THE LONG RUN

"They overturn the old order in a few hours or days, the whole upheaval takes a few weeks or at most years, but the fanatical spirit that inspired the upheavals is worshiped for decades thereafter, for centuries."

~ Boris Pasternak, *Doctor Zhivago*

Vladimir Putin. After the blush of world attention at Sochi (albeit spiced with repeated harpooning of his penchant for bare-chested horseback riding), the Russian leader rode a wave of decisively nationalist fervor all the way into Crimea. And, as of this writing, he is poised to annex more of eastern Ukraine which he recognizes as naturally Russian territory. Though shocking to the West, these brash forays have been cheered in the streets and in the government halls of a Russia that clearly seeks to revisit the glory days of the U.S.S.R.

We have been talking in our recent *Long Run* letters about the likelihood of a correction in the developed markets after what has been an historically long period of upward tracking without a significant retracement. We have discussed the structural issues in China that we believe have created a secular problem for emerging economies where growth is linked to China's unsustainable hyper-industrialization. Our thesis continues to be that deleveraging will mute overall global GDP growth for some time and that investors need to be focused on areas of innovation and invested in high-quality, low-debt companies for growth – avoiding the significant exposures that come with wide-investment architectures that are not designed for today's world.

In light of these clear global problems, the news out of Russia has been just the kind of surprising, unforeseen event that might usually tip the markets toward a meaningful correction. Well before troops started marching into the Crimean Peninsula, news desks had been channeling the specter of World War I on this 100th anniversary – likening the geopolitical tectonics and oblivious discourse of pre-war 1914 to our current world order and governmental dialogue. With this context, one would imagine that this eerie echo of unanticipated aggression in Eastern Europe should have side-swiped the markets with unusual force. Perhaps a deeper correction is yet to come; but, thus far, we have seen only an internal struggle in markets that are effectively moving sideways. High-momentum stocks that soared in 2013 have come down to earth, and technology shares have given way to consumer staples and other value stocks which have enjoyed a nice lift.

We believe that it would be healthy for the market to correct further as a natural course of consolidating gains. However, we also take heart that there is some good news behind the lack of an immediate sell-off on the Russian surprise.

Throughout this long recovery, markets have been fearing the menace of another "black swan" event. A "black swan" event, as popularized by Nassim Taleb, is a highly improbable, under-considered, contrary event that can lead to enormous disruption and pain – a perfect example being the overleverage in financial institutions in 2007 which led to bank failures and the ultimate unmasking of so much interconnected risk that it threatened the stability of the entire global financial system in 2008. For too long, investors have allowed the trauma of this recent crisis to dominate their perspective. Focused only on the potential for the next apocalypse, many investors have spent so much capital (both emotional and monetary) insuring themselves against the next potential "black swan" event that they have missed the entire recovery.

Many extreme calls made by prognosticators in 2005 and 2006 were validated by the financial crisis. These pundits have taken on exalted status – the more extreme the call, the more airtime he or she receives to map out the next explosive event. But investors beware, a recent article in the *New Yorker* explained that being spectacularly right once doesn't guarantee being right in the future. In fact, the opposite may be true. The author points to a study by business school professors Jerker Denrell and Christina Fang which found that people who successfully predicted an extreme event had *worse* overall forecasting records than their peers. “People who make these bold predictions tend to overestimate how likely extreme events are,” commented Fang. The *New Yorker* article also pointed out that success breeds overconfidence, citing Irving Fisher, an economic forecasting pioneer who announced that stocks had reached a “permanently high plateau” two weeks before the crash of 1929, and Meredith Whitney, who gained fame for her accurate call before the financial crisis that Citigroup would have to take huge write-downs and eliminate its dividend – only to be woefully incorrect with her warning (announced on *60 Minutes*) that municipalities across the U.S. were likely to default, costing investors “hundreds of billions of dollars.”

Our collective antennae for negative events are certainly up, and speculation today is much more centered on what can go wrong than it is focused on what can go right. Perhaps this limited reaction to Russia’s bellicose incursion signals a growing awareness in today’s markets that truly extreme financial events may be less common than we had conditioned ourselves to believe in the shadow of crisis. It may also be a sign that investors are recalibrating – understanding that a certain degree of disorder and volatility is the normal state of the global economic system.

Of course, the continued buoyancy of markets may have a great deal to do with the fact that the largest economy in the world continues to show signs of economic strength. The polar vortex chilled GDP growth here in the U.S. over a winter that many of us will be happy to put in the rearview mirror, but recent numbers have come in above estimates. The U.S. reached new highs in March for both domestic corporate profits and for total capital expenditures. The Institute for Supply Management (ISM) reported that economic activity in the manufacturing sector expanded in March for the 10th consecutive month, and that the overall economy grew for the 58th consecutive month. In addition, the non-manufacturing Purchasing Manager’s Index for employment rebounded sharply in March. Finally, The ISI Group’s March trucking survey, which measures movements of goods through the country and is highly correlated to GDP growth, reached its highest level since January of 2006.

It is important to study and understand the macroeconomic environment in order to avoid areas of unusual risk and to uncover industries and geographies where transparency, growth, and reasonable stability combine to deliver sustainable long-term investment opportunities. However, the quality and power of the underlying assets that we hold for clients are what allow portfolios to be resilient in down cycles and dynamic in up cycles. New research has come out showing that investments in the highest-quality companies have beaten the market over long periods. Jeremy Grantham comments, “Quality has outperformed forever.” Data from his firm, GMO, confirmed that “high-quality” companies have outperformed the S&P 500 by a cumulative 50% since 1965. Not only did they produce higher returns at lower risk, but they did best in times of market turmoil.

A recent study by Lasse Pederson of New York University looked at the performance of nearly 40,000 stocks in 24 countries (including the U.S.) since 1951. They used four measures to sort out “quality” companies: High profitability, high earnings growth, safety (measured in terms of low-stock volatility, low leverage, stable earnings, and high credit-ratings), and payouts (measured as the percentage of earnings paid to investors as dividends or through share buybacks). The study found that quality stocks tended to beat the market by about 3% a year on average. Further, it found that quality persisted – meaning that high-quality companies tended to stay high-quality over time – and that these quality stocks tended to outperform the most in times of stress.

We have always been vigilant about keeping our balance and our discipline as investors – recognizing that high-quality companies with strong balance sheets and sustainable cash flows are some of the best assets to invest in through times of distress and periods of prosperity. The performance of our Core Equity Composite through this harrowing economic cycle of the last eight years has certainly underscored the merits of this approach. With general market valuations approaching historic norms, we believe careful selection and a strong focus on quality will be a winning course as we head into the next market cycle. If continued discord in the global geopolitical landscape should lead to prolonged weakness in the general markets, we are prepared to redeploy some of the cash that we raised as the market soared in 2013 into high-quality companies with sustainable long-term growth prospects. And we continue to advise clients to hold close to their established long-term asset allocations.