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Competition

INSIDE STORY

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Competition

I'm a competitive person. There, I said it. I love competition and I get it honestly. Growing up in my family, almost everything was a competition. My parents both enjoyed watching sports on television and back then there was no cable package that allowed you to watch the game you wanted, which meant often we would watch games we did not really care about. The conversation would go something like this:

"Who is playing?"
"Green Bay and Chicago"
"Who are you pulling for?"
"I guess I'll pull for Green Bay."
"Okay then I'm pulling for Chicago."

We just thought that was normal. If one family member pulled for one team, then you pulled for the other. Otherwise, there was no competition, and what is the point of that?

Today many people seem to look at competition as a bad thing and I guess I can understand why. Many people think they are being competitive when they are not. Several years ago, I read "Changing the Game" by John O'Sullivan. O'Sullivan was a competitive soccer player and a soccer coach on every level from youth to professionals. He tells the story of watching his kids play soccer when they were very young and it was all fun, and right next to their game was a 10-year-old game. In that game there was no fun being had; parents were yelling, coaching were yelling, and the kids were serious as heart attacks. One comment he made hit home with me: he said that having coached for 20 years he knew something about competition, and what he saw on that field was not it.

The word competition comes from the Latin word "competere," which is best translated as, "to strive together." When true competitors compete, they make each other better. When great athletes are asked what they miss most in retirement, they usually say the competition; they do not say the winning. Of course it is more fun to win, but the true joy is in the competition itself. True competitors never take short cuts, and this is where the age old adage comes from, "winners never cheat."

Today too many people think being competitive is about winning at all costs. Earlier this year, the United States women's soccer team won the World Cup. During the tournament much was said about the fact they drew a very tough path. Notably they had to go through France, which many saw as their main rival. Pundits were saying it would be better to have an easy route into the finals. The reaction of the players and coaches was exactly what one should expect from competitors: They wanted to play France. They did not want a short cut, and they couldn't even understand why spectators thought an easy way would be better.

Many people just do not get it. Competitors do not compete against one another; they compete with one another. They strive together, and in the end, both are made better.

This is why capitalism works, and why so many don't seem to understand that. Competition makes us all better. I am old enough to remember what American-made cars were like in the 1970s. Then the Japanese cars started becoming popular, partly because of fuel efficiency, but largely due to the reliability; the German cars started eating away at the luxury end of the market for the same reasons. Then, Ford made "quality job one," and the American cars got better.

> *"Iron sharpens iron, so one person sharpens another."*
>
> – Proverbs 27:17

Back then many people feared that Japan would surpass us and that we would cease to be the world's leading economy, which proved to be a false narrative. Today those fears are pointed toward China, and to a lesser extent, the European Union. It is my opinion that this is once again a false narrative. Let's look at why.

If China is our competition, we need to know what game we are playing. If we are playing football, soccer, basketball or baseball, the high score wins. Then again, if we are playing golf, the low score wins. We are playing international trade.

In my book, when you play trade, the competitor who ends up with the most stuff is the one who is winning; yet many people tend to believe it is the opposite. For years the United States has gotten far more from China then we have given them. Some think that is a problem; to me it sounds like winning, but even then, it is probably overstated. For most of those years, services have either not been counted or undercounted. We are now a service-oriented economy, so we would be winning by far less if we counted correctly.

The more sticky issue with China is their use of intellectual property and so-called forced technology transfers; this is where the current negotiations keep breaking down. As a true believer in capitalism I have to say that I have mixed feeling here. I certainly do not think someone should steal another's intellectual property, but is it really stealing? In some cases it may be, but most of the time these were agreements made by American companies who wished to do business in China. Here is one of the great benefits of a capitalist system that often gets ignored: Every single transaction in capitalism is voluntary. No one ever forced Apple to make and sell iPhones in China; Apple voluntarily chose to do so.

If American companies made bad deals that they now regret, why should we bail them out? This is one thing that critics of capitalisms have right: In real capitalism there is no return without risk. Sometimes those risks come true and when they do, a company and its executives should pay the price. There is no such thing as a business that should not be allowed to fail, and if one drives his business into the ground, then he should have to live with those consequences. True champions are not those who never fail; they are those who fail and get back up. This should be as true in business as it is in anything else.

At Iron Capital we often tell prospective clients that we have never refused to work with someone because of the size of their portfolio, but we have refused to work with people for other reasons. You see, transactions in a capitalist society are voluntary. We would never dream of spending resources lobbying the government to force those people to be more to our liking. When we really think about the situation, it seems absurd. If we can come up with a national agreement that prohibits technology transfers to China, then that would certainly make individual companies' jobs easier. However, if these negotiations fail to make such a breakthrough, then we should remember that these companies chose to do business in China. They were not forced.

The trade war with China may or may not pay off in the end; only time will tell. The current situation, however, is clearly slowing our economy. The result is that the Federal Reserve Bank (Fed) has reversed course from last year and begun to lower interest rates. Some suggest that they have not gone far enough. Once again, I am a very competitive person, but even I know that not everything is a competition. Interest rates in the United States are at or very near historically low levels, but compared to places like Germany, our interest rates are high. As of this writing the yield, or interest rate, on the 10-year U.S. Treasury is 1.61 percent, and the yield on the German 10-year is -0.50 percent. This means that if an investor were to loan money to the U.S. government for ten years, then she would get her money back plus interest of 1.61 percent per year. If that same investor loaned her money to Germany, she would get back her money minus 0.50 percent per year.

It has been suggested that the Fed is losing by not trying to match countries like Germany in the race to lower and lower rates. In my opinion, this should not be a

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REVIEW *of* ECONOMY

The 2nd quarter 2019 GDP growth came in at 2.0 percent. Underneath the surface the consumer is doing fantastically well, as business investment has come to a sudden halt. It is all about tariffs. If we get a breakthrough with China, business investment will resume and we will continue to grow. If we do not, it becomes a matter of how long the consumer can keep us afloat.

The official unemployment rate is 3.5 percent in September. This is the lowest rate in 50 years. What else can we say?

Inflation is 1.7 percent based on the latest consumer price index report. Inflation remains low even with full employment and rising wages. +

REVIEW *of* MARKET

Markets were volatile and mixed. For the quarter the S&P 500 finished up 1.70 percent and small company stocks represented by the Russell 2000 index were down 2.40 percent. Growth outpaced value barely in large stocks, but value investors faired much better in the small company market.

Bonds rallied. The Barclays U.S. Aggregate Bond index ended up 2.27 percent. High yield bonds rose 1.33 percent.

International stocks were down. The EAFE index finished down 1.00 percent while the MSCI Emerging Markets index ended the quarter down 4.11 percent. +

MARKET *forecast*

The trade war appears to be hitting home. We are more cautious now then we have been in a while. Fundamentals remain strong, and if we get a deal with China the market should rally. However, if we do not then the economy will continue to slow and the market will drop.

Small company stocks and value stocks are still overdue to come into a cycle of out-performance. Emerging economy stocks are also attractive and the best managers in this space are doing much better than the indices would indicate. There is los of risk there, but this is still the most attractive area based on valuations.

Bonds remain overpriced and not likely to perform well. +

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competition. Each central bank should be doing what they believe is correct for their country. However, let's say it is a competition. Once again, with any competition, we have to know how the scoring works. Who wins the high score or the low score?

Let's give this some thought. What causes interest rates to rise or fall? We know the Fed sets a target for overnight rates, but the rest of the interest rates are set by the market. Investors chose to invest or not to invest in an auction. The prevailing rate is the one that satisfies the most investors. If investors are willing to accept a 1.6 percent return on their investment, it means they believe that return is fair in comparison to what other options they have. In other words, this is a poll on what investors believe the future economy will look like. The higher the interest rate they demand, the more growth they believe will occur in other investments. The lower the rate they settle for, the more they believe other investments will not grow very much. To be willing to accept negative rates is to believe that more money would be lost if one invested in anything else.

With this realization, it sure sounds to me that the country with higher interest rates is the one who is winning. Just to check that theory, look at the current Gross Domestic Production (GDP) growth. In the second quarter of this year the U.S. economy grew at 2 percent. The German economy, on the other hand, shrank 0.1 percent. Germany is on the brink of recession if not already in one. Again, it isn't a competition, but if it were, we would be winning.

Competitive games are zero-sum. This means that there is a winner and a loser. My daughter loves to play Candy Land and Chutes and Ladders. Anyone who has ever played these games knows that they are actually the same game with different graphics. However, if we are playing one and I win a few times in a row, then we must switch to the other game. In Candy Land and Chutes and Ladders there is one winner and everyone else loses; there is a plus one and a minus one for a zero sum.

Life is not like that; Life is not a zero-sum game. Life is more like a marathon. Sure, there is some professional athlete who wins the race, but what every serious marathon runner is interested in is their personal best. They compete mainly with themselves, striving together with the other runners to achieve their goals. This is a far better representation of the competition of life.

Life is not a zero-sum game.
Life is more like a marathon.

This is what we try to explain to our clients: When we talk about prudent investing being absolute return-oriented and not relative return-oriented, we are talking about focusing on reaching your goals. We do not want to focus on beating some artificial benchmark or, for that matter, your neighbor. Real competitors know that competition is not win-at-all-costs. Sure, we want to win, and it is that desire that drives us to strive. In the end, however, the striving together is what it is really about. Hopefully our representatives negotiating a better relationship with China and Europe understand that. "Iron sharpens iron, so one person sharpens another." Competition can make all of us better, if we understand what it is really about.

Warm Regards,

Chuck Osborne

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