational Exuberance**

Fed Chairman Alan Greenspan's famous remarks in 1996 clearly suggested he considered stock prices to

be too high. This was relative to his forecast of business prospects and the outlook for our economy at that time. However, after the Chairman's remarks, the Dow Jones Industrial Average increased 78% to more than 11,497 from 1996 to 2000. That was the first time I said to myself, "if the Chairman of the Federal Reserve with all the analytics at his disposal can't predict what the 'market' is going to do, it is unlikely that I (or others) can either!" This is why MWM started to focus on investing solely in well-managed growth businesses with durable competitive advantages and not the 'stock market.'

2000 to 2009 was considered by many a "lost decade" for the stock market. The S&P 500 Index was -0.95% during that 10-year period,<sup>9</sup> one of only a few decades that registered a negative result. However, many businesses we invested in during that period grew significantly, and their stock prices increased substantially. We still own many of these businesses today, and their growth trajectories are still quite impressive in our opinion. Both of these facts are excellent proof that the ownership of a great company is the best way to create and maintain wealth; and that ownership should also be focused on the long-term and not swayed by interim trends or an instinct to "tactically trade" these terrific businesses.

I began my career in 1998, right before the Long-Term Capital Management debacle, the Russian debt default, and the looming Dot.Com bubble bursting in March of 2000. Those times of heightened uncertainty turned out to be great opportunities to buy great companies at a discounted price. In fact, from March 2000 to September 30, 2021, the stock market increased 3.1 times, seeing the S&P 500 Index climb from 1,379 to 4,308 and the Dow Jones increase from 10,138 to 33,844!<sup>10</sup> This represented a 5.4% (S&P) or 5.8% (Dow) compounded rate of return over 21.5<sup>11</sup> years. What's even more interesting is if you invested at the height of the market in mid-1999, when almost every market pundit was screaming about nose-bleed level valuations, you still achieved a compounded rate of return of 5.2% (S&P 500).<sup>12</sup> There are two important takeaways from this data: (1) "timing" the market even at a time when the Fed Chairman himself was screaming about high valuations made essentially no difference in the long-term return; and (2) finding the great businesses of a generation or decade is critical to generating long-term returns above the benchmark.

So, despite impeachments, wars, 9/11, the Great Financial Crisis, multiple bear markets, the 1987 crash, crazy high interest rates, and crazy low interest rates, nominal U.S. GDP increased about 2.4 times since 1999.<sup>13</sup> The stock market grew even faster! In our opinion, this happened because more business models in Corporate America have changed to "capital-light" (more recurring revenues and faster technology-driven growth). Those characteristics are more valuable today as they provide

more transparency into the profitability trajectory of these companies.

The Merlin Wealth Management Investment Philosophy has always contended that the best way to create or maintain wealth is through the ownership of great businesses. The ownership of great American businesses also connects us with our country's future prosperity and economic growth. As Warren Buffett says, "never bet against America!" In today's economic environment, where inflation and higher interest rates are on everyone's minds, the ownership of these great American businesses—which typically have competitive advantages, pricing power, and earnings growth runways that far exceed any measure of inflation—also helps to maintain purchasing power. And, as I've discussed with many of you over the course of this year, the dollar historically has lost about half of its value every 17 to 20 years."<sup>14</sup>

### Blurring the Line Between Safety and Growth

At Merlin Wealth Management, we seek first to preserve and then grow our clients' capital. We are constantly risk-testing our equity portfolios and often use hedging strategies in the most volatile of markets. In addition, we attempt to identify companies in our portfolio that should be more resilient in the face of economic or

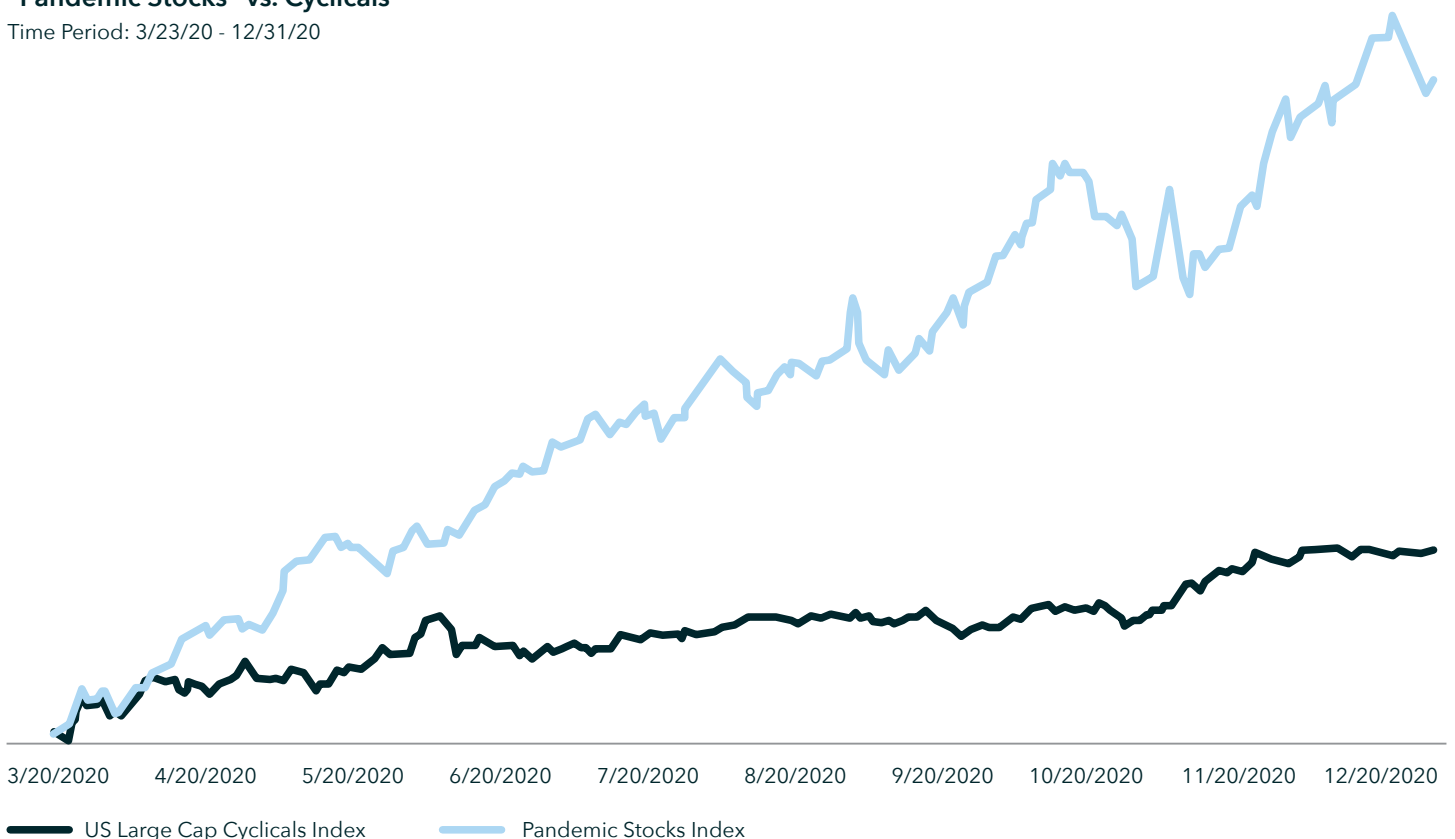
market volatility. "Historically, we found these "safety" investments in classic recession-resistant sectors like consumer staples. However, more recently, software subscription businesses appear to be taking on the same "safety" characteristics but with arguably more sustainable growth. Meanwhile, consumer staples companies have experienced slower growth and more competition and may even offer fewer safety characteristics than in years past."<sup>15</sup>

This new dynamic was fully on display during the height of the pandemic in early 2020. We saw traditionally "safe" stocks plummet as their dependence on the physical, consumer-facing economy was determined to be a weakness as we all went into an extended lockdown. On the other hand, software and data services companies like Microsoft were never more important to the individual or the companies for which they worked. As we've written about before in these pages, technology companies today are not your father's or grandfather's tech. Gone are the days of insanely high valuations, no earnings, and no cash flow. Rather, many of today's software companies in particular can offer some stability during challenging market environments due to their recurring revenue, strong cash flow, and higher levels of sustainable growth.

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### "Pandemic Stocks" vs. Cyclical

Time Period: 3/23/20 - 12/31/20

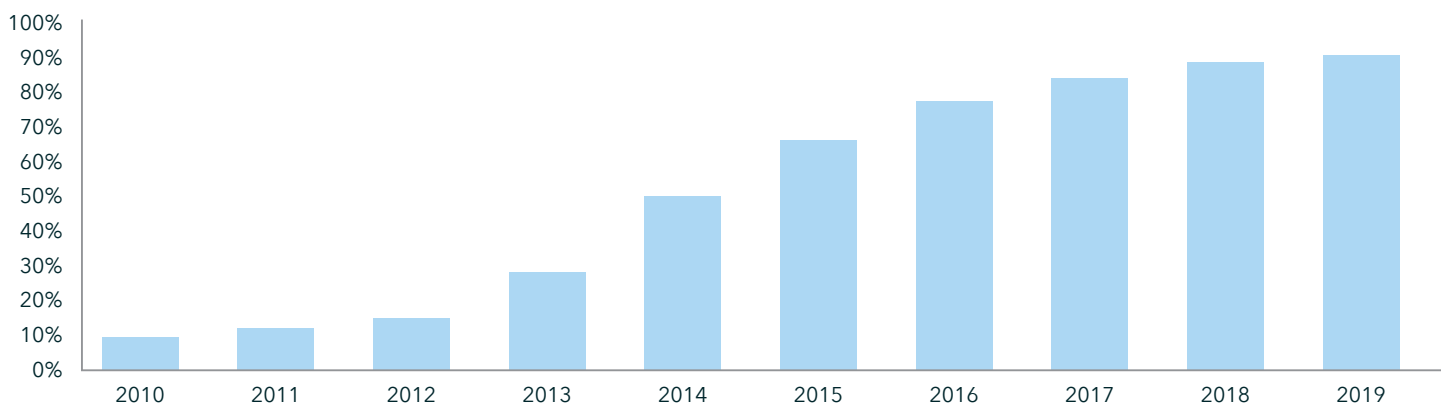


Source: Bloomberg (Pandemic Index is a basket of ZM, PTON, SQ, NFLX, ETSY, PYPL, MRNA compared to the Bloomberg Cyclical Index for date range 3/20/20-12/31/20)

“Arguably, no current holding in our strategies exemplifies the power of this subscription transition better than Adobe.”<sup>16</sup> Polen Capital, a respected peer in the asset management business, wrote in their whitepaper, Are SaaS Businesses the New Safeties? Here is an excerpt with charts from the piece:<sup>17</sup>

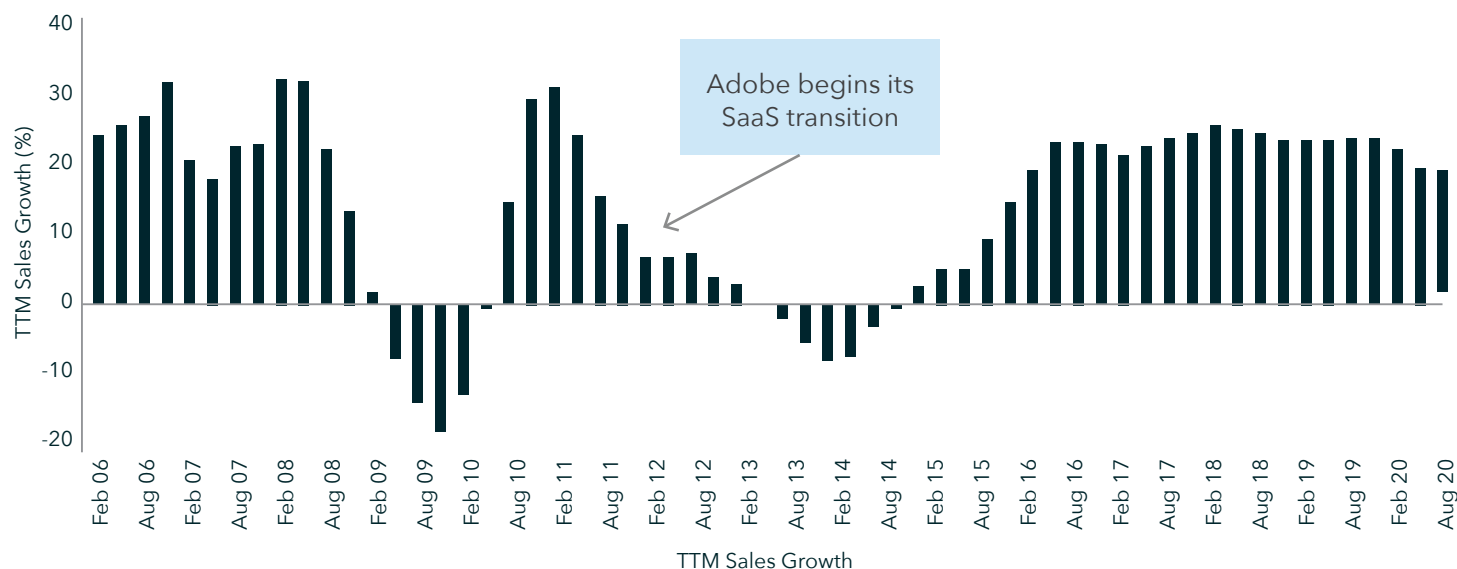
“One of the first large-cap companies to shift its traditional software business, Adobe turned its dominant digital media franchise into a SaaS-based model starting in 2011. Adobe's subscription revenues approached nearly 80% of total revenues by 2016, and sales growth was strong (20+%) and relatively more stable than before this period (see charts below). Compare this to the recessionary period in 2008-2009, where trailing twelve-month sales growth declined nearly 20% by the end of 2009, even though Adobe's software was as mission-critical to clients then as it is today. We believe the primary difference between now and then is the subscription structure of its business model. In the 2008-2009 recession period, it would have been possible for Adobe clients to temporarily delay paying for upgrades or maintenance services to reduce their expenses while still using their existing software license. Today, Adobe no longer provides this option. As a result, in 2020's weak economic environment, we have seen resilience in Adobe's revenue growth despite some deceleration.”

Adobe: Subscription Revenues/Total Revenues



Source: Company filings.

Adobe: TTM Sales Growth



Source: FactSet

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## The sale of a family business, or the decision to retire from a long and successful career, should be a celebrated end of one chapter and the beginning of another. Yet, that is not always how such a transition is perceived.

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Another positive investment theme has been the proliferation of digital marketplaces. With in-person shopping constrained and customers sheltering in place for most of 2020, digital marketplaces quickly became essential to consumers and businesses alike. The shift to e-commerce has been a windfall for established leaders (like Amazon) but has also given rise to new innovative marketplaces. Those that offer a frictionless framework, connect users in fragmented markets, focus on maintaining abundant supply for customers, and foster trust, are the types of marketplaces that we have and will continue to invest in. We believe the best management teams establish feedback loops to understand the needs of stakeholders on a deep level and make decisions through the lens of the customer. In our view, companies that exhibit these characteristics are best positioned to reap the long-term benefits of the secular shift to online shopping.

A great example of such a company within the MWM Equity Portfolios is Shopify. Shopify started out as an online store to sell snowboards. The founders discovered that none of the e-commerce solutions available gave them the control they needed to succeed. So, they built their own. Today, over 1.7 million businesses worldwide use Shopify as their all-in-one commerce platform to start, run, and grow a business. Instead of marketing their own products, Shopify provides the tools to small businesses everywhere to sell their goods and control their own marketplace.

Further, Shopify has created a network of global partners, including app developers, theme designers, and others who now provide a robust resource community for their merchants. All of this to drive more sales for each merchant, who will, in turn, reinvest in their businesses, benefitting their buyers, their enterprises, and of course, Shopify. The ease of access to high-quality tools, a rich network of resources to assist with business development, marketing, and sales, coupled with the demand for online shopping as described above, place Shopify in a unique position, in our view, to continue to grow their revenues and earnings rapidly. Investors clearly recognized this unique opportunity as well, driving Shopify's stock price from \$397.58 in December 2019 to \$1,022.01 today.<sup>18</sup>

### The Hourglass

It was inevitable. The hourglass, a revelation in time management, was unceremoniously replaced by the clock. The clock was more reliable, more accurate, and had parts that could be replaced repeatedly to keep the clock running, seemingly forever. On the other hand, the hourglass was clunky, imprecise, and when the glass broke, and sand went running out of the apparatus, there was no repair. However, while the hourglass may no longer be the preferred method of telling time (there's no way you're getting my Apple Watch off my arm in exchange for a bulbous, sand-filled timepiece), this unique instrument still teaches us amazing lessons that are relevant to this very day.

The hourglass, in many ways, is a metaphor for life. The grains of sand represent years or memories that make our lives so special—different grains of sand, different colors of sand, different shades of it. And, while the sand is running out of the hourglass slowly, eventually, it empties. We would love to flip that hourglass over and start again in life, but we know that is impossible unless you are Doc Brown or Marty McFly and have a really cool DeLorean.

When it comes to our business lives or retirement planning, we all get a "second life" when the proverbial hourglass flips over. While that sounds refreshing and exciting, for many, these can be the most difficult years in their financial journey. The sale of a family business, or the decision to retire from a long and successful career, should be a celebrated end of one chapter and the beginning of another. Yet, that is not always how such a transition is perceived.

Think of it. For your entire life, you work to save money, build a business, a legacy if you're lucky, and then with the stroke of a pen, all of that is over. You wake up the following day, and there are no emails in your inbox other than the ones trying to sell you something; the phone doesn't ring as much; that neurotic energy that you carried with you every day that drove you to succeed isn't burning as fiercely in your stomach.

Whether retiring from a long and successful career or selling the business you built from the ground up, we



identify two conditions that afflict almost every client we encounter at this stage of their financial lives- The Hourglass Syndrome and Separation Anxiety.

The Hourglass Syndrome is simple to understand but not nearly as easy to overcome. We are taught from a very young age that we should save money for a rainy day or to buy things we may covet but can't afford at the moment. Later in life, we learn that if we can save money and invest those funds at a reasonable rate of return, we can accumulate enough wealth that, at some point, we can stop working. However, it is awkward to start taking money out of our savings when we've spent so many years accumulating it when that day comes. I equate it to the hourglass. We fill the hourglass with grains of sand (money) over the course of our lives, then we turn it over at retirement or at the time of a liquidity event, and even though the grains of sand are coming out slowly, it is still an uncomfortable feeling. For some, that sensation is just the breaking of a habit they've relied on for decades. For others, when they lost money in the past, they always had the income to replace those grains of sand in the hourglass. With the hourglass turned over, there is a sense of permanency to what they have and a discomfort in knowing that they can't add to the pot as easily.

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The salve for the discomfort caused by the Hourglass Syndrome is time and sound planning. A sound cash management, investment, estate, and philanthropic plan, create a machine and a structure that helps ease the transition from saving to spending. As time passes, well-structured wealth continues to grow while also providing all the necessary income and liquidity needed for life and legacy. As this construct becomes the new normal, the anxiety brought about by the Hourglass Syndrome fades away. As the saying goes, "I love it when a good plan comes together!"<sup>19</sup>

When you research separation anxiety, most of what you find talks about children fearing separation from their parents or a dog that barks and runs in circles when its owner leaves the house. In either case, what you learn is that separation anxiety is less about the act and more about the thought. The child or the pet is fine alone, but the idea of that loneliness brings anxiety.

The same is true when we wake up on the first morning we don't have to show up at the office. We'll be fine, but the thought of it scares us to death. The Hourglass Syndrome enhances the sensation of this separation anxiety from a career or family business. Anxiety like this can lead to poor decision-making, the aftermath of which can be quite costly. We often think we can replicate the sense of accomplishment and the adrenaline that comes with success by investing passively and giving advice to others trying to do the same. While we wholeheartedly believe that the key to moving past separation anxiety from a business or career is finding new endeavors to occupy our minds, rarely can a passive investment opportunity provide that satisfaction. We advise entrepreneurs to join boards of directors or donate their time to provide mentorship and pass along the best practices that made them successful. Similarly, we always counsel our clients that investments in businesses- public or private- should be made dispassionately and based on a reliable and repeatable discipline. Investing in a business to try and relive a time that has passed usually leads to an undesirable outcome that is not just financial.

Conversely, there are incredibly effective strategies that allow a founder or former executive to feel like they are *paying it forward*. As I mentioned before, serving on company boards is one way. If the family business was passed on to the next generation, acting as an advisor to provide key advice to the new leadership is another. Also, philanthropy can be a very fulfilling way to use one's energy and past experiences to benefit others.

In the end, we don't want to be like Robin Williams in the acclaimed film Mrs. Doubtfire<sup>20</sup> dressing up in a latex mask and bodysuit to "spy" on our old lives. Instead, like the transition from the hourglass to the clock, we should embrace this new chapter of life with excitement and optimism, knowing that it is the reward for our hard work, courage, and persistence.



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