Thoughts that count

April 2021

Ashes are never the end

In the winter of 1835, Manhattan, New York suffered a double tragedy; a warehouse fire kickstarted a city-wide blaze so fierce it was visible 100 miles away. At the same time, a freak winter storm caused temperatures to plunge below -27C which froze all the water available to fight the fire. To finally extinguish the flames, the mayor ordered all adjacent buildings be blown up. The result was a totally devastated Manhattan.

For the individual Manhattanite, the winter of 1835 was a disaster. Residents shuddered at the thought of painful and difficult rebuilding. The city was blanketed in pessimism. Unfortunately, pessimism is sticky. Once it has ahold of your imagination, it is hard to shed its grasp.

For many individuals, the impact of the 1835 New York winter shares similarities with our present-day pandemic. There have clearly been major setbacks over the past year; illnesses, missed opportunities at work, isolation, forgone family milestones and even death. These obstacles have been real, and they are deeply personal.

Remarkably, a new kind of city would grow from the tragedy of 1835. Buildings were reconstructed from stone rather than wood, streets were made wider, and buildings taller. The New York City professional Fire Department was invented. The state built a system to carry fresh water to all areas of Manhattan which had the added benefit of providing residents with clean drinking water, solving a chronic waterborne epidemic. These measures began a revolution in city construction and in hygiene. Had this fire not occurred, fundamental improvements would not have seemed necessary and life saving upgrades would not have been made.

Individuals justifiably focus on how events affect them personally. One of the ironies of tragedies is that while they are negative for the individuals directly involved, they are often a positive springboard for the larger group. The crowd, not the individual, benefits from the inevitable cumulative effect of group problem solving. Individuals easily miss that declines, setbacks, and panics are the fuel used to solve difficult problems. Historically, there has really been no other way for progress to occur.

Thankfully, it appears we are likely past the mid-point of current Covid situation. As science continues to perfect our understanding of how to navigate this illness, we can begin to see how life might begin to return to pre-pandemic levels. However, just like rebuilding a city after a devastating fire, some permanent changes are necessary. With this in mind, I think there are a few investment lessons we can draw from our knowledge of crises.

Invest like a reasonable optimist. A reasonable optimist knows that surprising things happen surprisingly often. Today's permanent access to an endless stream of information, means we are constantly bombarded with bad news. Most of this news is not personally relevant to any of us, but modern-day information flow presents every tidbit as important. Successful investors must accept that bad news is never ending, but most of it can be ignored. If more people are trying to progress rather than regress, the long-term odds are in the corner of the optimistic. With extremely few exceptions, this is always the case.

Setbacks are a feature of progress, not a bug. No one chooses chaos over peace, but from time to time it is unavoidable. This is true of all cycles, including investment cycles. The only way to entirely avoid temporary investment declines is to accept returns equal to the interest rate on cash, which will always pay less than inflation. It is typically not possible to reach financial goals when inflation outpaces the return on your principal.

'If it ain't broke, don't fix it' is short-sighted thinking (that presents opportunities for others). Society requires crises to enact change. Had Manhattan city council asked for gigantic budget increases in 1834 to fundamentally change city planning, they would have certainly been denied. It took a catastrophic fire to kickstart the problem-solving process.

The world's best companies exist because they figure out solutions to difficult problems, often after several failures. In 1835, because of the fire, New York insurance companies faltered. Sensing an opportunity, insurance companies in nearby Hartford, Connecticut swooped in and overtook the Manhattan market. Their efforts were so successful, Hartford is still recognized as the insurance capital of America 185 years later. Identifying companies who are positioned to flourish when a crisis develops can be a significant investment opportunity.

Setbacks are temporary, while progress is cumulative. A vibrant city is similar to a living being. It has properties which are physical (buildings), social (people), mental (government and business leaders) and spiritual (culture). A crisis will not affect all these things equally. While a fire ruins physical resources; social, mental, and spiritual attributes come together to compensate. In fact, these other attributes often strengthen as the physical buildings need time to repair. After the city is rebuilt, its vibrancy does not revert to pre-crisis levels, the growth it has enjoyed becomes the new norm. Progress compounds over time.

Investment setbacks are on average 2/3 shorter than periods of investment growth. Because setbacks have a beginning and an end, investors should know that if they can survive the inevitable short-term upsets, they will capture the benefits of the more significant long-term growth.

The longer between crises, the closer they are to occurring. Smaller, more frequent setbacks allow an opportunity for modifying actions. In a similar way, fire brigades enact safety guidelines and controlled burns to reduce the probability of major fires in the future. In the economy, small setbacks are controlled by changes in interest rates; raising rates slowly limits the kindling available to an overheating economy. When interest rates stay at near zero for significant periods of time, accumulating kindling can become hazardous. The longer money can be borrowed without cost, the more assets prices rise. While increasing net worth is a good thing, unabated growth tempts many to take abnormal risks which can ultimately unbalance the economy in unintended, and often painful, ways. Our investment process allows us to take advantage of low interest rates, but we are particularly careful not to make decisions that put us squarely offside should a setback emerge.

It is important investors recognize setbacks are an inevitability, but if positioned appropriately, they need not be feared. Our investment process takes advantage of this natural cycle in several ways, including:

- We invest in companies that have a high probability of generating stable profits in good times and bad.
- We put a premium on companies who can grow their businesses when setbacks occur.
- We avoid companies who do not make a profit. These companies often have the highest potential growth but are also the most impaired during a setback.

Overall, investment markets have been resilient in the face of Covid. A primary reason for this is public investment markets are mostly large companies, while the economy is made up small and medium size businesses that are far more economically sensitive. Perversely, larger companies perform even better when conditions make it harder for smaller businesses to operate. Because interest rates will stay low for the foreseeable future, this large business resiliency trend is likely to continue.

For the balance of 2021, we should feel confident our investments will advance along with the global economy. At the same time, we will continue to watch for opportunities when the inevitable setbacks emerge.

Your *happy to hear about all our clients receiving their Covid vaccine* portfolio manager,

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