THOUGHTS

HANSON & DOREMUS INVESTMENT MANAGEMENT

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Life is Understood Backwards…But Lived Forwards…

We are Value investors which means we believe that successful long-term investing involves buying out of favor securities selling cheap relative to their earnings and assets. Stock prices are a function of many things - earnings, dividends and the level of interest rates – but equally important is human emotions.

Ray DeVoe, a well known market commentator of past decades, summed up the market well, "The stock market is only indirectly related to economics. It is a function of human fear, greed and apprehension, all overlaid on a business cycle." The reason Value works is people don't like to be associated with losers and their fear and apprehension has them sell securities even when they are often very undervalued.

Richard Thaler of the University of Chicago recently won the Nobel Prize for Economics for his work in human behavior and how this affects our decision making process. Although we are rational and logical most of the time, we are also very irrational at other times. And I mean both the unsophisticated individual investor and the most professional portfolio manager.

Here are some examples of Behavioral Finance in action. First the Endowment Effect. This is the tendency to value things we already own more highly than those we don't. Give people a common coffee cup and ask them to price it and sell it to others. Theory would suggest both buyers and sellers would value a cup fairly similarly. They don't. Few mugs sell because the sellers value them far more highly than the buyers. Does this sound familiar? Think of your family heirlooms and the value you ascribe to them or the stocks you own. Owners and non-owners value things very differently.

A second example is anchoring. A stock does not know you own it. But you know you paid $25 for it even though the price today is $16. You focus on the $25 price. You will often not sell until you get back to your starting point. Maybe it would be better to disregard your purchase price and simply ask, would I buy this stock today or hold it or sell it?

A final example is how we value the present versus the future. When you take a new job, HR asks you how much you want to contribute to your retirement plan. Since expenses are high and the future is far away you put down a very small amount or none at all.

Thaler knows that how you frame a proposition affects the outcome. If the HR Department were to say that unless you tell us differently we are going to put 5% of your salary in the retirement account and then increase this percentage every time you get a wage increase, what do you think would happen? The answer is, participation and overall savings jump significantly. Framing matters.

Pogo could have been talking about our decision making process when he said, "We have met the enemy and he is us."

Source: *Harley Schwadron, Schwadron Cartoon and Illustration Services, Ann Arbor, Michigan*

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Hanson & Doremus Investment Management is an investment counsel firm managing portfolios for individuals and institutional clients. The firm also consults with individuals on financial planning and works with self-directed retirement plans on investment options.

So When Is The Next Big Drop Coming?...

Wow, talk about a question beyond my pay grade! But in this charged environment we have to ask. A lot of people are very anxious and nervous in this market. Since March 2009 it has been nothing but up for stock prices. This is the second longest uptrend in history. Only the 1987 – 2001 run is longer.

In addition, the market is expensive today (*see chart at bottom*). We are not in Bubble territory yet but the market price-to-earnings ratio is above the long term average of 15X. We have gotten used to expecting big crashes every six or eight years - the tech bust in 2000 and the housing bubble in 2006 - 2009 – so shouldn't we be expecting another one soon? The Fed is starting to push up interest rates and inflation may follow soon so the economic environment may be taking a turn for the worse.

And then there are the foreign policy issues like North Korea and Brexit and, of course, the daily tweets out of Washington. These are generating increasing investor fatigue and exhaustion.

So, you get the picture, there is plenty to worry about. But stocks continue to move higher and stay stable (*see chart at bottom*) and the world has rarely been more in sync. Not only is the U.S. economy growing but so is Europe (even Greece is growing!), and Emerging markets today are better able to handle global stress.

We will get a Bear Market (a 20%+ drop) at some point in the future, we always do, but the experience doesn't have to be life threatening. *As the chart above shows* (sorry for the small print) even the big drops are followed in pretty short order by recoveries. The secret to long term investing is often neglect!

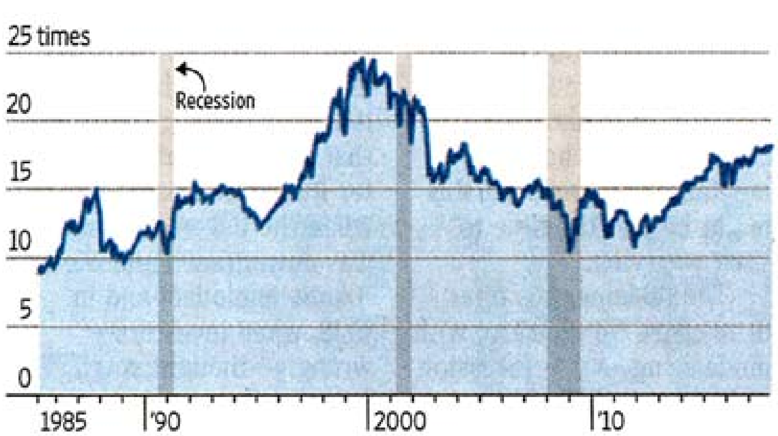
Black Monday in context: US equities since 1980

S&P 500 (log scale)

Source: *Financial Times*

An Expensive Market

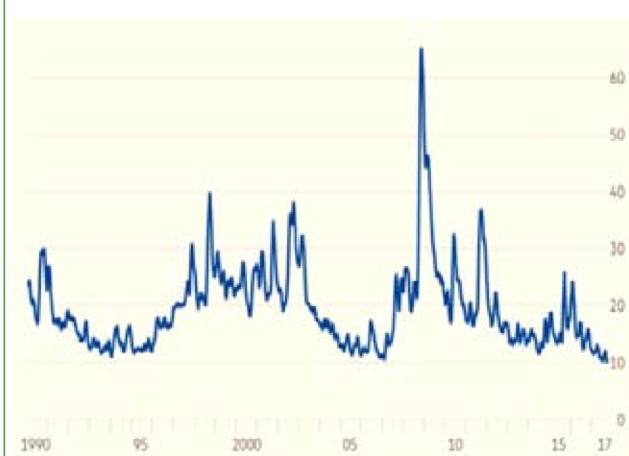
The S&P 500 is pricey on most measures, including price to 12-month forward earnings.



Source: *The Wall Street Journal*

Volatility: since Black Monday, stocks have never been calmer

Vix index (30-day moving average)



Source: *Financial Times*

Julie Won

High School Kids Aren't What They Used To Be…

Move over baby boomers, Generation X and Millennials. All the fretting and worrying over you is done. The focus now is on Generation Z, or the "iGen." These are kids and teens born between 1995 and 2012 who have never known life without the internet. They have Instagram accounts before they get into high school, and they've grown up using smartphones to do almost everything – schedule their lives, make friends, socialize, get information and entertain themselves.

The heavy use of smartphones has some people worried. Yes, smartphones mean we'll never get lost – and that we'll always be able to look up the population of Burkina Faso and find a decently rated Thai restaurant in a strange town. But they also mean constant distraction and potentially, changes in the way we think, sleep and interact socially.

So imagine what it's like to not remember the world before smartphones. Jean Twenge, the psychologist at San Diego State who coined the label "iGen," has pointed out that when the first iPhone came out in 2007, the oldest members of iGen were about 12. The youngest have never known life without smartphones. And while Millennials, or Generation Y, also grew up with the internet, it was never as all-consuming as it is for Generation Z.

But before starting to tsk-tsk and tut-tut, let's remember that every new technology has always brought on a wave of alarm about what could happen to youths, and so far, every generation has made it to adulthood pretty well.

Let's also note that iGen-ers have a lot of good things going for them. For one thing, according to a research summary by Samantha Guerry, a market strategist, Generation Z kids are whizzes at sorting information "at light speed," thanks to their "eight-second filters." They have so many options and so little time that they've become expert at handling a lot of information quickly – and at figuring out who the "trusted curators" are to help them manage the information flow.

By many accounts, Generation Z-ers are highly pragmatic and career-minded. More than past generations, they are realistic about what it takes to prepare to support themselves financially. And they are living healthier, safer lives than teenagers in the past. They drink less, smoke less, try or use drugs less frequently, and have less sex. Partying and rebellion are out. Safety and risk aversion are in.

Generation Z also is extremely tolerant. The iGen-ers grew up with diversity and gay marriage being no big deal, so being judgmental just isn't part of their fabric. If there's anything they disapprove of, it's being intolerant. As Twenge says, they "are just less willing to label anything as 'wrong.'"

But, of course, there's a less positive side to Generation Z, and it's a biggie: It's that iGen-ers have much higher rates of anxiety and depression than past generations. Teen depression and suicide rates have soared since 2011, and though there are many possible reasons for this, smartphones are a key suspect. The conjecture is that always being hyper-connected affects more than sleep and concentration. It also can lead to feeling left out, isolated, and lonely.

Twenge says that more screen time clearly has been linked to more unhappiness. That doesn't mean the causation flows from smartphones to depression – and there are other reasons for teens being stressed today, including increased competition, college admissions and the job market. But she says, according to the surveys, "There's not a single exception. All screen activities are linked to less happiness, and all non-screen activities are linked to more happiness."

That sounds awful, and the knee-jerk reaction is to ban or at least sharply curtail smartphone use. But let's be realistic. Smartphone use is not going away any time soon, and teens are teens. Perhaps the best we can do is stay vigilant but also keep an open mind. Yes, by all means let's worry about teens being in their rooms alone, on their phones and possibly distressed. But let's also accept that Generation Z has learned to use smartphones in ways that aren't always bad – just different.

Compare Millennials, Gen Z

Generation Z is replacing the Millennial Generation among traditional-aged students. According to Corey Seemiller and Meghan Grace, the authors of *Generation Z Goes to College,* the two generations compare as follows:

Millennial Generation	Generation Z
Socially and financially liberal	Socially liberal to moderate, financially moderate to conservative
More optimistic	More realistic
Service-oriented	Social change–oriented
Confident (high sense of self-importance)	Confident (self-assured)
"Me" generation	"We" generation
Tech savvy	Tech integrated
Facebook to share	Instagram to share
Share	Follow
Pre-scheduled learning	On demand/just-in-time learning
Want to learn something? Google it	Want to learn something? YouTube it

Source: Samantha Guerry; Dean & Provost Newsletter April 2016; *"Get Your Campus Ready for Generation Z"* by Joan Hope

Anne W. Doremus

When Success Leads To Failure…

A handful of firms are having a larger and larger impact on the U.S. economy. Nowhere is this more evident than in the stock market where top tech titans Apple, Microsoft, Amazon, Facebook and Google alone represent almost 15% of the S&P 500's overall market capitalization. Market observers, and Value investors in particular, are scratching their heads wondering how long this dominance can last.

A close examination of recent history provides some clues. Consider the case of Sears. In the early part of the last century, the firm grew to dominate retailing by capitalizing on two compelling trends; consumers' desire for thriftiness and a new distribution channel – in this case not the internet but the introduction and expansion of the U.S. Postal Service.

It has been reported that by the 1960s, one out of every 200 U.S. workers was employed by Sears and the firm's sales of everything from appliances to kit homes had grown to total just less than 1% of the nation's GDP. By the 1980s, with sales growth slowing, the firm began expanding into financial services (Dean Witter, the Discover Card, Coldwell Bank) and other businesses. Distracted by these diversification efforts, management failed to notice emerging competition in the form of discount retailers such as Walmart and Target. Sales and earnings had been on the downswing for years when in 2005 current CEO Edward Lambert stepped in, merging the firm with rival Kmart. Unfortunately, this move was both too little and too late. Sales and employee headcount have fallen precipitously since then. Divisions including Craftsman have been sold or spun off and store count has been dramatically reduced (*see below*). Further liquidations are possible as Sears faces approximately $1 billion in loans next year.

While the lesson from Sears sad tale now seem obvious (don't stray from your core competency), it is not the only threat to today's leading firms. Both IBM and Microsoft faced regulatory scrutiny as they grew in size. In 1969, IBM was sued by the Justice Department for monopolizing the market for mainframe disk drives. Microsoft faced similar regulatory challenges in 1998. In this case, antitrust claims focused on the company's efforts to tie its Windows operating system to its Internet Explorer browser.

Both companies ultimately successfully defended themselves against these anti-trust claims but the related distraction prevented them from fully addressing key competitive threats. In IBM's case, the shift from mainframes to PCs and in Microsoft's case, the move to mobile technology now dominated by Google and Apple.

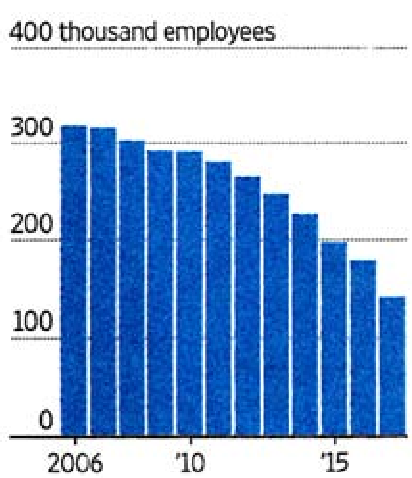
Two points come to mind when considering the history of these earlier giants. First, regulatory or competitive challenges alone do not spell demise. Sears is indeed struggling for survival. But Microsoft has fared better. The company has successfully reinvented itself as a leading provider of software and cloud storage. The jury is still out on IBM which is working hard to monetize impressive artificial intelligence and data analytics technology.

While seemingly new, Google and Amazon are each more than 20 years old and Apple, the grand-daddy of the group, is over 40. It took years to build these giants and they will not be easy to unseat. Each benefits from a strong network effect (the more people use them, the more that want to) and have impressive financial war chests they can use to invest in new growth initiatives. But success is never guaranteed and shareholders expect a great deal from these firms. Continuing to flawlessly deliver on those elevated expectations will be no easy task.

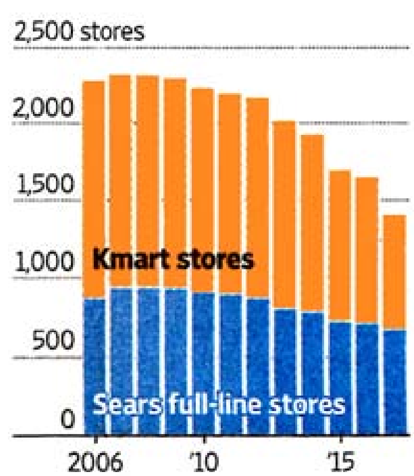
Long Decline

Sears was struggling before Edward Lampert engineered a merger with Kmart in 2005, but losses have worsened in recent years.

Once one of the biggest U.S. employers, Sears today has less than half the workers it did a decade ago.



Over the last decade, Sears has closed half its Kmart locations and a quarter of its full-line Sears stores.*



*Sears store count excludes auto centers, other specialty stores, repair and delivery services.

Source: *The Wall Street Journal*