INVESTMENT UPDATE
NEWSLETTER

ALLEN TRUST
COMPANY

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# Mid-Year Update and Long-term Outlook

Stock markets around the world have been jumpy since April, and they have given up some serious ground. Losses have been swift, and in some areas deep. In the second quarter, the S&P 500 lost 11.4% and foreign developed markets as embodied by the MSCI EAFE gave up 14.0%.

Fortunately, we had been throttling back on aggregate equity exposure prior to May, not because we have a crystal ball (a couple of the small buys we've made on the way down prove we don't!), but because we weren't seeing sufficient prospect of reward given the risk factors we saw piling up. By springtime, our largest equity position across most portfolios was a long-short fund which has actually appreciated amid broader declines.

As I emphasized in last month's letter, market volatility can be a good thing to the extent that it enables us to move cash into quality assets whose prices have shaken loose from their intrinsic value. It can also be a good thing for building out a portfolio to fit our long-term, strategic vision.

Here are long-term themes (none of them top secret or earth-shaking in their revelation) which we hope short-term volatility will enable us to buy into at better prices:

- **The developed world is aging:** Healthcare spending will rise, no matter what the funding mechanisms may be; this has major downsides from a productivity and tax-base standpoint, but is very positive for healthcare and eldercare industries.
- **Emerging market countries have vibrant demographics:** Unburdened by high retiree:worker ratios, emerging markets with growing throngs of working-age adults will compete more profitably, and their governments' fiscal stability will be an additional competitive advantage over the debt-laden developed world.
- **Energy consumption will accelerate:** Growing prosperity in the emerging world will increase energy demand, and cheapest energy sources (fossil fuels) will remain the foremost choice.
- **Climate volatility is a constant:** Periodic water scarcity and loss of arable land will benefit companies which enable agricultural efficiency and flexibility, and which improve crop yields.
- **The world remains a dangerous place:** Even more than potential flash points Iran and North Korea, or ongoing threats from religious extremists, the rise of China as a strategic adversary will keep the US from drastic cuts in defense expenditure.
- **Rising US Federal and municipal debts will make tax-exemption more valuable:** Rising liabilities will beget rising taxes, and the tax-exemption component of municipal bonds' valuation will increase accordingly. The longer-dated the security, the greater the appreciation benefit from higher tax rates. Note: this dynamic is a two-edged sword; more than ever we must discriminate between municipal credits to control risk.
- **Western world's fiscal woes increase possibility of downside surprises:** The growing Matterhorn of government debts is not *new* news, and their orderly settlement is not an impossibility; that said, systemic leverage increases systemic instability, and a disorderly unwinding of debts – or outright repudiation of fiat currencies – should be insured against by owning durable claims on real assets.
- **American ingenuity is a wondrous thing:** Granted, much genius was squandered in the last couple of decades innovating financial complexities which served no greater good, but that doesn't mean phenomenal things can't happen again here, and in ways most of us can't yet imagine. Whether it turns out to be whiz-bang technology, bioscience or *???*, the future, we believe, holds wonders as much as challenge.