

The INDEPENDENT ADVISOR

Quarterly Newsletter of The Fiduciary Group

Investment Maxims

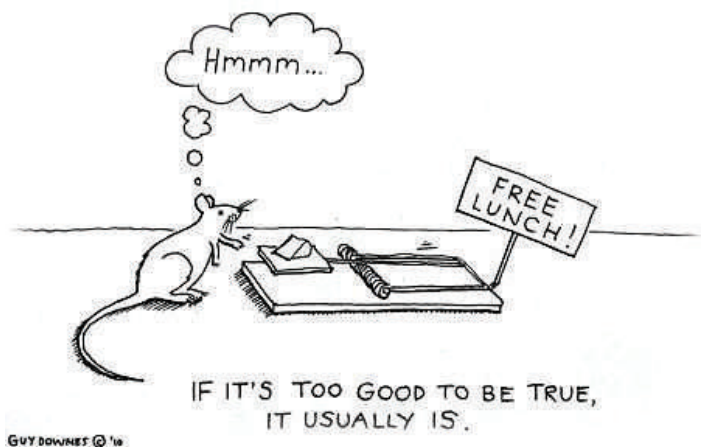


Malcolm Butler, JD
 President
malcolm@tfginvest.com

I attended an investment conference recently and one of the speakers was Stephen Friedman, former Chairman of Goldman Sachs. During his fireside chat, he mentioned that when it comes to investing, he follows some basic rules of risk management. He said that these rules were universal truths that grandparents have shared with their grandchildren over multiple generations. These maxims provide parameters on avoiding or minimizing losses that are as much a part of investment management as trying to find successful long-term investments. I have utilized some form of each these rules to guide my analysis over the course of my own investment career and thought I would share them with our readers.

“If it sounds too good to be true, then it is too good to be true.” This phrase is a warning against falling prey to financial offers that sound enticing and tempting, almost too good. The offer is typically flawed in some respect. For example, when I see an investment that pays above market dividends or interest, then I know that there are elevated risks with this investment. Several years ago, non-traded Real Estate Investment Trusts (REITs) were being widely sold with a 10% yield. This income return was at-

tractive relative to other comparable investments that paid half that amount. However, these REITs could not maintain their payouts and there was no market in which to sell them when investors wanted to bail out of them. I have used the “too good to be true” phrase dozens of times when describing why a client should avoid an investment opportunity.



Mr. Friedman shared with us the expression “Trees don’t grow to the sky,” in which he explained that we should be mindful that there are typically limits on the growth rates that companies can sustain over longer periods. When we look at companies with extraordinarily high rates of growth, we expect these companies to command a high valuation. The danger is assuming that growth will continue at the same rapid pace as the company becomes larger. As a company grows larger, it is usually difficult for it to main-

CONTENTS

Investment Maxims
 Malcolm Butler, JD

Summer Reading
 Joel Goodman, CFA
 Scott McGhie, CFA, CPA
 Alex Morris, CFA, MBA

The Graduates’ Trillion Dollar Problem
 Ernesto Montes

tain its high growth rate. We saw investors bidding up the value of companies during the dot-com bubble based on the erroneous assumption that extraordinary growth rates could be maintained for many years to come.

"If you go to bed with dogs, then you will wake up with fleas" was another of Mr. Friedman's favorite phrases. This adage has been attributed to Ben Franklin and refers to the disappointment likely to result from investing in poor quality companies (also known as "dogs" in investment parlance). Enron comes to mind when I think of this axiom. Enron was a company that was growing rapidly but was doing so based on acquisitions fueled by questionable accounting practices. The stock rose sharply and fell even faster once investors became aware of the fraud. The CFO ended up serving prison time and investors who stuck with the company lost their entire investment. We have always tried to build portfolios with high quality businesses that are managed by senior officers known as much for their integrity as their business acumen.

An investment maxim that has stood the test of time is "Don't put all of your eggs in one basket." In terms of prudent investing, this means to be wary of concentrating too much of your investment assets in one security or one economic sector. As prudent investment advisors, we are constantly preaching the advantages of diversification which is the strategy of avoiding the risk of holding concentrated positions. Until the financial crisis hit in 2008, investors in bank stocks had done very well for decades by buying and holding bank stocks. The banks were steady earners and their stock performance had been quite good for long periods of time. It was only natural for portfolio allocation of bank stocks to increase and investors who had not kept their overall risk exposure to the financial sector to an acceptable level suffered extraordinary losses as bank stocks got crushed. During the financial crisis, it was not unusual to see investors lose 80% or more of the value of their investments in this sector. It was a painful experience for investors who had not properly diversified their portfolios.

Mr. Friedman mentioned that one of his favorite quotes came from the title of a successful business management book written by one of the founders of Intel, Andy Grove. The book is titled "Only The Paranoid Survive" and the point Grove was making was that success can breed complacency and complacency leads to failure. Friedman also believes that the quote supports the proposition that investors should exercise caution when they consider investment opportunities. One example of how we exercise caution in crafting client portfolios is our custom of including less volatile fixed income investments in a portfolio even when we believe that better long-term returns will

come from our equity investments. A healthy dose of fear can be helpful especially during times when asset values are rocketing higher.

Mr. Friedman quoted Baron Nathan Rothschild, the wealthy British 18th century investor, as saying "Fortunes are made by buying low and selling too soon". A companion quote is "pigs get fat, hogs get slaughtered". As one of my clients used to tell me, "No one goes broke taking a profit". These quotes are a reminder that sometimes it is a good idea to rebalance a portfolio and take profits on a successful investment.



Toward the end of his remarks, Mr. Friedman told us a story about the importance of contingency planning. When he was playing a leading role at Goldman Sachs, he was concerned that because their offices were located on low land on the island of Manhattan, they could be at risk of flooding during a severe storm. He directed that the firm maintain a large supply of sandbags and deploy them whenever severe storms were approaching. For years he maintained this policy at considerable expense and without any tangible benefit. Then Hurricane Sandy hit and because the firm was properly prepared, their building avoided cataclysmic water damage unlike many of their Wall Street neighbors.

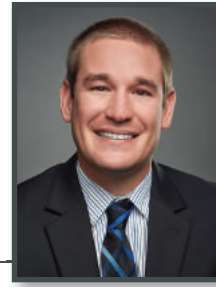
Adhering to Mr. Friedman's time-tested investment rules is an important component of successful investing. Our firm practices appropriate risk management and contingency planning for client portfolios as an integral part of our portfolio construction and management. We strive to build durable portfolios that can weather any kind of economic or financial storm. We do this by investing in globally diversified portfolios that are consistent with one's investment objectives, risk tolerance, and time horizon.



Joel Goodman, CFA
 Chief Investment Officer
 joel@tfginvest.com



Scott McGhie, CFA, CPA
 Director of Research & Portfolio Management
 scott@tfginvest.com



Alex Morris, CFA, MBA
 Research Analyst
 alex@tfginvest.com

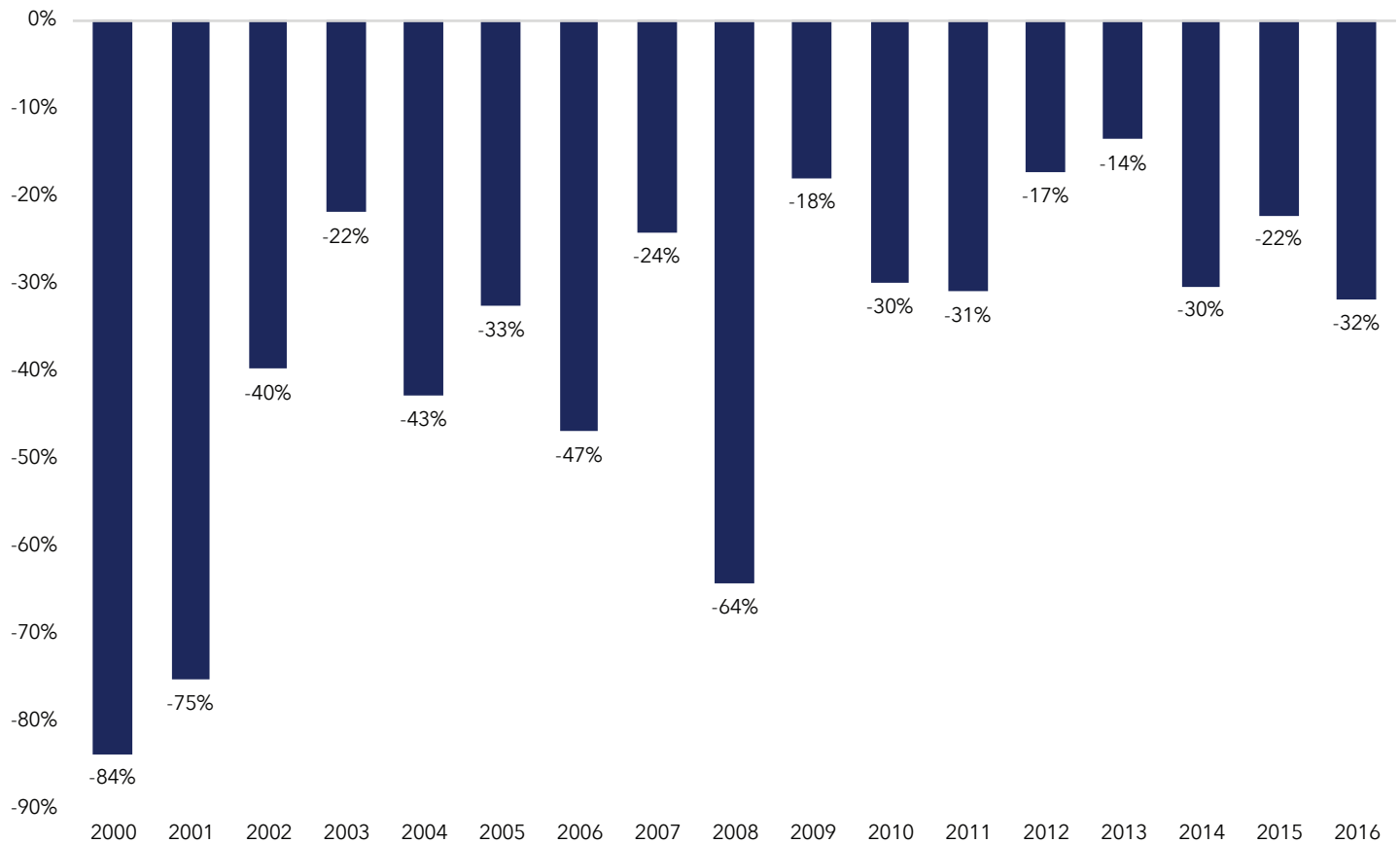
Summer Reading

As part of our job as investment managers, we read numerous shareholder letters every year. Occasionally, these letters offer a unique perspective or insight that renews our enthusiasm for how we think about businesses and the art of long-term investing. The most recent letter from Amazon CEO Jeff Bezos is a gem that has kept our attention since it was published in April.

It's important (for this discussion) that we delineate between

the company and the stock price. While we understand the fascination with the stock, remember that it has been a bumpy ride. For example, Amazon stock fell more than 90% after the tech bubble (from a high of \$106 per share in December 1999 to less than \$6 per share in September 2001). Even as the company has matured and put itself on solid footing, annual stock price corrections of 30% or more have consistently occurred (see chart below). Staying on the roller coaster has been easier said than done.

AMAZON (AMZN) STOCK, HISTORICAL % CORRECTION PER YEAR



Source: Strategas

The experience of Amazon shareholders isn't the focal point of this article. The stock price may be the headline - but it's not where the true insights are derived. Bezos' letter covers multiple facets - from corporate culture and the art of management to value creation and the importance of long-term thinking. In two decades, Amazon has grown from a start-up to one of the most valuable companies in the world. Its rise has been a wake-up call for a growing list of competitors, other businesses, and investors.

The premise of Bezos' recent annual letter was to encapsulate what has worked for Amazon over the past two decades - and what it needs to do to ensure its continued success in the years to come. For Bezos, these two different states in a company's lifecycle are "Day 1" and "Day 2":

"Day 2 is stasis. Followed by irrelevance. Followed by excruciating, painful decline. Followed by death. And that is why it is always Day 1."

In the letter, Bezos outlines a "starter pack" that Amazon has used to make sure it's still "Day 1":

"Customer obsession, a skeptical view of proxies, the eager adoption of external trends, and high-velocity decision making."

There's considerable value in these ideas, particularly when they're wrapped in long-term focus. Most public companies are living quarter to quarter. With a long-term perspective, companies end up playing a different game than competitors - and as a result, end up making different decisions. We'll look at each of these ideas individually in hopes of getting a better sense for how they collectively impact strategic decision-making at Amazon.

Customer Obsession

"In business, we often find that the winning system goes almost ridiculously far in maximizing and or minimizing one or a few variables."

This quote, from Charlie Munger, is a useful framework for thinking about how one of a kind businesses manage to differentiate themselves from the competition. From the beginning, Bezos has been singularly focused on optimizing a few variables that he expected to endure long-term:

"I very frequently get the question: 'What's going to change in the next 10 years?' And

that is a very interesting question; it's a very common one. I almost never get the question: 'What's not going to change in the next 10 years?' And I submit to you the second question is the more important of the two - because you can build a business strategy around the things that are stable in time. We know customers want low prices, and I know that's going to be true ten years from now. They want fast delivery and vast selection... The effort we put into those things today will still be paying dividends for our customers ten years from now."

Obsessing over ways to satisfy customers is central to Amazon's ethos. We see a great example with free shipping, which Amazon tested for the first time in 2000. While the economics may have been tough to justify, surveys consistently showed - as they do today - that shipping costs are very important to customers (and a primary driver of abandoned "carts"). Unlike many competitors, Amazon actively addressed this early on. In 2005, Amazon took the next step forward with Prime, which gave members access to two-day "free" shipping. Amazon priced Prime at \$79 per year even though every financial analysis they ran suggested it was crazy to do so. Bezos realized early that customers were receptive to forming relationships with emerging online brands. *Building customer relationships that would last years—or even decades—was the real objective.* Focusing solely on the impact on this year's income statement would be mistake.

As an aside, outsized spending on customer acquisition isn't a new idea. In the years prior to the tech bust, countless startups operated under the belief that large upfront "investments" (funded by VC's or IPO's) used to acquire new customers promised large payoffs at some point in the future. For many, that payoff never came. Many learned (all too late) that they were buying temporary loyalty. When the money stopped flowing and the discounts disappeared, customers bailed.

Amazon, on the other hand, was making a straight forward bet: the success of Prime came down to whether the value proposition was attractive for customers. Prime had to lay the groundwork for a true relationship, not a fling. The economics only worked if subscribers became long-term customers. In hindsight, we can see Prime has clearly achieved that goal: while the company stays quiet on the numbers, it's estimated that Prime has eighty million subscribers with retention rates above 90% (comparable to Costco). Amazon has earned best in class customer loyalty

by exceeding customer expectations. The outcome has been attractive economics for Amazon.

The negative impact of Prime on the P&L in the short-term shouldn't be overlooked. It's the type of "investment" many companies pass on. A study of 400 financial executives (*"The Economic Implications of Corporate Financial Reporting"*) found that most would avoid initiating a new project with attractive economics (positive NPV) if it meant missing the consensus earnings estimate. These CFO's argue that financial market pressures encourage them to make decisions that sacrifice long-term value to meet quarterly targets. Companies that find themselves playing the Wall Street game of quarterly earnings will invariably make decisions that are not in owners' interests. They will forgo risky "bets" with an uncertain outcome that take a long time to pay-off. The problem is these "bets" sow the seeds of future value creation. Shortsighted managers that are unwilling to invest (and fail) in the near-term set their organizations up for long-term decline (if they only plan to stick around a few more years, that's a price they may be willing to "pay").

Skeptical View of Proxies

The second component of the "Day 1 starter pack" may be the most difficult for large companies to implement.

Bezos writes: *"As companies get larger and more complex, there's a tendency to manage to proxies... This can happen very easily in large organizations.*

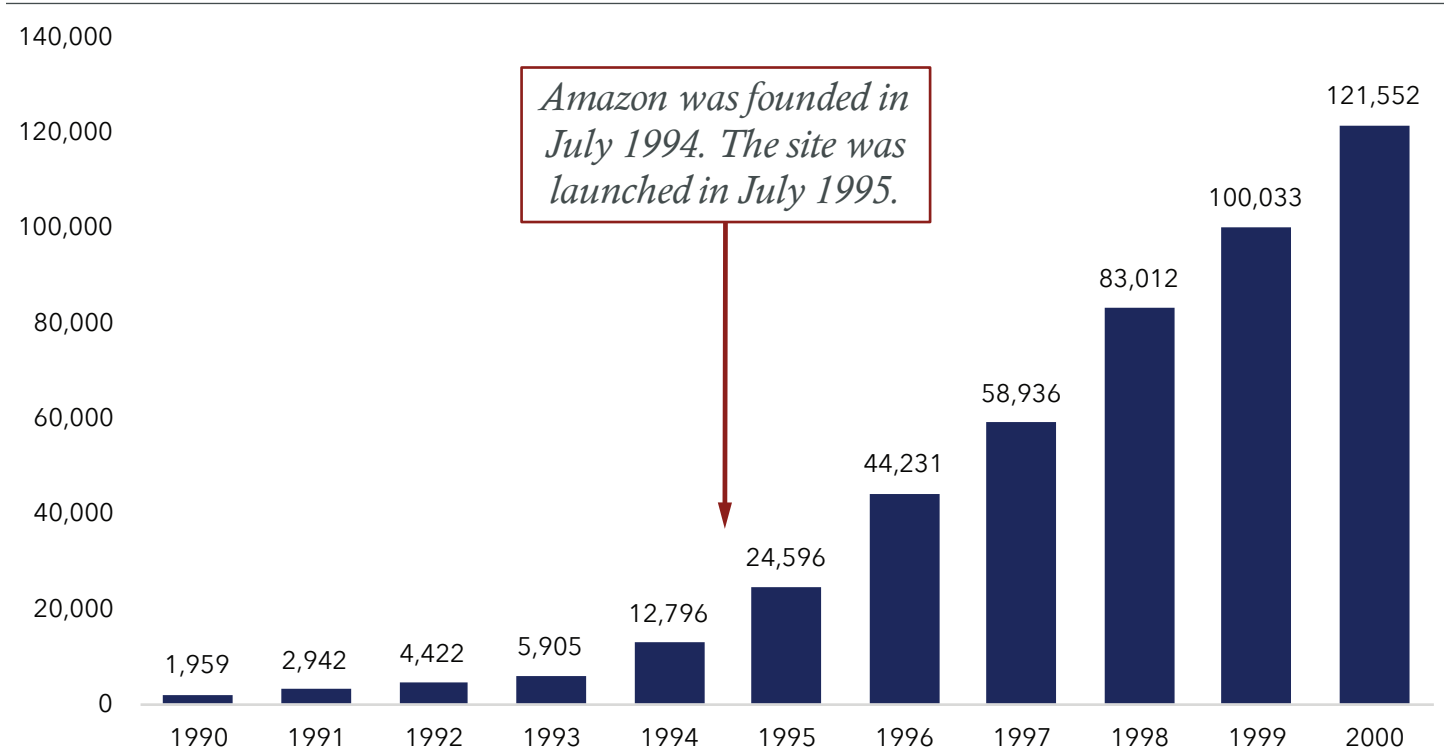
The process becomes the proxy for the result you want. You stop looking at outcomes and just make sure you're doing the process right. The process is not the thing. It's always worth asking, do we own the process or does the process own us? In a Day 2 company, you might find it's the second."

In his letter, Bezos uses the example of customer surveys and other market research as a proxy for the actual customer. While these tools can play a helpful role in the decision-making process, they cannot replace the intuition and discretion required to understand the customer.

Eager Adoption of External Trends

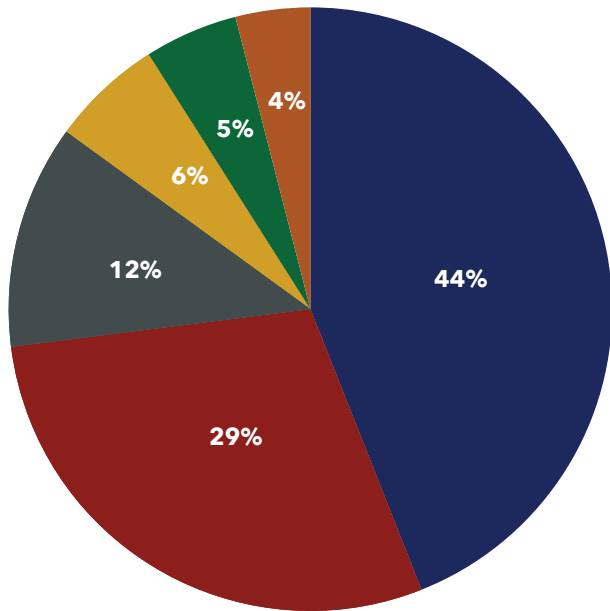
2,300% a year. That's how quickly web usage was increasing in the Spring of 1994. This number astounded Bezos—*"things just do not grow that fast."* As shown in the chart below, the number of internet users in the United States more than doubled to nearly 13 million in 1994 (the difference between ~2,300% growth in usage and the increase in the number of users is explained by a significant increase in usage per user). The realization that the internet would change the world is what drove Bezos to start Amazon later that year. This early (and relentless) focus gave the company a critical advantage over established companies that waited many years before they sufficiently appreciated the disruptive potential of e-commerce to traditional retail.

NUMBER OF INTERNET USERS IN THE U.S. (THOUSANDS)



Source: ITU

CLOUD COMPUTING INFRASTRUCTURE SHARE BY VENDOR (Q1 2017)



■ Amazon ■ Other ■ Microsoft ■ Alphabet ■ Alibaba ■ IBM

Source: Synergy Research Group

Amazingly, Amazon has played a similarly disruptive role with Amazon Web Services (AWS). Cloud computing, which is directly in the wheelhouse of IBM, Microsoft, and other IT service providers, was pioneered by Amazon in the early-mid 2000's. Management realized that the tools and services they were developing for internal use had commercial applications. The tech stalwarts doubled-down on their mistake by sticking their heads in the sand and largely ignoring what Amazon was working on: AWS was essentially given a seven-year head start before others recognized the threat of cloud computing to their legacy businesses and responded. Despite some recent success, the damage still shows: in the first quarter of 2017, AWS held 44% market share of the global cloud computing (infrastructure) business - quadruple the share of the number two player (Microsoft). Being early has given Amazon a meaningful advantage. As Bezos noted in his shareholder letter:

"These big trends are not that hard to spot (they get talked and written about a lot), but they can be strangely hard for large organizations to embrace."

High-Velocity Decision Making

Amazon commits significant resources to planting seeds despite knowing most won't become trees. When results

are discouraging, they recognize reality and correct course. Otherwise, they have the patience to continue investing and thinking long-term. You can only fail "successfully" if your company supports honest feedback, has realistic expectations, and maintains a long-term commitment to investing the necessary resources for bets that won't pay off for years (if ever).

Bezos takes willingness to fail seriously: he trumpets Amazon's "gigantic failures" in interviews. This is more than self-deprecation. He recognizes *"culture is created slowly over time... by the stories of past success and failure that become a deep part of the company lore."* Encouraging experimentation - and even failure - is an important part of Amazon's culture.

Conclusion

Marketing consultant Simon Sinek argues that companies like Amazon think, act, and communicate in a way that's fundamentally different than most companies. Instead of focusing on what they do, they focus on why they do it. Why does your organization exist? For Amazon, the "Day 1 starter pack" helps ensure continued focus on its primary objective: to be "Earth's most customer-centric company." A recent survey from analytics firm ForeSee suggests it's working: Amazon ranked first among the 100 largest retailers in overall customer satisfaction for the ninth consecutive year.

For Amazon, there's a clear distinction between *what* they do and *why* they do it. What they do has changed over time: Amazon actively reinvents itself and is willing to cannibalize its own business if it means a better customer experience. The most notable example was the decision to list products from third-party sellers alongside Amazon's own inventory, a decision that angered and mystified internal buyers. They were willing to change in a way that challenged their core business to improve the user experience. The point is that what they do is not who they are.

On the other hand, why they do it - their mission - is set in stone. Some companies lose sight of their purpose over time. Their goals are replaced by targeted outcomes (usually higher profits). The way Amazon looks at the world is foreign to these organizations. When you become more focused on what you're doing than why you're doing it, "Day 2" is on the horizon.

Capitalism is evolution. Companies that resist change will wither and die. Companies that won't or can't accept and embrace change in the world are in for some trouble. Studying Amazon and its competitors offers valuable lessons for identifying companies that will stand the test of time.



The Graduates' Trillion Dollar Problem

Ernesto Montes
Associate Investment Advisor
ernesto@tfginvest.com

Over the past few decades, student debt has transformed from a tool for accessing higher education to a significant obstacle preventing young people from accumulating wealth and saving towards retirement. According to a February 2017 report published by the Federal Reserve Bank of New York, outstanding student loan balances increased by \$31 billion in 2016. This has resulted in a total student debt of \$1.31 trillion, the highest level of student loans ever recorded in the United States. With the level of student debt increasing to record amounts, it is now more important than ever for borrowers to be aware of all their options so that they may be able to eliminate their debt in the most efficient manner possible. The quicker student debt can be eliminated, the quicker one can begin allocating his or her income towards their financial goals.

Private Loans vs. Federal Loans

Student debt falls into one of two buckets: private loans or federal loans. It is important to distinguish between the two to better understand what repayment options are available for the borrower. Federal loans are loans that are issued by the federal government. Private loans are loans that are NOT issued by the federal government, and thus are not eligible for any of the federal loan repayment programs (more on that later). While there are various differences between private and federal loans, we will highlight the main differences below:

1. Most private loans require payments while the borrower is still in school (Federal loans do not).
2. Private loans might have variable interest rates, which may result in a substantial increase in the total amount to be repaid (federal loan interest rates are always fixed).
3. Private loans are not subsidized, which means that only the borrower can pay the interest on the loan (federal loans can sometimes be subsidized, meaning that the government will pay the interest on the loan while the borrower is still in school).

Private Loans/Repayment Options

Private loans generally carry variable interest rates, which means that the rate can increase at any point and, as a result, increase the total amount that needs to be repaid to the

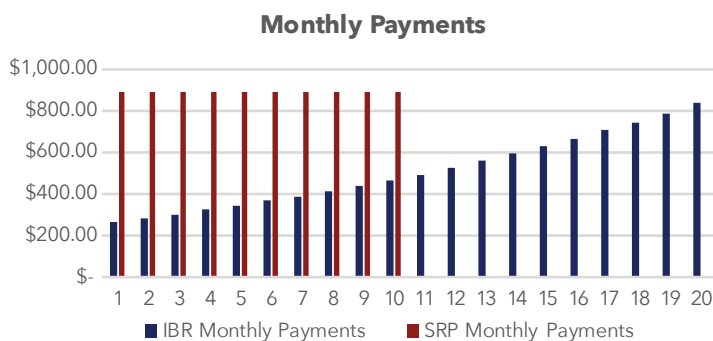
lender. While the initial terms of the loan might offer an attractive low variable rate, the borrower must be cognizant to the potential risk of interest rates rising. There are a couple of ways to help minimize or even eliminate this risk. Some private lenders offer fixed rate loans. While the fixed rate will most likely be higher than a fixed rate on a federal loan, the borrower can have peace of mind knowing that the interest rate will never suddenly change. If an individual is already paying back private loans, an attractive option would be to refinance the loan at a lower rate. A borrower that has built up a good credit score over the years can take advantage of a lower fixed interest rate, which would result in big savings over the course of repaying the loan.

Because private lenders operate under their own rules, it is crucial for any borrower of private loans to be fully aware of what they are signing when they agree to borrow from the lender. Private loans can potentially carry prepayment penalty fees, which should be considered before refinancing a private loan. Private loans also do not typically offer forbearance or deferment options if a borrower is having issues paying the loan back. Private loans are not subsidized, so the borrower is responsible for all interest accrued. It is also highly unlikely that a private lender offers any sort of loan forgiveness program. These factors should all be considered before agreeing to borrow from a private lender.

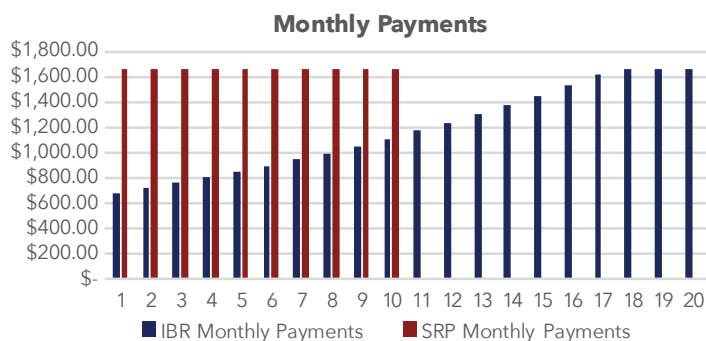
Federal Loans/Repayment Options

Unlike the realm of private loans, federal student loans have a wide variety of repayment choices available to the borrower. The two repayment plans that have the most overlap regarding loans that qualify for the plans are The Standard Repayment Plan (SRP) and the Income Based Repayment Plan (IBR). The SRP allows the borrower to repay outstanding student debt over a ten-year period with fixed monthly payments over the course of the repayment period. The IBR plan allows the borrower to pay the outstanding loan balance over a 20-year period, with monthly payments totaling 10% of the borrower's discretionary income. Discretionary income is defined as the difference between your income and 150 percent of the poverty guideline for your family size and state of residence.

**SCENARIO A: YEAR 1 INCOME: \$50,000,
OUTSTANDING DEBT: \$80,000**



**SCENARIO B: YEAR 1 INCOME: \$100,000,
OUTSTANDING DEBT: \$150,000**



It is important to note that while all student loans are eligible for both repayment plans, the borrower must have a high debt relative to income in order to qualify for the IBR plan. There are two important features unique to the IBR plan. The first is that any balance not paid off after the 20-year repayment period is forgiven. The amount that is forgiven, however, is treated as income to the borrower, thus there will be a tax liability the borrower must incur the year the balance is forgiven. The second unique feature of the IBR is that the monthly payment can never exceed the monthly payment under the SRP. The lower monthly payments can be helpful if the borrower is in a situation where their salary or any other source of income is not sufficient to cover the cost of an SRP loan repayment. For high income earners, the lower monthly payments might appear to be an attractive alternative to the higher monthly payments. The following analysis will demonstrate why this is a flawed way to look at loan repayment by highlighting the tradeoff between lower monthly payments and higher overall interest payments.

We will model out two cases: Scenario A and Scenario B. The base assumptions will remain identical for each scenario, with only the loan amount and the income of the borrower being adjusted. Our goal here is to demonstrate the financial impact on a borrower of the different loan repayment options. To ensure consistency across our projections, we have kept our assumptions in line with the assumptions the federal government uses in its "Repayment Estimator" tool located at studentloans.gov.

The Base Assumptions are:

1. Salary will be increase at a rate of 5% annually.
2. The repayment interest rate is assumed to be 6%.
3. The poverty level (used to calculate discretionary income) is inflated at a rate of 2%. The tax filing status of the borrower is assumed to be a single tax filer living in the continental USA.

In both scenarios A and B, the yearly total of loan expenditures under the SRP comes out to be about 20% of the incomes of borrowers A and B. Although the proportion of loan payments to income is nearly identical for both borrowers, it would be safe to assume that the 20% of income that borrower A would have to pay towards their student debt would have a higher likelihood of eating into money that would need to be allocated

towards fixed living expenses than for borrower B. As a result, the IBR plan probably makes sense for borrower A. Borrower A would pay \$137K over the lifetime of the IBR compared to the \$106K he/she would pay under the SRP. **Borrower A also benefits from loan forgiveness on the outstanding balance of \$57K at the end of the borrowing period**, and the tax liability for this is already included in the total expenditure figure for the IBR plan. Although this means that borrower A will pay more over the lifetime of the loan, the lower initial monthly payments under the IBR will allow the borrower to stretch out their limited dollars while also being able to tuck away funds for retirement accounts and other financial goals. The extra interest becomes the "opportunity cost" of allowing the borrower to have financial flexibility in their lowest earning years.

In scenario B, we see a similar picture as we do in Scenario A: an income which is dwarfed by the loan balance. However, borrower B has a much higher starting salary than in the previous scenario, and in theory should have more free dollars to budget for loan repayment. While borrower B can opt for lower monthly payments under the IBR, we can see why this would not be the smartest choice. **Under the IBR, borrower B would be paying \$285K over the repayment period, while only paying \$200K on the SRP. This is a difference of \$85K! The main explanation for this huge discrepancy is the difference in total interest paid (almost 100K more for the IBR) and the fact that there is minimal loan forgiveness.** This demonstrates that while lower monthly payments might be attractive for borrower B, he/she would be making a costly financial mistake if they did not pay off their debt under the SRP. The significant interest expense under the IBR for high earners with high debt is a major factor which should be considered when choosing between repayment options. Although the borrower might have to budget and make some sacrifices to fulfill the higher monthly payment under the SRP, the extra \$100K saved in interest could make a positive impact down the line whether it be for a down payment on a mortgage or contributions to a retirement account.

By being aware of their specific situation and the tradeoffs we have just discussed, borrowers of federal loans can make sound decisions in regard to paying off their debt. Eliminating student debt in an efficient way minimizes the crippling effect debt has on finances and can help borrowers look forward to beginning their journey towards amassing wealth.