

The Quarterly Report

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Details *Still* Matter

INSIDE STORY

*"It's the little details that
are vital. Little things make
the big things happen."*

-JOHN WOODEN



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JOHAN WOODEN is arguably the greatest coach of all time. Not just the greatest basketball coach, but perhaps the greatest coach of any kind. The man won ten national championships. To put that in perspective, that is twice as many as Mike Krzyzewski. What made him so good?

In his book, “Wooden: A Lifetime of Observations and Reflections On and Off the Court,” Coach Wooden admitted that he was not the greatest tactician in basketball. He gave Dean Smith credit for being the best teacher of fundamentals he had ever known. He credited his own success to his attention to detail. The most famous example of which was his annual first practice. Many coaches have first practice rituals. Dean Smith made his team run as fast as they could for 12 minutes, a tradition also used by football coach Don Shula. Wooden, however, spent his first practice teaching his players how to correctly put on their socks.

That is right. Wooden would sit his team down and show them the proper method for putting socks on their feet. This might seem silly, but remember Wooden’s prime was in the 1960’s and early 1970’s. Today when I go for a run I put on socks that are made from a manmade material that wicks away sweat. They are contoured to my feet and marked right and left so I know which sock goes where. In Wooden’s day the socks were cotton and they were straight tubes. They would get wet and sag and rub, and most importantly cause blisters. Blisters hurt, and if you have blisters on your feet you are likely to move slower than if you don’t. Wooden wanted his team to be the faster team on the court, which meant they had better be blister-free, and that required adequate attention to putting socks on properly.

It also sent a message to his team: details matter. I wrote about this back in 2010 when Congress was debating massive new regulations of the healthcare and financial industries. I focused on what I know best, the financial realm. We were recovering from the financial crisis, which was blamed on a lack of regulation. For those of us who have spent our careers in the financial world it was laughable to suggest that there was not enough regulation, yet to the outside world this was a simple, easy explanation for the financial crisis, and therefore it became the unquestionable story.

I argued at the time that most in the financial world would welcome regulatory reform. It should not be about the number of rules, but about getting the rules right. There should be a consolidation of regulators. As it stands now some large financial firms have as many as five different regulators, and they tend to contradict one another. It is a major frustration for ethical firms just trying to comply, but an opportunity for those who wish to shop regulators. This was a problem leading up to the crisis and it was only made worse by the addition of the Consumer Financial Protection Agency. Instead of having fewer regulators, the big banks got one more.

Just as I was writing this, the media announced that Wells Fargo has “clawed back” \$75 million in compensation to their former CEO and the former head of community banking Carrie Tolsted. This was in response to the fact that Wells Fargo, specifically the department run by Ms. Tolsted, created fraudulent accounts in order to meet sales goals and receive bonuses.

The outrage over this scandal, which broke into the news last Fall, is understandable. However, I have yet to read a mainstream news article asking the question, Where were the regulators? Let us count them: There is the aforementioned Consumer Financial Protection Agency; the Securities and Exchange Commission; the Office of the Comptroller of Currency; The Federal Reserve; and the state regulators in California and Arizona where most of these activities took place. Which one of these policemen caught Wells Fargo red handed? It was the LA Times.

If adding regulations and regulators worked, then we should be all for it; but it doesn’t. This is a fact that many in America have come to accept. Now there is a different political wind blowing. The desire for a change of course – any change of course – was sounded loud and clear last November.

Leading up to our general election for the office of president, a political outsider with an abrasive style received 45 percent of the Republican primary votes – enough to win in a very crowded field. On the other side a self-described socialist won 43 percent of the Democratic primary votes. In a field of only two, that similar result did not have the same effect. However,

put together, a strong majority of voters agreed that the current path was not working.

The day after the election the stock markets rallied, and this strong momentum is just now beginning to slow. We will never know, but I suspect that the rally would have taken place regardless of the victor. The day after the election I believe the markets were mostly excited about the fact that there was no call to count the hanging chads in south Florida; that the election was decisive was enough of a call for celebration in and of itself. I say this because there was a real fear that the election would not be decided on election day, and that outcome would have been taken as the worst possible outcome by a market that dislikes the perception of uncertainty more than anything.

I also say this because the rally actually started in the third quarter, before the election and during a time when most experts were calling for the opposite outcome. The rally took place because for a few years the market had been so focused on the lack of economic growth and the extraordinary moves of the Federal Reserve that most stocks were priced well below their real value. After all, stock is simply ownership of a company. Ultimately it is the business results of the company that should matter. Politics, interest rates, and the daily news obsessions may have some impact on the business of various companies, but they are not the biggest driver. People buy iPhones in communist China just as they do in democratic America. Eventually the market comes back to business fundamentals and that is what started the rally.

That fact notwithstanding, the outcome of the election has certainly influenced the character of the rally. The stocks of financial companies took off like wildfire, and that probably would not have happened to the same extent. International stocks initially did not participate, although they have gotten back in the game more recently. These occurrences are influenced by the anticipated policies of the new administration. This is an important distinction. Our current political atmosphere is emotional, and it is driven by personality over substance. Financial markets, on the other hand, are not reacting to personality. While there may be some short-term trading on tweets and other out-of-context comments, the real trading is about policy.

I know it is an old-fashioned notion, and perhaps a bit romantic, but at Iron Capital we still believe that actions speak louder than words. There are three actions that the market is anticipating. First, the market anticipates tax reform, and at the very least, corporate tax reform. Secondly, the market anticipates de-regulation. Finally, the market is anticipating some restriction in international trade. We see the first two as positives, while the latter would be a huge negative.

Let's take these in order. Corporate tax reform is one of many issues where just about all experts agree on the need for it to happen. Yet because of our dysfunctional political environment, nothing gets done. Meanwhile the U.S. has lost its competitiveness internationally because we have among the highest corporate tax rates in the world. Some would argue this is misleading because so many corporations have been given favorable treatment and/or find loopholes. What is not fully understood is that this is precisely the

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THE 4TH QUARTER 2016 GDP

growth came in at 2.1 percent and first quarter is thought to be a little slower. The optimism for more pro-growth policies remains strong and sentiment levels have risen.

The official unemployment rate dropped to 4.5 percent in March. Jobs growth slowed a little but the labor market is looking strong.

Inflation has kicked up and the 12 months ending February gave us a reading of 2.7 percent. The Fed continues to raise rates as this is now above their 2 percent target. Thus far that has gone along with greater optimism. Time will tell if that continues. +

REVIEW of ECONOMY

THE RALLY CONTINUES. For the quarter the S&P 500 was up 6.07 percent. Growth outpaced value in a change from the early part of the rally. The Russell 1000 Growth index finished up 8.91 percent, while its value counterpart was up 3.27 percent. Small companies came back to earth as well with the Russell 2000 index finishing up 2.47 percent.

Bonds rose slightly during the quarter.

The Barclays US Aggregate Bond index ended up 0.82 percent. High yield bonds ended the quarter up 2.71 percent.

International stocks rejoined the rally. The EAFE index finished up 7.39 percent and the MSCI Emerging Markets index ended the quarter up 11.49 percent. +

REVIEW of MARKET

MARKET *forecast*

THE RALLY IS DUE FOR A PAUSE. The rotation back to growth from value does not bode well for its longevity. The hope for more growth friendly policies needs to be fueled by some actual policies. We remain optimistic for the year but would not be surprised if we have a flat summer.

Emerging markets still look attractive and the rally in international stocks should have more legs.

Bonds remain our biggest concern over the long term and will until the yield on the 10 year treasury exceeds 3 percent. The run in high yield bonds will likely slow down, but not stop. +

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The devil is always in the details.

problem. High tax rates always lead to political favors for the well-connected. Again, there is no debate on this in economic circles. Sure, different economists may have different ideas about what an ideal reform would look like, but there really is not anyone who does not agree that reform is necessary.

Similarly, the need for regulatory reform is universally agreed upon. The problem the U.S. has in our regulatory mess is that old regulations never seem to die. We need rules. The rules should be clear, and they should hold people accountable. Take Wells Fargo's Ms. Tolstedt for example. She fraudulently created accounts to hit sales goals and gain huge bonuses. The Dodd-Frank financial reform is 848 pages long, and that is just the tip of financial regulation. While Wells Fargo itself is going after Ms. Tolstedt, there are no reports of which we are aware that any regulatory body is trying to prosecute her. Compare that to the Eighth Commandment, "Thou shall not steal." That is just four words, but Ms. Tolstedt would have a difficult time escaping accountability from that regulation.

Trade reform is a trickier issue. While it is understandable that some people see protection from international competition as a good thing, the fact is that international trade is a net positive for all involved. Without trade our lives would be far more difficult. However, some countries have cheated on trade deals with very little ramifications. As with all these issues, we are guilty of speaking in very broad terms. Trade is a positive thing, but are our friends in Canada subsidizing lumber prices to undermine U.S. competition? Senator Ron Wyden of Oregon called this, "the longest running battle since the Trojan War."

It is easy to say we need tax and regulatory reform. It is easy to say that trade is good. However, the devil is always in the details. The market has rallied a long way since the election largely on the assumption that we would get lower taxes, better regulation and that the trade talk is only talk. No one knows if any of these things will happen. If they do happen, what will they look like?

We are as happy as anyone that the market has rallied over the last three quarters, and all in all we are happy with the results we have been able to deliver. However, we did not make a single decision based on policies that have not happened. We did not "bet" on any outcome of the election, and we have not piled on to hot trades built on assumptions of details to come. If we have said it once we have probably said it a thousand times: Prudent investment decisions are made from the bottom-up: Is this company a good investment? This means that prudent decisions are not made from the top-down: What impact will Trump's policies have?

Don't get me wrong. I would love to see thoughtful tax reform. I would love to see simpler regulations that bring actual accountability. I hope we don't repeat the trade mistakes that contributed to the Great Depression and ultimately to World War II. But, these wishes are not the basis for prudent investing. We will stick to making bottom-up investment decisions and pray that policymakers understand that details still matter.

Warm Regards,



CHUCK OSBORNE, CFA
Managing Director