Memo to the Darcy Family: To Thine Own Self Be True

(A talk given by Jim Garland to a family office group in Banff, Alberta, in June 2013)

INTRODUCTION

The hero of Jane Austen's great novel, *Pride and Prejudice*, was a Mr. Darcy. Mr. Darcy was wealthy — but Austen expressed that fact in a way that today sounds odd. She wrote that Mr. Darcy was worth £10,000 a year. The income from his properties was far more important than the market value of those properties, because he lived off that income.

I suspect that in the room today there are many Mr. and Mrs. Darcys, as well as their advisors, but I also suspect that some of you may not know it.

If you are living off income and, in particular, if you want to pass down your capital to children and grandchildren, you're going to have to invest and spend in a thoughtful manner. And you're also going to have to steel yourself to ignore most of the advice that's being thrown your way.

The world doesn't understand who you are.

MAIN BODY

Three Types of Investors

Investors can be roughly separated into three groups.

Savers (for emergencies)

The first group has the least amount of money and the shortest time horizon. These are people who are setting aside cash for emergencies or for near-term needs like buying a car. Typically these folks don't fool around with stocks or bonds — they put their money in safe, liquid places like bank savings accounts. I'll call these people **savers**.

Total Return Investors (for retirement)

The second group has more financial assets and an intermediate-term time horizon – a horizon often as long as their lifetimes.

These people typically are saving for retirement. They expect to consume not only the income from their investments, but their investment capital as well, because retirement planning calls for burning down one's capital so that the last dollars are spent at death. I'll call this group **total return investors**, because for them both income and market values matter. Total return investing is hard, because market values are unpredictable and largely uncontrollable. As a result, total return investors, and the investment community at large, spend lots of time worrying about total returns, and about market volatility.

Endowment Investors (for you, the children, and the grandchildren)

The third group has the greatest amount of financial assets and also the longest time horizon – either an intergenerational time horizon that includes the lives of their children and grandchildren, or sometimes the perpetual time horizons of charitable foundations.

These few — these very fortunate few — are investors whose cash flows are greater than their annual spending. These investors can invest for the very long term. For the moment I'll call these people **endowment investors**, because the capital they've accumulated functions like a family endowment fund.

Different Investors, Different Asset Mixes

These three groups naturally gravitate toward different asset classes. *Savers* prefer bank accounts. *Total return investors* prefer stocks, bonds, and real estate. *Endowment investors*, who generally have little need for liquidity, use stocks, bonds, and real estate, but they also often own illiquid assets such as operating businesses, private equity, timberland, and so on.

But what's more important is that these three groups have different mindsets when handling their money.

For savers, safety matters. Don't screw around – just protect what you've saved so far, and if possible save some more.

For total return investors, total returns matter. And as I've just said, total return investing is hard. Good luck!

However, for endowment investors, something else matters. But I'm going to wait a moment before telling you what that is.

Jeffrey Company Background

First, here's some background on the company where I've worked for the past twenty years.

The Jeffrey Company was founded in the 1870s to build the world's first underground coal mining machines. The Company was quite successful, eventually manufacturing not only mining machines, but also related devices such as rock crushers, conveyor belts, and road building machinery. At its peak it had over six thousand employees.

The Company was owned by one individual, Joseph Jeffrey. In the year 1914, he deposited all of his Jeffrey Company shares into what's known as a generation-skipping trust. Generation-skipping trusts can shelter assets from estate taxes for a very long time. The Jeffrey Company has paid capital gains taxes when it's sold individual securities, so its capital has been slowly shrinking. But its securities have *never* been subject to the once-every-generation capital gains tax that you face in Canada, or to the estate taxes that we face in the United States. The 1914 Jeffrey Trust is still alive today. Its *sole* objective is to provide spendable cash to Mr. Jeffrey's descendants. Thus the Jeffrey Company, through its owner, the Jeffrey Trust, has been operating like a family endowment fund.

Sold for Cash

Having all of a family's eggs in just one basket can be risky. In the late 1960s, my predecessors decided to sell the Company's operating businesses, and the sale — for cash — took place in May 1974, when the Dow Jones Industrial Average was well under 1,000. The Company used that cash to build a well-diversified portfolio of stocks and bonds.

Today, the Company is still owned by the Jeffrey Trust. Through that Trust, the family has been able to enjoy for many decades a stable flow of cash. The Company has sought to be intergenerationally equitable — to treat all generations of Jeffrey family members on an equal basis, with no single generation favored at another's expense. That's why I say that the Company acts like a family endowment fund.

What Endowments Want

A wise step for investors – particularly in a communal investment operation such as ours — is to put down objectives on paper. Here in **Figure 1** are our Company's objectives, which essentially have been unchanged since 1974.

Figure 1
Investment Objectives

> Recognizing, one, that the primary purpose of establishing objectives is to provide guidelines for subsequent actions; and, two, that the establishment of such objectives neither ensures their achievement nor necessarily limits what might actually be achieved; the following are the long-term investment objectives of The Jeffrey Company in descending order of priority:
>
> 1. To provide over the long term a stable dividend payout in inflation-adjusted dollars;
> 2. To provide through long-term principal appreciation the expanding capital base required to achieve Objective #1 in the face of inflation and capital gains taxes;
> 3. To avoid risks which in the aggregate might reasonably impair the ability to achieve Objective #1; and
> 4. In determining dividend policy, the Board shall attempt to increase dividends at rates that would theoretically under normal market conditions permit the underlying assets of the Company to grow at similar rates over the long term, thereby presumably providing generally comparable benefits to present and future recipients.

Note the emphasis on payouts to family members. More than anything else, what matters to us is spendable cash, year after year after year. Good total returns *might* be nice, but they are not necessary.

Tad Jeffrey's Definition of Risk

These objectives were written by my immediate predecessor, Tad Jeffrey. Tad has written several papers for professional journals. In one, entitled "A New Paradigm for Portfolio Risk," Tad wrote that the standard definition of investment risk — i.e., return volatility — was seriously flawed. Defining risk in terms of portfolio volatility said nothing about what was being risked.

Instead, Tad said that true risk was <u>the probability of not having sufficient cash with which to buy something important</u>. ….. Consider our family's circumstances. To Jeffrey family members, "risk" means <u>*not*</u> receiving checks for the amounts of money they expect, on the dates they expect them. The market value of the Jeffrey Company is irrelevant — it was irrelevant back when the Company was a private operating business, and it's still irrelevant today. Because the family wants "a stable dividend payout in inflation-adjusted dollars," *all* that matters to them is that payout — and our ability to sustain that payout over the very long term.

These two points — our focus on income, and a definition of risk that's customized to our needs — color everything that we do.

Definitions

Joseph Jeffrey had six children, and his descendants have compounded into quite a large family, now numbering over 300 people, and scattered across four continents. Virtually <u>*all*</u> family members are interested in the Company, and for that reason we spend a lot of time writing to and visiting with them.

Wall Street and the media spend almost all of *their* time courting total return investors, and almost none courting endowment investors. One of my primary responsibilities has been to remind Jeffrey family members that they are endowment investors, and that *their* objectives and risks are very different from those of other investors. I've had to remind them that virtually all that they read and hear in the media is irrelevant. To strengthen this message, I've used over and over again a farming metaphor that fits our situation quite well.

Imagine two farms and two farmers. One farmer raises chickens and sells them to grocery stores. We'll call him a chicken farmer. The other farmer keeps hens in a henhouse and feeds the eggs to his rather large family. The second one is an egg farmer.

The first person, the chicken farmer, is vitally interested in the market value of chickens.

The second one, the egg farmer, is vitally interested in the *number* of eggs that his hens can lay, and in the *health* of the hens, but he doesn't care at all about the *market value* of his hens.

For the chicken farmer, <u>*risk*</u> means the probability of a decline in the price of chickens.

On the other hand, the egg farmer could care less about market values. <u>*His risks*</u> are foxes, and viruses, and other such threats to the well-being of his hens.

Think of stocks as being chickens, and dividends as being the eggs that those stocks provide. Total return investors are chicken farmer investors, because total return investors worry about the market value of their "chickens" — of their stocks. On the other hand, endowment investors are egg farmer investors. All that endowment investors worry about is the current and future quantities of their "eggs" — of their dividends.

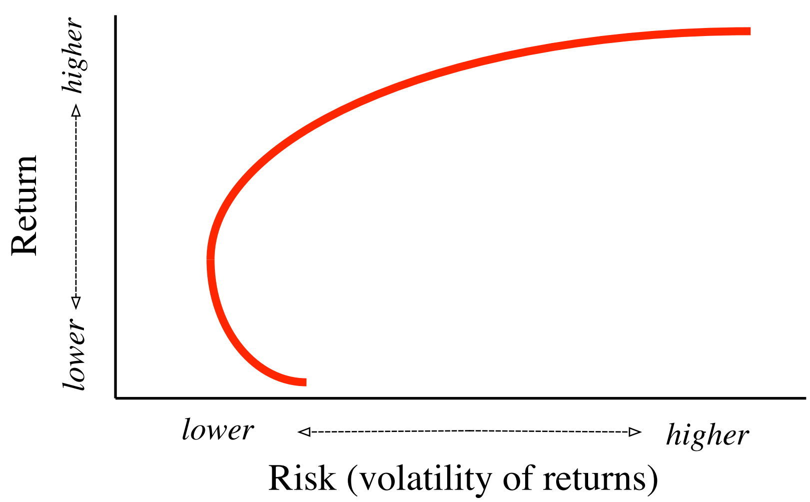
We constantly remind Jeffrey family members that *they* are egg-farmer investors.

The CAPM and the CEPM

Plot of the CAPM

Many tactics that total return investors use are based upon an academic model called the Capital Asset Pricing Model or CAPM, which appears in **Figure 2**. That model, now about fifty years old, and which to the uninitiated looks like a child's doodle, won its creators a Nobel Prize.

Figure 2
Capital Asset Pricing Model
(CAPM)



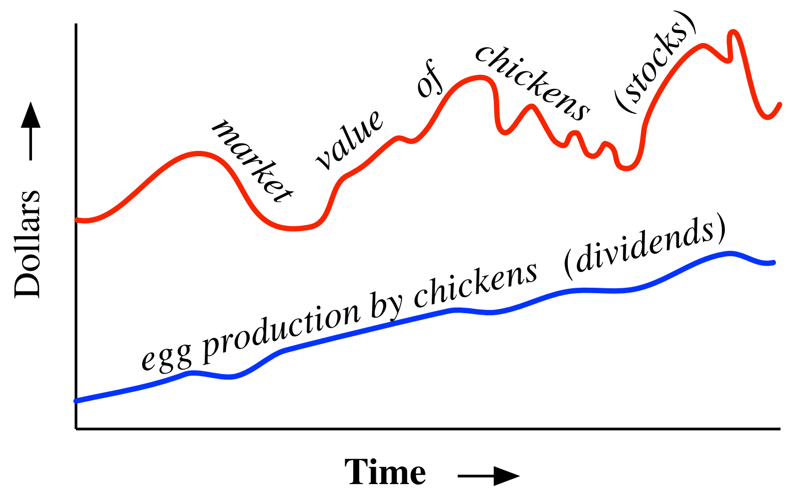
The CAPM plots annualized returns on the vertical axis, and the volatility of returns on the horizontal axis. Academics love the CAPM because both these numbers are easily calculated (academics love mathematical models), and because the relationship seems logical. Investment professionals like this model, too. Since virtually all of their clients are total return investors who have to worry about market values, this model – for all its weaknesses – at least provides a basis for discussing the subject.

Plot of the CEPM

But remember that endowment investors — whom I'm now calling egg-farmer investors — don't care about market values. If they don't care about market values, they don't care about market volatility, either, which makes the Capital Asset Pricing Model useless. Instead, egg-farmer investors rely upon a Chickens' Egg Production Model, or C*E*PM, which appears in **Figure 3**. The CEPM says that 'chicken' prices — the prices of stocks — wiggle all over the place, but that 'egg production' — the dividends generated by those stocks — is pretty stable and tends to grow over time.

Figure 3

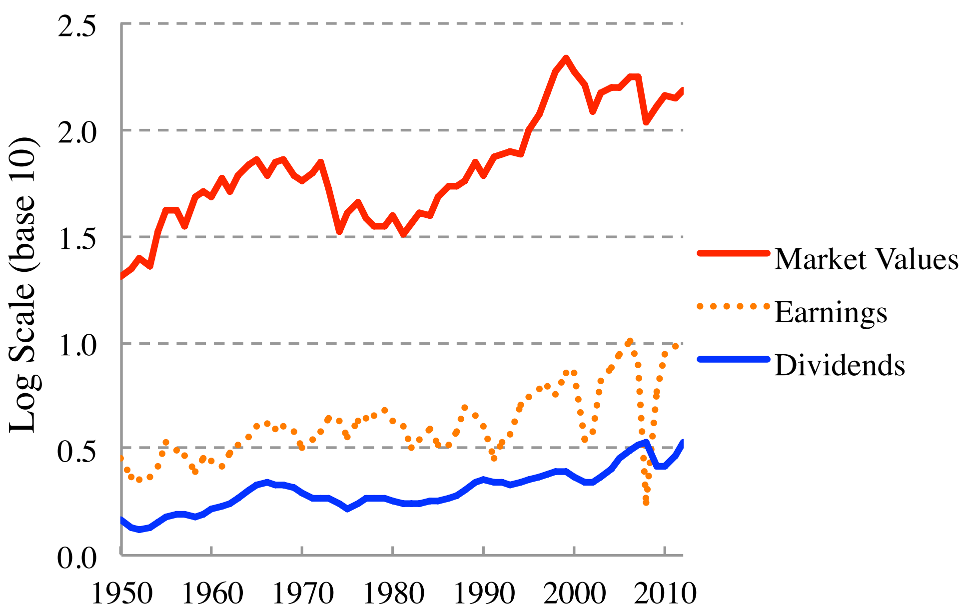
Chickens' Egg Production Model
(CEPM)



While the C*E*PM has yet to win its Nobel Prize, it describes the real world pretty well.

For a glimpse of the *real* real world, look at **Figure 4**, at the top of the next page, which shows the results for the Standard & Poor's Composite Stock Index for the past sixty-two years. (I apologize for being US-centric in my data. Standard & Poor's does an excellent job reporting on aggregate earnings and dividends for large American corporations. Other national data providers do not.) This graph shows the S&P Composite since 1950, in real dollars, and using a logarithmic scale so that a constant growth rate would appear here as a straight line. The top red line is the Index's market value, which moves up and down in large, slow movements, sort of like tides in the ocean. The middle orange line is the Index's earnings, which wiggle violently back and forth like waves. The bottom blue line — by far the most stable of the three — represents dividends. Dividends are not perfectly stable, but they tend to grow year after year, and mild recessions don't affect them. Dividends are our 'eggs' — they're the primary source of the cash that we provide to the Jeffrey family. We like dividends because they are reliable, and because they grow over time, just as our family's need for cash grows over time.

Figure 4
S&P 500 Market Values, Earnings, and Dividends
(in real 1950 dollars)



Asset Fecundity

There's a lot of sloppy thinking in the investment business. In discussing the amounts of cash that we have available to distribute each year, we try to be precise — and for that purpose we've once again gone to the farm, so to speak. We've borrowed from farming the word **fecundity**. On the farm, fecundity means fruitfulness in offspring or vegetation. For *us*, fecundity means the fruitfulness of our assets — or, specifically, the cash that we can withdraw from our portfolio each year without endangering the portfolio's ability to provide similar amounts of cash, in inflation-adjusted dollars, in the future. …… As a friend recently put it, fecundity means "whatever you can spend that leaves you as well off as you were before."

We focus on fecundity for two reasons. One is that *different asset classes have very different fecundities*. The simplest asset class is real return bonds. The yield today on long-term Canadian real return bonds is about 0.6%. That therefore is their fecundity — you could withdraw 0.6% from a real return bond portfolio each year without endangering the portfolio's ability to throw off similar amounts of cash in the future. On the other hand, the fecundity of equities today is much higher than the fecundity of bonds — I'll say more about this in a moment. The important point here is that different asset classes can have very different fecundities. That's useful to know when building portfolios for family endowments such as ours.

The second important point is that *fecundity is a <u>gross</u> number*. It's the amount that can be withdrawn *<u>for all purposes</u>*, including paying for trustees, custodians, and money managers — and paying for what's usually the greatest expense of all, capital gains taxes. I see people all the time setting spending rates on a *net* basis – in other words, ignoring expenses — but that's sloppy thinking. If the fecundity of your investments is (say) $1 million a year, and if you have a choice of either using index funds and a minimal office staff, and shelling out $100,000 a year for these expenses, or using active managers and a larger office staff, and shelling out $400,000 a year, then you also face the choice of having $900,000 to distribute to your beneficiaries or of just having $600,000 to distribute instead. Expenses matter, and ignoring expenses in calculating payouts to the people who matter – to your family members, or to charities – is just passing the buck, in effect saying that someone else will pay those expenses instead. Unfortunately, "let the grandchildren pay for it" is the unwritten budgetary rule in Washington and many other national capitols these days, but that's not a practice that you should emulate.

Optimal Asset Mix

What's the best asset mix for egg-farmer investors? The least risky assets are those that naturally provide growing cash flows. Thus real return bonds are less risky than traditional fixed-interest bonds, for example. But besides real return bonds, the other two best assets are <u>real estate</u> — because rents tend to grow over time, and <u>equities</u> — because dividends tend to grow over time as well. Other cash-generating assets such as <u>farmland and timberland</u> would also work, but they're only suitable in special situations. The Jeffrey Company has done very little with real estate, and we've done nothing with non-traditional assets, and instead we've focused our attention just on equities.

Most American endowment funds have also emphasized equities, but because these endowments typically base their spending on market values, the funds have tried to smooth market values by also investing in bonds. A typical endowment might have a bond weighting of 30% or so. But even with bonds as stabilizers, endowments had a wild ride during the past sixty years. For example, an endowment invested 30% in bonds and 70% in equities, and spending 5% of market value, would have suffered during the 1970s a <u>60% decline</u> in spending, and during the past twelve years a <u>40% decline</u> in spending. Basing spending on *dividends*, rather than market values, is a much more sensible idea, as

Figure 4 suggests. Dividends grow because the economy grows. And corporations smooth their dividend payouts because dividend cuts are a mark of shame.

Because of their naturally growing dividends, the theoretically optimal asset mix for the Jeffrey family has been 100% equities. American dividends have tended to grow slightly faster than inflation, which means that the fecundity of our equities has been slightly more than our actual dividend receipts. The yield of the S&P 500 today being roughly 2%, <u>the current fecundity of our equity portfolio is roughly 3% of its market value</u>. Said differently, for every $100 that we have invested in equities today, we pay out to *all parties* roughly *<u>$3</u>*. After operating expenses, and after income and capital gains taxes, the net cash in our family's pockets is roughly 2% of our market value.

Do 2% and 3% sound low? They are – but not because we're being miserly. Since we define fecundity in relation to dividends, when dividend yields are low, fecundity will seem low as well. Today, market values are very high and dividend yields are very low.

In inflation-adjusted dollars, we've maintained payouts to family members for almost thirty years now *<u>without a cut</u>*. ….. Compared to most endowed institutions that we know, that's a pretty darn good record.

The reason we've been able to avoid payout cuts is partly because we've based payouts on dividends rather than on market values, but also because we've insured ourselves against those rare times when dividends decline. I said a moment ago that our *theoretically* optimal asset allocation was 100% equities. In reality, we own a small pool of high-grade tax-exempt municipal bonds that acts as a self-insurance fund to maintain our payout during rough times. Our actual asset allocation is roughly 85% equities and 15% muni bonds. S&P 500 dividends have only declined a few times during my lifetime. One such decline — the most severe one — took place during the recent Great Recession. S&P 500 dividends declined over 20% from 2008 to 2009, and have only recently crept back to their pre-Recession peak. That dip is obvious in Figure 4. We refer to these occasional declines as 'dividend potholes.' To pave over the Great Recession's 'pothole,' we had to liquidate roughly one-tenth of our muni bond portfolio, or about 1% of our total capital. By taking this step, our family members survived the Great Recession without a cut to their cash distributions. Insurance is not free – but the cost was not great, considering that this was the deepest 'pothole' that American investors have experienced in over 70 years.

Hedge funds make *<u>no</u>* sense for the Jeffrey family. Hedge funds have no natural fecundity – they don't throw off any cash, and their future earnings (if any) are unknowable in advance. And most hedge funds are terribly tax-*<u>in</u>*efficient. Remember that fecundity is a gross number. Before giving money to a hedge fund manager, remember that he's going to take a huge chunk of profits – if there are any profits – and that you're going to lose far more to taxes than you would with a simpler and more passive approach. Taxable investors who choose to invest in hedge funds are choosing to join a baseball game where two strikes have already been called against them.

Optimal Strategy

Our investment approach is not an exciting one. Our strategy has been to think rather than to act — to figure out what to do, to do it, and then to do as little as possible afterwards. For twenty years, I went to the office each day and did not fire our money managers. Our managers in turn went to their offices and made no trades. And Jeffrey family members went about their lives without spending time worrying about what our money managers and I were doing. Their checks arrived on time, and the amounts were never a surprise. Warren Buffett used a phrase that describes us nicely — "lethargy bordering on sloth."[1]

Because of their low costs and low portfolio turnover, index funds make perfect sense for many egg-farming families. We have not used index funds, because in 1974, when we sold the business, these funds did not exist. Instead, we hired managers who were willing in effect to build custom index funds for us, ones emphasizing dividend-paying stocks and having very low turnover. The last time I looked, our average holding was 17 years old.

I said earlier that the fecundity of American equities today is roughly 3% of their market value. Living off 3% is not a very attractive proposition — but, for the record, that figure only applies to families who are selling businesses today and who therefore are forced to create family endowment funds at a time when dividend yields are extraordinarily low. The Jeffrey family was fortunate to sell its operating business in 1974 when the yield of the S&P 500 was over 5%. Today, after almost forty years, our after-tax yield on cost — our annual fecundity — is almost 19%.

But what can <u>*you*</u> do with cash today? There are no easy options.

Buying traditional safe-haven bonds such as Treasuries is a losing proposition — yields worldwide have been crushed by the actions of European and American central banks. Global high-yield bonds are an option, but that's an area where you'll need professional guides to help you — which will be more expensive than just buying Treasuries.

Dividend yields from stocks in Canada, in Europe, and in emerging markets are higher than in the U.S., and while dividend yields alone are not direct indicators of fecundity, the fecundity of non-U.S. stocks generally is probably higher than for U.S. stocks. Therefore avoiding or at least minimizing holdings of U.S. equities is probably worthwhile.

Another option is to just sit on cash and wait for lower prices. Reversion to the mean is one of the most powerful forces in finance, and American stock prices are floating above their historic means. However, there are two problems with this strategy. First, means change over time. Stock markets don't know and also don't care what their historical means were. Second, stock markets are never in a hurry to do what you want them to do. An American investor who stepped out of the stock market in the late 1990s, when stocks

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[1] *Fortune*, June 21, 1999, p. 42.

clearly were overvalued, would have had to wait a decade before being able to buy stocks at reasonable prices. Individuals can *sometimes* wait that long, but groups *never* can.

How Egg Farmers Differ from Chicken Farmers

As mentioned earlier, I've spent most of my time reminding Jeffrey family members that our family is different from most families, that we are egg farmers in a chicken-farming world. I've told you that market values don't matter to us, but that's actually not quite true. One unusual fact about egg-farmer investors is that they love down markets.

Since fecundity is a gross number, the *less* you pay your money managers, the *more* will be available for you. If market values decline, the fecundity of your assets will not change, but your managers' fees will decline, and therefore more cash will be left for you. That's point one.

Point two: in low markets, the capital gains cost of making changes is less. While we try not to trade, there are occasions when trades are desirable. We'd much rather make those trades in a low market than a high market.

Point three: the same logic applies when thinking about bequeathing your family nest egg to your children. If you're an egg-farmer investor, and if your children are as well, then they'd prefer that you die nearer a market bottom than a market top, because then a greater fraction of your assets will pass down to them.

Chicken Farmers' Sayings & Egg Farmers' Responses

To remind Jeffrey family members of their unusual circumstances, I drew up some years ago a list of the differences between them and other investors. This list appears below.

Chicken-Farmer Investors Say:	**Egg-Farmer Investors Say:**
Watch stock prices.	Don't bother.
Price volatility equals risk.	Not for us.
Don't let taxes interfere with your investment decisions.	Not an option – they already do.
Up markets are good markets.	Down markets are good markets.
Cash is a low-risk investment.	Not for us.
Stocks are high-risk investments.	Not for us.
Success = higher market values.	Success = growing distributions.

CONCLUSION

It's natural for Wall Street to pay attention to people who are investing for their retirements, and to ignore people who are investing for their children and grandchildren.

There are far more retirement investors than there are intergenerational investors. But because of the near-total absence of attention paid to intergenerational investors (or to egg-farmer investors, as I've called them here), these people can easily become confused.

Know who you are. Know your investment objectives. Once you've settled those two important issues, if you are an *egg-farmer* investor, steel yourself for the fact that most of what you'll read and hear will be irrelevant.

Jane Austen knew, and her character Mr. Darcy knew, that long-term wealth should be measured by its sustainable cash flows rather than by its ephemeral market values. But what Jane Austen knew has been lost in the thundering dissonance of modern finance.

Those Mr. and Mrs. Darcys in the room today need to think carefully about their own needs, and to pay little attention to the advice that Wall Street offers them. William Shakespeare's words still work: "This above all: to thine *ownself* be true…."

James P. Garland
The Jeffrey Company
100 East Broad Street, #1700
Columbus, OH 43215-2607

office phone: (614) 221 0828

e-mail: jgarland@jeffreyco.com