Northstar Notes

"The idea of being objective and dispassionate will never be obsolete."

– Charlie Munger, Berkshire Annual Meeting 2003

Correlation and Certainty: It's Not That Simple

Notes from Henry and Linda

As the year draws to a close, rational thought is as important as ever in a country marked by emotion and division. We try every day at Northstar to avoid behavioral and emotional traps that can detract from the work we do with our clients. It is not always easy to detach from daily news flows, but we do our best. Nor is it easy to avoid simple narratives to explain an incredibly complex global environment. We believe that results are driven by rational behavior. Investment programs built on glib assumptions and presented with an eye to political and economic forecasts are best ignored.

Hindsight is not in fact 20/20. The Great Depression was not caused by a single factor, or even a small set of decisions made by inept policy makers around the world. And yet, entire careers have been built on just those assumptions. Why do so many of us seek out neat little explanations for profoundly complex issues? Could it be that it is simply too upsetting to think that something so awful as a depression or world war could have just … happened.

When studying the First World War, can we really come up with a single moment or decision in July or August of 1914 that started it? But that untidiness is part of studying history … and the markets as well. And just as historians cannot wrap up an era in a neat package, neither can we explain exactly why the market has behaved ebulliently this year after finishing 2018 on a dour note. But at this point, we are gratified by the results.

Ambiguity is part of being human, and a necessary condition in the world of capital. Of course, we cannot forecast the direction of interest rates, currencies, tariffs, tax rates and corporate earnings. Not only can we not perform those magic acts simultaneously, we can't even predict any one element with confidence. So how do we explain the onslaught of "Investor's Guide to 2020!" headlines, along with the annual "roundtable" features where investment managers confidently offer their forecasts for the year ahead?

At Northstar, we have learned to avoid simplistic explanations and forecasts. With that in mind, let's take a look at where Linda and I think we are as the year draws to a close.

- Quite clearly, the biggest news event in our daily lives continues to be, in its broadest sense, the presidency. This is the moment to state the obvious: The prices of publicly traded businesses are tied to their earnings now and future, and those earnings are valued in connection with interest rates. We haven't fallen into the trap of using our political beliefs as part of this calculus.

- We have managed through an impeachment before, and much of our 1998 playbook seems applicable this time too.

- A year ago, we were in the midst of a sharp, 20% correction, and there was widespread concern that the market would continue to decline. Since that point, stock prices have climbed significantly in the face of negative interest rates; widespread use of trade tariffs; fear of a slowing domestic economy; deteriorating relationships with former allies; discord with China; threatening actions and rhetoric from North Korea; chaos on Britain's political scene; and, of course, the pitched battle over President Trump's impeachment. Our focus amidst these political and economic crosswinds has been to follow the guidelines we outlined in January's newsletter: invest rationally in response to each of our clients' personal cash flow needs. If the greatest urgency is short-term, we look to shorter-term fixed income vehicles. When our financial needs are longer-term, and they usually are, we invest across a wide range of the world's leading businesses. None of this has to do with market forecasts, nor does it stem from our belief that we can time or predict the directional change in stock prices. We cannot.

- Did we *expect* the S&P 500 to climb by more than 25%?

  Of course not, but we ignored the temptation of moving to cash early in the year. This decision allowed the earnings of our country's great businesses to flow to you. And that is the key takeaway from 2019: **Political chaos does not always find its way into corporate performance.**

  Do we view much of the current political landscape with a mix of anger, dread and revulsion? Yes, and those feelings inform our political support and charitable activities. But of paramount importance to our work at Northstar, those views do not shade our view of American business.

- Looking ahead, we have plenty of headwinds to consider, and our team at Northstar will work through them. One of the advantages to long experience in this field, is that we have a track record of investing during unprecedented times.

Notes from Bobby, Jeff and Joshua

Bobby Asher:

In the past year, we have confronted major changes in the investing landscape. These range from the digital technology in media to macro-economic relationships between the United States and China.

Business Example: Disney

While most investment commentary has been dedicated to macro-economic issues, thousands of talented and focused people worked to transfer the magic of Disney onto one of the most impressive product rollouts ever: Disney+. In their first day as a live service, Disney created a base of over ten million subscribers. Our reaction, and the stock market's, was astonishment. Disney+ streaming service is a nod to strong future relationships.

At Northstar, we have continued to pride ourselves on relationships which allow you to take comfort in the fact that when you call us, you are connecting with relationships which contribute to your own financial health, and the prosperity of those you love.

Jeff Dziegielewski:

Recently, the S&P 500 dividend surpassed the yield on the US government's ten-year bond. We view this as a meaningful milestone, one that should lead some to reconsider long-term investing assumptions.

One of our most important functions is determining your allocation between equities (ownership of companies), bonds, and cash in your portfolio. Many advisors fall back on the memorable saying: "Own your age in bonds." This phrase, coined by Vanguard's founder Jack Bogle, refers to the percentage you should have allocated towards the asset class. When this slogan began to gain traction, interest rates were *significantly* higher, as some may remember with less-than-fond memories from their home, auto, and business loans of decades past. The idea of paying greater than 10% on a mortgage may seem unfathomable today, but that was the reality as recently as the early 1980's. Using that same logic, we don't believe the creators of the aforementioned simple allocation shortcut would advocate for it today under much different conditions.

Far from the double-digit interest payments of yesteryear, buying a ten-year treasury bond actually returns less than 2%. In real terms, the expectation is that we might well lose *purchasing power* over the life of that investment. Let's say you had a choice – buy a $1 candy bar today or lend that $1 to the US government for ten years. Simple math tells us you wouldn't be able to afford the 2029 candy bar, since the bond is essentially a loan with an interest rate so low that it is bound to lose ground to inflation. Some countries have even employed negative interest rates, but let's not even go there.

When many football stadiums changed from natural grass to a synthetic turf, it was wise of teams to re-assess their footwear. The cleats they had been wearing for years and years didn't grip on the new surface. Game plans had to be adjusted, and those who refused were unceremoniously left behind. We feel similarly to allocation strategy; what may have been a workable solution at one time, owning your age in bonds, does not necessarily mean it will be a successful strategy for you and your family in this era. The playing field has changed.

As it has been since the start, our strategy should always be in the service of your goals. We use actual cash needs as the starting point, rather than relying on overly simple, age-based formulas. Bonds play an important role as we plan for expenses over the near-term, but much less so beyond that. In order to grow, or even maintain, purchasing power, we feel being owners of a diversified group of the world's leading businesses is the far wiser course.

Joshua Garcia:

I began working at Northstar on September 24, 2013. Since then, the Dow Jones Industrial Average ("DJIA") has increased from 15,334.59 to 28,135.38 and the S&P from 1,697.42 to 3,168.80. With dividends, that's an approximate double.

In looking at the results, one might be tempted to say, correctly: "Boy, it sure didn't feel that way!" Because, it didn't. But, that's the point - it never does feel that way. For watching history unfold in real-time has never been, nor will it ever be, an easy or lighthearted task.

In May 2015, I attended my first Berkshire Hathaway annual meeting in Omaha. One of the most important lessons I learned, and one that Warren Buffett has been teaching for over fifty years, is that a successful business is a business that never ceases to delight its customers. And, perhaps, to dig deeper into this lesson, a successful business worth owning is one that either emphasizes the wholesome parts of life or makes the difficult parts of life that much more tolerable. And, ideally, a bit of both.

It is not an aberration that the market has climbed during tumultuous times. In fact, the market's increase over this period of time reflects exactly what has happened: instability in Chinese markets (August 2015), overproduction of oil (Jan-Feb 2016), presidential election and party division (Nov 2016), tax changes (2018), tariffs and trade wars (current), all taking place during an economic recovery in the United States that has been both "too slow" and "too jobless" (2012-ongoing).

But that isn't the whole story. During this period, countless businesses have been created with the express pursuit of solving some of society's more recent ills, making our lives easier, and in doing so, delighting their customers. Delighting us, whether it be the package that arrives the next day, the medicine that does its job, or the movie that is available on demand at the exact moment you want it.

The truth, then, seems to follow that times are always tumultuous for someone somewhere; and, conversely, times are always good for someone somewhere. To shamelessly borrow from Charles Dickens, it has always been a tale of two markets. And so, it only makes sense that our portfolios are designed, uniquely and purposefully, not to avoid but to withstand the vagaries of life. For while we will most likely always be surprised how something happened, we will never be surprised that something did. We will simply be prepared.

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