The Quarterly Report

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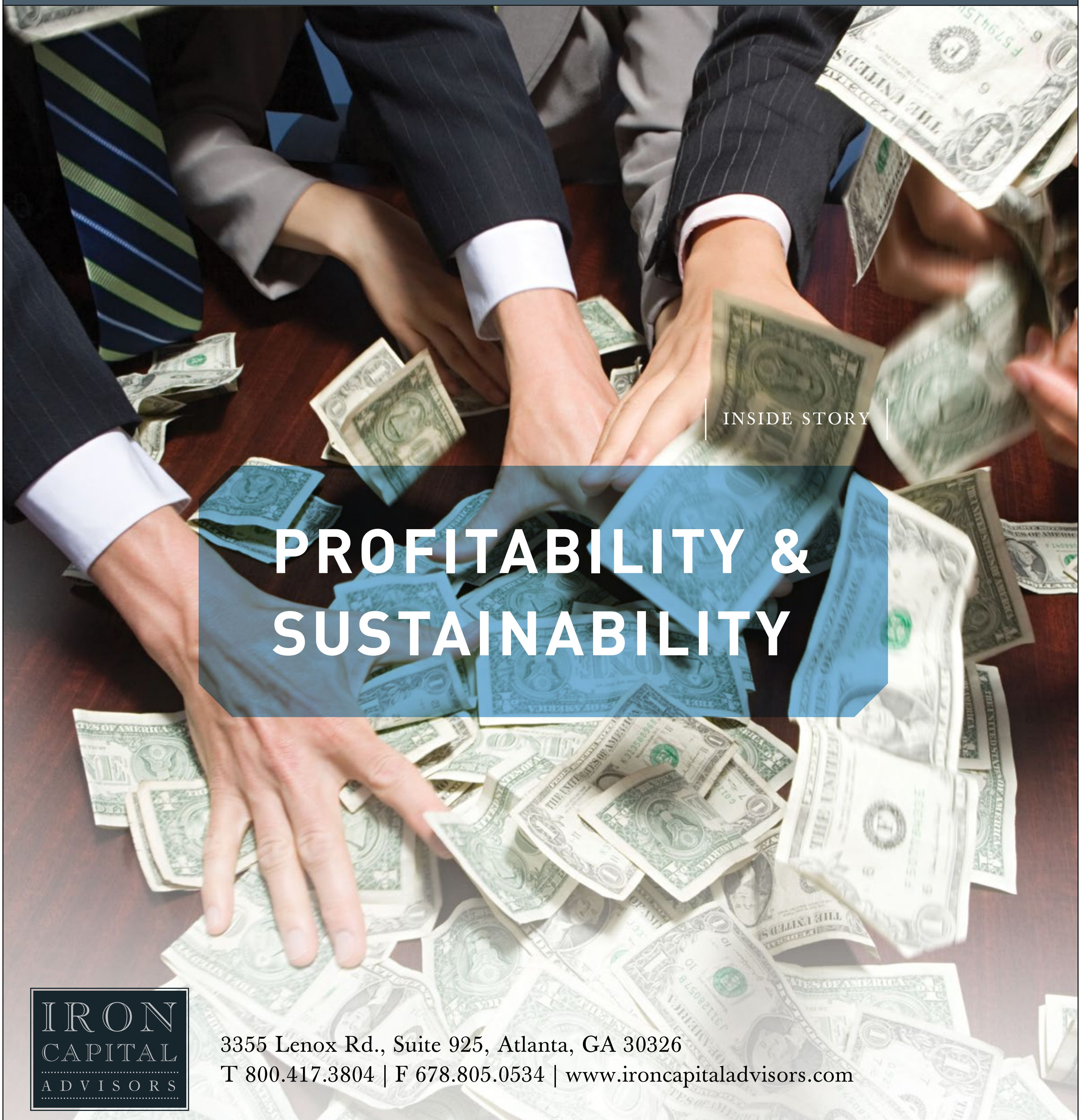

INSIDE STORY

PROFITABILITY & SUSTAINABILITY

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PROFITABILITY & SUSTAINABILITY

I have a daughter who just turned seven years old. Approximately 18 months ago she finally got over the phenomenon which will partially define children of her generation: Yes, I am speaking of the Disney movie Frozen. Much like earlier generations are defined by Bambi, The Jungle Book, The Little Mermaid or The Lion King, my daughter's time is marked by Frozen.

My parents are lucky. Once the movie was out of the theaters there was no way for my generation to keep watching. My wife and I, on the other hand, have seen or usually just overheard Frozen at least 30 times. Fortunately for us Disney is very good at throwing the parents some entertaining bones that go right over our children's heads. One such scene in Frozen is when Princess Anna is going after her sister, Princess Elsa, aka the Snow Queen in the original fairy tale, who had inadvertently turned summer into winter. Just before she freezes to death, Anna comes upon a small store which is largely stocked with summertime goods, except in one small corner. The store owner charges her an outrageous amount for her winter supplies because, "These are from our winter stock, where supply and demand have a big problem."

This is when my confused daughter would look at me and wonder why I was laughing. She did not understand the humor of a price-gouging capitalist being plopped in the middle of a movie inspired by an old Hans Christain Andersen fairy tale. This is, however, many people's view of what it means to be in a for-profit business: the cliché goes that it is all about gouging people, getting the most one can out of every sucker.

Last quarter I wrote about healthcare. I courageously predicted that Congress would end up doing nothing. While it is always somewhat gratifying to be correct, I admit that was not my boldest of predictions. The reason I felt so comfortable in that prediction is because healthcare requires tough decisions, and politicians don't do tough decisions. We need statesmen for that, but this term is so far removed from our current reality that it hasn't even been degenderfied.

The need for profit drives efficiency and innovation

One of our readers responded asking why I did not bring up insurance company profit margins as major driver of costs in our system. So, let's bring it up.

A few years back I was on the board of an industry group now known as the Atlanta Society of Financial and Investment Professionals. They provided new board members with an orientation/training session. The material finally got around to the finances of the organization, and the first slide simply read: Not-For-Profit is an Income Tax Designation, NOT a Business Plan. What did they mean?

To understand what they meant one must understand the definition of profit. Investopedia.com defines it as follows: *Profit is a financial benefit that is realized when the amount of revenue gained from a business activity exceeds the expenses, costs and taxes needed to sustain the activity. Any profit that is gained goes to the business owners, who may or may not decide to spend it on the business.*

To put it another way, to be profitable an organization must spend less money than it generates. Where have we heard this before? The number one goal for individuals in financial planning is to spend less than they make. It is the only way to be financially stable. If one spends more than he makes, it will not take long for him to go bankrupt. If one even spends exactly what she makes, she still is living paycheck to paycheck and is one bump in the road away from financial ruin. Why would an organization be any different?

In fact, they are not. I have spent most of my career in for-profit businesses, but I also worked for the Life Office Management Association (LOMA) at one time. LOMA is an industry educational association and a not-for-profit organization. When I was there we had two cost-cutting reorganizations, and the second time the president was replaced with someone who could focus on the bottom line. Not-for-profit is a tax designation, not a business plan.

Organizations, just like individuals, must spend less money than they make or they will eventually go bankrupt. But, this does not directly answer the question of whether the need for profit raises prices. Let's think on this for a while. What organizations do you associate with the term "low prices"?

My guess is that you came up with names like Amazon, Walmart, or maybe Dollar General. These organizations operate as a for-profit entities. They are corporations, you know those evil things that provide people with everything they want, including jobs. Amazon recently purchased the grocery chain Whole Foods. Did you hear anyone saying, "Now that Whole Foods is owned by a business they are going to raise all their prices?" No, it was exactly the opposite.

It is shocking to me how so many people who live in a world blessed by the freedom of capitalism do not understand it and even claim to despise it. Capitalism is driven by what Harvard Business School professor Clayton Christensen calls disruptive innovation. Disruptive innovation is not invention; it is not coming up with some grand new technology. That isn't what innovative capitalists do. What they do is take technology that already exists and make it cheaper and more available to the masses. The profit motive does not drive prices up; in reality it does the opposite.

The motive for profits drives efficiency. It drives the quest to make one's products available to more and more people. The only way to do that is to be better at what you do so that more people want what it is you offer, and to be able to give it to them at a price they find reasonable. Henry Ford did not invent the automobile, no matter how many times you may have been told otherwise; he invented the production line, which was a way to produce cars so cheaply that everyone could afford one. He became a very rich man by selling cars at a price his own employees could afford. Today Amazon makes reading less expensive and Netflix brings entertainment to us less expensively. This is what capitalism's profit motive does.

If one wishes to criticize capitalism it would be much more accurate to mourn the demise of the local bookstore. Grocery stores replaced the local market and now grocery stores face off against Walmart on one side and Amazon on the other. One also could accurately point to situations where individuals cut corners to cut costs. These are far more accurate criticisms.

What about high costs? In what areas of your life do you run into outrageous prices? My guess is the first two thoughts that came into your mind were healthcare and education – both industries dominated by not-for profit organizations. I graduated from Wake Forest University is 1992. The last year of my college experience, the full cost of attending Wake Forest was $12,000. Upon graduation I purchased the first car I ever paid for myself: a Toyota Camry, which cost approximately $16,000. Today the manufacturer's suggested retail price for a Toyota Camry is $23,070, while today total cost at Wake Forest University is $66,512. Toyota is a for-profit corporation, while Wake Forest University would never stoop to such levels.

The need to produce profits also does something else: It promotes sustainability, which is a very popular notion in our culture today. Most of the time, the people who use this word today are speaking of environmental sustainability (which is also possible only in a capitalistic society, but that is another topic). I am speaking of economic sustainability. The need for profit drives efficiency and innovation, and without these things organizations eventually collapse. We are beginning to see this already within education. Just a few years ago Sweet Briar College in Virginia shut its doors. Dedicated alumni bailed them out, but the college is still far from out of the woods. Moody's has predicted that college closures will triple in 2017.

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REVIEW *of* ECONOMY

The 2nd quarter 2017 GDP growth came in at 3.1 percent and third quarter is thought to be strong as well. Without some actual policy movement it is unlikely that this can continue. But if tax reform gets done then we could see a brighter future.

The official unemployment rate dropped to 4.2 percent in September. The labor market keeps improving and perhaps more importantly we are seeing wage growth of 2.9 percent. That is an encouraging sign.

Inflation is at 1.9 percent based on the latest consumer price index report. This appears to be close enough to the Fed's 2 percent target to continue its tightening. +

REVIEW *of* MARKET

We just keep climbing. For the quarter the S&P 500 was up 4.48 percent. Growth outpaced value for the third quarter in a row. The Russell 1000 Growth index finished up 5.90 percent, while its value counterpart was up 3.11 percent. Small companies held their own with the Russell 2000 index finishing up 5.67 percent.

Bonds rose slightly during the quarter. The Barclays US Aggregate Bond index ended up 0.85 percent. High yield bonds ended the quarter up 2.04 percent.

International stocks led the way. The EAFE index finished up 5.47 percent and the MSCI Emerging Markets index ended the quarter up 8.04 percent. +

MARKET *forecast*

We have been calling for a pause and continue to do so. The question mark is what comes out of Congress on taxes? If some tax reform gets done then the rally is likely back on and the beneficiaries are likely value stocks and small company stocks.

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. High yield remains the best place within the bond universe. +

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When a for-profit organization suddenly becomes unprofitable, the reaction most of the time is to look for ways to cut costs. Leadership makes hard decisions which may sometimes mean cutting jobs. It is hard and unpopular, but often it is the only way to survive. On the other hand, at not-for-profits the answer too often is to raise prices. Universities for too long have just raised tuition. This building isn't working, let's build a new one. Finance professors don't like being part of the larger Economics or Business schools; fine, they can be their own department. We'll just get a gift from an alum, or once again raise tuition. It is not sustainable.

> *Show me a company that is growing earnings primarily through raising prices, and I will show you a stock that should be sold immediately*

This is also true when making investments. I would be naive to believe that no lazy executive hasn't looked at their bottom line shrinking and decided to raise prices. It does happen. Some companies can do it more easily than others; we call it having pricing power. It is the kiss of death. Show me a company that is growing earnings primarily through raising prices, and I will show you a stock that should be sold immediately. The days of this company are numbered. When high prices exist in a world where others are free to compete, then competition is not far behind and that competition will deliver justice to price-hikers. If you don't believe me, then ask Borders Books or Blockbuster or the hundreds of other companies who no longer exist today because they failed to compete.

Another misconception is that all profits go to the owners. This is not true in most businesses and certainly not true in the best businesses. When profits are paid out to owners they come in the form of a dividend. It is true that at one point in our history the vast majority of profits were paid out to the owners. According the Wikipedia the average payout ratio – the percentage of profits given back to the owners – for the S&P 500 was 90 percent in the 1940s. Today that rate is 30 percent. The amounts not paid out to the owners are reinvested in growing the business. The better the business, the more money is usually reinvested. Amazon does not pay out any of its profits, nor does Netflix, Alphabet (Google's parent company), or Facebook. That reinvestment leads to new products, new departments, new jobs and usually higher wages.

So, does the insurance industry's for-profit structure lead to higher cost in healthcare? The simple answer is no, it does not. I want to be clear that this does not mean that health insurance companies don't share blame in the total mess that is our healthcare industry. They certainly do. I am simply saying that being for-profit is not the problem. When we think about our daily lives in terms of the things that bring us joy and bring us stress, this truth becomes self-evident. Would you rather order something from Amazon or wait in line at the post office? What is more fun, buying a new car or getting a new driver's license?

Granted, Disney films can bring joy and stress…joy to the child, stress to the parent who must listen to that song one more time…but our kids do eventually grow out of it. Fortunately, Disney is a profitable enterprise so our children will be able to take their kids to whatever hit they come up with at that time…and we can enjoy what is commonly known as grandparents' revenge. Now that is a profitable and sustainable concept.

Warm Regards,

Chuck Osborne

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