
## Newsletter
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*Reflections on SKBA's 30th Anniversary*

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### A Retrospective…

Thirty years is a long time to maintain a consistent investment discipline; yet here we are this month, celebrating SKBA's 30th anniversary. It was back in 1989 that we received approval by the SEC as an independent investment management company. Hurrah!

There aren't many firms that can claim that founding employees have stayed together that long. And we would not be here today without the faith and trust of our clients. We give you all our heartfelt thanks.

It takes a kind of – ok single-mindedness – to be a steadfast value investor when so many investment fads become hugely popular and then usually blow up. Yet, it is this devotion to discovering value, and periodically becoming a contrarian to the groupthink so prevalent in financial markets, that have led to our success. It is also with this in mind that SKBA has focused on "home-grown" professionals – inculcated in SKBA's unique principles, perspectives and methods of analysis. Without our committed and vested team of employees and owners, we would not have been successful over the years and well positioned to continue on into the future.

Given the ups and downs in financial markets since 1989, a slightly modified reference from Queen's "We Are the Champions" seems appropriate here.

> Although at times, it's been no bed of roses, no pleasure cruise…*but for our clients*, we ain't gonna lose…

OK that last phrase is just a figure of speech; we don't always get it right in the short term. Nevertheless, it really has been a work of joy to serve clients with our investment wisdom, even during the inevitable rough patches in the markets. There have been many periods of extraordinary returns, as well as market plunges. You only have to look back at the last twelve months to find market volatility: October, December, May and now the just completed month of August.

Yet, I thought it might be entertaining and insightful to take a walk down memory lane and recall the challenges that we have faced in financial markets. Let me start with some of the "glorious" (meaning the contrary - dangerous) market fads of the last 50 years:

1. 1972 to 1973 – Anyone old enough to remember the era of the "Nifty 50?" They were 50 "one-decision" growth stocks, many of which were priced at astronomical price-earnings ratios of 50 times or more. Why own them? They were expected to grow earnings rapidly into…forever, of course. What happened to those overvalued perpetual growth stocks like: Burroughs Corp. (mainframe computers), Eastman Kodak, Polaroid, and Xerox? Suffice it to say, the story for the vast majority of those 50 ended not too "nifty."

2. 1981 – The economy would never get out of the upward pressure on inflation rates from OPEC's high oil prices and government deficits. With inflation—measured by the Consumer Price Index, going up at a 12% annual rate, 30-year Treasury bond yields at 15% and the Prime Rate at 20%—the future outlook was bleak. Yet that was the beginning of the 35-year bull market in Treasury bonds we've experienced since.

3. 1987 – We saw one of the first examples of the disaster of quantitative techniques that were supposed to reduce market risk – right? The interaction of "Program Trading" and "Portfolio Insurance" was the disaster that drove the Dow Jones Industrial Average down 20% on Black Monday (October 19, 1987). When the portfolio insurance crowd got worried about the stock market, they sold market futures contracts to supposedly reduce risk! But the program trading crowd saw the emerging gap between the now lower implied market from futures contracts and sold the blocks of actual stocks to arbitrage the difference, driving down the cash market relative to the futures market. Thus the downward spiral was perpetuated as the decline in the cash market triggered another round of sales of futures by the portfolio insurers. What folly it is to rely on such mechanical techniques!

4. 1990 to 1991 – In a foretelling of the future risks from housing and junk bond investing, the inverted yield curve at the beginning of the financial crisis of 1990-91 drove many Savings & Loans (S&L's) to the point of insolvency. Other major banks were forced to slash dividends amid mounting loan losses.

5. 1995 to 1999 – "Dividends don't matter anymore" was the fad of the day. The emergence of Economic Value Added (EVA) led to our most serious challenge to investing in dividend-paying companies. According to EVA, only earnings growth and returning cash flow through stock buybacks mattered. We have an old adage for this foolishness, "Dividends don't lie, sometime earnings do." It turns out that those companies that pay consistent dividends typically have the best financial management and balance sheets. The EVA fad came crashing down along with the recession and bear market of 2000-2003.

6. 1999 – In a replay of the "Nifty 50 Era", the "New Paradigm Era" (implying technology and internet stocks would sustain high economic and corporate earnings growth into perpetuity) drove valuations of growth stocks to levels above those seen in 1973. We witnessed the emergence of IPO's of companies with no earnings and negative cash flow get priced at 100 times sales! The New Paradigm was built upon a false belief regarding perpetual growth rates that did not account for the acceleration of technology spending to fix the "Y2K" problem of changing all tech data inputs from 2-digit years to 4-digit years at the turn of the century. You'd think investors would remember such excesses…but they easily forget.

7. 2008 to 2009 – Once again mechanical tools that supposedly reduced market risk turned out to increase it. Remember how subprime mortgage-backed securities were sliced and diced into risk tranches so that you could tailor your risk/return choices using collateralized mortgage obligations (CMOs)? And what was the wisdom in pushing government-backed mortgage insurers Fannie Mae and Freddie Mac to buying huge amounts of subprime mortgages fueling the housing bubble? When the housing boom turned to bust and banks and the agencies became insolvent, we got the Great Recession and financial crisis.

This is just a partial list of what seems like a myriad of events we've seen over the years. We get paid to be your steady anchor and trusted advisor during the wave after wave of market fads and economic volatility.

Having weathered all these storms, how do we do this for you?

- By first focusing on your needs and objectives. While our Value*Plus* portfolio is our flagship equity strategy that buys only dividend-paying companies, we also offer other solutions to meet client needs. We manage portfolios that comply with a client's faith-based and/or ethical values that weigh environmental or other concerns, and/or seek wealth accretion. In addition, we offer fixed income strategies that produce income and diversify equity risk.

- By sticking to our investment disciplines. For example, using our Relative Dividend Yield Discipline framework to identify when low expectations are believed to be already discounted into a stock's price is a key starting point for our analysis. This often requires that we go against the prevailing optimism or pessimism of Wall Street.

- By using economic scenario forecasting to anticipate the consequences of economic actions of governments and central banks.

- By not getting sucked in by the fads and presumed wisdom of many of the past and present investment techniques or doctrines.

## …Looking Ahead at the Markets

So what are today's challenges? While all of today's news seems to contain political overtones, there are two growing philosophies that seem to transcend party differences and should turn out badly at some point in the future: Modern Monetary Theory (MMT) and Mercantilism. While each may ultimately prove to be a fad, they both pose systemic risks to economic growth and financial market returns.

The first, MMT, suggests that there should be no constraint on monetary policy accommodation. It is the belief that permanently easy money and suppressed interest rates have no long-term economic cost. Since the rate of inflation is benign, central banks can create money to buy enormous amounts of government bonds or grow monetary aggregates to push down both real and nominal interest rates even into negative territory. It's hard to believe this is becoming accepted dogma by the ECB (European Central Bank), but this policy is being actively pursued in Europe. Japan's central bank has "pegged" its 10-year government bond yield at 0%, meaning its real interest rate is negative equal to 10-year inflation expectations.

Let me ask one question: Have negative real or nominal interest rates caused non-government lending to increase in these countries or economic growth to reaccelerate? NO! Think of it like this. If you are a bank lending money in Europe, instead of receiving income from the loan, you have to pay the borrower to take your money; or, if you buy a government bond, you get either no positive interest, receive less back at maturity, OR BOTH. How does this make any sense? It doesn't.

All these policies do is further distort credit markets. In order to get positive yield, banks, financial institutions, and investors have to reach even further into higher risk investments to get some sort of positive return. Have the economic growth rates of Japan and the EU (European Union) accelerated due to these policies? Of course not, yet their answer is to drive rates even lower! The real solution is for these countries is to reduce the burdens of regulation. Yet, such flawed monetary policies are the only tool they seem to be willing to use.

What's that definition of insanity? Doing the exact same thing over and over again and yet expecting a different result.

Developed country central banks have essentially pursued MMT long enough that it is hard to simply call this trend a fad. The deeper they go into negative rates, the more severe the eventual outcome is likely to be when no more bonds can be sold as weak money finally creates higher price inflation. MMT also inherently robs Peter (savers) to pay Paul (government borrowing).

Now, the Federal Reserve Board is "encouraged" to pursue the same policies – drive the Fed Funds Rate back to 0% or lower to stimulate growth and not only stop the appreciation in the exchange rate of the U.S. dollar, but cause the dollar to decline to promote the competitiveness of U.S. exports. It won't work, and it poses a dangerous shift toward increased investor risk taking that we saw in the U.S. during the eight years when the Fed pursued its Zero Interest Rate Policy (ZIRP) and where U.S. economic growth was stuck at 2% (real GDP). If the Fed is persuaded, cajoled or badgered into following the footsteps of Japan and the EU into negative interest rate territory, it could be a disaster for the real economy by once more stunting growth and encouraging excessive systemic risk taking.

The renewed popularity of Mercantilism suggests that trade deficits by themselves put a country at a competitive disadvantage. The 17th and 18th centuries saw a surge in the use of mercantile systems to promote the growth of empires like those of Spain and England. The philosophy rested on the belief that a positive balance of trade (more exports than imports) built a nation's wealth (in the form of gold reserves for the Spanish) and power. Local industries were sheltered by high tariffs and trade restrictions, and colonies (like the Thirteen American Colonies) were required to buy finished goods nearly exclusively from the mother country.

It took a revolution, as well as Adam Smith's Law of Absolute Advantage from The Wealth of Nations (1776) and David Ricardo's subsequent Law of Comparative Advantage, to break down the flawed logic of Mercantilism. Through much of the Post WWII era, trade barriers (including tariffs) were reduced, promoting growth in world trade.

Mercantilist philosophy has made a comeback with the rise of the economic importance and trade abuses of China. As China, Japan, and the U.S. all promote mercantilist approaches to trade they seek to create (U.S.) or maintain (China) a positive balance of trade. Each of their individual goals by themselves cannot, mathematically, all be met. Bilateral trade deficits simply don't matter by themselves. Growth in world trade does matter.

What are the tools used in this trade battle?

- High tariffs
- Non-tariffs barriers (e.g. excessive product or inspection requirements)
- Forced transfer of IP (Intellectual Property rights)
- Restrictions on foreign majority ownership of companies

There is little doubt China has created an unfair trade advantage and accumulated wealth in the form, not of gold, but of Treasury bonds in the most desired reserve currency, the U.S. dollar! Yet rather than focus on creating Chinese import quotas (i.e. buying more soybeans), liberalizing trade restrictions would have the greatest long-term benefit (seeking 0% mutual tariffs or eliminating the forced transfer of intellectual property). The problem for China and the U.S. is that trade deficits and surpluses are more created by the relative attraction of investing in a country and relative growth rates than by currency manipulation or trade barriers. The irony for the Trump Administration (that it does not yet understand) is that even if we "win" the trade war, creating a more favorable trade balance between the U.S. and China, the resulting return to faster growth in the U.S. economy, by its nature, may suck in more imports from China and other countries. This would ADD to the overall trade deficit, not shrink it! Oh my! Yet the stock market would love it, and the bond market would likely hate it.

Because of the uncertainty of the outcome from the trade war, corporate capital spending has been put on hold and has resulted in slowing economic growth.  The best one can realistically hope for is a deal that by the end of 2019 allows both sides to declare some kind of victory.  It doesn't have to be much.  The risk is if each side digs in its heels, and the uncertainty persists to and beyond the 2020 election.  The downward pressure on U.S. economic growth would hurt corporate earnings, and the Fed may feel forced to succumb to the folly of MMT, moving the Fed Funds Rate back toward 0%.

Sounds ugly, but we don't put a high chance of the worst-case outcome occurring.  The reduction in tax rates and regulatory burdens have created a resiliency within the U.S. economy.  And it is our job to judge the impact of the ever changing landscape, while resisting getting swept up in the day-to-day swings in investor sentiment.

It is at uncertain times such as these that SKBA's history of seeking value, minding economic fundamentals, and sticking to our disciplines has worked out favorably for our clients.  We are thankful to have reached our 30th anniversary and we celebrate our success over cycle after cycle with you and work diligently to ensure this continues for many cycles to come.

Thank you!

Andy

*This report includes candid statements and observations regarding investment strategies and economic and market conditions; however, there is no guarantee that these statements, opinions or forecasts will prove to be correct.  These comments may also include the expression of opinions that are speculative in nature and should not be relied on as statements of fact.*