Capital
INVESTMENT SERVICES
of America, Inc.

Observations

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Walking the Dog

We recently were reminded of an investment analogy once offered by investment veteran Ralph Wanger[i]. We recount it below for we believe it adds some perspective to the current focus on “Brexit” and the uncertainty it has triggered within global financial markets.

Investing is like walking a dog on a leash, Wanger noted. The dog never walks in a straight line but careens from side to side distracted by a squirrel here, a fluttering leaf there, a fire hydrant in yet another spot. Still, it is the dog’s owner that ultimately guides the frenetic dog on the walk.

"What is astonishing," Wanger said, "is that almost all investors, big and small, seem to have their eye on the *dog* (markets), and not the *owner* (the fundamental aspects of the underlying investment)."

In recent years investors have encountered a number of events that have, for a time, captivated the investment “dog’s” full attention. To name just a few; there was the “fiscal cliff”, the Ebola virus, Greece’s financial woes on (at least) a couple of occasions and before that Cyprus.

Still, the U.S. financial markets regained their footings as the economic expansion—while slow—continued on and most businesses went about their business of seeking to solve customer problems and satisfy their needs. These fundamentals after all, represent the dog’s “owner” and determine the ultimate investment direction.

In recent days the so-called Brexit is capturing the full attention of the investment dog. And while the UK voting to leave the European Union may not be a trivial matter, it will likely prove to be just one factor in the investment equation for most investors.

The relevant questions surrounding the Brexit are, in our estimation, those that relate to the underlying fundamentals. Namely:

- Will it trigger a U.S. recession?
- Will corporate earnings progress be materially impaired, and will that unleash a stock "bear market"?
- Does it represent another 2008 "Lehman moment" where the collapse of the investment firm, Lehman Brothers triggered the 2008 Financial Panic?

We believe the answer to these questions is "no"!

Although the US economy is mired in a slow-growth mode, a lack of excesses (unsustainable private debt loads and rising inflation) that typically make an economy vulnerable to recession remain generally lacking.

Brexit may well cause the UK to suffer a recession, and is not a favorable development in the short run for world growth, but the U.S. economic expansion should remain sufficiently resilient to withstand the effects.

Meanwhile, our banking system is better capitalized than it has been in many decades. Leverage in the financial system is nowhere near 2008 levels and financial system liquidity is abundant today. True, the largest domestic banks (which are not among our common stock holdings) do have operations in the UK that may be impacted by Brexit. However, any impact will likely be on the income statement side of these bank's ledgers and not of materially impact to the soundness of their balance sheets.

More specifically; the structure within our clients' portfolios that own bonds remains conservative both with regards to interest rate risk and credit risk. These attributes we believe will continue to allow bond investments to fulfill their dual portfolio roles of providing a worthwhile return while also tempering overall portfolio volatility.

And our stock investments continue to emphasize "growth" businesses bolstered by abundant free cash flow and strong balance sheets. We believe these "compounding machines" will provide rewarding returns over the next several years…even as the market "dog" is apt to be distracted many times along the way.

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[i] Morgan Housel, *Two Short Stories to Put Successful Investing Into Context*, May 13, 2016