

# Thoughts that count

## A + B = C (maybe)

Combining two-parts hydrogen with one-part oxygen creates water. If you apply enough heat to this water until it boils, you create steam. If you lower the temperature below the freezing point, your water becomes ice. Combining water and temperature in different combinations will result in a liquid, solid or gas. These are the only possible outcomes. You can perform these experiments millions of times and will get identical results. This is true now, was true when dinosaurs roamed the earth and will still be true when income taxes are finally abolished (Canadian taxation was implemented as a temporary measure July 6th, 1917...).

There is something beautiful about the integrity of science. We count on thousands of scientific properties every day, yet we don't think about them because science is entirely reliable. If chemistry was unpredictable, and we didn't know properties such as two-parts Hydrogen + Oxygen = water, every single time, our society would cease to function. This level of predictability allows our lives to be sustained. Unfortunately, not everything operates as neatly as science.

Economics is often referred to as a science. This is a misnomer. Economics is not scientific, and no one should treat it as such. There is no economic equivalent to creating liquid water, ice or steam, though many people speak as if there is. Consider if a scientist performed three identical experiments applying extreme heat to water. Imagine if the results were the creation of steam in the first two trials, followed by the creation of ice in the third. That is economics. Every recipe in economics is unreliable. In science, A + B will equal C with absolute certainty. In economics, A + B may equal C, but it might also equal anything from A to Z.

To date, President Donald Trump's style of governing has been through impulsive announcements, many of which have been unanticipated and/or controversial. Edicts from the leader of the free world (via Twitter or otherwise) can have immediate real-world impacts. Last March, President Trump took public aim at two industrial targets, one he liked; the steel industry and one he did not; the online retailing industry.

Feeling the US steel industry needed help, he imposed a 25% tariff (a tax) on all non-US steel imports, with the goal of increasing domestic steel consumption. Immediately, this made it significantly more expensive for US companies to use anything but American made steel. US steel producers and their employees were thrilled.

The same week, President Trump accused online retailer *Amazon* of engaging in villainous behavior; complaining the online behemoth has not paid any Federal income tax (which is correct) and denouncing its financial drain on government resources (specifically the US Postal Service, which is partially correct). Also catching the President's ire was Jeff Bezos, *Amazon*'s founder, CEO and largest single shareholder. Bezos also owns *The Washington Post* newspaper, which is a frequent and emphatic critic of Donald Trump. The President clearly dislikes *Amazon* and its billionaire CEO and was overtly trying to damage its business and sully Bezo's reputation.

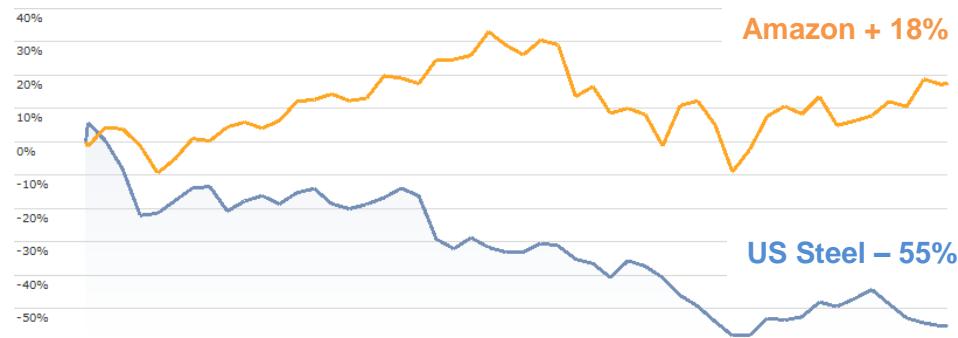
So, in the span of a few days, the Office of the President, the most powerful political voice on the planet, had implemented significant financial incentives for one industry while aggressively speaking out against another. The economic implications of this situation were blatant:

- US steelmakers had a 25% cost advantage over their competition, a gigantic edge in an industry where cost containment is vital. A big plus for US steel.
- At the same time, immense pressure had been applied to major cost inputs for Amazon's business; potentially increasing taxation and disrupting its lifeblood; distribution. A big minus for Amazon.

An investor watching this economic situation unfold might think they had stumbled across a "can't lose" investment thesis; bet on the US steel industry and bet against *Amazon*. To execute this strategy, an investor would buy the shares of *US Steel Corporation*, one of the largest American steel producers, and sell the shares of *Amazon*. It seems clear this strategy should be a winner. The economics are obvious; the President of the United States has chosen a winner and a loser for us. An investor simply needs to implement the trades, then sit back and watch the thesis come to fruition...



**US Steel and Amazon stock, 1 year; March 2018 to March 2019**



Unfortunately, one year later this “can’t lose” strategy has not been a winner. In fact, it has been a total disaster. As shown in the chart above, *US Steel Corporation* (the company bet on) has lost 55% of its value while *Amazon* (the company bet against) has increased 18%. This result is the exact opposite of what was anticipated. An investor who implemented this strategy would have lost 73% of their investment in one year. Economic theory, in this case, was quite incorrect. A + B did not equal C.

Stories for humans are like flames to a moth. Stories speak to both our emotional brain (where decisions are made) as well as our analytical brain (where we justify the decision our emotional selves just made). However, narratives are not scientific theorems. Economics is really good at telling us why something happened in the past, or what might possibly happen in the future but it would be a mistake to treat economics as anything close to a scientific certainty.

What is an investor to do if we cannot simply follow the recommendations provided by credible sounding economic theory? Is there not any scientific process we can use to help create an environment with more certainty? While there is no economic prescription akin to what exists in science, there are some principles that can help us make better decisions. When I look at economic material, there are three main principles I use as a filter. Faced with an economic narrative, I infuse my thoughts with these precepts;

1. The future is largely unknowable. It is always best to focus on probabilities and not possibilities; there are more things that could happen, than will happen. Focus on high probability events and leave the low probability events for others to worry about. Severely limit the size of each bet.
2. All humans crave sensible narratives to feed our illusion of control, without which, the world would seem chaotic and unmanageable. Look at history to help connect whether a similar pattern has existed previously. Correlation does not equal causation (not all things that seem related, are related).
3. Markets are complex, adaptive systems and rarely follow neat, linear narratives. Even things that seem very straight forward and sensible can be very wrong. Don’t bet the farm on a story.

The first quarter of 2019 has started off with a significant market advance, erasing the dip experienced in the fourth quarter of 2018. As the economy looks to be cooling slightly, we continue our judicious approach. One of our biggest investment advantages is shying away from the multitude of investment strategies that proclaim A + B always equals C. We know investing is much more subjective art than it is prescriptive science.

Your pleased science ensures that springtime always follows winter investment advisor,

Duncan Stewart, MBA, CIMA, FCSI, CFP, CPWA  
[duncan@stewartfinancial.ca](mailto:duncan@stewartfinancial.ca)