The Quarterly Report

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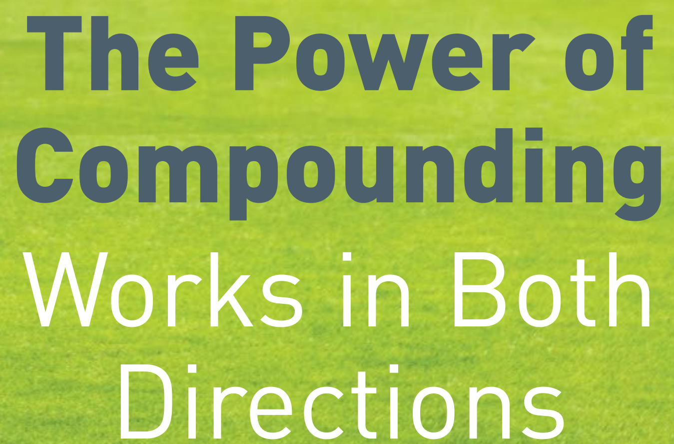
INSIDE STORY



IRON CAPITAL ADVISORS

3355 Lenox Rd., Suite 925, Atlanta, GA 30326
T 800.417.3804 | F 678.805.0534 | www.ironcapitaladvisors.com

The Power of Compounding Works in Both Directions

On July 19 the best golfers in the world will begin to compete for The Open Championship, often referred to as The British Open on this side of the pond. This year they are playing at a course named Carnoustie. Golf fans remember this course as the one that hosted this event in 1999, which saw one of the most memorable and painful golf finishes most have ever witnessed.

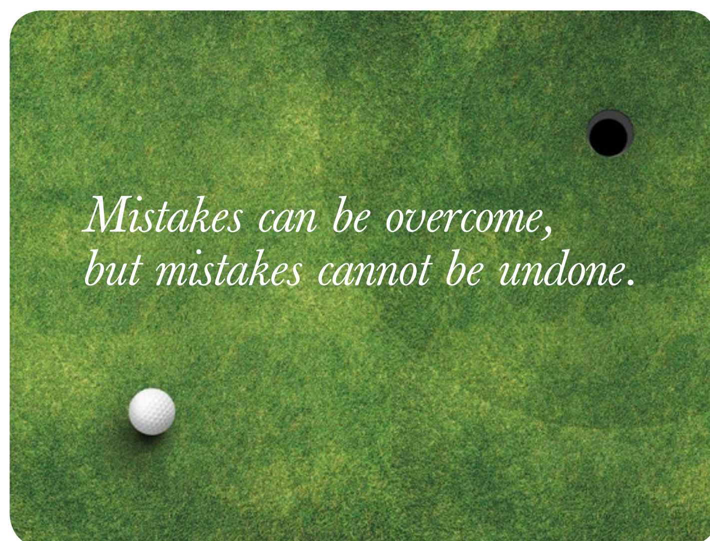
It was the 128th Open and on Sunday, a French golfer named Jean van de Velde came to the final hole with a three-shot lead. The last hole at Carnoustie is a long, difficult par four. Even with the three-shot lead, van de Velde decided to use his driver off the tee. At the time the announcers were saying they thought that was a mistake. If he simply played safe, he would be the champion.

The announcers proved to be correct. Van de Velde's drive went well right of the fairway. In fact, he got lucky: the drive was so far to the right that it flew over a creek (they call it a burn over there) and onto another hole. Now it was decision time. He made a mistake; would he admit it, take his medicine and just get himself back into play, or would he try to undo his mistake? Van de Velde did the latter. He went for the green, and five strokes later finally finished with his three-shot lead gone. He lost in the playoff. Paul Lawrie won, but no one outside of his immediate family remembers that. The 1999 Open will always be remembered as the greatest collapse in the history of golf.

Behold the power of compounding, when one event piles on top of another, then another. In the investing world we usually talk about compounding and how it impacts investment returns. Albert Einstein may have won a Nobel Prize for his theory of relativitiy, but when asked what the greatest invention in human history was, he said, "compound interest." He is attributed for having said, "Compound interest is the eighth wonder of the world. He who understands it, earns it… he who doesn't…pays it." In other words, prudent people save in order to purchase something. They invest their savings, and that savings earns a return, or interest. This grows their purchasing power. Impatient people borrow to buy things. They pay interest on those loans and end up reducing their buying power by paying more over time.

The compounding effect comes from the interest earned on your interest. For example, if one invests $100 and earns 8 percent over the next year, then she will have gained $8 for a total of $108. If the next year she earns the same 8 percent, then she will earn $8.64 for a total of $116.64. The $0.64 is the interest she earned on her interest. This is how money grows.

Today we use computers to illustrate this growth when we conduct financial plans, but when I started in my career we simply used something called the rule of 72. If one knows the average annual return that he will obtain on his investment, then he can divide that number into 72 and approximate



how long it will take him to double his money. If he gets an 8 percent return then his money will double in nine years. It takes the same nine years for $10,000 to turn into $20,000 as it does for $20,000 to turn into $40,000. My first boss used to say that it is the last double that gets you there.

However, compounding does not only work in the positive direction. Too often we ignore the damage caused by compounding mistakes. The first mistake almost never causes insurmountable damage, it is the compounding of mistakes that leads to ruin. In investing this leads to a phenomenon known as whipsawing. Markets move in cycles, and if an investor is out of sync with the market cycle, then it becomes

easy to compound that mistake. For example, stocks of banks and stocks of technology companies often – not always, but often – move at different times. It is not uncommon for bank stocks to go nowhere while technology stocks are booming, or vice versa. So, if an investor buys the stock of a bank and it just sits there while stocks of technology companies grow, then he has made a "mistake." Now what? Most investors will then attempt to undo their mistake by selling the bank stock and buying the stock of a technology company. Of course, most do this just in time for the market cycle to change and then they watch bank stocks grow while their technology stock just sits there. This is whipsawing. Instead of missing out once, this investor missed out twice. The mistake has been compounded.

People also compound their mistakes in financial planning. An easy example would be a person who fails to build an emergency savings fund. Stuff happens in life. Unexpected expenses will occur. It could be a health issue or a car repair. At our house this summer we have had to deal with the loss of two very large oak trees. Unexpected expenses will happen, and having an emergency fund to deal with such issues is very important.

If one makes the mistake of not having such a fund, then she must rely on borrowing money to take care of these issues. Usually that takes the form of credit card debt, which is the worst way in the world to borrow money as the interest payments are often ridiculous. This debt weighs on people. Once again, the normal reflex is to undo the mistake – this time by paying as much as humanly possible to reduce that debt as quickly as possible. This actually sounds logical, right? The problem is that if one follows this course of action then she is not building up that emergency fund, and emergencies don't stop happening just because she is still paying for the last one. Debts start to compound, and before one knows it she is buried in debt with seemingly no way out.

Individuals are not the only ones who fall victim to compounding. Policymakers often fall into this trap. As I am writing this, The Wall Street Journal has reported on administration efforts to help farmers. Why do farmers need help? Because the administration decided to place tariffs on Chinese goods. The Chinese respond by placing tariffs on American crops. Now all of us will be paying more for anything that comes from China and we will be paying taxes to bail out farmers who can no longer sell their goods.

Policymakers do this all the time. They increase regulations and raise taxes, which makes it more expensive to run a business. This means fewer jobs are created. Because there are fewer jobs, that means there are more people unemployed. More people unemployed leads to more poverty, which leads to poverty programs, which leads to some people deciding they would rather get government benefits than hold down a job. That leads to more unemployment. It is an endless cycle which eventually leads to more and more inequality and polarization. Sound familiar?

How do we prevent compounding mistakes? Most of our readers know that when I'm not analyzing stocks I am often coaching youth sports. One of the things I learned my very first year was a clever little acronym for dealing with mistakes. C.L.a.P.! We clap for mistakes. The C stands for claiming the mistake. The L stands for learning from our mistake. The a is simply for and, and P is play through the mistake. I know what you are thinking, which is what I thought when

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REVIEW *of* ECONOMY

The 1st quarter 2018 GDP growth came in at 2.0 percent which is much better than the past several opening quarters. We may finally be 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 4.0 percent in June. The labor market keeps improving and perhaps more importantly we are seeing wage growth of 2.7 percent. That is an encouraging sign.

Inflation is at 2.9 percent based on the latest consumer price index report. Core inflation stands below the Fed target at 2.3 percent. This is higher than it has been in some time and will likely lead to further rate hikes from the Federal Reserve. +

REVIEW *of* MARKET

Tariff talk put a scare in the market. For the quarter the S&P 500 finished up 3.43 percent but how we got there was the real story. Growth outpaced value for the sixth quarter in a row. The Russell 1000 Growth index finished up 5.76 percent, while its value counterpart was up only 1.18 percent. Small companies led the way with the Russell 2000 up 7.75 percent.

Bonds dropped during the quarter as interest rate crept higher. The Barclays US Aggregate Bond index ended down 0.16 percent. High yield bonds ended the quarter up 1.00 percent.

International stocks suffered over trade. The EAFE index finished down 0.97 percent while the MSCI Emerging Markets index ended the quarter down 7.86 percent. +

MARKET *forecast*

Volatility has returned and is likely to stay. We are still positive on the markets for the year as the economy and corporate earnings are still strong. Those are the things that really matter. In the meantime any threat of a trade war or other political unrest will continue to cause day to day fluctuations.

Small company stocks should do well. Emerging markets still look attractive as do international stocks but momentum has turned negative with trade talk.

Bonds remain our biggest concern over the long term and will until the yield on the 10-year treasury exceeds 3 percent. It has gotten closer but is still not there. +

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I first heard it: How wonderfully gentle of us. No wonder colleges have to create "safe spaces." But I was wrong. Clapping for mistakes isn't a soft easy way out, it is hard.

It is hard on everybody, but in my experience in two different ways. Most of the kids I have coached have trouble with the C. It is very difficult for most people to ever admit that they made a mistake. We simply are hard-wired to avoid admitting that we are less than perfect. In her book "Mindset," Carol Dweck claims that people can be put into two broad categories: we either have a fixed mindset or a growth mindset. Fixed mindset means that one believes that talent drives performance and you are just born with talent or not. A growth mindset would say that skill drives performance, and that skill grows, and new skills can be learned.

For someone with a fixed mindset, admitting a mistake is next to impossible. That would mean that they are not good at whatever it is they are doing. It could even mean that they are stupid, worthless, etc. Obviously that isn't actually true, but that is how this person feels. To admit a mistake takes a growth mindset. For someone with a growth mindset mistakes are how we learn, even really stupid mistakes. One's performance has nothing to do with who she is, it has everything to do with where she is on her journey. This isn't easy.

After we admit a mistake, then and only then can we learn from it. The first mistake is usually not fatal. Van de Velde could have simply hit a wedge shot to get himself back in play after his drive and he would be an Open Champion. Failure to learn is what kills us. It is hard to learn when one continually makes excuses.

Finally, one must play through their mistake. There are very few mistakes in life, and certainly in finance, that cannot be overcome. Mistakes can be overcome, but mistakes cannot be undone. This is the second trap I mentioned. Some will admit their mistakes, but instead of just continuing to play the game from where they are now, they try to undo the mistake.

Van de Velde tried to undo his mistake by attempting a near impossible shot in order to end with a score of par or better. He is not alone. It is common in sports to see a basketball player turn the ball over to the other team, then try to undo it by stealing it back, only to commit a foul. In football a quarterback may take a sack one play and try to get the yards back on the next, only to throw an interception. In baseball a player drops a fly ball and then tries to make a miracle throw to undo it, only to give up extra bases. We cannot erase the mistake, but we can keep playing the game.

In finance, one cannot change the fact that he invested in a bank when he should have invested in a technology company. That cannot be undone, but we can make prudent decisions, including diversifying and not putting all our eggs in one basket. One cannot undo not having savings when needed, but she can begin to build that emergency fund while prudently dealing with her debt. We can overcome the mistake, but not by trying to undo it.

Ultimately we want our earnings to compound, not our mistakes. Try to be the wise person Albert Einstein describes who understands compounding interest. Be the one who earns it, not the one who pays it. We all make mistakes, so the next time you do, clap and don't compound.

Warm Regards,

Chuck Osborne, CFA
Managing Director