COLBERT INVESTMENT MANAGEMENT

2016 Annual Letter to Clients

The election of Donald Trump as President of the United States has nearly unprecedented implications: some predictable, most unpredictable, some excellent, others very bad. Therefore we are departing from the format in our past (and future) letters that usually focus on our bottom-up process of making investment decisions, with little emphasis on general economic forecasts or political noise (the "macro"). This letter will cover the macro.

But first, a warning. Investing according to what macro events may happen, and their potential impact on markets is exceedingly difficult (and consequently risky). As investing guru Howard Marks wrote last week: *I had dinner with Warren Buffett about a year ago, and he pointed out that for a piece of information to be worth pursuing, it should be important, and it should be knowable. These days, investors are clamoring more than ever for insights regarding the macro future, because it's important: it moves markets. But there's a hitch: Warren and I both consider these things are largely unknowable. He rarely bases his investment actions on them, and neither does Oaktree*.

The U.S. stock market initially got very scared by the election of Donald Trump on the night of November 8. The next morning, after having heard Mr. Trump's conciliatory acceptance speech, things rapidly changed for the better. Markets have since continued to appreciate the high probability of corporate tax cuts and reduction of overly burdensome regulations, along with a possible increase in infrastructure spending. These action could push economic growth higher, along with some higher inflation and interest rates.

In the recent Barron's 2017 Roundtable, an event at which several well regarded investment professionals give their outlook for the year, much of the conversation revolved around what the election of Mr. Trump means to markets.

> **Mario Gabelli**: *Trump's victory meant a rebirth of capitalism, with all its flaws, and a defeat for creeping socialism. It meant the U.S. would remain a place where capital would be honored, as opposed to impaled. Republican control of Congress means regulations will be reviewed and reformed, because the implementation wasn't practical. Our tax policies could be reformed to make U.S. companies more competitive with the rest of the world. Monetary stimulus is ending; fiscal stimulus is coming, and could include spending on infrastructure and revitalizing the military.*
> *The companies and people I've talked to see American innovation taking center stage. We are witnessing a wave of optimism sweeping the country. The question is: How much of the good news has the stock market already discounted? Financial companies will have good earnings this year. The oil ecosystem will improve. But currency translation will remain a problem for some companies, given the strength of the dollar. I continue to look for companies that have been ignored by the market, or unloved.*

But there were cautionary words too:

> **Oscar Schafer**: *From the time Ronald Reagan was elected in November 1980 until he was inaugurated in January 1981, the market was up 9%. It then fell about 30% through August 1982. I'm not predicting that, but we have had a lot of euphoria*.

A rising economy usually comes with pressure on prices, inflation, and a resulting increase in interest rates. The 10-year U.S. government bond has gone from 1.80% in early November 2016 to around 2.40% now. Most pundits think interest rates will continue creeping higher.

> **Jeff Gundlach** *(who correctly predicted a Trump win a year ago): If fiscal stimulus lifts the growth rate this year to 2.5% to 3%, and you throw an inflation rate of 2% to 3% atop that, conservatively you're talking about nominal GDP around 5%. How can bond yields stay at 2.4% in that environment?*
> *…..*
> *The shift in sentiment to positive from negative, regarding the efficacy of Trump is one of the biggest I've seen in my career. I wonder if sentiment can swing just as quickly the other way. Many people who voted for him think something is going to change for them. They expect their wages to rise, and America to be "great again." What will happen by July or August if nothing has changed? Put that together with the timing of an interest-rate rise, and we potentially could see a very different psychological environment*.

Other well-known investors like Ray Dalio have expressed their views on LinkedIn: *The question is whether this administration will be a) aggressive and thoughtful or b) aggressive and reckless*. He further added in an interview on CNBC on January 18 at the World Economic Forum at Davos, Switzerland: *Right now as an influence [populism] is more important than central banking. This is the first year I would say politics is more important. If you look at Europe as a whole and you're going to say what is the greatest threat to the European Union? It is not the debt crisis. It is not central bank policy. It is the movement of populism.*

In his last Memo on January 10, Howard Marks wrote about the folly of relying on expert opinions and their forecasts: *How would the two candidates differ as president? It didn't take any brilliance to conclude that a Clinton administration would be quite predictable and operate within rather narrow boundaries, while anything was possible from a Trump presidency – in some cases better than a Clinton one, but also with considerable potential for worse… Any expert who tells you what's in store from the Trump administration – or from Britain's departure from the EU; Italy without reform and Renzi; the Indian economy (…); or the coming elections in France and Germany – is talking through his hat*.

Finally, Robert Shiller asks what Donald Trump's campaign slogan "Make America Great Again" really means, that it can't be just about money and power.

> **Robert Shiller**: *"Make America Great Again," the slogan of President-elect Donald J. Trump's successful election campaign, has been etched in the national consciousness. But it is hard to know what to make of those vague words.*
> *We don't have a clear definition of "great," for example, or of the historical moment when, presumably, America was truly great. From an economic standpoint, we can't be talking about national wealth, because the country is wealthier than it has ever been: Real per capita household net worth has reached a record high, as Federal Reserve Board data shows.*
> *…..*
> *All of which is to say that government intervention to enhance greatness will not be a simple matter. There is a risk that well-meaning change may make matters worse. Protectionist policies and penalties for exporters of jobs may not increase long-term opportunities for Americans who have been left behind. Large-scale reduction of environmental or social regulations or in health care benefits, or in America's involvement in the wider world may increase our consumption, yet leave all of us with a sense of deeper loss.*

Greatness reflects not only prosperity, but it is also linked with an atmosphere, a social environment that makes life meaningful.

As an investment manager, having a pragmatic businessman trying to reduce bureaucratic nonsense and improve on a ridiculously complex tax system is exciting. Mr. Trump's choices for cabinet positions is as good as it gets (it's never perfect). On the negative side, I have had strong reservations about Mr. Trump's social and political statements. His attacks on his own country's institutions, while embracing Vladimir Putin's post-truth world are puzzling. Is there a positive strategy behind this? I certainly hope so. He has spoken much, now we will see what actions he takes. Having said all that, I am giving him and his administration the benefit of the doubt: I truly hope he achieves great things as President.

In closing, please remember my warning at the beginning of this letter. Macro events and expert opinions about the future are a not often the basis for making sound investment decisions, there are too many variables. You should start by having an asset allocation that fits your financial situation and long term objectives. Then have factual important information dictate the composition of your portfolio, based on each selection's merit. That's what I do.

Sincerely yours,

Karim Armand
President
January 20, 2017

(I recommend you read the Robert Shiller article in the New York Times: https://www.nytimes.com/2017/01/12/upshot/make-america-great-again-isnt-just-about-money-and-power.html)

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