Growth Through Focus - The Next 100 Years

Our 2018 Intellectual Capital Conference

1919 INVESTMENT COUNSEL
Complexity to Clarity

We are committed to providing counsel that helps families, individuals, and institutions achieve their financial goals.

In a financial world increasingly populated by small boutiques or huge conglomerates, 1919 Investment Counsel is a unique, if not rare, entity.

Firm Facts:

- Founded in 1919 as Scudder, Stevens & Clark
- 20 portfolio managers who average 32 years of experience
- Proprietary research
- Independent thinking
- Over 100 employees
- Offices located in Baltimore, Birmingham, Cincinnati, New York, Philadelphia and St. Louis
- $11.1 billion in Assets Under Management (as of March 31, 2018)

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Complexity to Clarity. I hope you have come across that phrase on 1919's correspondence and materials over the past year. It is at the heart of what we do. In a world of product proliferation and information crosscurrents, we believe that having a partner who is committed to rigorously parsing noise from information and freely sharing our best thinking across a number of disciplines is a big part of the counsel we provide. Our annual conference is a meaningful demonstration of our commitment to educating ourselves with the ultimate goal of bringing a measure of clarity to our clients' complex financial lives.

This year marks 1919's thirteenth annual Intellectual Capital Conference. As in years past, our goal is to take on pressing matters of the day from multiple perspectives and thereby make the advice and counsel we provide as relevant and useful to our clients as possible. This year's topics included – investing in fixed income during a period of expected rising rates, our third revisit of the future of the Euro and the EU, the rationale for and against trade tariffs, a critical look at whether China is in fact growing at the rate generally believed as well as the implications thereof and, finally, a preview of the midterm elections scheduled for this fall. While there is healthy debate and there are multiple views surrounding the issues we studied, each of the speakers added to our understanding of issues that we believe will have meaningful impacts on our clients' lives in the coming year.

I invite you to read through the pieces that follow and to feel free to call any of us at 1919 should you wish to learn more or to discuss any of the topics presented.

Harry O'Mealia, Chief Executive Officer

Christopher Alwine, CFA

Principal, Head of Active Corporate Bond Portfolio Management and Global Credit Research

Allocation to Fixed Income

An allocation to fixed income is generally a prudent part of any portfolio, there to provide diversification and ballast to more volatile investments. From enjoying a 30+ year bull market to frustration with low interest rates, the asset class faces what is uncharted territory for most investors – rising interest rates. After reaching an all-time low less than two years ago following the unexpected BREXIT vote, Treasury yields reached a seven year high, passing the pivotal 3% level for the 10-year. Fears of recession are ignited by the extremely flat yield curve, which is known to indicate a downturn if inverted. The flattening could continue with an actively tightening Fed, another change after six years of zero interest rate policy. As we navigate this evolving environment, Christopher Alwine, Head of Active Corporate Bond Portfolio Management and Global Credit Research at Vanguard, reminds us it is important to focus on the role of bonds within a portfolio.

Mr. Alwine, although recently transitioned to taxable fixed income, was Vanguard's Head of Municipals for over 10 years. When analyzing risks in any market, it is imperative to take a macro look at the economy. With a strengthening economy he sees limited risk of recession in the next one to two years but in regards to monetary policy, there is no room for error. Although the Fed is focused on transparency and open communication, monetary policy is understandably more difficult as historically evident relationships have weakened. One would expect wages to accelerate with full-employment, but we have yet to see a meaningful impact on inflation as the correlation is not as strong as past cycles. Despite inflation less than 2%, the Fed is committed to raising rates, resulting in a flatter yield curve. With a growing Federal deficit to fund tax reform and the Fed simultaneously unwinding the balance sheet, long rates should also continue to move higher.

The rush to pass tax reform late last year left investors with a multitude of questions and unknown implications. For individuals, Mr. Alwine highlighted the State and Local Tax (SALT) deduction limitation as noteworthy, as well as the slight decrease in the top marginal rate to 37% from 39.6%. Corporations benefit from a larger tax cut to 21% from 35%. Specific to the municipal market, the elimination of advance refundings as well as the rush to market prior to the tax code change has reduced supply thus far in 2018 and this is expected to continue. The first quarter of 2018 saw the lightest new issuance since 2011 and could reduce annual issuance for the year by 25%. These changes could have an interesting impact on market technicals, increasing interest from individuals in high-tax states and reducing demand from corporations.

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Despite headlines surrounding some highly publicized defaults, municipal issuers remain very high quality and defaults rare. Mr. Alwine noted that out of nearly 24,000 municipal issuers, there were only 20 defaults in 2017 and 14 were concentrated in Puerto Rico issuers. Aside from issues faced by the US territory, the other looming concern is pension funding. Funding ratios have steadily declined since 2000 but seem to have stabilized. While certain states dominate the headlines, namely Connecticut, Illinois, New Jersey and Pennsylvania, they all need to be assessed individually. Mr. Alwine views the most important factor in this assessment as the need for a unified government committed to improving financial stability. Another lesson learned from bankruptcy proceedings in both Puerto Rico and Detroit is that everything is open to negotiation during bankruptcy. For revenue and general obligation bonds, credit work and a team of dedicated credit analysts can provide the analysis and guidance for how to manage this risk.

Risk is inherent in all asset classes and municipals are not exempt, subject to both credit and interest rate risk. The sector has garnered more attention from mainstream bankruptcies, but Mr. Alwine continues to view municipal bonds as a dominant fixed income class and the best tax-adjusted option. Our job as investment managers, whether for large mutual funds and ETFs such as those managed by Vanguard or separate accounts managed by 1919 Investment Counsel, is not to avoid risk but to manage it. Mr. Alwine's years of experience and expertise in fixed income management provided valuable insight in how to do so.

Lauren Krieger, CFA
Sr. Investment Associate
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known as the four factors of production: land, labor, capital, and entrepreneurship (innovation). According to Dr. Scissors, if we examine each one of these factors closely, we would find that China is lacking in all four. Land is automatically out of the picture as China has historically abused its natural resources. Dr. Scissors explains that they realize this and are working to remediate the situation, but as we all know, it is much easier to chop down a tree than it is to grow one. Labor is another thing that the Party is trying to fix. They have recently repealed the one child policy in China, but the social stigma that is attached to multiple children still remains and it will be some time before the benefits of the repeal will be seen. For now, China must cope with an aging population and a labor market that is not able to meaningfully contribute to growth. Capital too is a problem. One of the benefits of having a system like China's is that you can very effectively control where capital is allocated. Unfortunately for the Chinese, over-reliance on inefficient and poorly run State Owned Entities (SOEs) cripple their ability to grow through progressive capital allocation.

Innovation is really China's last hope to grow. While possible, it will not be an easy path. Dr. Scissors highlights the two main issues; innovation is hard to measure and there is no real incentive for innovation in China. The first issue is self-explanatory – innovation is not something we can really quantify like GDP or wealth, therefore it is extremely difficult to measure. Would-be entrepreneurs in China generally have no incentive to create and innovate due to the lack of intellectual property protections in the country. Stealing ideas then, seems to be the only path to innovation – and who better to steal from than the world's largest economy? Dr. Scissors argues that this theft of IP causes Americans to lose jobs. To further illustrate his point, Dr. Scissors explains that when the Chinese steal American IP, they are able to produce similar goods cheaply for their home market, reducing the demand for American goods. Taking that to the next level, Chinese firms can then begin to export these goods back to the United States causing pressure on the US businesses who developed the technology in the first place. This pressure leads to Americans losing jobs and/or American companies going out of business.

While Dr. Scissors spent most of his time talking about China and its struggles – he concludes with a stark warning to the United States: protecting American IP is protecting American jobs and we must send a message to the world that American laws (including IP) are not to be broken without consequences. The recent ZTE headlines are a prime example of this. ZTE is a cell phone company that has repeatedly violated American sanctions against Iran. In 2017, ZTE was fined $1.2 billion for selling American made goods to Iran through parts of their finished product. Recently ZTE has again admitted to breaking sanctions which prompted the US to ban American companies from doing business with ZTE. President Trump had originally taken a hard stance against ZTE (effectively putting them out of business), but then backpedaled towards a more accommodative position citing loss of Chinese jobs. Now if you've followed Dr. Scissors' argument in the previous paragraph, you will find the President's reasoning a little backwards. American jobs are lost when the Chinese steal IP so it is a little ironic that they are now being sheltered from job loss that would have been a result of breaking American law. Dr. Scissors maintains that the ZTE situation should under no circumstances be a bargaining chip in the President's "trade war". If the President makes the ZTE issue a focal point of the discussions surrounding the "trade war" it sends a message to China that American laws are negotiable and incentivizes them to continue to steal American IP. The message is simple: negotiate on other topics, but let the law stand.

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Thank you to our 2018 Speakers and their Organizations

We hope you enjoyed reading a condensed version of the remarks made by our speakers who addressed our annual Intellectual Capital Conference. In order to have a solid understanding of a problem and feel confident in making decisions, we have to hear all facts and opinions concerning the issue we are studying. In our attempt to accomplish this goal we invite speakers with varied opinions concerning the subjects we are studying. We encourage our speakers to be candid and express their opinions to the fullest. It is clear then that the opinions expressed by the speakers are not necessarily ours but we need to hear them in order to make the best decisions possible.

A great debt of gratitude is owed to the five bright people who acted as reporters.

To all our clients and friends thank you and we hope you have gained knowledge and enjoyment from this effort.

At our 2018 conference, these organizations were represented:

Vanguard

EUROPEAN UNION
DELEGATION TO THE USA

AEI

UNIVERSITY *of* VIRGINIA
CENTER *for* POLITICS

CSIS | CENTER FOR STRATEGIC & INTERNATIONAL STUDIES

1919 Investment Counsel Mission Statement

Each of our clients is unique, and we are committed to understanding their specific values and goals. Our loyalty to clients governs the counsel we provide, bringing clarity to their complex financial lives. We are passionate about consistently delivering an extraordinary client experience.

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