

Property Rights and “Fairness”

Quick Look

<u>Market</u>	<u>Next Expected Move</u>	<u>Month</u>	<u>YTD</u>
?			
DJI		0.95%	1.05%
COMP		2.60%	7.05%
SPX		1.05%	2.36%
Gold		0.65%	0.53%

- After 5 months, large cap stocks and gold are roughly flat on the year. Smaller caps have outperformed so far year-to-date.
- Government constantly strives for control over all aspects of our lives and our society. How does achieving some of this control affect economic, business and investor behavior?

Notes:

- The NASDAQ COMP has set all-time highs this year, finally eclipsing its 2000 high over 5000. While having several daily closes over 5000, the COMP has only closed one month over the 5000 benchmark – May.
- It’s unusual for smaller cap stocks to be outperforming large caps as a group. The meaning and final outcome of this isn’t yet clear.

Government Does NOT Equal “The People”

A few years ago, on a family vacation in Ireland, I chanced upon a display in a Dublin museum of some historical piece that was very old and had been only recently discovered on some Irish farmer’s land. It turns out that the

item had been confiscated from the farmer without compensation by the Irish government. Some young, idealistic Irish college student joined in on our conversation after hearing me talk about how that was unfair to my kids, stating that it was only right because, “it belonged to the people.”

He seemed like a bright, young kid, so, I kept my mouth shut. No sense in riling the locals. We were on vacation.

But, the young man was dead wrong, if you have any belief in private property rights whatsoever. While I can understand a government taking control of an item of historical significance, not compensating the farmer for some semblance of the item’s fair market value is theft, plain and simple. If he discovered gold or oil on his land, would the government confiscate that too?

Understand, we are NOT talking about property that actually belongs to someone else, but was found on his property. We’re talking about an item hundreds of years old, with no known family that could even lay claim to it. Confiscating the item without compensation is a complete denial of property rights.

Moreover, the young man, who seemed quite nice, surely didn’t understand the difference between property owned by “the people” and that owned by the *government*. I wonder how far his argument would have gotten with the local authorities if he chose to borrow the item (fully intending to return it) because he was one of “the people.”

Harken back to the 2000 election between Bush and Gore. Remember Gore talking about “the government’s money?”

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“The problem with socialism is that you eventually run out of other peoples’ money.”

- Margaret Thatcher

Trend Capital Management, LLC

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Putting it simply and brutally, the government's property belongs to the government, not "the people." The only time you will hear otherwise is when a politician is trying to acquire (not *earn*) your vote. Keep this last concept in mind as you read on.

Startups, Private and Public

Recently, Kelly Evans of CNBC wrote an article: *Uber casts \$50 billion shadow over public markets*. The link: <http://www.cnbc.com/id/102671710>. By the way, Ms. Evans appears to be a fine young reporter to me. But, some of the things discussed in this article lead directly to why the recession has lasted so long and economic growth remains weak. It also appears to us that the thoughts behind some of the article's assertions are illustrative of current business and economic problems.

The gist of the article is this: the author and cited sources are bemoaning the fact that many of the more successful start-ups today become enormously large and fully valued prior to issuing an IPO. This effectively cuts the small investor out of much of the early, sometimes explosive, growth of the enterprise as it seeks private (instead of public) capital to fund its growth. Obviously, this is a large change from the 1990's and prior, when quite small companies with potentially solid futures would IPO (Initial Public Offering) to seek capital, instead of borrowing or issuing ownership shares to venture capitalists, angel investors, etc. Some managing partner of a VC firm stated this was not a good thing for society, further stating, "There's no reason why mom and pop shouldn't be able to invest in that."

Let's examine what we just read.

First, these firms, like virtually all small companies, start out with an idea and a founder or a group of founders forming a private company to realize their goal(s). They usually put their financial lives and their reputations on the line to do this. These are *private* companies. The owners have taken the risk. Do they not have the right to chart the course of the company they create as they see fit? What *right* does anyone *not associated* with the enterprise have regarding if or when the company should go public? Shouldn't that be the *owners'* decision(s)? *They* took the risk.

Typical of people who think this way, no one cited in the article was clamoring for the stock or ownership of one of the many companies that fail for each successful one. Sadly, in the pursuit of "fairness,"

some of the most boneheaded ideas appear reasonable, until examined.

One of the sources in the article was bemoaning that startups can do anything as a private company that they can do as a public one. Isn't that as it *should* be? Do we not want companies with new/better/cheaper products or services to have more than one path to success? Do we not want the jobs? The better products or services? Perhaps more importantly, what happened to the recognition of the property rights of the *owners* here?

Before going on, how many "Moms and Pops" have either the fiscal or psychological risk tolerance to invest in startup companies? Government regulators would probably censure or jail advisors placing non-accredited investors into significant amounts of such investments. Should we throw out the accredited investor rules while we're at it? Should we *make* moms and pops invest in these since we would like to *make* the companies go public? Where's our common sense? More importantly, what makes us think government has the *right* to do these things? Just because the government does things doesn't mean it's actually *allowed* to under the law.

Getting back to the substance of the article, one cause of this behavior change is the Sarbanes-Oxley Act, at least in more than a few informed opinions. The additional regulations and reporting requirements imposed by this act definitely put a chill on IPO and other business friendly behavior since its passage. So much so that Congress passed the JOBS (Jumpstart Our Business Startups) Act in 2012 that alleviated some of the more burdensome regulations imposed upon small startup companies. Companies whose resources are and should be primarily devoted to keeping the company alive, growing and establishing its market position.

Assume you were an entrepreneur trying to establish a self-sustaining startup and help it grow into whatever vision you had for it. You could use capital from private sources to whom you would be responsible for various agreed-upon covenants. You could acquire public capital through an IPO and deal with activist investors, the SEC, state and local regulators, and exchange rules, just to name a few? Given where your energies and capital must be expended to succeed, it seems like a simple choice to us.

Quoting directly from the article:

"The pressure on public companies to meet short-term
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results as opposed to investing heavily in their future is said to be one of the reasons Facebook dragged its feet so long before going public. Even those start-ups who do eventually list, like Google and Alibaba, today often adopt protective structures that leave more control in the hands of executives than has traditionally been the case.

“Regulators are aware that the appeal for companies of participating in public markets has dimmed—to the detriment, perhaps, of those very markets.

”Many growing businesses have consciously avoided the public markets over the past decade because of the regulatory baggage that accompanies the offering regime,” said SEC Commissioner Dan Gallagher in a January speech.”

The article goes on to describe how some mutual funds have been attempting to gain investment access to these startups for “Moms and Pops” through various means, all of which have drawbacks. Issues of reporting and liquidity are pervasive in pursuing these investments. TCM seriously questions whether delivering investments of this type through mutual funds or ETF’s doesn’t deliver a level of risk to smaller investors they don’t understand and are supposed to be protected from through the accredited investor rules.

The Bigger Questions

There, Ms. Evan’s article stops. However, the pervasive attitude throughout the article is that there is something inherently *unfair* about companies growing through private investment instead of going through an IPO to acquire capital to grow and establish their companies.

This attitude begs two questions:

- Why is it unfair?
- Who gets to decide if it’s unfair?

Alexis de Tocqueville, French historian and author of Democracy in America (1835), once prophetically said, “*The American Republic will endure until the day Congress discovers it can bribe the public with the public’s money.*”

The last paragraph may seem somewhat unrelated to the subject at hand, but please let us explain. Even in the last 75 years, there has been a major shift in the attitudes of Americans as a country. That shift has political roots related to the quote you just read.

Americans prior to the 1950’s and 1960’s were taught to be stubbornly independent and self-reliant and to be proud of their country – for good reason. Since that time, some politicians, using compliant press and educational systems, have instilled feelings of victimhood and American unfairness into the population. The use of the educational system to change these attitudes of the young is obvious to those of us old enough to remember what the old texts said vis-à-vis what is contained in new ones.

It seems that an independent, self-reliant populace would not approve nor appreciate politicians attempting to bribe them in order to be elected. They understood what was theirs and what was not theirs. What they earned was theirs. The rest was not. They also understood that benefits they would receive they didn’t earn would have had to be paid for by someone else who *did* earn the money to pay the taxes for benefits they would receive. AND, they didn’t want the “charity,” as it would have been called back then. They would also *realize* they were being bribed, and would be insulted by that. Not always. Not everyone. But, enough.

So, if you are an enterprising politician, or party, looking for a means of bribing self-reliant people for their votes – and therefore strip them of some of their power – how would you go about doing that? Begin discussing how their society is “cheating” them of something – say opportunity – and subtly instill a sense of victimhood, not self-reliance over long periods. Years. Decades. Misuse phrases like “you deserve” when referring to something many or most do not have. Logically, it’s hard to deserve something you didn’t earn, since that’s a primary meaning of the word. Shades of Orwellian doublespeak!

And, naturally, your friendly, helpful government will be there to rectify the “wrongs” done to you. To give you what “you deserve.” All it takes is your vote. And your willingness to give up your grip on the truth. Perhaps the term “deserve” should be re-defined to mean “voted for.”

Of course, misuse of the terms “rights” and “fairness” are also effective. How do you think someone before 1970 would react to anyone using the phrase “right to (pick one) healthcare, college education, a car, etc.?” They *might* not burst out in laughter, but certainly, they would not regard the speaker seriously. Now, many of us listen to politicians, academics and media folks go completely unchallenged when they put forward such ideas.

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The United States was founded with the principle that rights are granted by the Creator, not by government. The entire point is that, since these rights come from the Creator, it is not/should not be something that can be *denied* people by government. They are intrinsic to people simply because they *are* people.

The Declaration of Independence enumerated three rights: life, liberty and the pursuit of happiness. The Bill of Rights (the first 10 amendments to the US Constitution) enumerated a few more, mostly to establish as foundational law articles preventing the abuses of power exercised by the English government against the populace when we were colonies. Perhaps the most famous of these are the right to assemble, the right to bear arms and the right not to self-incriminate.

We don't see or know of any rights granted by either the Creator or recognized in the Constitution to have any private agency or government *provide* anything to individuals they had not earned on their own. Government or private agencies may in fact choose to provide opportunities that benefit individuals. That is NOT the same thing as individuals having the "right" to those benefits.

That is how de Tocqueville's quote about bribing the public ties in to the denial of private property rights *and* excessive taxation. It's part of the pervasive attitude foisted upon Americans by politicians needing to be elected by giving things away, instead of earning their votes.

Our last misused word before expanding the discussion is "equality." From de Tocqueville: "*Americans are so enamored of equality that they would rather be equal in slavery than unequal in freedom.*" Such a statement indicates the deep understanding possessed by de Tocqueville of the American psyche – even as far back as the early- to mid-1800's! If we are given all of our true rights, we would all be equal in freedom and opportunity, limited only by our own talents and drives, and perhaps the interventions of fate.

To try to enforce equality of outcomes upon the populace necessitates the sacrifice of some, perhaps all, of our freedoms in the process. And, so we have. The massive taxation of our medium to highly successful, in what is more of a power grab than altruism by our governments, amounts to both theft (backed by armed force) of property rightfully theirs and a limit on their freedom to use the earnings and profits they have legally earned as they see fit. Perhaps it would be appropriate here to posit that

without property rights, there can be no real freedom. I have heard it said that in one of the initial drafts of the Declaration of Independence, the rights cited were "life, liberty and the pursuit of property."

De Tocqueville also famously said, "*Democracy and socialism have nothing in common but one word, equality. But notice the difference: while democracy seeks equality in liberty, socialism seeks equality in restraint and servitude.*" Ultimately, equality in servitude seems a high price to pay for only being able to make one decision – for whom to vote. If we put enough socialists in office, we won't have to worry about making any other decisions at all. They will be made by the governments to whom we abdicated our power.

Such politics as described above often run in cycles. However, it's unlikely that America has ever had more socialist, anti-capitalistic roots established than at the current time. It would seem that the pendulum would begin to swing back towards a freer, more independent and self-reliant society with less societal control through taxation, legal and regulatory means. But, once held, power is difficult to remove from a government and return to the people. And, there is always the chance that the pendulum could swing still further and the chance the pendulum will never swing back – at least in America. We hope not, but it's certainly possible, especially starting from here.

Effects on Business, Investing and the Economy

It's well known that companies, both public and private, are almost always run better, more efficiently and with greater care for company property than any type of government organization. The underlying reason for this is generally considered private ownership of the companies.

One of the prime drivers behind capitalism is the human drive to improve one's condition. About the only drive behind doing good government work is the pride of a job well done. Not *your* job; the job someone *else* told you to do. Which of those two drives would you consider stronger? What if you threw pride of ownership into the mix?

Keep in mind, there are only two ways to increase societal wealth:

- Savings
- Profits (or beneficial innovations in a non-capitalist economy)

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Capitalism thrives based upon many factors, but essentially, good works are done based upon self-interest – *i.e.* improving one's condition. (This is fundamental, going all the way back to Adam Smith.) The entrepreneur solves a problem in a superior way to those currently available – new, more, better, faster, cheaper – and provides it to a population, providing a better life for all AND improving his/her own condition through the profits made increasing societal wealth.

The entrepreneur (or entrepreneurial activity within an organization) is the source of virtually all societal improvements involving the production of goods and services. The pace of improvements depends heavily upon the rewards entrepreneurs can receive for their societal contributions. More rewards, faster pace. Lesser rewards, slower pace. No rewards, almost no pace.

This might explain why China doesn't respect our intellectual property laws. Their system discourages such entrepreneurial activity by limiting or eliminating rewards, so, they would be hopelessly uncompetitive in a world where cheap labor alone wouldn't win. Therefore, no recognition of intellectual property rights allows them to reverse engineer (steal) what entrepreneurs bring to the world. What happens to those needed innovations when the last true stronghold of capitalism, the US, no longer allows entrepreneurs to reap enough rewards to make them want to take the risks necessary to innovate and bring to market?

The massive increases in US regulation since 2000 and, especially 2009, coupled with high taxation levels and other unwise tax policies, undoubtedly discourage some potential entrepreneurs from attempting to start a company to realize their dream. Between the reduced return and the massive headaches, it's simply not worth the effort. Unless, they have no other viable options because they're unemployed or underemployed.

Is this beginning to explain the lack of vigor in the "recovery" the government and their lackeys tell us we are experiencing? Strip away enough of the true sources of new societal wealth, and you end up with a weak, almost nonexistent recovery. No amount of liquidity the Fed could ever create could compensate for the reduction in entrepreneurship due to socialist government limitations. However, the dangers of a financial markets bubble and subsequent crash from such Fed policies continues to be very real.

The last time the United States was in such a situation

was the 1960's to the 1970's. Extremely high taxation; even higher than today's, in fact. Government becoming ever more socialistic, even with Republican Presidents. The wealth and psyche of America deteriorated, beginning with Lyndon Johnson's Great Society Program and its unintended effects and his escalation of the Vietnamese War, a war the government bungled in almost every way possible. In fact, perhaps Lyndon Johnson's most lasting legacies are the massive deficit spending he began, continuing uninterrupted since, and the breaking into the Social Security trust fund to use for all government projects through his "unified budget."

Matters continued to deteriorate as Keynesian economic and egalitarian political policies were unable to deal with our internal problems, weakening our economy, our world position and our psyches to the point that the United States was considered a "second class power" to the then Soviet Union by the end of President Carter's term.

Tax rates were so high that the engine of capitalism, innovation, virtually came to a standstill. I have heard more than once that the core engines of today's computer and communication technology were known in the early 1970's. The DRAM (1970, 1973), EPROM (1971) and microprocessor (1971, 1972) are the "guts" of a microcomputer or PC. These had existed years before IBM finally created the first PC and Apple had created its first microcomputers. Why was this critical electronic machine, the basis for all subsequent computing and communications improvements, including the internet (Sorry, Al Gore), not assembled and marketed?

Because the risk of loss was high and the gains that could have been realized from >70% tax rates made it so neither private investors (90% highest income tax rate on "passive investments") nor corporations felt the resources necessary to launch such a game changing product – or many others perhaps we never saw. This doesn't even include the combined rates that would apply since income was taxed at both the corporate and individual levels. Corporate income would be taxed, and then shareholder dividends paid would be further taxed at the individual level.

Essentially, if you suffered the loss, the government was happy to let you incur it alone, but if you made massive gains from society changing products, you were *allowed to keep maybe 10%* of your profits. I guess that's an offer all *could* refuse – and did. Talk about disincentivizing what makes us successful!

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Just to remind us why the government would want to tax our businesses and citizens so heavily is because their “altruistic” programs designed to gather votes cost an enormous amount of money. Even with unhealthy and continuous deficit spending, the taxes upon the successful of our society still need to be prohibitively high. Providing “rights” to people using other people’s money tends to work that way. Throw in a war or two, a further move towards the left and socialism, and you have oppressive taxation on the successful.

Only Ronald Reagan’s programs, especially ERTA (Economic Recover Tax Act of 1981) swept aside the oppressive taxation of the 1950’s to the 1970’s for a short time. The drive to tax at higher rates has been in full season ever since, and taxes and tax rates have consistently climbed ever since ERTA was passed. TEFRA in 1982 gave back some of the gains. The Tax Reform act of 1986 took back much more. Each President and Congress subsequent to the end of Reagan’s administrations have changed taxes in one way or another (not necessarily rates) to raise more and more revenue to feed “the machine.”

Reagan’s reduction in taxation was intended to reignite the fire of American entrepreneurship. The US economy flowered under an unprecedented increase in entrepreneurial activity from the early 1980’s through the end of the 1990’s, demonstrating the power of entrepreneurship and capitalism. Reagan’s arms buildup and heavy deficit spending was designed to cripple the Soviet Union. It worked, too. Incidentally, he suffered great heaps of criticism from friends and enemies alike for that, not to mention the press. Strange how those criticisms rarely surface when the opposition party has a sitting President. Regardless, America, a force for good, was once again the world’s superpower.

Shortly after Reagan and ERTA, the IBM PC and its clones appeared. The rewards warranted the effort, so PC’s got better and better until they became ubiquitous in business by 1990, perhaps earlier. The original modems which allowed communications between PC’s arose, then the internet, eventually becoming close to what we know today in the electronically connected world.

We have always wondered how George H. W. Bush, Reagan’s VP could have watched the transformation of the American economy and its people through Reagan’s policies and still not believe in them. He turned his back on those policies almost immediately upon being elected in 1988. But, he is hardly the only one. The press, academia and politicians all ignored those lessons and returned to greater government control (socialism), greater taxation and continued deficit spending as their policies of choice.

Now we find ourselves almost where we were at the end of the Carter Era. The economy is weak and failing after never recovering fully from the last recession. Only unprecedented amounts of liquidity keeping interest rates artificially low and invoking Marshallian K theory, have kept the financial markets alive and the economy on life support. But, that is a Band-Aid, not a fix, as we well understand. Despite high-profile successes, it certainly seems innovation and entrepreneurship is on the decline, taking the economy with it. Just not worth the risk or the effort.

The answer is right there, to be found in recent history, if we just pay attention. Freedom through individual property rights and less government. The next time a national politician says we can fix things if the “rich” pay “just a little bit more,” will we remember that’s not the path to prosperity, strength and peace?

Purpose

The *CJ* Investment Newsletter deals with most of the spectrum of securities investing, including cash (money market funds), bonds, equities and derivatives. It will evaluate the overall investing environment and, from time to time, discuss the relative allocations (including avoidance) of these asset types, as well as strategies to implement them (individual stocks or bonds, CEF’s, ETF’s, open-end mutual funds, and derivatives). Essentially, it reflects what I’m actually doing with my clients.

However, that’s not its only purpose. Even if you never become a client, if you want this information, I want you to have it – for a while, anyway. My hope

is that providing this information and teaching you what I consider important when investing may help you. I’d also love to hear any questions or comments you may have about my letter.

These letters are not sent “cold.” Either I know you or someone you know gave me your name. Yes, this letter *is* a sales tool. It communicates how I analyze the markets and economy, as well as how I apply my investment strategies, so that you can decide, without any sales pressure, if my thinking is compatible with how you want your money invested. If you’re not already a client, I would like to discuss your *becoming* a client. Please contact me for more information.