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My Daughter Thinks I Work for Some Sort of a Political Company

If you ask my teenage daughter Jane where I work, the answer would be something like: "He works for Baystate Political Management. His job is to listen to, read, and analyze the news to figure out what governments and their banks are going to do."

I can understand her vantage point. She's grown up accustomed to overhearing an endless supply of opinionated comments from me regarding the Federal Reserve, the European Central Bank, The Bank of Japan, elections across the globe, and even the make-up of our Congress. More recently she's heard all about our new administration, fiscal stimulus, Brexit, a decision by our central bank and the upcoming French elections.

It hasn't always been this way. As my career has progressed, the extent to which governments and central banks influence the market has grown substantially. At least it certainly feels that way. It is true that in my mid 20's the size of Greenspan's briefcase was often used to gain some insight into the direction of interest rates. However, that type of analysis was secondary to what is more important to stock prices - fundamentals. Specifically, earnings, expected earnings, revenues, dividends and valuations. Back then, my conversations with investors and colleagues were dominated by the basics – how much money do companies make, how much will they make, and what's a fair price for the stock.

Even though the discussions have changed, it is still true that stock prices are directly influenced by earnings, and more importantly, changes in expected future earnings. If that's true, then why is there so much focus on politics, politicians and central bankers? And is this change good or bad?

I find the transformation in investors' focus to be a function of globalization, the role of governments, and even the evolution of exchange traded funds (ETFs).

Globalization

Globalization, or the integration and inter-dependence of domestic and foreign markets, has increased over time. Whether investors like it or not, policy decisions across the globe affect corporate profits here at home in the U.S. The same is true for investors overseas as it relates to our fiscal, monetary and

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regulatory conditions. To quantify this theory, consider the S&P 500, which is a common gauge of the U.S. stock market. As time has progressed, the amount of revenue generated by S&P 500 companies derived from foreign profits has increased. Today, foreign sales account for roughly 40% of the total revenue for S&P 500 companies. Consequently, the economic health of foreign countries, in which a company has a market, is relevant because there is a direct connection with spending patterns and revenues. In other words, if a company has about 40% of its client base in another country and that population is reducing spending due to economic hardship, the result is likely to be detrimental to the corporate top and bottom lines. Undeniably, geopolitics do matter to the bottom line, and this is particularly true for larger, multinational companies.

The bottom line is that these types of geopolitical variables are more important to investors and corporate decision-makers now than they have been in the past. Even U.S.-based investors who are allocated solely to domestic companies must factor geopolitics into their decisions. A recent example is observed in the global equity market sell-off shortly after the results of the U.K. referendum ("Brexit") last summer.

Is this good or bad? There is no consensus on this point. Some pundits claim this debate is at the heart of why our new President was elected. Baystate Wealth's view is that, in the aggregate, globalization is a positive evolution. We believe it raises the standard of living of millions of people but we also recognize not all people participate in that benefit equally, and the transition can be painful. This transition is done in exchange for cheaper goods produced in the developing world but often comes at the expense of low-skilled labor in the developed world. It is unfortunately the case that some find themselves displaced from their employment as a direct result of the mobility of the global workforce (witness Goldman Sachs and other companies relocating or firing people who work in London because of Brexit concerns).

There is currently a growing populist sentiment across the world that could very well slow, or temporarily halt, the progression of globalization. This too, would likely have both positive and negative effects. It's true that a more domestic economy might save some jobs that would be otherwise lost. However, at the same time, the cost of many products we have all become accustomed to might become out of the reach of more people than were helped by the repatriation of some jobs.

<u>Government</u>

As with globalization, the role of government is a topic that can create heated debates. Some feel government should play a larger part in our lives and others think the influence should be *de minimis*. One thing is certain; the more involved a government becomes in business, the more important it is as a variable in the investment decision-making process.

Changes in taxes and regulation can have a direct, and often-times immediate impact on revenues and earnings and, therefore, stock prices. Given the extent to which government involvement around the world has increased over the years, it's not a surprise those of us in the wealth management business find ourselves analyzing and discussing geopolitics more than in the past.

The reason that many governments have amplified their effect on markets was, at least in my view, born out of good intentions. Specifically, the Great Recession about a decade ago created unprecedented involvement by governments and agencies across the globe. Recently, central banks drove interest rates down to near-zero percent levels; governments bailed out car companies, insurance companies and established financial institutions; and we even found some banks were "too big to fail". Many claimed government didn't do enough to protect us and therefore they needed to be involved in regulating the banks, rating agencies, and hedge funds. On the other hand, some claimed the reason for the market collapse and recession was the fact that government meddled in free markets and incentivized banks to lend money to investors with little chance of paying back their mortgages. Do you remember "NINJA loans" – No Income, No Job No Assets? As time progressed and we dug ourselves out of a global recession, new phrases and acronyms began to appear like TARP, QE, austerity, bail-out packages,

European Stability Mechanism, and eventually the Dodd-Frank Wall Street Reform and Consumer Protection Act. All of the aforementioned describes measures to increase government's role in the economy and business.

Is this good or bad? In my view, it would be good if governments would take a few steps back and get out of the way. This is especially true of the U.S. for two reasons. First, the U.S. is about 50% of the global stock market so it's obviously important to most markets, not just domestic markets but global markets as well. Second, the amount of regulation and government involvement has steadily increased over the terms of our last two Presidents. To be clear, this is not a politically-biased statement. In my analysis of equity markets, I find the consensus from corporate decision-makers on both sides of the political spectrum to be seeking some degree of regulatory relief. The market, which is supposed to be an efficient interpreter of information, appears to agree as evidenced by the fact that equities have rallied on the likelihood of a pull-back on some regulations.

The Evolution of ETFs

Over the last 20 years ETFs, which are "Exchange Traded Funds," have transformed the investment landscape by allowing investors to gain low-cost, tax-efficient exposure to various "buckets" of stocks. The first ETF was introduced in 1993. Today, ETFs are over a $3 trillion industry.

The connection between ETFs and why investors focus more on geopolitics may not be direct and obvious at first glance. However, I've found that when investors own diversified groups of stocks under one "wrapper" like an ETF, they focus more on aggregate valuations and what might increase or decrease earnings, on the aggregate, in the future. When using ETFs, the noise of specific companies and their products and services is removed. For example, an investor who owns SPY (the ETF that tracks the S&P 500 Index) is likely to be focused on the recent price movement of the index, the valuation relative to its history, and how changes in taxes, government regimes and regulations might impact companies, on average, within that index. This would be opposed to an investor owning Samsung focusing on whether the company will survive the recent debacle of exploding phones.

Is this good or bad? We believe the evolution of ETFs and the focus on aggregate profits is a good thing. At Baystate Wealth, we believe asset allocation and higher level top down analysis is key to a successful investment strategy. A benefit of owning ETFs is that they remove company-specific issues which we believe are effectively "noise" in the investment decision making process. Given the increasing popularity of ETFs it is logical that many investors have turned their attention away from analyses of products and services and towards higher level issues like the direction of interest rates, currencies, trade negotiations, the Tweet *de jour* and the stability of the European Union.

Summary

Overall I think it's good that investors seem to focus more on high level geopolitical factors than in the past. Anything that keeps the emphasis on bottom-line earnings and what might help or harm future earnings is good in my book. The additional benefit this dynamic has is that investors are more likely to focus on asset allocation rather than individual companies. At Baystate Wealth, a core component of our philosophy is that asset allocation is a critical factor in the success or failure of an investment strategy.

Although globalization has certainly had some negative consequences, it has contributed to lower rates of inflation, higher living standards, and arguably increased the speed at which technology has developed.

The role of governments and central banks in the global economy does seem excessive. Again, although the intentions may have been pure, the magnitude of current regulations coupled with a lack of clarity about the future isn't helping the business environment. Too little regulation could lead to excessive risk taking, while too much regulation could stifle it. Like the three bears and their porridge – not too hot, not too cold – somewhere in the middle is just right and optimal.

Aside from creating a simple low-cost, tax-advantaged vehicle for investors, ETFs have helped many investors focus on what we believe is most important – earnings, valuations and a proper asset allocation.

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