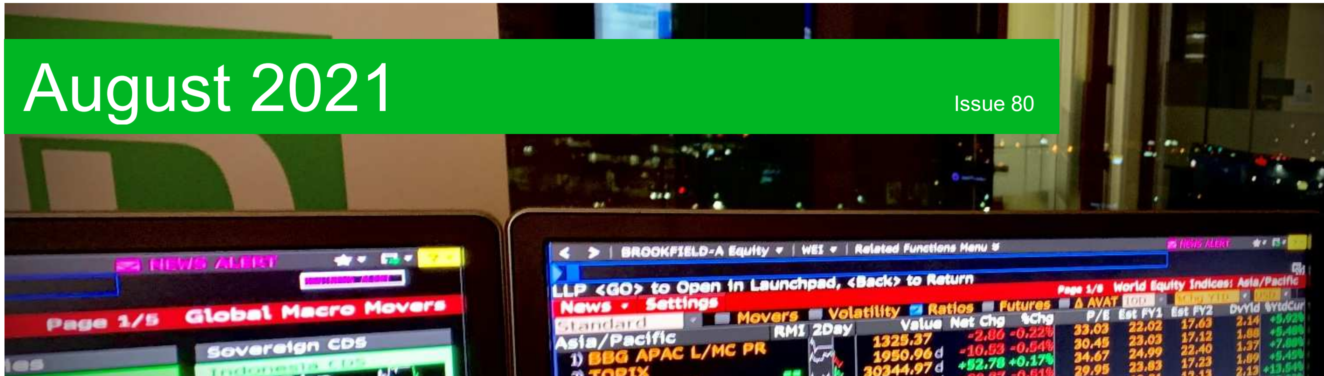
The Charter Group Monthly Letter



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Economic & Market Update

Summer Reading – Partnerships, Panics & Profits

Back in 2011, while scanning some headlines on my Bloomberg terminal, I noticed a company that I had not heard from for a number of years. The company was Brown Brothers Harriman & Co., a New York-based private bank structured as a partnership.

Back in college, and then in the work-world thereafter, I was aware of the company because of its historical prominence in American finance and because of the occasional announcement in *The Wall Street Journal* regarding significant loans that they were making.

However, hearing their name again in 2011, after a lengthy period of time, was surprising to me mainly because of the tumult that the economy, the markets, and the financial system went through in the latter part of the 2000's. Virtually every major financial institution was in the news during that time and the headlines were generally not very positive.

Financial firms, whose structure promotes risk-management, can survive centuries' worth of panics.

For investment portfolios looking to survive the next panic, that might be a lesson or two.

TD Wealth

In the run-up to the later 2000's, the U.S. federal government promoted home ownership. The initiative had broad bipartisan support and helped to act as a balm for the sting caused by the Dot Com bubble implosion and 9/11. Expanding home ownership combined with rising home prices contributed to keeping the 2001 U.S. recession brief and shallow.

Many financial firms suffered while taking risks in the run-up to the Sub-prime mortgage crisis in the latter 2000's.

However, with the encouragement of Washington, the financial industry accelerated the expansion of home ownership and the associated consumer debt burden to unprecedented levels. In order to facilitate this, new esoteric investment products were created to draw in investor capital[1], and lending standards fell compared to levels in previous decades as mortgage applications were often approved with little evidence of income or assets. The term "Sub-prime" became commonly used to encapsulate these trends.

Then, in 2006, real estate price gains slowed down, causing pressure to build across the entire edifice. Without sufficient price gains, many homeowners were unable to refinance before the step-up rate on their adjustable rate mortgages kicked in after the initial "teaser" rate expired. Slowing price gains eventually morphed into price declines as foreclosures began to dot the real estate map. Investment banks were saddled with the distressed esoteric products on their balance sheets and commercial banks were faced with loan losses.

So, where was Brown Brothers Harriman & Co. during this time? A book I just finished reading might provide some clues as well as some lessons for risk management.

Inside Money: Brown Brothers Harriman and the American Way of Power[2] outlines the story of the bank all the way back to its founding two centuries ago. A theme that is reiterated through the book is the structure of the bank and how it contrasts to the modern-day structures of most of its competitors. As a partnership, the partners had to post their own capital in order for the bank to operate. Up until the 1930s, this was common for most banks. After that, commercial banks began to go public, raising outside capital and listing their shares on an exchange. Investment banks, with the odd exception, mostly remained as partnerships up until the late 1990s at which time they were also converted into public corporations and were able to attract capital from outside shareholders. Except for Brown

However, those that were still structured as partnerships did not appear to participate much in the hysteria.

[1] A veritable alphabetical potpourri filled the headlines in that era: MBS (Mortgage Backed Securities), CDOs (Collateralized Debt Obligations), CDS (Credit Default Swaps), ARMs (Adjustable Rate Mortgages).
[2] Zachary Karabell, *Inside Money: Brown Brothers Harriman and the American Way of Power* (New York: Penguin Press, 2021.

Brothers Harriman and a few other small holdouts.

According to the book, to understand the history of Brown Brothers Harriman and to understand the decisions that it made through the Sub-prime mortgage crisis, we need to look at things from the perspective of the partners who had their own capital at stake. It would be reasonable to assume that someone who stands to lose if things don't work out would have looked at issuing risky mortgages or investing in the products that financed the mortgage market at the time with great skepticism. Those author goes on to write "It was and is a culture that emphasizes risk management not as a box to be checked but as a first principle."[3]

It might be more challenging to embrace riskier propositions when partners see their own capital at stake.

Now, compare that to a situation where managers of a public corporation with outside shareholder money at stake. Perhaps there may not be quite the hesitancy involved when looking at the potential windfall gains associated with riskier products and loans. In business school, this is taught under the heading of "agency risk." There is nothing inherently wrong with it and a number of business school case studies examine how to manage it. However, it is a different approach compared to structures where the decision-makers are partners, principals, or owe a fiduciary duty to manage the affairs of others as they would manage their own.

The book makes it clear that other banks reaped the benefits of taking more risks during the emergence of transformative industries such as railroads, mass manufacturing, semiconductors, internet, and social media. But many of those risk-taking institutions have gone by the wayside. That's probably why when looking to write a book about a financial firm with 200-year history, there are not that many to choose from.

Some profitable opportunities may be foregone in order to ensure long-term preservation.

The flip-side is that long-term preservation captures compounding growth over time.

Even with the primary focus on risk management, there were a couple of close calls for Brown Brothers Harriman. The panic of 1837 was really the first one that impacted both sides of the Atlantic, so having operations in both the United States and England did not help to cushion the blow. Also, there was a long lag in the ability to communicate, so both American and English offices did not know they were simultaneously being hit by a panic. In the end, the Bank of England essentially saved the firm with the notion that it was "too important to fail", a concept which still persists with policymakers to the current day.

Then, in 1930, the merger took place between Brown Brothers, which was very well

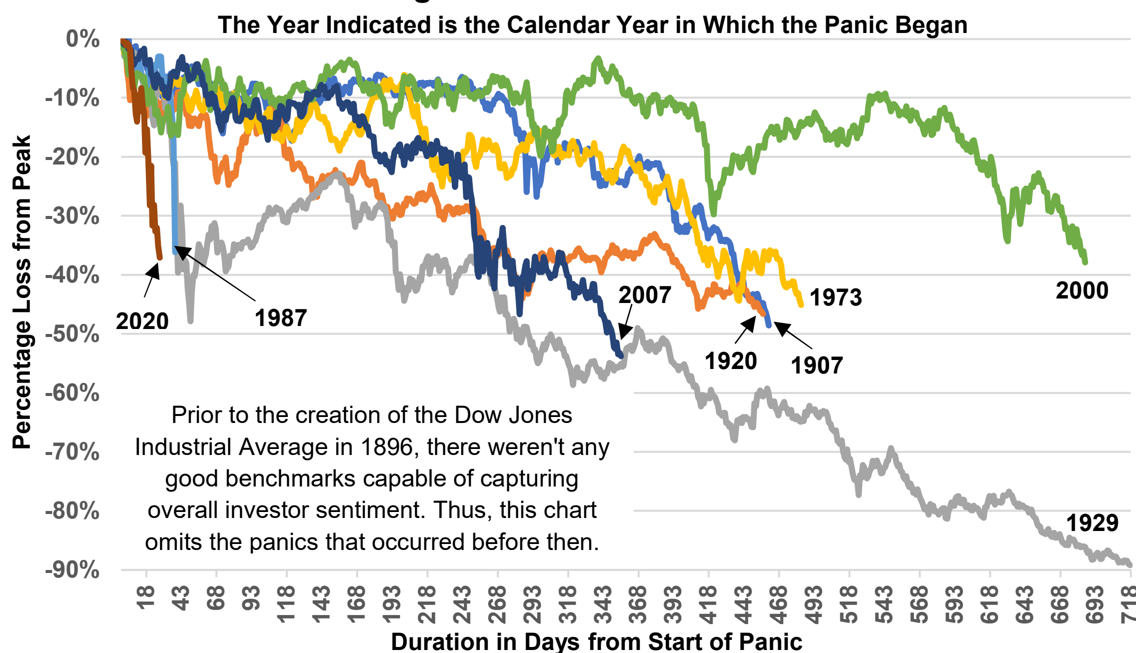
[3] Ibid, page 403.

connected, and Harriman Brothers, which was extremely well capitalized as a result of a massive stake in Union Pacific Railroad previously accumulated by the Harriman family's patriarch. The 1929 crash on Wall Street had created vulnerabilities that convinced the two firms that they needed to combine their strengths in order to survive.

However, when those two incidents are included on a list of *all* the panics that the firm endured (1819, 1837, 1857, 1873, 1893, 1907, 1920, 1929, 1973, 1987, 2000, 2008, & 2020), we can see how resisting temptation contributed to the firm's longevity, and presumably, to the compounded growth of the partners' capital. **Chart 1** illustrates how those panics unfolded as measured by the performance of the Dow Jones Industrial Average after it was created in 1896.

Chart 1:

Dow Jones Industrial Average from Start of Historial Panics



Source: Bloomberg Finance L.P. as of 8/12/2021

The career arcs of Mike Elliott and myself encompass the last three of those panics (plus, while studying finance and economics in college, 1987 got my full attention). Although it can be a challenge during the lulls between the panics to convince everybody on the virtues of fiduciary duty, or by having principals co-investing alongside clients, the volatile periods have helped convey the message. A priority on risk management certainly does not prevent asset declines during the panics. However, it can help in weathering the storm in order to be in place to reap the benefits of the next cycle of economic and investment market growth.

Partners, co-investing principals, and fiduciaries often share similar conservative viewpoints on risk.

Such viewpoints may not be popular in raging bull markets but can help to avoid regret in the aftermath.

Model Portfolio Update[4]

The Charter Group Balanced Portfolio
(A Pension-Style Portfolio)

	Target Allocation %	Change
Equities:		
Canadian Equities	12.0	None
U.S. Equities	38.0	None
International Equities	8.0	None
Fixed Income:		
Canadian Bonds	22.0	None
U.S. Bonds	6.0	None
Alternative Investments:		
Gold	8.0	None
Silver	1.0	None
Commodities & Agriculture	3.0	None
Cash	2.0	None

There were no changes to the asset allocations or the investment holdings in our model portfolios during July.

No changes were made during July.

Every asset class contributed positively to the results during the month, even gold for a change which has been mostly in a lagging position over the last year. Bullion has been somewhat dampened by the strength of the U.S. dollar since the spring (which helped our U.S. dollar-denominated investments) and by cryptocurrencies competing in "store of value" space. Wild fluctuations in bitcoin over the last few months have not deterred the believers. However, I am willing to believe that gold's hedging and store of value qualities will shine through once the difficult economic realities associated with financing all the pandemic spending become more evident.

Gold did well after lagging the other asset classes over the last year.

[4] The asset allocation represents the current *target* asset allocation of the Balanced Model Portfolio as of 8/12/2021. The asset allocations of individual clients invested in this Portfolio may differ because of the relative performance of the asset classes since the last rebalancing and because of differences in the timing of deposits and withdrawals. The Balanced Model Portfolio is part of a sequence of five portfolios ranging from conservative to aggressive: Conservative, Balanced Income, Balanced, Balanced Growth, and Growth.

The stock market indices in developed countries around the world, including the U.S. and Canada, continued to charge ahead in July, with many of the U.S. indices setting new record highs. Continued suppression of interest rates combined with the ongoing flow of pandemic relief money maintained the tailwind.

Stock markets continued to benefit from the tailwind created by artificially low interest rates and high rates of government spending and pandemic relief.

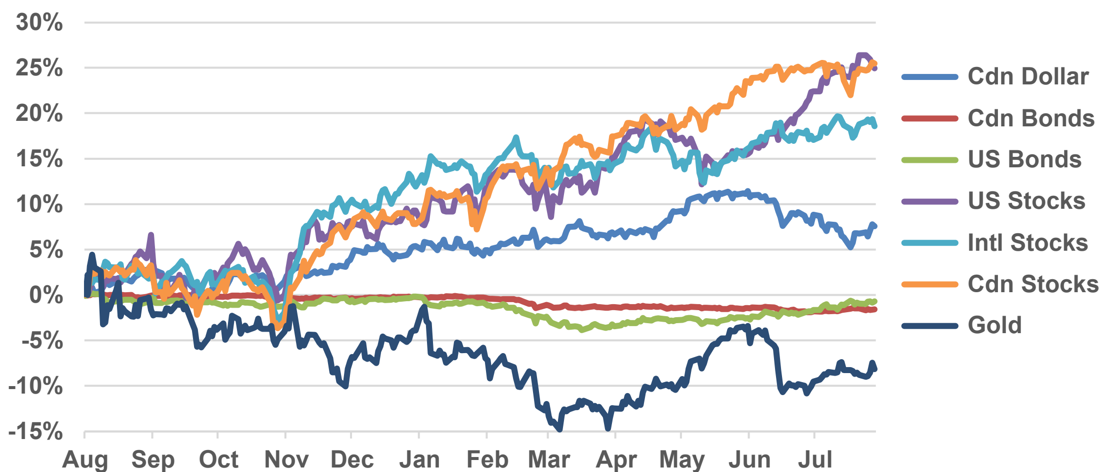
As mentioned in the last two editions of *The Charter Group Monthly Letter*, all eyes will be on the global central banking conference in Jackson Hole, Wyoming at the end of this month. Historically, changes in monetary policy direction have been announced there. Some of the regional Federal Reserve Bank presidents have hinted at slowing down the rate at which the Federal Reserve Board purchases government and mortgage bonds in the open market. Obviously, this is something the stock market will have to digest if announced. The best hope against such a policy change is the persistence of the Delta-variant of SARS-CoV-2. If it looks like that will impact economic growth, then perhaps the tapering of bond purchases will be delayed. Markets could view the Delta-variant as a positive, adhering to the maxim: "Sometimes bad news is good news." We shall see.

The Jackson Hole central banker conference at the end of the month is the next waypoint in assessing the monetary policy environment that is currently benefitting stocks.

Below is the 12-month performance of the asset classes that we have used in the construction of The Charter Group's model portfolios. (**Chart 2**).[5]

Chart 2:

12-Month Performance of the Asset Classes (in Canadian dollars)



Source: Bloomberg Finance L.P. for the interval from 8/1/2020 to 7/31/2021

[5] Source: Bloomberg Finance L.P. – The Canadian dollar rate is the CAD/USD cross rate which is the amount of Canadian dollars per one U.S. dollar; Canadian bonds are represented by the current 3-year Government of Canada Bond; US bonds are represented by Barclays US Aggregate Bond Index; U.S. stocks are represented by the S&P 500 Index; International stocks are represented by the MSCI EAFE Index; Canadian stocks are represented by the S&P/TSX 60 Composite Index; Gold is represented by the Gold to US Dollar spot price.

Top Investment Issues[6]

Issue	Importance	Potential Impact
1. U.S. Fiscal Spending Stimulus	Significant	Positive
2. Coronavirus Geopolitics	Moderate	Negative
3. Canadian Dollar Decline	Moderate	Positive
4. Canadian Federal Economic Policy	Moderate	Negative
6. Short-term U.S. Interest Rates	Moderate	Positive
5. China's Economic Growth	Moderate	Negative
9. Global Trade Wars	Moderate	Negative
8. Deglobalization	Medium	Negative
7. Canada's Economic Growth (Oil)	Light	Positive
10. Long-term U.S. Interest Rates	Light	Negative

[6] This is a list of the issues that we currently deem to be the ten most important with respect to the potential impact on our model portfolios over the next 12 months. This is only a ranking of importance and potential impact and *not* an explicit forecast. The list is to illustrate where our attention is focused at the present time. If you would like an in-depth discussion as to the potential magnitude and direction of the issues potentially affecting the model portfolios, I encourage you to email me at mark.jasayko@td.com or call me directly on my mobile at 778-995-8872.

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The Charter Group is a wealth management team that specializes in discretionary investment management. For an annual fee, we manage model portfolios for private clients and institutions. All investment and asset allocation decisions for our model portfolios are made in our Langley, B.C. office. We do not outsource any of the decision-making for our model portfolios – there are no outside actively-managed products or funds. We strive to bring the best practices and the calibre of investment management normally seen in global financial centres directly to the Fraser Valley and are accountable for the results.

Accountability is further enhanced by the fact that we commit our own investable wealth to the same model portfolios in which our clients are invested.

The information contained herein is current as of August 12, 2021.

The information contained herein has been provided by Mark Jasayko, Portfolio Manager and Investment Advisor, TD Wealth Private Investment Advice, and is for information purposes only. The information has been drawn from sources believed to be reliable. Graphs and charts are used for illustrative purposes only and do not reflect future values or future performance of any investment. The information does not provide financial, legal, tax or investment advice. Particular investment, tax, or trading strategies should be evaluated relative to each individual's objectives and risk tolerance.

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