STEPPING STONES MANAGEMENT, LLC

Third Quarter 2014 Commentary

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Former Federal Reserve Chairman Ben Bernanke has begun his new career and reportedly earns more in one speech than he did in an entire year at the Fed. His $250,000 speaking fee puts him on the A list of that circuit. Organizations that want to impress their members or clients find it to be a reasonable price to hear from the man who navigated the world economy through the worst financial crisis in any of our lives. President Clinton commands more but Bernanke is in league with former British Prime Minister Tony Blair, who also had to navigate a crisis or two. Bernanke undoubtedly has a rewarding career ahead of him especially considering his candid style and dry wit. It was the former but not the latter at work when he told a recent audience of real estate investors that he has had trouble refinancing his home mortgage.

When the audience laughed he said "I'm not making that up" and went on to say he thinks "it's entirely possible" that lenders "may have gone a little bit too far on mortgage credit conditions." Public records show the former Fed chairman to have a 30 year fixed rate mortgage taken out in 2011 and while it is slightly above the Fannie Mae limit of $625,500, there is a vibrant secondary market for such loans. The reason for Bernanke's financial difficulties is that he has now joined the swelling ranks of America's self employed who report their income on an IRS form 1099 rather than a W-2. Self employed income is not as steady as salary income so banks have to treat loans to such clients as riskier than loans made to salaried workers.

Finance is not as simple as it was back when George Bailey was running the Bedford Falls Building and Loan. Back then banks would take in deposits and make loans with the money. As long as they earned more interest than they paid out, life was wonderful. Nowadays, banks primarily issue debt to buy other higher yielding debt which becomes their assets. Everything is wonderful as long as they can roll over their short term debt before their long term assets mature. Lehman Brothers failed to do so in 2008 and the rest is history. That history includes the Dodd-Frank Wall Street Reform and Consumer Protection Act passed to prevent another financial crisis. The Act directs the Fed to impose capital requirements on banks forcing them to raise equity capital to offset certain types of risky assets, like loans to self employed people. Nobody likes to share their equity so the banks shun the assets that require higher equity capital.

Cutting self employed people out of the credit market is not an intended consequence of the Fed's post crisis policies which are meant to boost asset prices so that wealth can trickle down though the broader economy. The first part worked splendidly for the five years of quantitative easing (QE) as the stock market rose along with the size of the Fed's balance sheet, but the third quarter saw the S&P 500 return only 0.62%, its smallest quarterly gain since the third round of QE began in late 2012. The policy is set to conclude this month and markets have become jittery to learn just how much of the rally was attributable to the monetary expansion.

Buffett's Whopper

The rally has drawn sustenance from strength in earnings per share numbers even as bottom line profits have struggled. These letters have highlighted several examples of equity market shrinkage from financial engineering such as stock buybacks but the story of the third quarter was another one. In a trend that began to accelerate before the financial crisis, more large American companies are selling themselves to foreign competitors. In many cases the US management remains in control and even keeps their US offices. Known as corporate inversions, the practice has been portrayed as a way to reduce corporate taxes but they do not reduce them by much as the companies will continue to pay US taxes on their US operations. The Treasury Department estimates that corporate inversions will cost the US taxpayers about $20 billion over the next decade, representing less than one tenth of one percent of tax revenues.

The trend has been dominated by health care related firms selling themselves to competitors in Ireland which enjoys one of the developed world's lowest corporate tax rates, even after they eliminated one particularly egregious loophole this week. However, the most famous deal of the third quarter was Burger King's sale to Canadian Tim Hortons. Not only is Burger King an American institution, so was Anheuser Busch before it became Belgian, the transaction drew attention because it was financed by Warren Buffet's Berkshire Hathaway. America's moral exemplar of ethical taxation told us the deal has nothing to do with taxes but is all about corporate strategy. Being a Canadian company will enable Burger King to invest its large foreign cash balances more flexibly, including in the US. In fact, all the companies engaging in Wall Street's latest investment banking offering will be able to invest more in the lucrative US market as foreign companies. The Treasury Department estimates are probably overstating a problem that might actually be a benefit.

The US is the only country that taxes foreign profits, so corporations keep those profits sheltered overseas. If they want to invest the money in the US, they have to first relinquish about a third of it to the government. Tim Hortons will not have to pay US taxes on that money before building more Burger Kings in America. So the flexibility that warrants Mr. Buffet's investment is tax related after all.

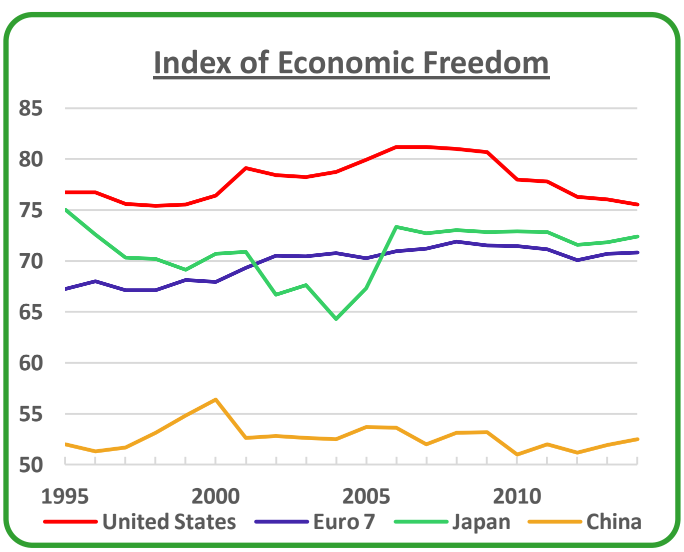
It is just one of a plethora of perversities afflicting the US tax code. The Treasury Department recommends adding another wrinkle to plug the alleged leak even as one of those supposedly extinct bipartisan solutions exists. Over recent years, the Democratic Chairman of the Senate Finance Committee had been working with his Republican counterpart in the House of Representatives to reform the corporate tax code. Senator Max Baucus and Congressman Dave Camp travelled the country a year ago to build support for their reform that would have lowered the corporate tax rate and offset the revenue loss by abolishing tax loopholes that are the market in which our politicians trade.

President Obama said he would not accept any reform that did not increase revenues and Majority Leader Harry Reid has not allowed the US Senate to vote on a bill, even though most analysts say it would pass with a bipartisan majority. Supporters say the reform would add revenues due to the economic growth that would come with a simpler system. Senator Baucus has since retired to become Ambassador to China and Representative Camp is retiring after this term so reform is dead until another team emerges to push it through our political process that has become beholden to the status quo. They will wail about the problem as they block the solution. Better to have the issue as a political cudgel.

A Heritage of Economic Freedom

Although inversions increase the flexibility for corporations to invest in the US, the story of the post recession economy has been the lack of investment. Zero percent interest rates have not provided the boon to investment that the practitioners predicted (they forget that investment requires return), but another factor appears to be at work at least in the US economy. 2014 marks the twentieth year that the Wall Street Journal and the Heritage Foundation have compiled their Index of Economic Freedom. The Index scores and ranks 186 countries on ten qualitative and quantitative factors that fall within four broad categories of economic freedom. The rule of law, limited government, regulatory efficiency and open markets are seen as being integral to providing the freedoms that encourage economic development and rising living standards. Over the past twenty years, those countries scoring the highest have enjoyed the strongest economic growth. Sadly, the recent US score is almost its lowest ever. The 2014 index has only six countries in the “free” category: Hong Kong, Singapore, Australia, Switzerland, New Zealand and Canada. The United States achieved that level in 2006 but only maintained the status until 2009 and as the chart below shows, we have been declining since then to our current score of 75.5. That puts us in the “mostly free” category and 12th place rank. Although many countries have expanded government powers to deal with the post crisis economic difficulties, The U.S. is the only country to have recorded a loss of economic freedom in each of the past seven years.

The other lines on the chart represent an average of the seven largest European economies (including the UK), Japan and China. Notice the US has experienced the most precipitous decline which happens to have coincided with a decline in the median US household income as reported by the Census Bureau. Both figures are at levels not seen since the mid-1990s. The difference is back then both were rising.



Twenty years ago, the US had a property rights score of 90 which was maintained until 2009 but has steadily declined to 80 this year. Freedom from corruption also scored 90 back then but has been declining since 1997 to only 72 this year. Both scores have suffered from major regulatory expansions in the financial and health care sectors. Government spending scored a not so great 57.8 in 1995 but an even worse 48.1 in 2014. Fed policies have not scored well either as 1995's monetary freedom score of 83.8 has fallen to 75.4 under the QE policies that have appropriated return from America's savers. Business freedom has increased from 85 in 1995 to 89.2 today but if you don't have a line to your Senator or Congressman that may not apply to your business.

For example, if you want to open a restaurant in America today, you will need to navigate the thicket of local building and health regulations even if you were able to get a small business loan, which is highly unlikely for a startup. A better idea may be to open a franchise of a large restaurant chain whose lawyers are adept at compliance with various regulatory schemes and can provide financing from their large corporate parent. Not just restaurants but most segments of our economy are witnessing the major corporations expanding at the expense of smaller players who cannot afford the lobbyists and lawyers that are increasingly necessary to do business in America.

Andrew Puzder, the CEO of CKE Restaurants which runs the Carl's Jr. fast food chain says it takes 60 days to get a building permit in Texas after signing a lease, 63 days in Shanghai and 125 in Russia; but it takes 285 days in Los Angeles. "I can open up a restaurant faster on Karl Marx Prospect in Siberia than on Carl Karcher Boulevard in California," he says. If you don't have CKE Restaurants' stable of corporate lawyers, you can expect it to take longer for your business. Various studies confirm that the regulatory structure in America costs our economy trillions of dollars in lost output which has been realized in the falling income for the typical American family.

Earlier this week the Nobel Prize in Economic Sciences was awarded to Dr. Jean Tirole of France for his work on market power and regulation. Particularly cited by the award committee was his work on regulatory capture, the collusion between the regulators and their subjects. Much of Dr. Tirole's work on the topic regarded financial firms after the 2008 crisis and the third quarter gave us a prime example of the phenomenon. News organizations released tapes made by a regulator at the New York Fed who was assigned to work in the offices of Goldman Sachs. The tapes came to light because Carmen Segarra was fired from her job allegedly for being too hard on the firm. At issue was a transaction that even the regulator's supervisor characterized as "legal but shady" and was only undertaken to allow one party to subvert their capital requirements. It not only provides a vivid example of the Laureate's work but also why the US freedom from corruption score has fallen so far. Heritage explains that excessive red tape can incentivize bribery and encourage illegitimate market interactions.

Dr. Tirole says regulation is entirely necessary especially in industries with a few dominant players. That said, his research into credit card exchange fees showed that government agencies are less adept at deciding on optimal prices than the businesses they regulate and convey advantages to those corporations who best exploit the inefficiencies. In a press briefing by phone, Dr. Tirole acknowledged the necessity of a strong government but said regulation needs to be "light enough not to kill entrepreneurship."

Public companies are usually not entrepreneurial but most have seen their stock prices suffer more than the market cap weighted S&P 500 which has just begun to reflect the broader weakness that emerged in the third quarter. The Stepping Stones fully invested Global Equity ETF strategy gave back much of the second quarter's strong gains. Continued strength in the China and Japan positions was offset by similar weakness in the Europe and US value positions. Our consumer staples and utilities funds also lost ground while the semiconductor position rose slightly. Third quarter performance was most impacted by double digit declines in the energy service funds and the gold miners. We remain committed to both sectors but will look to lower the energy weighting in a more favorable environment than the fourth quarter has provided thus far. Our favorable view has been confirmed by recent merger and acquisition activity in the energy sector. The strategy declined by more than 6% in the third quarter but was still positive for the year thus far.

As the fourth quarter gets underway we are again following the prior quarter's trend only this time it is down. At this writing the S&P 500 has fallen below its 200 day moving average which has not happened since late 2012. The bull market resumed then after the Fed announced the latest round of quantitative easing but few expect that to happen again, even though more voices are calling for it. The bullish case now is that the economy has finally regained its footing and no longer needs the monetary crutch. That was the case made in 2010 and 2011 when the stock market fell by more than 15% each time before further rounds of QE were announced. The Fed never gave the market a chance to see a 10% correction before they announced QE3 in 2012. We think it would take more than any of those to force the Fed's hand again.

Absent another round of monetary expansion, we expect the stock market to focus more on income statements and balance sheets in the quarters ahead. That view is not very bright considering the Fed's efforts of the last five years, especially when we look across the globe. Asia and Latin America are experiencing economic slowdowns though not as severe as we are seeing in Europe where European Central Bank Chairman Mario Draghi continues to implore his political counterparts to structurally reform those economies. The economic freedom chart's rising blue line shows modest gains on that front but the markets say it has not been enough.

There is little hope for any progress on that front in the US as our political system has been unable to even function under regular budgetary rules for several years. Much of the US economic leadership has been squandered but if that index when back prior to 1995 it would likely show a historical ebb and flow so it would be foolish to count out the US. We will inevitably get our house in order and use all our competitive advantages to once again lead the world economy. However, that will not happen as long as our regulatory regime prevents even the former Fed chairman from refinancing his mortgage. We will continue to hold our excess cash positions at least until we see recognition of the problems afflicting the economy.

Please call us to discuss any of your financial concerns. Until then and as always, thank you for your trust and thank you for your business.

Yours truly,

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