LOWELL, BLAKE & ASSOCIATES
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Reflections & Observations

March 9th was the ninth anniversary of the start of the bull market. As of the time of this writing, the S&P 500 increased 264 percent since its low on that date. For the last two years, we've experienced unusually low market volatility, which has been a unique side effect of this bull market.

In 2018, however, volatility has returned. While the return to volatility was inevitable, it is jarring nonetheless. At last, it appears that the monetary policies that led to excess liquidity—and unnaturally low volatility—are ending. It is easy to be swept up in the hysteria of these market moves but you should be confident in your portfolio. Our investment strategy guides us away from debt, complex financial products, and speculation, the three primary culprits of economic downturns.

- **Debt** is a drain for individuals, but also a distraction for company managers who, instead, should be focused on innovation and growth. Debt acts as a double-edged sword; it fuels the good (for a while) but exacerbates the bad. Often, as history shows, the culprits of downturns work together; this occurred in February, when highly leveraged (culprit: debt), exchange-traded products (culprit: financial products) compounded the selloff.
- **Financial Products** are expensive and reduce transparency. As long as there has been a stock market, there have been people searching for easy, market-beating formulas and strategies. When there are layers of complex financial products it is difficult to have a focused portfolio or understand how your assets are allocated. Our fall newsletter noted our concerns related to the growing and widespread use of exchange-traded products (ETPs); in February, we glimpsed just how much those products can affect markets when volatility is present.
- **Speculation** is avoided by focusing on the long term, and steering clear of quick, easy money-making strategies. Often, new investment trends are described reassuringly, with phrases such as "this time is different." We stick to our methodology.

In this newsletter, we explore these culprits in relation to past downturns. Our intention is to provide comfort through education, and a better understanding of the drivers behind economic downturns.

On another note, we felt it would be helpful for you to understand why you should apply the same rigorous analysis to charitable giving that you do to stock selection. After all, charitable donations—like stocks—are investments in an organization's long-term vision. You want to make sure your money will be used wisely, and our financial benchmarks and strategic advice can help you do that.

There is also much to learn about the tax reforms that recently went into effect. We have highlighted a selection of tax code changes that may be of interest to you, or someone you know.

In previous newsletters, you have read about our quantitative metrics for analyzing stocks. In this issue, we cover one of the most important qualitative steps we take in assessing companies: evaluating senior management. While we could easily fill an entire issue with management teams, we want to highlight three chief executives we find noteworthy.

Finally, we had a great response to the LBA reading/watching/listening list we shared in our last newsletter. Since then, many friends of LBA have shared with us what they are reading, and we've included these titles on the last page. If something has piqued your interest, we'd love to hear about it.

We hope you find our newsletter helpful and look forward to hearing from you.

- Diana B. Malcom

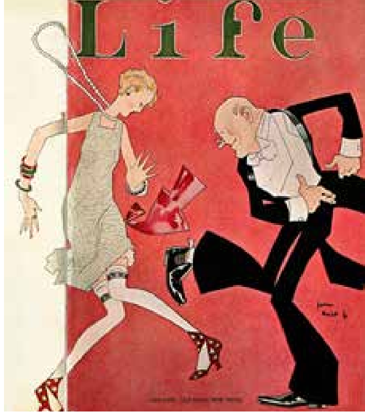
See disclosures on last page

Debt, Financial Products, and Speculation

Debt is not good; complex financial products are worse. Either one can significantly damage a company or portfolio. But add speculation to the mix, and you have a full-fledged recipe for disaster. Following are some notable economic lowlights that occurred because of these three factors.

Crash of 1929 and the Great Depression

(Main Culprits: Debt and Speculation)



The "Roaring Twenties" kicked off the 20th century with flappers, dance halls, and radio empires. Americans borrowed money like never before, not only using store credit lines to purchase modern appliances from RCA and Sears, but using credit to buy stocks. By the late 1920s, the Federal Reserve began to fear the continual rise in stock prices, which was driven by investor use of speculative credit. The Fed tightened monetary policy, and the rest is (unfortunate) history. In 1933, President Roosevelt established the FDIC and the SEC, two institutions designed to instill confidence in, and to ensure stability of, the financial markets.

1970 - The Bankruptcy of Penn Central Railroad

(Main Culprits: Debt and Financial Products)

The late-1960s introduced commercial paper, an innovation that allowed short-term, unsecured debt to be issued by nonfinancial corporations. In early 1966 outstanding commercial paper totaled nearly $10 billion, but this figure grew to $32 billion by May 1970. Once again, the Fed raised rates—from six percent in late 1968 to nine percent in mid-1969—to slow the rapid boom in corporate investments. The tightening caused Penn Central Railroad to default on $82 million in commercial paper, triggering its record-breaking bankruptcy as well as a run on the commercial paper market. Once again, the Fed intervened to save the day, but later tweaked regulatory rules to accommodate the innovation. To offset risks, new regulations required companies to maintain a bank credit line sufficient to pay off their commercial paper commitments. This liability still exists today, however, it does not appear on bank balance sheets, and is not closely monitored by the Federal Reserve.

1973-1974 Stock Market Crash

(Main Culprits: Debt, Financial Products and Speculation)

Profits soared after the 1970 recession and the "Nifty Fifty," an index of large firms that began to outperform in the late-1960s, were coveted holdings. While the S&P 500 carried a price-to-earnings ratio of 19, the average ratio for the Nifty Fifty was 42. Since the Great Depression, markets had favored companies that issued dividend payments, yet this philosophy shifted in the early 1970s as markets instead began to reward companies who borrowed capital to grow rapidly. The early 1970s also bred a new financial innovation: The Real Estate Investment Trust (REIT). The popularity of REITs, and easy access to capital, drove a housing boom and a bust in 1974. Banks absorbed the losses, and their balance sheets weakened as a result. Around the same time, the London branch of Franklin National Bank (the 20th largest bank in the U.S.) accumulated bad loans and nearly triggered an international banking crisis, until it was provided with loans by the Federal Reserve. As a result of the severe economic effects of the U.S. housing crash and bursting stock bubble, no regulation ensued. Banks took this as a vote of confidence, and grew their overseas business aggressively.

A Timeline of Bubbles & Crises

1636 – 1637
Netherlands Tulip Mania

1719 - 1721
French Louisiana-Mississippi Bubble

1982 – The Latin American Debt Crisis

(Main Culprits: Debt, Financial Products and Speculation)

During the commodity boom of the 1970s, Latin American economies thrived. Between 1975 and 1982 debt from Brazil, Argentina and Mexico grew at a rate of 20 percent. Eventually, the outstanding debt of Latin America reached 50 percent of its GDP. Mexico went so far as to borrow (in U.S. dollars) against its future oil earnings. During these boom years, foreign governments and corporations borrowed in U.S. dollars, since the dollar was viewed as a relatively cheap and stable source of capital. Unfortunately, this backfired when Paul Volcker's Fed raised interest rates to 20 percent in 1979; major financial casualties ensued, including Silver Thursday. On this day, the family of H.L. Hunt (a Texas oil billionaire) faced losses of $1.7 billion on aggressive bets in the silver futures market. These losses almost destroyed a major Wall Street firm, but a consortium of banks collaborated to save the Hunt family and the banks. In August 1982, Mexico was the first of 16 Latin American countries to default on its debt. The decade that followed became known as the "Lost Decade" for Latin America.

October 19, 1987 - Black Monday

(Main Culprits: Financial Products and Speculation)

Pensions and other institutional investors purchased portfolio insurance, a product sold by consultants to protect against the downside of a market selloff. Essentially, portfolio insurance was a combination of put options and a computer short selling futures. The put options provided owners (pensions and institutions) with the right to sell stock at a specific price should the market fall. Shorting the market, on the other hand, was a strategy to generate gains during a market decline. As the market fell, both put options and short-selling markets were triggered, which caused more selling, which in turn triggered more put options, and more shorting of the futures market, which triggered more selling…. The result? The Dow fell over 23 percent in one day, and portfolio insurance products were unable to cover the downside. As a result, several firms were left with margin calls and realized losses.

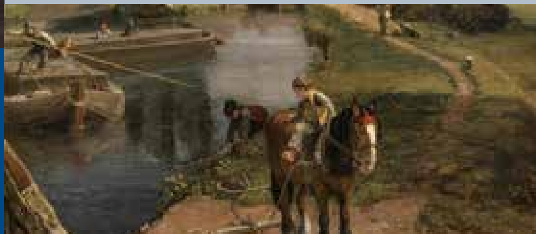
1998 – Long-Term Capital Management and Dot-Com Bubble

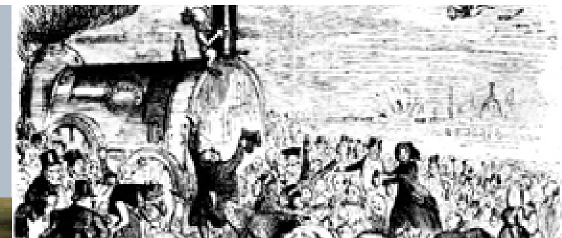
(Main Culprits: Debt, Financial Products and Speculation)

In 1998, Long-Term Capital Management (LTCM), a large and highly-levered hedge fund, collapsed after making bets that soured during the 1997 Asian Financial Crisis. LTCM used massive amounts of leverage to churn out very small profits; the fund leveraged its $4.7 billion in equity with $129 billion in debt (a debt-to-equity ratio of more than 25:1). One investment was the 29.75-year Treasury bond, which was cheap when compared to the more popular 30-year bond. Without leverage the trade would have generated a return of just .02%, but with leverage it could return 0.5% quickly because of the size of the trade. When the Asian crisis peaked, prices moved in unexpected ways, and LTCM's bets failed spectacularly. The Federal Reserve coordinated a $3.6 billion bailout of the fund, which was financed by 16 banks. In the 12 months preceding the crisis the S&P 500 had grown by 17 percent, but, out of caution, the Greenspan Fed cut interest rates by 75 basis points. Companies borrowed to grow quickly, and stock prices skyrocketed; the NASDAQ increased by more than 50 percent in the following 18 months, the final rally of the dot-com bubble.

1720 - 1721
UK/South Sea Bubble

1790 - 1810
UK/Canal Mania





1840 - 1846
UK/Railway Mania

Debt, Financial Products, and Speculation (Cont.)

2008 – The Global Financial Crisis
(Main Culprits: Debt, Financial Products and Speculation)

Pinpointing the underlying causes of the global financial crisis is complicated, but a series of deregulatory acts amplified the crisis. First, beginning in the mid-1990s, banks were pressured to increase mortgages to less-qualified borrowers, use alternative credit metrics, relax income requirements and use automated underwriting programs (to reduce bias). Second, the repeal of Glass-Steagall legislation in 1999 enabled investment banks to merge with commercial banks, resulting in financial behemoths such as Citibank. Finally, in 2004 the SEC changed its net capital rule, allowing the largest U.S. investment banks to assume debt without debt-to-capital constraints. Funds that were previously held to cushion against losses were increasingly used to finance complicated instruments, including mortgage-backed securities. The leverage ratio at Bear Stearns famously rose from 8:1 to 35:1. The company's $395 billion of debt was supported by just $11.1 billion in equity before its collapse in 2008. Once again, sustained, easy monetary policy (enacted after the dot-com bubble) coupled with new and innovative debt instruments lay the groundwork for economic collapse. Economic policies tightened in 2006, the housing market peaked soon thereafter, and the monstrous bust followed.

LBA's Approach to Booms and Busts
Like investors, good companies can uncover new opportunities during busts. At LBA, we favor companies whose balance sheets are strong, and whose management can not only weather market turmoil, but capitalize on it as well. Every crisis presents opportunities for those who remain calm, think clearly, and act rationally.

Notable Leadership

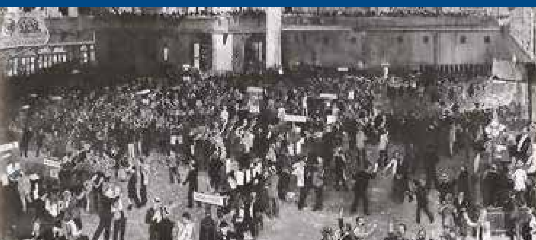
The quality of top management is an important consideration in our company research and evaluation process. A CEO isn't just a figurehead who attends conferences and spews company rhetoric; he or she sets the tone of the organization, defines its culture, and plans strategic, long-term objectives. Following are the profiles of three chief executives we find noteworthy.

Satya Nadella (Age: 50)
Company: Microsoft
Hometown: Hyderabad, India

Background
Prior to becoming Microsoft's CEO, Nadella was executive vice president of Microsoft's Cloud and Enterprise group. In this role he led the transformation to the cloud infrastructure and services business, which outperformed the market and took share from competition. Previously, Nadella led Research and Development for the Online Services Division and was vice president of the Microsoft Business Division. Before joining Microsoft, Nadella was a member of the technology staff at Sun Microsystems.

Our Thoughts on Nadella
Since becoming CEO in 2014, Nadella has completely

1893
U.S. Panic



1907
Bankers' Panic/Knickerbocker Crisis

1929
Stock Market Crash and
Great Depression

transformed Microsoft. He is laser-focused on executing the company's "mobile-first, cloud-first" strategy. Financial results have significantly improved, and Microsoft is a strong leader in the rapidly-expanding cloud industry. Considering the size and scope of the operations that Nadella inherited—which focused on products for PCs, and not cloud services—his achievement is admirable.

Indra Nooyi (Age: 62)
Company: PepsiCo
Hometown: Chennai, India

Background

Prior to becoming CEO in 2006, Ms. Nooyi served as PepsiCo's president and chief financial officer beginning in 2001, when she was also named to PepsiCo's board of directors. Mrs. Nooyi also served as the senior vice president of Corporate Strategy and Development from 1996 until 2000, and as the senior vice president of Strategic Planning from 1994 until 1996. Before joining PepsiCo in 1994, Mrs. Nooyi spent four years as the senior vice president of Strategy and Strategic Marketing for Asea Brown Boveri (ABB). Between 1980 and 1990, Mrs. Nooyi worked for Motorola, and for the Boston Consulting Group, where she spent six years directing international corporate strategy projects. Mrs. Nooyi began her career in India, where she held product manager positions at Johnson & Johnson and Mettur Beardsell, Ltd., a textile firm.

Our Thoughts on Nooyi

Ms. Nooyi's knack for product innovation is rarely seen in the fairly monotonous food and beverage industry. The inquisitive, highly-efficient executive frequently contemplates new food and beverage offerings to introduce under Pepsi and Frito-Lay umbrellas. In a recent public forum, Nooyi proclaimed the company's need to constantly challenge itself by investing in popular products that may be foreign to the Western palate, including insects.

Gary (CEO; 73) and Randall (Chairman; 86) Rollins
Company: Rollins, Inc.
Hometown: Atlanta, Georgia

Background

The biography of Gary and Randall Rollins is inseparable from that of the company that they run. Rollins, Inc. was started as a broadcasting company in 1948 by brothers John and O. Wayne Rollins (Gary and Randall's father), with the purchase of a radio station in Virginia. Over the years, the company diversified and in 1964, the company completed its first leveraged buyout when it purchased Orkin Pest Control. Since then, Rollins has flourished, becoming the largest pest control business in the U.S., operating under 14 different brands across the globe. Both Rollins brothers have worked at the company for most of their adult lives, holding numerous positions throughout the organization. Randall began working at the company in 1949 and Gary in 1967. Randall was appointed chairman in 1991, and Gary CEO in 2001.

Our Thoughts on the Rollins Brothers

We believe the Rollins brothers' honesty and integrity are unparalleled in today's universe of publicly-traded companies. The company simply doesn't play any games with investors; the quarterly report, for example, includes no appendices, no adjustments, and no "pro-forma non-GAAP" numbers. Even their quarterly earnings calls are succinct and to the point. In today's environment, where management teams usually try to massage quarterly numbers to their benefit, we welcome Rollins's honest and straightforward approach.

1966
U.S. Credit Crunch

The Recession of 1973 - 1975

1980s
Latin American Debt Crisis

Recent Changes To Tax Code

Generally, taxes have been more fluid than straightforward, particularly for those eligible for the Alternative Minimum Tax. However, because of the last-minute nature of the 2018 tax code overhaul, you may have missed several important tax code changes. Listed below are just some of the biggest changes individuals may encounter next year. Please give us a call if you have questions about these (or any other) significant changes. Please note that generational differences in income impact tax strategies for multi-generational families; as such, we recommend clients with multiple generations speak with their CPA about family tax-treatment concerns and circumstances.

529 Plans and K-12 Private Schools
Previously designated for higher education only, 529 plans can now be used for K-12 private schools. All other rules surrounding 529 plans still apply.

Charities Will Be Hurt
While most of our clients itemize deductions, it is important to note that the standard deduction will nearly double for individuals and families. Why does this matter? Because now, more people will claim the standard deduction instead of itemizing (and benefiting from) charitable donations. Charities—particularly those that rely on smaller donations—will likely suffer. Please note that no changes were made to the IRA charitable transfer, which enables one to donate up to $100,000 directly to a charity (assuming one qualifies for a required minimum distribution).

Mortgage Caps and Local Taxes
Homeowners with existing mortgages may continue to deduct interest on debt up to $1 million. However, new mortgage holders (those activated after Dec. 31, 2017, including refinancings) may only deduct interest on debt up to $750,000. There is also a $10,000 cap on state and local tax deductions (SALT) for 2018. Previously, these deductions were unlimited.

Spousal Support Income and Deductions
Currently, spousal support must be reported as taxable income by the recipient, and can be deducted by the paying spouse. If, however, you divorce in 2018, recipients will no longer have to report spousal support as taxable income, and paying spouses will no longer be able to deduct it. Courts will resolve the discrepancy, but this can be a nasty surprise or a pleasant surprise, depending on which end of the agreement you find yourself.

Business Benefits and Incentives
If your business is planning on buying new equipment, the new tax law allows you to deduct the entire cost of (qualifying) equipment in the same tax year. While not a drastic change for small companies, this change provides a huge incentive to large companies to purchase new equipment.

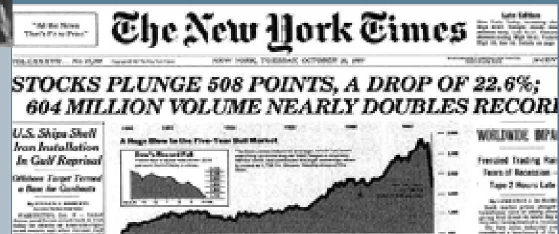
The 2018 tax law also encourages large companies to reduce their debt. Large companies will only be able to deduct net interest costs of up to 30 percent of earnings before interest, taxes, and depreciation. After 2022, that figure becomes just 30 percent of earnings before interest and taxes. This change is important because many companies—thanks to today's low interest rates—have been borrowing heavily to buy back stock. McDonald's, we are looking at you! By limiting the net interest tax advantage, we anticipate these questionable buyback efforts will dwindle.

There are several more changes that may affect you and your account, as the IRS continues to address holes in the new code (e.g., passive income and newly-formed Delaware LLCs). The best way to ensure your tax strategy is effective is to hold a joint conversation with your portfolio manager and your accountant.

1986 - 1991
Japanese Asset Price Bubble

1986 -1995
Savings & Loan Crisis

1987
Black Monday

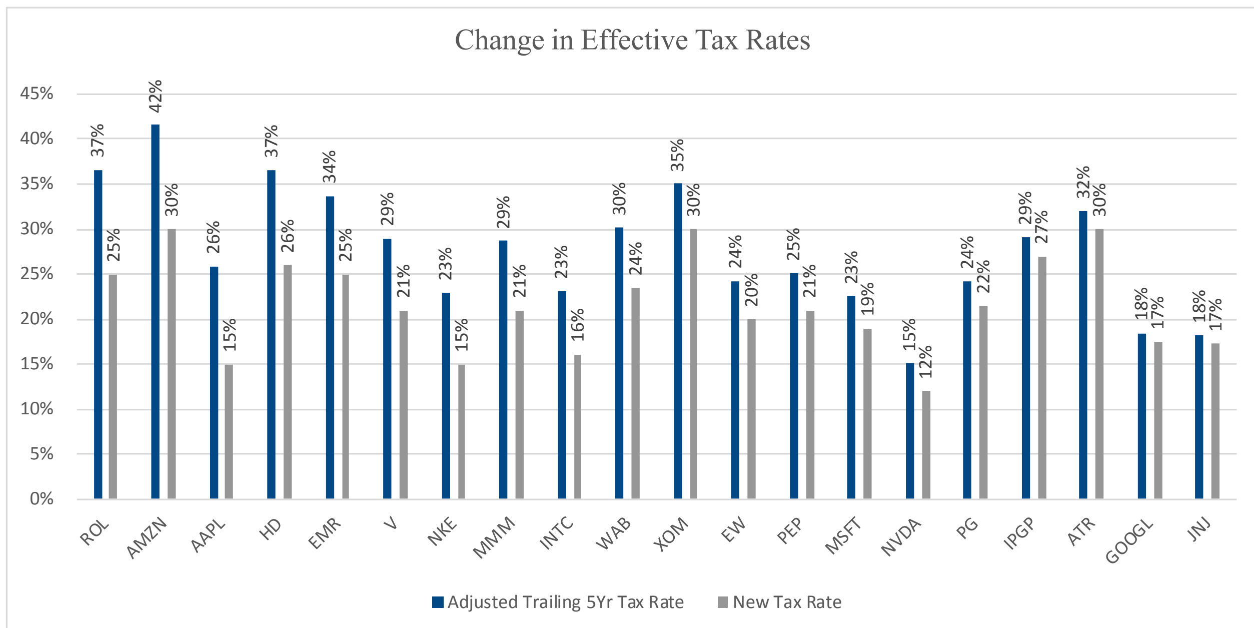

The New York Times

STOCKS PLUNGE 508 POINTS, A DROP OF 22.6%;
604 MILLION VOLUME NEARLY DOUBLES RECORD

U.S. Ships Shell Iran Installation In Gulf Reprisal

Corporate Tax Rates

As this chart illustrates, the companies with large U.S. revenues stand to benefit most from new tax reforms. We expect companies to use their tax savings to invest in, and grow, their business lines.



Assessing a Charity

Whether you are looking to support a new charity or an old cause, it is important to look closely at how effectively your charitable gift is being used. Since this can be a daunting task, we've outlined some best practices to help get you started.

Read the Mission Statement
At first blush this seems obvious. However, if you have been giving to a charity for several years, it is important to make sure that your initial reason for giving hasn't changed. A mission statement should concisely present a charity's core programing, and align with your philanthropic goals.

Check the Financials
The cornerstone for evaluating any organization, regardless of the nature of the business, includes reviewing its financials. An organization with solid financials will have healthy, unfettered cash flow, a strong balance sheet with low to no debt, and easily-understood financial statements. Studying an organization's annual report or Form-990 (which is like a tax return) should allow you to discern its financial health. By learning how much debt a charity holds, and by calculating some simple financial ratios, you will develop a strong sense of its financial stability.

Speak With Management
How long has senior management been at the organization? What drives them? Do they have a three- to five-year strategic plan with specific and measurable goals? Do you like them? What does your gut tell you? As a donor, you should feel good about

1998
Asian/Russian Financial Crisis

1997 - 2000
Dot-Com Bubble

2007 - 2008
Global Financial Crisis

Assessing a Charity (Cont.)

charitable gifting. A conversation that leaves you with an uneasy or negative feeling raises a large, red flag.

Benchmark Expenses
Charity-specific benchmarks, such as percent of total expenses spent on programs, cost of fundraising, and diversity of funding sources provide a clear picture of how well the organization stewards its gifts. The ideal ratio of programmatic expenses to total operating expenses is above 70 percent; this indicates the charity is directing support to its mission. The cost of fundraising illustrates how much the charity is spending on fundraising efforts; a cost of less than $0.30 to raise $1.00 is a good benchmark. Lastly, a diverse funding stream is vital to an organization's sustainability and allows for the natural ebb and flow of individual, foundation, corporate, and government support.

Seek Our Advice
LBA would be happy to help you assess an organization's financial health and the overall effectiveness of its programs. Did you know that LBA has its own Charitable Fund called MENTOR? Our mission is to support regional charities that are tied to the themes of Medicine, Education, Nature, Tolerance, Opportunity, and Responsibility. We target charities with a limited budget, high rate of volunteerism, and strong leadership. Our strategy for selecting charities is routed in the same philosophies outlined above. Next year, MENTOR will be turning 15 years old, so please be on the lookout for more information.

Finally, in case you missed it, Jess Welch recently joined our team as Giving Coordinator. Please feel free to give Jess a call to chat about anything related to charitable giving.

What Our Clients Are Reading

- The Lost City of the Monkey God: A True Story
- Islands of Profit in a Sea of Red Ink
- Last Hope Island: Britain, Occupied Europe, and the Brotherhood That Helped Turn the Tide of War
- Elephant Company: The Inspiring Story of an Unlikely Hero and the Animals Who Helped Him Save Lives in World War II
- Clementine: The Life of Mrs. Winston Churchill
- 12 Rules for Life
- Endurance: Shackleton's Incredible Voyage
- The Book of Joy
- The Shadow of Sirius
- Red Notice: A True Story of High Finance, Murder, and One Man's Fight for Justice
- Eleanor Oliphant is Completely Fine
- The Time of Our Lives: A Conversation About America
- In the Hands of Providence
- Citizens of London
- Grant

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