It's Time to Weed the Economic Garden
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After experiencing a near-record fifteen consecutive days of rain here in Baltimore, and mostly rainy, dreary days since, it is easy to contemplate the effects. While it's true that some plants that were dry are now much healthier, it's also true that many things are overgrown and full of weeds.

As we look across the business landscape and analyze companies, we increasingly find many things overgrown here too. A number of companies seem to be growing only because of the persistence of low rates, others by circumventing or outright violating rules and yet others by taking unsustainable shortcuts. Regardless, the presence of too many companies like this chokes off the growth of other, more productive companies and inhibits economic growth. By our account, it's time to do some weeding in the economic "garden".

For certain, across an economy as large and diverse as that of the US, it is hard to keep the economic landscape as tidy as we might like. However, when very little or no effort is exerted things can get out of hand in a hurry. Just as weeds can infest a garden at the slightest lapse of attention, so too can unproductive and non-value creating companies crop up when culling forces are suppressed. Although many such companies exist, the following three examples are especially illustrative.

Historically one of the great strengths of the American economy has been its ability to innovate and there is no greater symbol of this than Silicon Valley. As was apparent in the tech crash in the early 2000s, however, Silicon Valley, is far from perfect in its ability to nurture either growth or innovation. The lurid tale of Dan Lyons's experience at Hubspot as told in a review of his recent book in the Financial Times unveils some of the considerably less than glamorous aspects of the world of emerging tech companies.

According to the account, "At one point his [Lyons's] desk moved to a 'boiler room' of telemarketers selling HubSpot software, which claims to replace such dated practices". In addition, "The company says it evaluates its employees on 'HEART' — an anodyne acronym for 'humble, effective, adaptable, remarkable and transparent' — but holds its sales reps to strict quotas." In many ways the hypocrisy and inefficiency of the "bad old economy" seem just as rampant in the new one.

After Lyons fell out with HubSpot and returned to journalism to write his book, "HubSpot's chief marketing officer [was] sacked for unethical conduct after trying to obtain Lyons's manuscript, another executive resigns before he too can be fired and the chief executive is sanctioned for his role in the affair. The Federal Bureau of Investigation probes the incident." In other words, not exactly your run of the mill, well intended effort to use technology to make things
better.

The Lending Club serves as another example of technology startup gone awry. Founded near the last market peak in 2006, The Lending Club pioneered "peer to peer lending" and claims to be "the world's largest online marketplace connecting borrowers and investors." The company describes its mission as: "transforming the banking system to make credit more affordable and investing more rewarding. We operate at a lower cost than traditional bank lending programs and pass the savings on to borrowers in the form of lower rates and to investors in the form of solid returns." Heady words like "innovation" and "disruption" are used liberally through its materials.

All good stuff and ostensibly an opportunistic effort to apply technology to create ever-better solutions. Indeed, the premise of the company is a classic example of "creative destruction". The only problem is that rather than providing "the antidote to the financial sector's shady practices", as described in the Financial Times, the company imitated a number of those shady practices.

The immediate transgressions of mis-selling and lack of disclosure at Lending Club are only part of the story though. As the FT also reported, these misdeeds show, "how far from its original vision Lending Club's business model has drifted. The company may have started out as a disruptive outsider ... What it increasingly resembles, however, is little more than a traditional finance company — dependent on market sentiment to stay afloat."

A third example of a company in the spotlight for the wrong reasons is Valeant Pharmaceuticals. Dubbed an "innovative" pharmaceutical company, it was run by Mike Pearson, a former partner at McKinsey. As described by John Gapper at the FT, "most of the innovation has been in its corporate structure rather than in discovering new drugs. Mr Pearson prefers to buy companies that already own treatments, slash costs and raise prices."

Although Valeant first raised eyebrows over accounting issues, the real issue is the viability of its business model. As James Litinsky described Valeant in the October 30, 2015 edition of Grant's Interest Rate Observer, "It's not really necessary to focus on the details ... Sometimes it's just important to really step back and think about what this company really is. It's effectively a stub of assets and then a bunch of stuff that they acquired from 2008 to today, and to do that they spent $43 billion. That's what it cost to assemble what this company has become. I would argue strongly that the significant majority of their assets are declining to zero over a long period of time." From this perspective, the company is more an unsustainable monolith of debt than an "innovative pharmaceutical company."

The common thread running through each of these examples is that while superficially they are the faces of a new economy that we rely on to drive economic growth, underneath they are really just business models and practices that don't inherently create much, if any, economic value. It's one thing to honestly try something and have it not work out. It's an entirely different thing to intentionally deceive, circumvent rules, or "cheat" the system.

As such, these examples are representative of a bigger problem: the economic system is not working very well. There are too many weeds popping up. In the vernacular of economics these are known as examples of "misallocation" or "malinvestment". Regardless, they include all forms of business models, decisions, and approaches that don't serve a useful purpose in an economy; they don't create value. Unfortunately, there seems to be an awful lot of it going on right now.

It may be tempting to blame the individual "weeds", and there are many blame-worthy individuals, but they are just
doing what they do - taking what the system gives. The bigger failing has been that of policy makers, our economic "gardeners". Ideally, and theoretically, capitalism works because private investors have strong incentives, free markets work because they provide useful information in the form of reasonably accurate prices, and the rule of law works to ensure that the greater good of society is still served even as members act in their own self-interest. With these elements working together, the processes of competition and creative destruction (which we discussed in our last post) naturally do the ongoing maintenance of weeding out and culling businesses that are not useful.

These failures are surely not escaping the attention of main street. As Rana Foroohar noted in Time Magazine, "The American public understands just how deeply and profoundly the economic order isn't working for the majority of people." She reports that, "a poll conducted by the Harvard Institute of Politics found something startling: only 19% of Americans ages 18 to 29 identified themselves as 'capitalists' ... The numbers were higher among older people; still, only 26% considered themselves capitalists." While she focuses on financialization as a major cause of the problem, we believe financialization is more a symptom of a deeper problem: we do not have a coherent economic policy.

The suggestion of a deficit in strategy was made by Ian Bremmer in his recent book, Superpower: Three choices for America's Role in the World, in regards to foreign policy, but captures well a broader phenomenon. In arguing that our country has lacked a coherent approach to foreign policy, Bremmer's point is captured succinctly in a quote by former Senator Jim Webb, "We have not had a clear articulation of what American foreign policy is basically since the end of the Cold War."

While Bremmer provides a fascinating read on geopolitics and foreign policy, he also creates an apt framework for assessing the failings of economic policy. At times such policy, insofar as it exists, seems capricious and at others it seems to simply lack a "clear articulation". As a result, inconsistencies and inefficiencies arise. Just as Bremmer describes, "Yet despite our recent setbacks, current U.S. foreign policy continues to represent the triumph of hope over experience, in part because there remains a messianic strain in America's approach to the world," so too has that "messianic strain" represented the triumph of hope over experience in regards to economic policy.

Bremmer also notes that, "The founders did not intend to leave questions of war and peace in the hands of a single individual, even one who has won a national election," and yet this is almost exactly what has happened in regards to monetary policy. All of this is worsened by the fact that monetary policy, set by the Fed's unelected chairperson, now also effectively serves as fiscal policy and social policy since the elected Congress has largely abdicated those responsibilities.

These failings in the economic system essentially boil down to an execution problem. Capitalism, free markets, and the rule of law do work when they are faithfully and conscientiously implemented. They have not been. Too often our economic policy makers have undermined the great strengths of these guiding principles by ignoring them. Plowing massive amounts of public capital into private markets significantly distorted incentives. Setting interest rates artificially low has tainted one of the most important "prices" in the world, the price of risk. Lax law enforcement has not only created a sense of unfairness, but has also ensured that competition, on the margin, too often revolves around the degree of rule-breaking. We need both a clearer articulation of economic strategy and a deeper commitment to it.

In the meantime, investors still need to be aware that conventional investment wisdom is unlikely to serve them well
in a policy driven environment. One of the most important ramifications of this involves the roles of cash and equities in a portfolio. Over the last thirty years equity exposure has been a sacrosanct element of asset allocation and cash has been derided as unproductive. Given such high valuations for stocks and most other risk assets, especially in light of so many other risks, investors must seriously reconsider the value of both stocks and cash in the current context.

Another important implication of the policy driven market is that by distorting prices and suppressing volatility, it diminishes the strength of economic warning signals. In this sense, the observation of so many "weeds" cropping up across the economy is a very useful signal that all is not well. While the rising tide of low rates and quantitative easing lifted (almost) all boats, some of the most visible consequences are now appearing in the form of company-specific manifestations. Fortunately, good security analysis can be extremely valuable in avoiding, or at least handicapping, such risks.

The final message for investors is that there is reason to hope for better times. Yes valuations are high now, and yes, the economy is overgrown with companies that don't create much value. These don't represent intractable problems though. Rather, they are the consequences of disjointed and counterproductive economic policy. And the policy prescription is actually pretty easy: just allow capitalism and free markets and the rule of law to do their thing, and the "invisible hand" will do the tough work of weeding out companies that don't create value. This will create more space for companies that do create value to grow and will produce a much healthier economic "garden".

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