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I. Predicted Effects of a More Active "Industrial Policy"

From *The Economist*, January 21, 2017 edition. The title of the article is "Zombies Ate Our Growth."

> "Equity markets have shrugged off the Brexit and Trump votes. Indices in London and New York have reached new highs. But individual stocks and industries have had the odd wobble, not least when they have been the subject of a hostile tweet from the incoming president. 'You've been fired at' may turn out to be a dominant theme of the next four years.
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> Indeed, what seems to be emerging on both sides of the Atlantic is a new version of industrial policy, in which Brexit negotiations, tax laws and trade talks are used as a way to favour some industries and punish others. And that ought to be cause for real investor concern.
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> The standard criticism of industrial policy is that it is all about 'picking winners.' But the real problem is that it is more about protecting the position of established corporations—cosseting losers, in other words.
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> Which companies are most likely to get protected? The obvious answer is incumbent groups that possess lobbying clout…Startups are unlikely to be afforded the same courtesy. The danger is that is cements in place the existing structure of the corporate sector and prevents the emergence of more efficient firms that can drive forward productivity improvements. This has been called the 'zombie company' phenomenon…
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> The new versions of industrial policy are likely only to exacerbate this problem. They look worryingly like the 'Latin American" model of the 1960s and 1970s…If a company makes an investment decision on the back of a tax break or a threatening presidential tweet, then it is probably not making the most efficient use of its capital. It may seem like good news in the short term for the workers who keep their jobs. But it is not good in the long run. The companies they work for will be less competitive in international markets; and, as consumers, workers will either pay higher prices or buy inferior goods. Instead of a flexible labour market, you get an inflexible corporate market.
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> It all adds up to a double problem for equity investors. For now the market may be benefiting from a couple of sugar highs: in Britain, the impact of a falling pound on the overseas earnings of multi-

> nationals; and, in America, the hopes for fiscal stimulus and lower corporate taxes. But in the long run, a more interventionist government policy is likely both to weigh on economic growth and to make equities riskier. Who knows, after all, which sectors will fall out of favour?"

Smartt comment: *The Economist* is consistently in favor of an economy with low tariffs and high levels of international trade, believing that such provides the best mix of goods to be purchased at the lowest prices to consumers. It notes that there will be losers and generally has been in favor of increasing the amount of assistance (either in the form of relocation and education assistance, or more recently, permanent financial assistance) to workers displaced by the effects of foreign trade/competition. The US does some of this but not nearly enough, a deficit which led to the Trump phenomenon.

II. What Are YOUR and MY Asset Allocations?

Each of us has a different ability to live with uncertainty (risk) and so our investments will be different:

As of December 31, 2016	Clients	John Smartt
Money Market Funds	3.1	4.2%
Bond Funds	23.9	16.2%
Stock Funds	73.0	79.6%
Totals	100.0%	100.0%

Remember each of us has different goals and needs and our asset allocation should fit us and our family. If you have questions about your asset allocation, or your retirement plan investments, I'd be pleased to assist.

I have made no significant changes in my investments since the November, 2016 election. A few clients, concerned about the uncertainties, have requested a decrease in their ownership of stock. Most of these clients are withdrawing from their investments in retirement. If you have questions, don't hesitate to contact me.

III. Vanguard Rates of Return (through Latest Quarter End)

Performance percentages are per ***Morningstar.*** Amounts in parentheses are percentile rankings (1= best and 100= worst) within category.

Periods ended December 31, 2016	Yr.-to-date		5 Years		10 Years	
Total Stock Market Index Admiral	**12.7%**	(20)	**14.5%**	(15)	**7.2%**	(13)
Tax-Managed Capital Appreciation Admiral	**12.0%**	(25)	**14.8%**	(12)	**7.2%**	(14)
Tax-Managed Small Capitalization	**25.7%**	(16)	**16.5%**	(6)	**9.1%**	(7)
REIT Index Admiral	**8.5%**	(18)	**11.8%**	(16)	**5.2%**	(17)
Total International Stock Index Admiral	**4.7%**	(12)	**5.5%**	(59)	**0.9%**	(32)
Balanced Index Admiral	**8.8%**	(22)	**9.6%**	(17)	**6.4%**	(11)
Total Bond Market Index Admiral	**2.6%**	(63)	**2.1%**	(69)	**4.3%**	(47)
Interim-Term Investment-Grade Bond	**3.8%**	(88)	**3.7%**	(69)	**5.3%**	(50)
High–Yield Corporate Bond	**11.2%**	(78)	**6.5%**	(39)	**6.3%**	(35)

For comparison, here are several stock and bond benchmarks:

Periods ended December 31, 2016	Yr.-to-date	5 Years	10 Years
S & P 500 (large stocks)	**12.2%**	**14.7%**	**6.9%**
Russell 2000 (small stocks)	**21.6%**	**14.6%**	**7.1%**
MSCI World Index	**7.5%**	**10.4%**	**3.8%**
Barclays Aggregate Bond Index	**2.4%**	**2.1%**	**4.2%**
BofAML US High Yield Master II TR (bond index)	**17.5%**	**7.4%**	**7.3%**

Vanguard mutual funds and ETFs (exchange-traded funds) continue to perform as expected. I expect each Vanguard fund or ETF, for each ten-year period to be in the <u>top 1/3 before taxes based on low cost</u>, and they <u>ought to be in the top 1/4 (stock funds) after income taxes</u>.

The Vanguard High Yield Corporate Bond fund takes significantly less risk that the average "high yield" (also known as "junk bond") fund. The Vanguard fund, which takes less risk, continues to rank very highly in the rankings over the last ten year period. When the more risky portions of the "junk bond" are stressed, the Vanguard fund shines. Over the last ten years the Vanguard fund has captured approximately 2/3 of the excess of junk bond returns over good quality bond returns—in accord with my expectation. I continue to believe that, for tax deferred accounts, this fund is a reasonable, additional diversification.

If you have questions about your investment asset allocation, please contact me.

IV. <u>The Retreat of the Global Company</u>

This article appeared in the January 28, 2017 edition of *The Economist*. Subtitle of the article is, "The biggest business idea of the past three decades is in deep trouble."

> "It was a though the world had a new appetite. A Kentucky Fried Chicken (KFC) outlet opened near Tiananmen Square in 1987. In 1990, a McDonald's sprang up in Pushkin Square, flipping burgers for 30,000 Muscovites on its first day…Between 1990 and 2005 the two companies' combined foreign sales soared by 400%.
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> McDonalds' and KFC embodied an idea that would become incredibly powerful: global firms, run by global managers, and owned by global shareholders, should sell global products to global customers. For a long time their planet-straddling model was as hot, crisp and moreish as their fries.
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> Today, both companies have gone soggy. Their shares have lagged behind America's stockmarket over the past half-decade. YUM, which owns KFC, saw its foreign profits peak in 2012; they have fallen by 20% since. Those of McDonald's are down by 29% since 2013…
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> About half of the deterioration in multinationals' ROE [return on equity invested] over the past 5-10 years is explained by the slump in commodity prices, and thus the profits of oil firms, mining firms and the like. Another 10% of the deterioration is due to banks. Firms that provide specialist services behind globalization have also been hammered…

The pain extends beyond these core industries, however, Half all big multinationals have seen their ROE fall in the past three years; 40% fail to make an ROE of over 10%, widely seen as a benchmark of whether a firm is creating any value worth speaking of…

Citizens of nowhere

The mood changed after the financial crisis [of 2007-2009]. Multinational firms started to be seen as agents of inequality. They created jobs abroad, but not at home. Between 2009 and 2013, only 5%, or 400,000 of the net jobs created in America were created by multinational firms domiciled there (although preliminary figures suggest that job creating picked up sharply in 2014). The profits from their hoards of intellectual property were pocketed by a wealthy shareholder elite. Political willingness to help multinationals duly lapsed.

As a result, the tapestry of rules designed to help businesses globally is fraying. Global accounting, antitrust, money laundering and bank-capital rules have splintered into American and European camps. Takeovers of Western firms now often come with strings attached by governments to safeguard local jobs and plants. Two American-led trade deals, known as TPP and TTIP, that gave protection to intellectual property, have flopped. The global tribunals that multinationals used to bypass national courts have come under attack.

The deep roots of globalization mean that trying to favour domestic companies by erecting tariffs no longer works once as it did. Over half of all exports, measured by value, cross a border at least twice before reaching the end-customer, so such tariffs hurt all alike…

The seeds of something more

The final element will be perhaps the most interesting: a rising cohort of small firms using e-commerce to buy and sell on a global scale. Up to 10% of America's 30 million or so small firms already do this to some extent. PayPal, a payments firm, says transactions involving such multinationalettes are running at $80 billion a year, and glowing fast. Jack Ma, the boss of Alibaba, a Chinese e-commerce firm, predicts that a wave of small Western firms exporting goods to Chinese consumers will go some way to reversing the past two decades of massive American firms importing goods from China…

The result will be a more fragmented and parochial kind of capitalism, and quite possibly a less efficient one—but also, perhaps, one with wider public support. And the infatuation with global companies will come to be seen as a passing episode in business history, rather than its end."

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