Patton Albertson & Miller LLC

INSIGHT AND OUTLOOK

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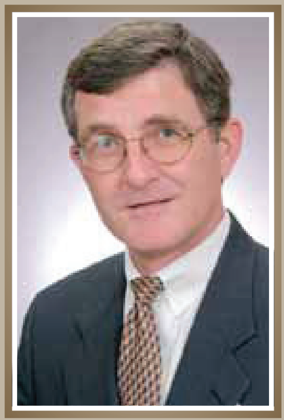
Brilliant Obscurity



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Claude Frederic Bastiat (1801-1850), the brilliant French economist, wrote dozens of insightful essays—all in French of course. Much of his writing still languishes untranslated to this day. For that reason he remains an obscurity to English speakers including most economists. And that's quite unfortunate because he had the rare gift of penetrating to the heart of a question and answering it clearly and persuasively. One of his finest economic essays is known as "The Parable of the Broken Window".

Bastiat recounts the story of the shopkeeper whose son accidentally breaks a windowpane in the shop. Repairing it will cost six francs, much to the shopkeeper's annoyance. Passesrby console him by pointing to the silver lining—the repair will be good for trade. They say, *Everyone must live, and what would become of the glaziers if panes of glass were never broken?*

So in due time

The glazier comes, performs his task, receives his six francs, rubs his hands, and, in his heart blesses the careless child. ***All this is that which is seen.***

But Bastiat takes the analysis one step further, ***It is not seen*** *that as our shopkeeper has spent six francs upon one thing, he cannot spend them upon another.* ***It is not seen*** *that if he had not had a window to replace, he would, perhaps, have replaced his old shoes, or added another book to his library.*

So the glazier's gain is some other trademan's loss, for no net advantage to the economy as a whole. Furthermore, the shopkeeper is worse off because he must spend six francs to repair his window and that merely restores him to his prior position (less the six francs!). Bastiat concludes, *Society loses the value of things which are uselessly destroyed.*

We see that the destruction caused by nature or by man provides no stimulation to the economy once we properly extend our analysis from that which is seen to that which is not seen. Contrast Bastiat's commensense insight to the nonsense often heard after natural disasters such as Hurricane Sandy and the "economic boost" reconstruction supposedly would provide. We can apply Bastiat's analytical method to a wide range of economic problems. In the next few sections we'll consider a few of them.

ZIRP vs. Consumer Spending

The Federal Reserve's zero interest rate policy (ZIRP) purportedly should encourage higher investment in housing and equipment which in turn should promote higher employment, more consumer spending, and a stronger economic recovery. That's the neo-Keynesian orthodoxy which dominates not only the Fed but also most economics departments and think tanks around the country. The fact that after five years of ultra low interest rates the U.S. recovery remains tepid only shows that more needs to be done in the opinion of such leading Keynesians as Paul Krugman and Larry Summers. Every policymaker can see that the Fed has driven interest rates to Depression era lows.

What is not seen by most of them, however, is the negative impact those low rates have on savers' spending. Remember that every interest payment by a borrower is the interest income of a lender. By driving down interest rates on CD's and bonds, the Fed has deeply impaired the cash flow of retirees, parents saving for their child's education, and pension plans. Not so very long ago $1 million in low risk CD's and bonds could easily provide $40,000 to $50,000 of income. Today a saver would be lucky to earn $10,000. We suspect that the dominant reason for ZIRP's ineffectiveness is that it merely robs Peter to pay Paul. We have responded to ZIRP by drawing down portfolio cash and using short term bonds and "alternatives" to generate some income. We look forward to the Fed's promised renormalization of interest rates

QE vs. Wealth Inequality

Quantitative easing (QE) has been the Federal Reserve's operational tactic for accomplishing ultra low interest rates. To somewhat oversimplify, QE means printing money out of thin air and using it to purchase U.S. treasuries and mortgage-backed securities. Those purchases not only elevate those

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Jimmy Patton
Patton Albertson & Miller, LLC

Mugged "On the Grid"

In September, I received notice from Home Depot and American Express that my credit card was one of the 50 million that had been breached in one of the largest corporate hacking cases to date (as I write this article, news is breaking about an even larger breach at J.P. Morgan). Every week seems to reveal another virus, another breach of privacy, another thing to worry about in our digital world.

If you are like me, you wish you could go "off the grid" and return to the analog world I grew up in. In reality, however, it's nearly impossible to live life without having your private information "on the grid." Your doctor likely has your health records in digital format, you use credit cards to make purchases, and the 3 major credit reporting agencies all have computer files with all the private information necessary for someone to steal your identity. The state has your birth certificate and your driver's license stored on computers, allegedly safe from intrusion. All of us do business with companies that collect private information and we trust them to protect and hold it safe. No matter how much we wish things could "go back," they cannot. So, to borrow a line from Winston Churchill, '…if we open a quarrel between the past and present, we shall find that we have lost the future."

So how do we become a full participant in this digital future without becoming a casualty of it? How do we walk the streets of the digital neighborhood without getting mugged? Furthermore, if you are reading this as a client, or prospective client, of Patton Albertson & Miller, how do you know the information we collect about you and your family is safe?

Let's start with 8 tips on how you can prevent identify theft. Remember, nothing can guarantee that you won't become a victim of identity theft but there are things you can do to minimize your risk.

1. **Protect your social security number.** Don't carry your social security card or number in your wallet. Don't use it as a user ID on websites, don't write it on checks (IRS quarterly tax estimates are the exception for the simple reason the IRS requires it). If a business asks for it, ask "why do you need it? How will it be used? How do you protect it? What happens if I don't give it to you? Satisfactory answers to these questions will help you decide whether to share it, or not.
2. **Use a Shredder.** Shred copies of receipts, credit applications, insurance forms, physician's statements, bank statements, expired credit cards, credit offers you receive in the mail and anything else that contains private information that someone could use to steal your identity. To opt out of prescreened credit offers visit www.**optout-prescreeen.com**. By the way, they will ask you for your social security number so they can match you with your file. To add another layer of protection, have mail delivered to a post office box rather than an unsecured curbside mailbox.
3. **Be careful when using the Internet.** The internet can be a wonderful place to shop and surf but you have to be careful and always keep your guard up. For practical tips on how you can protect your internet experience visit www.OnGuardOnline.gov and www.staysafeonline.org.
4. **Select intricate passwords.** This one has been a difficult one for me and probably your biggest headache as well. How do you create a unique password for each website and remember each one? Typically, the only person prevented from accessing my information is ME! I have finally found a solution that only requires me to remember one password but creates a unique password for every website I use. The solution is a digital wallet. There are several good ones on the market. I use Dashlane (www.dashlane.com) but eWallet (www.iliumsoft.com) and mSecure (www.msevensoftware.com) are also good and all three feature 256 bit encryption and synchronization between multiple devices. There is a small monthly cost but I find it well worth it. Now I only have to remember one password; what a relief!
5. **Verify sources before giving out information.** Never give out personal information over the phone unless you are sure you know who you are dealing with. If you don't know the person, tell them you will call them back and then independently look up the phone number. If you are on-line make sure the web address is legitimate. After my American Express card was compromised, I began receiving notices from what appeared to be American Express telling me they had a security concern regarding my card and to click on a link. When I carefully examined the web address I discovered it was not the American Express website at all but a close imposter. These "phishing" emails are becoming more and more sophisticated and hard to detect; protecting yourself requires your full attention!
6. **Store information in secure locations.** All of us have some things that we need to keep such as social security cards, tax returns, tax receipts, life insurance policies, etc. Many of us also have other people in our homes such as a housekeeper, a repairman, or exterminator. Important papers should be put in a secure place in your home, preferably under lock and key. A safe-deposit box at a local bank is another option but make sure you don't lock up papers that might be needed by your heirs if you became incapacitated or died.
7. **Consider using a credit freeze.** Many states let consumers "freeze" their credit file which means no one can access their file without you "lifting" the freeze which by the way can make applying for credit a more complicated and time-consuming process. In some states anyone can freeze their credit; in others only a victim of identity theft can place a freeze.
8. **Identity Protection Insurance.** You may want to consider Identity Protection Insurance. Although opinions differ on the effectiveness of services such as LifeLock®, PrivacyGuard®, and ID Patrol® (there are many others in addition to these three) they do provide an measure of protection in the areas of identity theft recover and information protection.

Now that we have covered what you can do, let me tell you what Patton Albertson & Miller does to keep your private

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securities' prices but also those of securities such as high yield bonds and common stocks which are farther out the risk curve. The low rates are inducing some desperate investors to "reach for yield". They are assuming more risk in exchange for the prospect of higher returns.

Former Fed chairman Ben Bernanke often expressed pride that the Fed's quantitative easing raised financial asset prices since Keynesians expected a strong "wealth effect" would trigger more investor spending and thus stimulate economic growth. Very little evidence exists of a lasting wealth effect, but anyone can see that QE has driven stock and bond prices dramatically higher since 2009. Wall Street has flourished even if Main Street hasn't.

What most do not see is the link between quantitative easing and the undeniable surge in wealth inequality in the U.S. After all, who owns most of the financial assets in this country? The top 10-20% of the population in terms of wealth. Fed money printing has certainly boosted their finances, yet critics of the growing wealth inequality rarely indict the Fed. Another French economist, Thomas Piketty, in his recent best seller *Capital in the Twenty-First Century* argued that it was capitalism by its very nature which fostered growing wealth inequality. His solution, eagerly embraced by some intellectuals and economic pundits, calls for ratcheting up income taxes on high income earners. We think the Fed's decision to finally wind down its wild experiment with quantitative easing is a better solution. In the meantime we have continued to focus on the artificiality of the financial asset boom and have emphasized strong financial strength in our stock and bond selections.

Student Loans vs. New Home Sales

The Federal government has largely taken charge of the student loan market and many people believe that is a good thing. Generous student loans enable hard pressed lower and middle income families to send their children to college. Even upper income families qualify for the government loans. Currently about 60% of all college students take advantage of the government loan program and such loans now exceed $1.2 trillion. More than half of all graduating seniors, however, carry student loan debt of $27,000 or more. Their diplomas and their debt are easily seen.

What is not so easily seen are the unintended consequences of that debt. The real estate industry, for example, worries that the burden of student debt impairs new home buying by the 25 to 35 year old cohort. These are the core "first home" new buyers. The industry estimates that every $250 per month of student loan repayments reduces home purchasing power by $44,000. That's a significant number in the starter home market. Some 5.9 million households pay over $250 monthly compared to just 2.2 million households back in 2005. Some realtors see the student loan burden as an increasing drag on the housing recovery, to the tune of $83 billion of lost sales in 2014. We doubt policymakers even considered the possible negative impact of the student loan program. In addition to the real estate consequences, free market economists believe that the easy flow of credit into higher education contributed to the surge in college tuition inflation, up 130% cumulatively since 2000 compared to 42% for the Consumer Price Index.

Stock Buybacks vs. Value Destruction

Corporate America uses share buybacks as a convenient way to increase earnings per share in a sluggish economic environment. Analysts expect S&P 500 companies to repurchase $565 billion of stock this year, nearly 59% of expected total profits of $964 billion. Since the bull market began in March 2009 corporations have bought back almost $2 trillion of their shares. Corporate demand for stock has undoubtedly contributed to the rise in stock prices over that period. Since the bulk of top management compensation comes from stock options and grants, most executive suites are favorably inclined to stock buybacks, perhaps regardless of the cost. Investors can easily see that fewer shares outstanding for a given amount of earnings must translate into higher earnings per share. Top executives see that higher stock prices mean higher total compensation for themselves.

What is not often seen, however, is the impact on shareholder value. Buybacks made at less than a company's intrinsic value per share are good for the shareholders who stay. But buybacks made at excessive prices actually destroy long term shareholder value. Analysts can only estimate intrinsic value, of course, but we can be fairly certain that after a five year bull market many stocks are near or even above their true "fair value". Therefore, we are cautious about purchasing shares of companies which announce stock buybacks in the current financial climate.

Conclusion

Frederic Bastiat demonstrated the insights available to us by looking beyond the immediate and the obvious to "that which is not seen". How many unforeseen results, later excused as "unintended consequences" could have been anticipated if only analysts had extended their reasoning forward another step or two? Quite a few in our opinion.

We recognize that analytical myopia is a common shortcoming, especially among the denizens of Wall Street and Washington. We can't do anything about them, but as investors in 2014 we will strive to remember the wisdom of Bastiat by looking beyond the broken windowpanes and what becomes of the glaziers.

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information and your account safe from unauthorized access.

1. **Full-time Director of Information Technology**. Earlier this year we hired Tim Hipps who is responsible for keeping our network running and secure. Most firms of our size outsource this function, but having a full time position gives us the resources necessary to run a tight ship.
2. **Email encryption.** If we send an email that contains personal information we encrypt that email so that even if it was intercepted, the bad guy only gets gibberish.
3. **Shredding.** We have locked shred collection bins in all three of our locations. The shred is removed by a third party vendor who is "AAA" certified by the National Association for Information Destruction. We also destroy the hard-drive from any and all retired workstations and servers.
4. **Call-back procedures.** If you email us instructions to move money or assets, we assume that is an unauthorized request until we physically talk to you on the telephone and confirm that you actually originated that request.
5. **Back-up systems.** We back-up our data twice; once on-site and a second time using a certified third-party provider with redundant data centers in geographically diverse locations in the United States. We also have multiple servers so that if one goes down we can use a backup.
6. **Network security.** We have physical firewalls installed in each of our three locations. Those firewalls filter any website traffic from outside North America. We have "locked down" our network so it can only be accessed through a VPN connection. We monitor our networks for intrusion and are alerted if someone attempts to "brute force" our network. Every portable device that accesses our network is owned by the company and is password protected. These devices can be remotely wiped clean if lost or stolen. We use "two-factor" authentication for remote access to our network and all network passwords expire every 45 days.
7. **Virus software and patch management.** We use a software solution that automatically updates virus software and installs software patches to every workstation and server so that no one "forgets" to run an update which would leave us vulnerable.
8. **Disaster recovery planning.** We have, continually update, and test our business interruption plan so we are prepared to conduct business even in the most difficult of circumstances.

I hope you now see that we take the protection of our clients' private information very seriously. While no company is immune from attack (Target, Home Depot and now, J.P. Morgan, are proof of that), we take every reasonable precaution and we continually look for more and better ways to protect the private information of our clients.

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