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The Past as Prologue

Two general prerequisites for stock investment success are: (a) an economic system under which businesses can operate with reasonable efficiency, and (b) a group of businesses which taken together produce reliable profits.

For nearly two hundred years the United States has maintained a system in which business has thrived. In our view, current events are unlikely to alter this winning streak. The past, Shakespeare said, is prologue. We believe this is true of free enterprise today.

Notions that events today will alter this path abound: debt is insurmountably high, wages are irreparably stagnant, and rising living standards are relics of the past.

In this commentary we will: (a) explore the potential for a different economic future, (b) comment on the potential impact of current economic events on our portfolios, and (c) explain how macroeconomic variables are factored into our stock valuations.

The past is prologue only when causal factors persist. This is true for individual businesses as well as for the general economy. The difficulty is identifying the causal factors.

Measuring prosperity is a good place to start. Real GDP per Capita measures the value of goods and services produced per person yearly (adjusted for inflation). Real GDP per Capita growth is a measure of increasing prosperity. The following table is taken from *Contours of the World Economy 1-2030 AD,* Angus Maddison's magnum opus on the world economy.

GDP per Capita Growth (Adjusted for Inflation)

	1-1000	1000-1500	1500-1820	1820-1870	1870-1913	1913-1950	1950-1973	1973-2003
US	0.00	0.00	0.36	1.34	1.82	1.61	2.45	1.86
W Europe	-0.03	0.12	0.14	0.98	1.33	0.76	4.05	1.87
Japan	0.01	0.03	0.09	0.19	1.48	0.88	8.06	2.08
China	0.00	0.06	0.00	-0.25	0.10	-0.56	2.76	5.99
Former USSR	0.00	0.04	0.10	0.63	1.06	1.76	3.35	-0.38
World	0.00	0.05	0.05	0.54	1.31	0.88	2.91	1.56

Growth in economic prosperity is anemic until the early 1800s, when the Industrial Revolution takes hold in the West. Interestingly, the former USSR also grows rapidly until the 1970s, but eventually fails along with the rest of the Communist Bloc, culminating in the fall of the Berlin Wall on November 9, 1989.

The free enterprise economic system is an important causal factor during this period. It is the economic regime under which businesses produced and consumers purchased an ever growing volume of goods and services. Below is a chart of US and worldwide GDP per capita since 1870 using the Maddison data.

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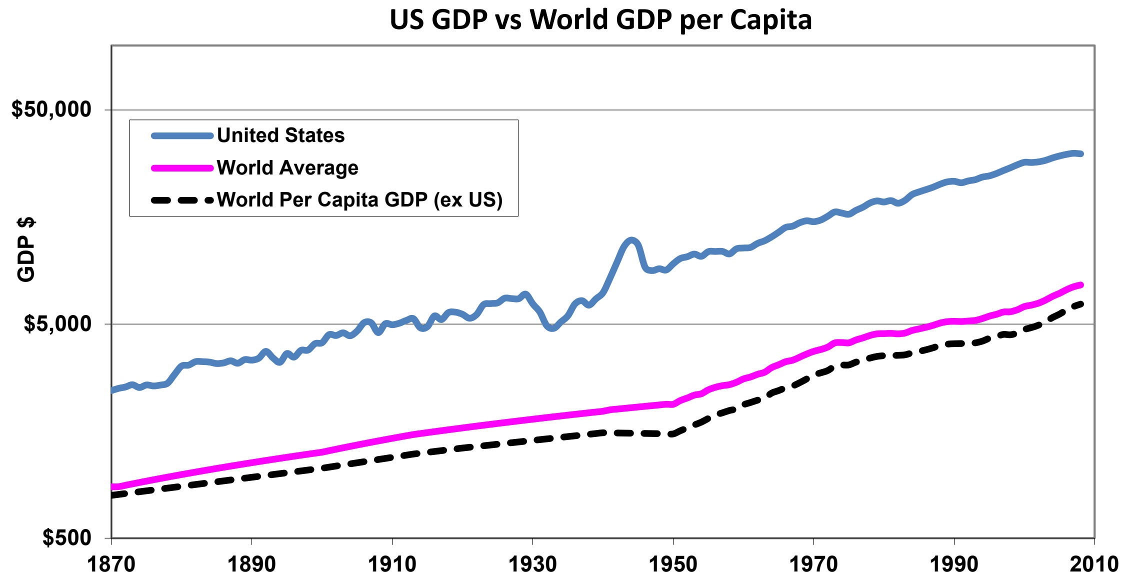

What is the likelihood of a radically different economic future? For starters, the free enterprise story is not so simple. For example, the rule of law and institutions that assure free and fair competition, as well as a fertile entrepreneurial culture, have very likely been integral to the success of the United States. This spontaneously developed economic infrastructure must be maintained. Moreover, unforeseen epic historical events are by definition always a wild card.

Conversely, there is no reason to believe the economic path of progress shown above will come to a grinding halt. The biggest clue in this regard would be easy for most businessmen to recognize. Business, the engine of free enterprise, is conducted today as effectively as it ever has been. Exogenous factors aside, the vast majority of businesses are more efficient today than they were twenty years ago, and twenty years before that, and so on all the way back to the early 1800's.

What about the seemingly endless stream of bad economic news under the media spotlight today? Government and consumer debt, unfunded future healthcare expenses, and over-spending relative to savings represent significant current and potential headwinds. However, there is a world of difference between a temporal economic dislocation and a permanent degeneration in economic conditions.

Over-indebtedness is ultimately a problem of too much paper relative to productive assets. Real productive assets – factories, equipment, software, patents, business know-how – make the economy tick, not the paper. The paper represents an economic "hole" insofar as creditors and debtors thought they had money that they really did not have.

Our "paper" problems are very real. Consumers who were spending money on goods and services are now using these funds to pay back debt. European governments who were spending money, and cannot print currency to pay back debt, are implementing austerity measures. The debt paybacks and

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austerity measures will, however, not last forever. Most importantly, the vast majority of real productive assets will not suddenly disappear.

Unfunded future healthcare expenses and profligate baby boomers also have the potential to goose current production and consumption relative to some future day of reckoning. However, it is doubtful these factors will produce a debilitating economic decline. One clue on that score is to look back at the data. "Over-consumption" has not produced wildly inordinate per capita economic growth compared to historic norms. Headwinds, yes. Game changers, no.

Overlooking these economic issues when investing, however, would be a fatal mistake. A severe financial crisis can devastate an investment portfolio. Our general recipe for protecting against such events remains the same – own quality businesses at fair or low prices. When properly executed, we believe this strategy will protect our client capital from future turmoil, just as it protected our client capital from past turmoil.

A more specific recipe for protecting against permanent losses today is to avoid any firm that does not have the wherewithal to finance itself without the support of Europe's financial institutions. A solid self-financing industrial company would be fine. An industrial or financial firm that relies on bank financing which is not in place for at least the next several years would not.

The circumstances in Europe appear to be intractable. Greece and other weaker EU countries must be allowed to devalue their currencies, or wealthier European countries must subsidize them. Otherwise, they will continue to endure insufferable economic consequences. The only way to devalue is to abandon the Euro, yet this is likely to spur crushing bank runs. In the end, we do not know how events will play out. We do know that we want to avoid the economic epicenter.

Being far from the epicenter does not mean our portfolios would remain untouched. In a worst case scenario, our equity accounts would decline significantly along with the rest of the market. However, as long as the productive asset value of our companies remains intact, the stock prices of our companies should rebound in a reasonable period of time like they did in 2008-2010. To be clear, we are not expecting the worst case. Rather, we believe we are in a position to weather the storm should it reach our shores.

Another essential element for protecting against permanent losses during a financial crisis is getting profit estimates right. When valuing stocks, if profit and growth estimates are too high, one can justify paying a price that is too high. Losses are then realized when expected profit levels and associated stock values do not materialize.

In our opinion, current operating profits in general are not sustainable, a point on which we have elaborated in past commentaries. We are estimating lower profits and growth for many of the companies that we own compared to current profits and analyst growth projections.

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Estimating sustainable profit and growth rates is the point at which macroeconomic considerations enter into our company valuations. One must have a sense of the current economic cycle, and not confuse sustainable profit levels with either boom or recession profit levels.

Our watchword when estimating profits is conservatism. We would rather be surprised by missing some of the upside rather than capturing more of the downside. Our opinion in recent years has also been informed by a more thorough macroeconomic analysis, and consequently our economic expectations have been appropriately muted for the past several years.

The past, we believe, is prologue. Interestingly, the world economy is not necessarily doomed even if it is not. Consider the highly unlikely event that population and productivity growth both cease. The proper response by companies would be to stop investing for future growth and pay all of their profits in dividends. If companies did this, stockholders would profit in proportion to their dividend yield. We believe the sustainable dividend yield for our portfolio companies would be about 9% under these circumstances. Inflation would be *added* to this figure to derive a total estimated return. The chart above would flat-line, but neither wealth nor production would have to decline. While we do not believe we are anywhere near such a scenario, it is interesting to contemplate how the economy could work just fine anyway.

Progress is not only likely to continue, however, it seems intrinsic to human nature. Moreover, with world income per capita at only $11,000 per year, the economic runway stretches as long as the eye can see.

Nick Tompras
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As of November 4, 2022, we have provided this supplement to accompany the commentary and satisfy changing regulations: https://acr-invest.com/commentary-supplement/

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