
ODDS & ENDS ... & THE HUMAN CONDITION IS AT AN ALL-TIME HIGH

2013 may have been the best year humankind has ever had. Before I write anything about that and before I make the case that humanity's relentless desire to improve its circumstances forms the basis for every investment thesis, I would first like to cover a few topical issues.

YELLEN SET TO GUIDE FEDERAL RESERVE

As Congress begins a new congressional year, it is likely to confirm Janet Yellen as Chair of the Federal Reserve. Although the overall composition of the Fed will be significantly more varied in terms of policy viewpoints, investors ought to favor Yellen's guidance since she has been an unwavering advocate of the central bank's policies to stimulate the U.S. economy over the past five years. She has also been the guiding force behind the Fed's improved transparency.

JANUARY 15TH FUNDING DEADLINE

The bipartisan budget deal that was enacted in December set overall spending levels for the rest of this fiscal year (which ends September 30th) as well for the following year. However, Congress still faces a January 15th deadline to pass an appropriations bill that will avert another government shutdown. Since neither party seems to be spoiling for another budget fight, there's some optimism in the air that Congress will pass the requisite legislation prior to this deadline.

DEBT CEILING

In an effort to end the government shutdown last October, Republicans reluctantly agreed to a debt-ceiling hike that had no major policy strings attached. Despite early Republican rumblings about demanding some kind of compromise deal to raise the debt ceiling, Democrats have already indicated that they will insist that the next debt-ceiling hike be free of such compromise. With the newly increased debt limit likely to be approached by the end of this winter, this topic could cause some investor angst over the next couple of months to the extent negotiations become overly political.

STOCKS FAIRLY VALUED

Despite there being fewer shopping days in 2013's holiday shopping season, U.S. retailers bettered their 2012 results. The rate of corporate earnings growth has slowed, but corporations are generally in good financial shape as are most municipal bond issuers. The International Monetary Fund has actually raised its economic outlook for the U.S. during 2014 and Morningstar estimates that despite materially higher stock prices, stock valuations seem roughly fair. Morningstar's sense of whether stock valuations are fair or not has some credibility because its analysis previously indicated that stocks were overvalued prior to the "tech wreck" of 2000 and were undervalued during the meltdown of 2008/9. With the S&P 500 trading at a little over 17 times trailing-12-month operating earnings per share, stock valuations are pretty much on par with their 25-year median.

Assuming that stock valuations are roughly fair, the stock market may do one of three things over time. It can remain fairly valued in which case investors might expect average returns. It can become overvalued, in which case investors might expect exceptional near-term returns at the expense or subpar returns thereafter. Or, it can become undervalued, in which case poor near-term returns could be followed by higher subsequent returns. While this analysis is admittedly not very actionable, it should also not dissuade anyone from holding a basket of stocks.

GOOD NEWS NO LONGER SEEMS TO BE BAD NEWS

Since 2009, equity investors have learned to welcome lackluster economic data on the grounds that it would ensure continued monetary support from the Federal Reserve. In essence, bad news came to be regarded as good news, and vice versa. This perverse relationship became especially apparent in May of 2013 after Federal Reserve Chairman Ben Bernanke intimated that newfound economic strength was causing the Fed to consider reducing the amount of stimulus it was pumping into the U.S. economy at some soon point. Interest rates spiked as investors fled bonds and stocks also behaved erratically until it became clear that the forthcoming reduction in stimulus was not imminent. After its most recent meeting in December, however, the Fed announced that economic news had finally become strong enough to warrant that long-expected reduction in Fed stimulus (from \$85 billion per month to \$75 billion per month) even though it vowed to keep short-term interest rates low for at least another year.

Whereas the Fed's positive economic assessment rattled the markets last summer as investors grappled with the notion of being weaned from Fed stimulus, investors embraced the idea this time around and stock prices surged. I do not know what this portends for future returns, but an investment climate where investors express a clear preference for good economic data is surely preferable to one where investors prefer lackluster or negative data simply because it is expected to result in additional Fed stimulus. I am gratified to see that this relationship at least appears to be normalizing.

RISING INTEREST RATES

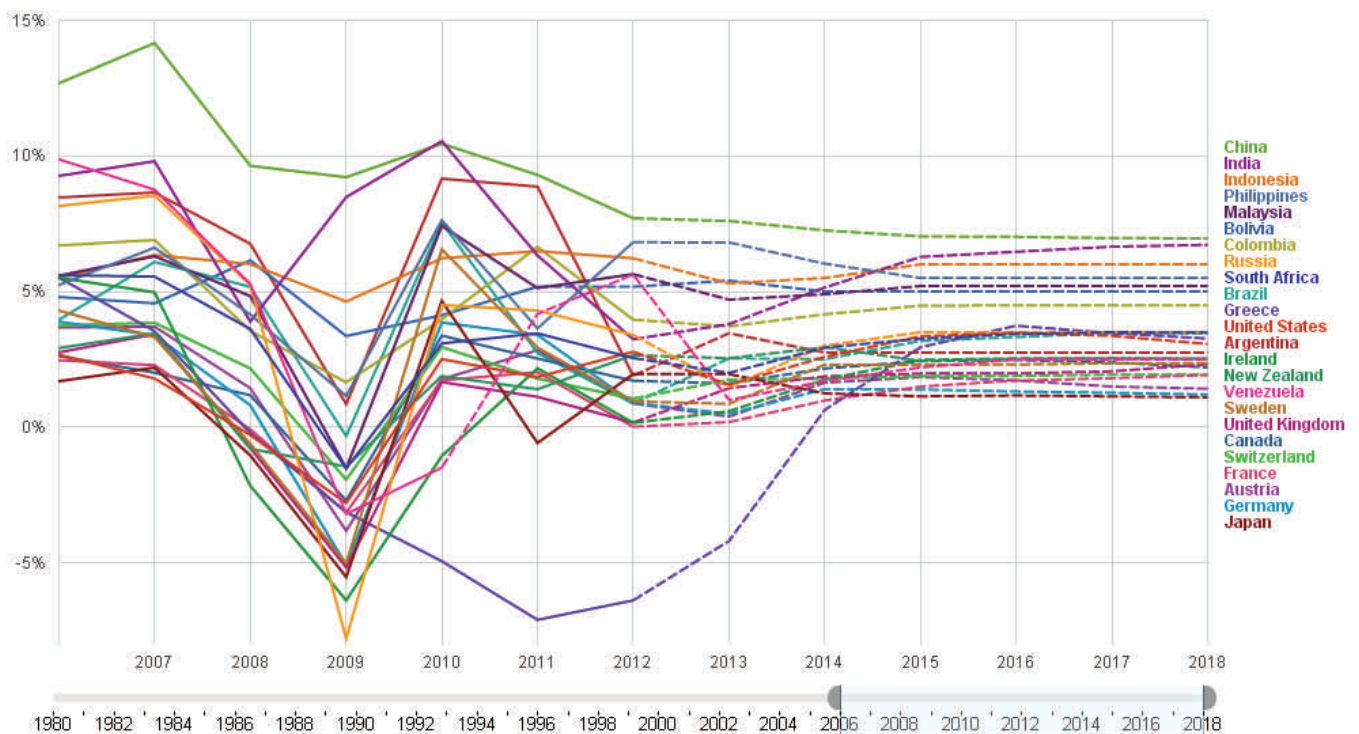
The eventuality of rising interest rates is likely to be tough on bond investors since rising interest rates are mathematically associated with falling bond prices. However, we are combating this threat by favoring certain classes of securities that we expect to weather rising rates better. For example, since floating rate instruments routinely adjust their interest payments to reflect the current interest-rate environment, their market values can remain more stable as rates rise. Because rising interest rates have historically been associated with improving economic conditions and because improving economic conditions have historically been associated with rising stock valuations, we believe it makes sense to hold debt securities that are convertible into stock when interest rates are expected to rise. During 2013, convertible debt securities have generated strong double-digit returns while the overall bond market as measured by the Barclays Aggregate Bond Index shed about 2% of its value. Floating rate securities have also outperformed, but not by as much.

IMF EXPECTS THE WORLD ECONOMY TO CONTINUE TO GROW

The basic role of the International Monetary Fund is to foster economic growth and cooperation with the aim of improving the global standard of living. As such, it monitors and forecasts economic activity for almost 200 of the world's economies. Without getting into the forecasting weeds of any specific country, I thought it might be instructive to see how the IMF expects some of the world's most important economies to fare over the next five years. Accordingly, the graph on the following page plots the actual gross domestic product (economic output) of those various economies back to about 2007 along with its expectation of their respective growth rates through 2018. I've included a large number of countries in this graph which congests it a bit, so instead of focusing on any given country

or line, you might simply note that the IMF expects every economy shown on this graph to exhibit positive growth over the next five years. For the sake of relative reference, the IMF expects Japan's economy (the bottom-most line) to grow by about 1.2% per year over the next five years while it expects China's economy (the top-most line) to expand by about 7% per year. While the relationship between economic growth and investment returns is highly variable, knowing that the IMF expects the world economy to expand materially over the next half decade might still provide some level of investment comfort.

GDP, constant prices (% change) ?



Data from IMF, October 2013 WEO Last updated: Oct 16, 2013

It's also worth noting that the IMF expects U.S. economic growth to be in the middle of the world pack, which is actually a pretty positive assessment when one considers that it's more difficult to grow things that are already huge (like the U.S. economy).

In his most recent letter to Berkshire Hathaway shareholders, Warren Buffett wrote, "American business will do fine over time. And stocks will do well just as certainly, since their fate is tied to business performance. Periodic setbacks will occur, yes, but investors and managers are in a game that is heavily stacked in their favor. (The Dow Jones Industrials advanced from 66 to 11,497 in the

20th Century, a staggering 17,320% increase that materialized despite four costly wars, a Great Depression and many recessions. And don't forget that shareholders received substantial dividends throughout the century as well.)” I thought you might appreciate Warren Buffett’s perspective.

THE MOST BASIC INVESTMENT CASE: HUMANITY’S QUEST TO IMPROVE ITS LOT

Evolution has resulted in a human brain that has become especially adept at noticing and processing danger signals and other threats. After all, survival is more positively promoted by being able to detect predators than it is by seeing art in clouds. Because sensitivity to negative information makes it difficult for humans to maintain a balanced perspective, I would like to suggest that humanity’s unrelenting quest to improve its circumstances has resulted in a human condition that is not only improving, but improving at an increasingly rapid pace. I believe that humankind’s unrelenting quest to improve its circumstances forms the foundation for every investment thesis.

The global standard of living is magnitudes better than it was just a century ago. Consider the fact that even the poorest Americans now have access to niceties like flushing toilets and microwaves, and to important technologies like wireless communication and immunization that didn’t even exist until recently. A quick check of Wikipedia reveals a host of emerging technologies that may dramatically improve the human experience in the years to come. Some emerging technologies that could be especially impactful may include 3D printing, vertical farming, regenerative medicine, retinal displays, electronic detection systems for things like cancer and chemical weapons, artificial photosynthesis processes to harness more of the sun’s free energy, off-the-grid energy production, wireless energy transfer, radio frequency identification, superconductivity, electromagnetic weapons, brain-computer interfaces, hypersonic aircraft, space travel by solar propulsion, biometric security systems, magnetic refrigeration, and many others.

The point is that human ingenuity has a tremendous record of success and, despite the seemingly endless stream of bad news, more of that success seems forthcoming. Technology aside, let’s take a closer look at some other reasons why it may be a particularly good time in the history of the world to be a human being. (Many of the following points have been distilled from a recent article written by Zack Beauchamp entitled “*5 Reasons 2013 was the Best Year in Human History.*”)

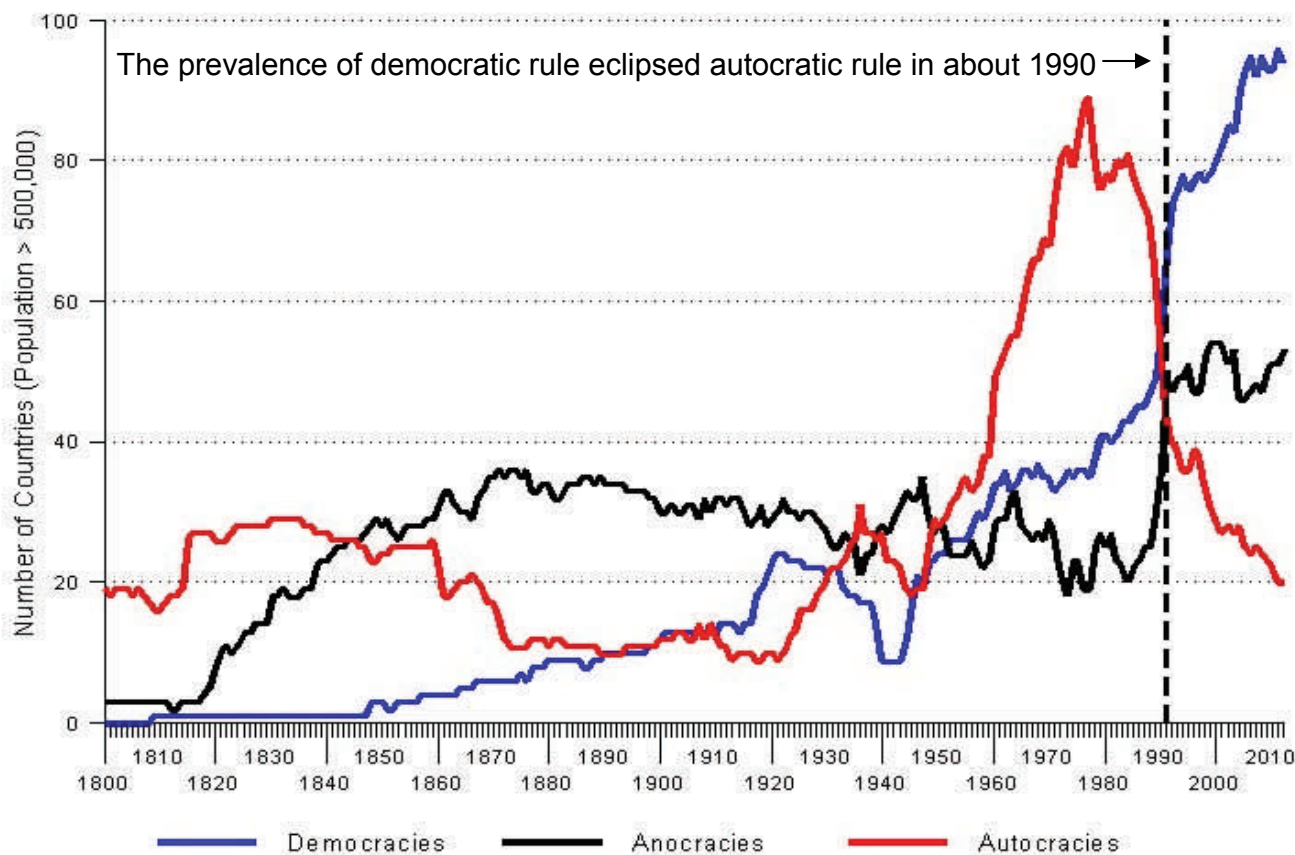
IMPORTANT FORCES HEADED IN THE RIGHT DIRECTION

Virtually all of the most important forces that determine the quality of human life such as innovation, morbidity and mortality rates, our collective standard of living, the incidence and severity of war and violence, the extent to which we must endure various forms of discrimination, and the extent to which we may exercise personal liberty, are trending very positively.

THE SCIENTIFIC METHOD, DEMOCRACY, CAPITALISM, & ALTRUISM

Advances in the scientific method have resulted in the Industrial Revolution as well as high quality research that has, in turn, spawned modern medicine along with a host of complex technologies that now allow us to more efficiently apply these medical advances around the globe. Meanwhile, the global spread of democracy has forced governments to become more accountable to their citizens and the birth of modern capitalism has resulted in an explosion of economic resources that can be devoted to the large-scale application of life-saving technologies. This explosion of resources has also allowed nations to act more benevolently and altruistically toward one another.

Global Trends in Governance, 1800-2012



FEWER PEOPLE ARE DYING YOUNG ... MORE ARE LIVING LONGER

There is not a single country in the world where infant or child mortality today is not lower than it was in 1950. Between 1990 and 2010, the percentage of children who died before their fifth birthday dropped by almost half. Death by Measles declined by 71 percent and both tuberculosis and maternal deaths declined by about half. Since 2005, HIV-related deaths have fallen by almost a quarter. In short, fewer people are dying untimely deaths. And, these trends are not only true for rich countries. Life expectancy has increased around the globe. Whereas the median life expectancy was 47 years during the 1950s, it had risen to 70 by 2011 and the average person today can expect to live almost twice as long as the average citizen of even the world's wealthiest country in 1850.

POVERTY IS ON THE DECLINE ... AND THE WORLD IS GETTING HAPPIER

We haven't come close to eliminating poverty, but 721 million fewer people lived in extreme poverty (defined as living on no more than \$1.25 per day) in 2010 than in 1981. About 80% of the recent decline in poverty comes from China, mostly as a result of its economic and social reforms, and another dollop of that improvement comes from India, but poverty rates are on the decline in every national income bracket. In low-income countries, the percentage of people living in extreme poverty has declined from 63% in 1981 to 44% in 2010. Living standards for the middle class are also at an all-time high as televisions, refrigerators, and other goods that were once associated with luxurious living have become commoditized and, hence, comparatively inexpensive. Therefore, it should come as no surprise that higher levels of economic output are associated with higher levels of national happiness. After all, people are naturally inclined to enjoy an easier and less worrying existence.

WAR IS BECOMING RARER AND LESS DEADLY

Steven Pinker's 2011 book, *The Better Angels Of Our Nature* is the gold standard in the debate about the incidence and severity of war and violence. Despite the advanced weaponry that now permeates our globe, war and violence appear to be in the midst of a centuries-long decline. Over the past 50 years, Pinker finds that the worldwide rate of death from interstate and civil war has declined from almost 300 per 100,000 of world population during World War II, to about 30 during the Korean War, to the low teens during the era of the Vietnam War, to the single digits in the 1970s and 1980s, and finally, to less than 1 per 100,000 in the twenty-first century.

So, the smallest percentage of humans alive since World War II is now living through the horrors of war. This is mostly because democracies rarely go to war with one another, partly because of organized efforts to thwart war (such as through U.N. peacekeeping operations), and possibly because people may actually be becoming somewhat more civilized.

MURDER AND VIOLENCE ARE IN FREE FALL

Crime, the sort states commit against their citizens and the sort citizens perpetrate against each other, is also on the decline. Slavery was once common, but is now illegal everywhere and the use of torture as a legal means of punishment has declined dramatically. The European murder rate fell 35-fold from the Middle Ages to the beginning of the 20th century with that decline becoming especially marked in recent years. 557,000 people were murdered in 2001, but despite global population growth, that number fell to 289,000 in 2008 and the homicide rate has been declining in 75 percent of the world's nations since then. As a whole, G7 nations show huge declines in homicide, robbery, and vehicle theft, but it's not due to increased incarceration, because violent crimes have also declined in countries that have reduced their incarceration rates (like Canada and the Netherlands). The same trend is apparent in the U.S. Despite the fact that New York now incarcerates fewer people, it saw the fastest decline in crime in the country. Globally, police have become more efficient and the relentless commoditization of many goods allows more people to buy things they might have otherwise stolen.

DISCRIMINATION IS ON THE DECLINE

In 1860, African-Americans were in chains, European Jews were routinely massacred, women were almost entirely subordinate to their husbands, and LGBT people were invisible. That the status of these groups has markedly improved today is incontestable. The illegitimacy of white minority rule led to South Africa's diplomatic, cultural, and economic isolation, and IMF data indicates a consistent decline in gender-related disparities in terms of wages, labor force participation, and educational attainment. In the beginning of 2003, zero Americans lived in marriage equality states; by the end of 2013, 38% of Americans will.

My sense is that the world is still full of opportunity and that it is, in fact, becoming a better place.

- Glenn Wessel