STRATEGIC INSIGHT

# A HINT OF CAPITALISM

December 22, 2010

The history of man shows, through example after example, that man thrives best in a free society. Free societies have made the greatest strides towards improving living standards for citizens.

Typically, some form of capitalism exists at the root of most free societies, allowing citizens to own private property. This right provides the incentive to accumulate wealth, and, when left unbridled, it has invariably been the secret key to prosperity. History also reminds us that when societies surrendered this freedom, they rapidly crumbled, leaving a legacy of misery in every conceivable way.

The United States of America is the best example of what free people can achieve through free market capitalism. In our system, individuals are free to decide whether to expend extra effort or risk savings in pursuit of greater financial return. Obviously, if the potential return is attractive, the individual will likely work longer and harder or commit capital to realize that return.

However, if the individual is punished for achieving success or limited as to how much can be achieved, the result will be even less effort and less investment. If government imposes a progressive penalty (tax) on financial success, individuals will work and invest only until they feel the penalty is excessive. A society that punishes or systematically penalizes success will stagnate and eventually crumble. Its citizens will quickly realize that they have lost the incentive to produce and the freedom to pursue greater financial rewards.

Being professional investors, we have become increasingly concerned about the loss of incentives in our economy. More regulation, higher tax rates, and harsh, punishing rhetoric have tempered economic and job growth to date. Returns for investors have consequentially suffered. America seemed to be at a point where class warfare arguments and emotions had become the drivers of policy. A looming higher death and income tax targeted at the most productive Americans would have had a further stagnating effect on our economy, simply because the incentives to produce would have been taken away. Fortunately, our awareness of these trends helped shape our investment strategy over the last few years, enabling us to avoid many of the sharp declines that have affected investors.

But that is beginning to look like yesterday's investment struggle. Four recent events have given us a new found optimism:

First, the recent election tells us that Americans are agitated and upset by the thought of government taxing more in order to spend more. They realize that deficits are caused primarily by spending, not under-taxing.

Second was the finding of the Commission on Fiscal Responsibility, put together with much fanfare last April by President Obama. Instead of the expected recommendation for higher taxes to support higher spending, the leaders of the group unveiled a majority view espousing lower tax rates for individuals and corporations along with significant spending cuts. To pay for the lower tax rates, many sacred deductions and exemptions would necessarily be removed, along with many spending plans. In short, we agree with the finding.

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Third, a compromise extending the Bush "tax cuts" effectively cancelled plans to increase death and income taxes for America's highest producers and the beneficiaries of wealth. This compromise will have the effect of keeping economic incentives alive, while keeping most existing investments intact.

Lastly, the $1 trillion plus, pork-laden, omnibus spending package failed to pass in the Senate. Instead, a short-term resolution to keep government funded until the new congress meets will be put together.

This last event is extremely important in that the new Congress can exercise budget restraints immediately, rather than having to wait and swallow another $1.5 trillion deficit in the meantime. The new found ability to attack spending immediately means that we probably will see an attempt at tax reform sooner rather than later. The two go hand in hand.

These events taking place over the last six weeks have given us a new found optimism. If our country can continue to put together the basis for a more dynamic economy while limiting spending, we will see deficits dwindle, high unemployment disappear, and our dollar and our markets increase in value.

Have no doubt about the fact that the opponents of these growth policies still have most of the important votes in Washington. They still favor government hiring and spending, over an incentivized private sector. We hope that enough of them have learned that more government is not the answer in a free capitalistic society. Nevertheless, 2011 promises to be an interesting year with both sides preparing for battle.

After a somewhat tepid first quarter, our outlook is now calling for strong economic numbers in 2011. This economic growth could hurt bond investors, but Federal Reserve Chairman Bernanke still plans to "print" more money to buy Treasurys through June of next year. Perhaps a spike in interest rates is still a way off.

For investors, this is not yet a call to go "all in." Rather, it is an early call to begin looking for opportunity, rather than folding and throwing in your cards.

The very genius of our free society manifests itself in surprising ways and this turnabout is yet another example of that. And surprisingly, capitalism still appears to be "alive and kicking." A few more good policy decisions and the rest of the world had better look out…America could be back.

Happy New Year!

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