CAIRN INVESTMENT GROUP

# Newsletter and Quarterly Update

June 2018

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### Important Reminders:

- Annual Privacy Notices Enclosed
- NYSE & Cairn Closed for Labor Day September 3 No Checks / Deposits No Settlement


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Greetings from the Northwest.

Summer sunshine is warming us up in the West. It feels so good! The last few days have been the hot type, where individual bones in your spine feel like they are melting out the last of the ice and chill of winter.

The stock market has also been hot for a while. But not all parts or sectors have been feeling the heat. Frustratingly, the hottest sectors and companies are also the most richly valued companies and hence not attractive to us as value or momentum investments. The purchase prices of our investments are of paramount importance to us. Time can heal a lot of investment wounds, but it is most difficult to recover from overpaying.

I hope the world is laughing with me when I ask, "Have you noticed the volcano of crazy, off-the-cuff, wacko ideas and plans that are being trotted out, run around the test globe and then re-evaluated?" Probably the biggest, loudest worries are coming from trade-war concerns. This has fired up volatility in currencies and stock markets around the planet. There is a lot of noise about potential longer term effects from tariffs and trade wars on U.S. companies and in particular industrial manufacturing. Please remember that manufacturing is only about 12% of GDP and we are in the 1st inning of a potentially long, hot, and politicized season.

Patrick and Tim are both itching to add to this quarter's letter, so I shall go back to the dugout.

Tim's Part

The DOL Fiduciary Rule may be dead, but Cairn's got your back.

The proposed DOL Fiduciary Rule, scheduled for implementation last year, was delayed numerous times before being terminated through court action in June. The courts determined that the Department of Labor had overreached its authority and that the topics addressed are better dealt with by the SEC, which in most other ways is responsible for the regulation of investment advisors.

*Cairn at Shorngate Cross Currick on the Northumberland Durham County Boundary* *Photo by Tygh P.*

What was this "DOL Fiduciary Rule" and why is this topic important? The growth of the employer sponsored retirement plan, such as the 401(k), has been tremendous over the last 35 years, with combined assets now above \$6 trillion. These employer sponsored plans are now the primary tool for retirement savings, with fewer than 2% of Americans being enrolled in a traditional pension plan. The financial security of our next generation of retirees depends heavily on the success of these newer plans. This explosive growth has attracted much attention from the financial industry, which provides the investment platforms for these plans and for the various "Individual Retirement Accounts" or IRAs. Holding these assets, managing them, and providing advice on them is good business, and a core profit center for almost any investment oriented financial institution (Fidelity, Vanguard, Cairn, etc.).

For decades the employer sponsored plans have been tightly regulated by ERISA (Employee Retirement Income Security Act). IRAs and the transfer of assets from employer plans into IRAs (rollovers) are not generally subject to ERISA. Some business models in the industry are intently focused upon this rollover process, and, like all great business opportunities, sometimes the interests of the consumer get overshadowed by the interests of the service and product providers, particularly without specifically designed legislation.

The DOL rule set out to fix this by making everyone involved in the process a "Fiduciary," someone who must be true to the consumer and put the consumer's interests first. This has caused major shifts in the industry, as firms were forced to evaluate their business models to determine how they were at risk of violating the new rule, how to eliminate conflicts of interest, and how to implement the prescribed procedures that came with this rule. An example of this is that Vanguard stepped away from advising clients on IRA assets. How could they maintain fiduciary standing when advising clients to purchase Vanguard funds? With the funds themselves being Vanguard's primary business, they quickly and preemptively made the decision to stop advising.

For Cairn and other fee-only investment advisers, the DOL Fiduciary Rule had a much lower impact as we already were, are, and will continue, to act as a fiduciary. For us the change was the implementation of some required documentation that detailed why a rollover or IRA transfer was appropriate in each circumstance.

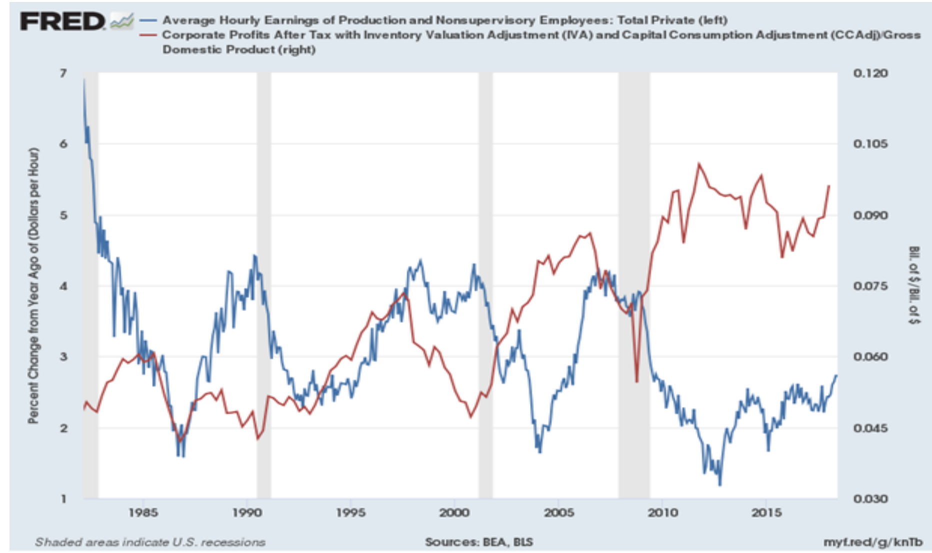
The DOL rule is dead, but the genie is out of the bottle, with many firms continuing to implement planned changes with the expectation that the SEC will soon roll out their own rules with a similar goal of improved consumer protection. What may be different is a more nuanced approach by a more informed SEC that recognizes the difference between commission-based brokers and insurance agents, and the fee-only advisers who are already acting as fiduciaries. Time will tell.

For now you can be assured that we will continue to act and advise in your best interests as we wait for the regulators to sort things out. —*Tim Mosier*

Patrick's Part

Last fall I wrote about inflation and how the slow growth in average hourly earnings was not matching the inflation worries that were being discussed by market pundits. Recently, with the passage of individual and corporate tax law reform, growth of average hourly wages has started to pick up. The chart (next column) shows a measure of corporate profit margins (red line) and the year-over-year change in average hourly earnings (blue line). As you can see, these two lines tend to move in opposite directions; the higher wage growth tends to be, the lower corporate profits tend to be. Inherently this makes sense, although many factors determine overall corporate profitability. The salaries paid to employees are a large fixed cost. Contrast this expense with, for instance, the cost of raw materials, which can be adjusted based on short term dislocations between supply and demand.

The takeaway from this chart is that higher wages should depress corporate profit margins, which are already sitting close to an all-time high. The possible




retreat in profit margins due to higher wage costs is currently not being priced in by market participants (let alone higher input costs if large tariffs take place). As we continue to navigate a market that is on the expensive side, we continue to watch for other indicators that could change the corporate landscape. Rising wages are one data point we are keeping a close eye on. Our investment discipline helps combat these possible pressures as we consistently look for market leaders that have the ability to pass on higher costs to their end customer, regardless of the type of industry.

We firmly believe that risk management is of high importance as we get to the later innings of the market and business cycle. However, we are still finding opportunities in the marketplace, and we will take advantage of them if the price is right. Please feel free to reach out to me with any questions regarding this or any topic. —*Patrick Mason*

As I'm fond of saying, please come on by when you are near. The coffee pot is always on.

Happy Trails,

Jim

Jim Parr, Principal
Cairn Investment Group, Inc.