

# *The Quarterly Report*

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| INSIDE STORY |

# Freedom

*“Underlying most arguments against the free market is a lack of belief in freedom itself.”*

– Milton Friedman

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# Freedom

**S**ocialism is supposedly more popular with people under the age of 30 than capitalism. Have you heard that? There are several such polls around. The question I have for those who make such claims is very simple: Can any of those respondents define those two terms? I have my doubts.

For most of my adult life this conversation was not necessary. Any time someone tried to attack capitalism, all one had to do was point to the collapse of the Soviet Union and the success of the Reagan / Thatcher reforms in the U.S. and U.K. One did not have to be an economic scholar to see the obvious contrast. Total collapse versus huge success, this wasn't nuance. Most people, especially in the investment world in which I live, thought this conversation – which had taken up so much oxygen in the 20th century – was over.

I had not heard anyone even try to argue against capitalism since Bill Clinton declared the age of big government over in 1992. Then, the financial crisis hit a decade ago. We started getting bank failures, and the anti-capitalism crowd was magically brought back to life. The actual crisis was caused, as all true crises are, by a confluence of things all happening at once. This, by definition, is complicated. I tell my children this all the time, especially my son: complicated things are just combinations of several simple things. Break it down into pieces and everything becomes simple, but the whole is complex.

The long-lost big government/anti-capitalism crowd, however, had a very simple one-word explanation for the whole thing: greed. Greed caused the crisis. That explanation sold because it was simple, and it easily identified a culprit: greedy Wall Street bankers. Of course, the idea that greed explained the crisis was and remains absolutely absurd. We wrote about this at the time. There are so many holes in that argument that one could not possibly count them all, but primarily for this argument to work it would mean that greed was somehow new. People have always been greedy, we do not live in a constant state of financial crisis. Milton Friedman said it best when he said, "Of course it is always the other guy who is greedy, we are never greedy."

Wall Street helped the simpleton's cause by providing

anecdotal stories of incredibly greedy, and frankly often stupid, bankers. I have been in this business a long time, and most people in it do not fit that description, but those that do are ever-present. They contribute to every crisis, but they do not explain a crisis. Let me be clear: this does not excuse the mortgage banking industry or the Wall Street bankers who financed the industry. They certainly deserve their portion of the blame.

*There's a direct relationship between inequality and regulation.*

However, the crime in that explanation was that it completely exonerated a group that deserves at least an equal portion of the blame: government politicians and regulators. The oft-used quote of the "blame capitalism" crowd was that the crisis was caused by the "unregulated banking industry." I suppose that I should have known then that the post-modernist idea of truth being whatever you feel it is had taken over our discourse. If there is an industry more regulated than the financial industry I would like to see it. Yet, I had college-educated people who had purchased multiple homes over the course of their lives look at me in all seriousness and claim that the mortgage industry was unregulated. I would ask them, "Was there a lawyer at your closing? How many disclosures and documents did you have to sign?" That is regulation. The OCC, SEC, FDIC, Federal Reserve and various state agencies all regulate financial firms and have since at least the 1930s.

Capital requirements, which were way too low, were set by regulators. The entire sub-prime mortgage market – the source of the crisis – was created by regulatory requirements. Ultimately what caused actual failures were the investments that the banks had made with their reserves, and again, what they were allowed to invest in was determined by regulation. Yet somehow this idea of "unregulatedness" caught on, while the regulators who were supposed to be providing oversight got rewarded with more power.

This idea has somehow remained. Just in the last year I had a conversation with an individual about the sad state of our healthcare system and the high price of drugs. He told me without hesitation that it was because the pharmaceutical companies were unregulated. My mouth dropped. Then I asked him what he thought the FDA did? It is regulation that grants these companies monopolies on their breakthroughs. Yet today any industry that is unpopular is evidently “unregulated.” That word must not mean what I think it means, because the truth is the most-hated companies in America are always in the most regulated industries. Therefore, for those who keep using the word, it must not mean free of regulation.

This misinformed idea magically overnight brought back some sort of legitimacy for the word socialism. I suspect, since these supporters do not know what unregulated means, they probably don’t actually know what socialism means. Socialism is an economic system under which the government owns the means of production. The first thing to understand about socialism is that it is not, as many believe, a political theory or system. It is an economic system. Some would believe that the two cannot be separated, but that is not correct and it is very important in actually understanding socialism. Socialism’s opposite is capitalism, which is also an economic system. Socialism is usually associated with totalitarian political systems, and capitalism is associated with democratic political systems. However, there have been democratic countries who have experimented with socialism, and both the Soviet Union (in its infancy) and currently China have experimented with capitalism.

Many may be familiar with Friedrich Hayek’s most famous book, “The Road to Serfdom.” Hayek argues in the book that economic freedom is a necessary element of political freedom. (If I were king for a day this book would be mandatory reading for all high school students in America, but that is another issue.) The book was inspired by Hayek’s life experience. As an Austrian he watched Germany embrace socialism, and he understood the role this played in allowing the Nazis to establish complete control over the country. Yes, you read that correctly: The economic system in Nazi Germany was socialism. Socialism is the natural economic system of any totalitarian form of government. The official name of the Nazi party was the National Socialist German Workers Party. I know this seems strange to the modern-day, capitalist-hating young socialist to whom anyone he does not like is automatically compared to Hitler, but when it came to economics, Hitler was a socialist.

As was Stalin. The two may have been on opposite sides of the political spectrum, but from an economic standpoint the only difference between fascism and communism is who the tyrants are. Tyranny is tyranny, and socialism is tyranny. When I was a young economics student we referred to capitalism and socialism as simply a free economy versus a command economy. These titles are perhaps more clear. Do we want an economy where we are each free to act as we desire, or do we wish to be commanded by some authority?

To me the answer to that question is as self-evident today as it was when our founding fathers found it to be self-evident. Liberty is our defining quality as a country, or it has been. Today many are asking for our freedom to be reduced. On college campuses there are actual arguments about limiting the freedom of speech. Thankfully most advocates for such are losing, but that it is even dreamed of in this country is more than a little scary.

Of course, it is only the other person’s speech that they wish to silence. Isn’t that

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**The 2nd quarter 2018** GDP growth came in at 4.2 percent which is the best growth we’ve seen in a long time. We seem to be finally breaking out of the so-called new normal, and the impact of tax reform is just beginning to be seen.

The official unemployment rate dropped to 3.9 percent in August. 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 2.7 percent based on the latest consumer price index report. Core inflation stands below the Fed target at 2.2 percent. This has leveled off and is slightly lower than last quarter. Still there is plenty of room for more rate hikes from the Fed. +

## REVIEW of ECONOMY

**Markets diverge.** For the quarter the S&P 500 finished up 7.71 percent but not all ships rose as quickly. Growth outpaced value for the seventh quarter in a row. The Russell 1000 Growth index finished up 9.17 percent, while the Russell 2000 Value index was up only 1.6 percent.

Bonds remained flat for the quarter. The Barclays U.S. Aggregate Bond index ended up 0.02 percent. High yield bonds ended the quarter up 2.44 percent.

International stocks suffered over trade. The EAFE index finished up 1.42 percent while the MSCI Emerging Markets index ended the quarter down 0.95 percent. +

## REVIEW of MARKET

# MARKET *forecast*

**Eventually markets must revert to the mean.** We are still positive on the markets for the year as the economy and corporate earnings are still strong and those are the things that really matter. However, all the returns cannot come from just large growth companies.

Small company stocks should be doing better as should value as a whole. Emerging markets still look attractive as do international stocks but momentum has remained negative with trade talk.

Bonds are finally breaking out of the multi-year historic low rate environment. A 10 year treasury over 3 percent makes bonds look more attractive for the long haul. +

» *Continued -*

always the case? There is no doubt that the best political system would be a monarchy...as long as I get to be king. Similarly, socialism is great if you are part of the ruling elite who get to tell everyone else what to do.

Unfortunately that isn't how it works. Hayek's most powerful realization was that given human nature, when you place that much power in government, the type of person who becomes attracted to wielding that power is usually some flavor of tyrant. As they say, power corrupts and absolute power corrupts absolutely.

But what about the less fortunate? A free world can be a cruel world, there is no doubt. I wish everyone who claims to support the ideas of economists like Friedman and Hayek actually read their work. I mean read as in word for word, not the Reader's Digest version which made Hayek a household name. Both Friedman and Hayek argue for the necessity of a social safety net provided by government. They also pointed out potential pit falls and certainly criticized specific programs, but both believed that a safety net was absolutely needed in any civilized society.

John Maynard Keynes is another famous economist who is often thought to be on the opposite side of most issues from Friedman and Hayek. This is because he endorsed government intervention in the economy in an effort to soften the blows of recessions. While that is true, what is often lost is the motive behind this intervention. Keynes feared that if government did not step in to thwart some crisis, then the day would come when people would begin to abandon capitalism altogether. He wanted to save capitalism, not replace it. Keynes and Friedman did disagree, but not on the superiority of capitalism: Keynes thought government should stimulate the economy through fiscal policy, while Friedman thought monetary policy was superior. In truth their differences a far more about nuance than anything fundamental. It is the politicians who possess a bumper-sticker understanding of economics that create

this supposed divide.

Keynes did speak more about income redistribution. However, it is important to understand that Friedman addressed inequality in his book "Capitalism and Freedom," which was published in 1962. His work at that time showed a direct relationship between inequality and regulation. This makes sense if one thinks about it: the more things are controlled by the government, the more one has to know how to work the system. In other words, regulation rigs the system; in fact it is the only way to rig a system. Rugged systems prevent social mobility, and economists today have shown that there is a link between social mobility and more equality overall.

Freedom works. Why is this so hard for us to understand? It is in our nature to want to control, to believe that someone has to be in control. This theme runs through every ancient religion, and overcoming that desire to control is central to all of them. Yet capitalism and its political partner, democracy, will always have their critics. I think Winston Churchill said it best when he said, "Many forms of government have been tried, and will be tried, in this world of sin and woe. No one pretends that democracy is perfect or all-wise. Indeed, it has been said that democracy is the worst form of government, except for all those other forms that have been tried from time to time...". The same can be said of capitalism. It's the worst form of economics, except for all those other forms that have been tried from time to time. Hopefully all those under-30 year-olds who think they want to try socialism will come to realize that before they actually lose their freedom.

Warm Regards,



CHUCK OSBORNE, CFA *Managing Director*