Economic Update

Broadleaf Partners, LLC

Yellow Jerseys
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Over the past two weeks, the media has been consumed by events unfolding in Washington DC. While the coverage must be good for television ratings – who doesn't like to whine about Congress – contemplating actual changes to your investment portfolio based on what happens with the debt ceiling debate could be a mistake without first considering your investment objectives.

The Tour de France is a three week long, two thousand mile cycling event I watch religiously each July. How this became a habit I'm not sure, but friends have accused me of loving European sports more than American ball sports, insinuating that I might even be a Socialist.

I love everything about the Tour. The dynamics of the peloton - the large body of riders that resembles a school of fish as it moves across the French countryside - the familiar voices of announcers Bob Roll, Phil Liggett and Paul Sherwen, and of course, the inevitable crashes and broken collarbones along the way.

As a short person, I suppose I might be drawn to the sport as it also tends to favor the smaller athlete, but I suspect that on a subconscious level, I really like it because it reminds me so much of the behavior of the stock market and the dynamics of investing. While there are many parallels, I'll share a few.

A new observer of the Tour might assume that the winner is the cyclist who covers the entire race in the least amount of time, and on that note, they would be right if they were talking about the coveted Yellow Jersey, but wrong if they assumed there were no other winners in the race. In the Tour, there are actually many stage races and point competitions within the larger 21 day race, and there is a competition for virtually everyone in the field of 190 or so riders.

Depending on a cyclist's individual strengths and their teams' overall objectives, there are races that include sprints, mountain stages, and time trials, with different color jerseys for the various winners. Like investing, winning is dependent on what race you're in, what your objectives are, and the risks you are willing to accept to get there. If you don't know where you're going or who you're competing with in the larger body of riders, your chances of winning shrink dramatically.

The Yellow Jersey winner of the overall race this year - Australian Cadel Evans – didn't win a single day's stage, but still completed the full tour in the least amount of time by plugging along day in and day out, taking more risks when his skills were noteworthy given the course at hand, but playing it conservatively when they were not. The rider who won the most individual stages over the tour – sprinter Mark Cavendish from the Isle of Man won five – achieved great success by these measures, but actually finished the overall race near the bottom of the pack, 130th overall.

Another parallel to investing is the behavior of the peloton. Invariably on each stage, a breakaway group of five or six riders tends to escape from the peloton, often establishing a lead of as many as ten minutes over the rest of the field. It's always fun rooting for this

group of riders, but history shows that few breakaways survive the eventual onslaught of the peloton. By riding in the peloton, a rider will often expend 40% less energy travelling over the same distance than if they were riding alone, as they are able to draft off others and shelter themselves from the wind. Riding in the peloton, it is said, literally helps pull you along.

As an investor, it is important to realize that while you can "win" the occasional stage race by going it on your own and betting big on a single stock or perhaps along the outcome of a singular event like the debt ceiling, more often than not, the market – like the peloton – will usually catch and pass you by, leaving you in the dust. Like the peloton, evidence suggests that few investment managers outperform the market year in and year out, but over time, those that understand the race they are in significantly increase their odds of emerging victorious.

The objective of the Broadleaf Growth Equity portfolio is most similar to the race for the Yellow Jersey, but over an even longer period of many years. We know we won't win big every day or even every quarter, but by remaining disciplined, we expect to build a long term lead over the S&P 500 and our peers. I don't mean to discount short term events and moves in the stock market as irrelevant, but would suggest that they matter only to the extent that they are relevant to the race you've chosen.

Whether or not Congress passes the debt ceiling today or tomorrow is like a single stage in the Tour. Yesterday and again today, we've caught a glimpse of what might happen if the debt ceiling passes. The stock market is selling off as investors realize there is yet another mountain looming on the horizon, in the form of a slow growing economy that lacks momentum or, as some have put it in recent months, is flying at stall speed.

Last week, I took my family to Washington DC and while there, I saw plenty of evidence that our country wasn't built overnight, but by the sweat, tears, and debates of multiple generations. The Washington monument took nearly forty years to complete, partly because of partisan bickering that occurred between Jefferson Republicans and Washington Federalists. The British still harbored a grudge against us from the Revolutionary War when they burned down our Capitol building in 1814, many years later. Civil War, World Wars, and Foreign Wars both divided us and brought us together as a country, but with the slow passage of time, progress continued, sometimes remarkably.

Usually, I have CNBC running in the background on my computer, but as the bickering and blaming over the debt ceiling have escalated, I've often muted it as counterproductive noise. Instead, I've found myself returning to our investment philosophy playbook, seeking to more deeply understand the interplay of the three cycles we believe contribute to wealth creation over time. These three cycles - the economic cycle, the innovation cycle and the credit cycle - help us to understand longer term themes at work in the market, ones which we believe will enable us to beat the S&P 500 over a period of years and contribute to your long term investing goals.

Regardless of how the debt ceiling debate ends, the economy will likely remain in slow growth mode since a credit bubble accompanied the last recession. The workout period may take far longer than most expect as the availability of credit to finance the consumption of individuals, businesses and the government remains restrained.

While the economic and credit cycles usually have large influences over the pattern of stock market returns, it appears less likely that the momentum achieved in the recovery will be sufficient enough to induce the asset bubbles and crashes that have become commonplace in recent years. With both of these cycles more subdued in their influence, we believe the innovation cycle becomes paramount.

Apple Computer is the poster child of serial innovators, a company whose value has been far more influenced by innovation than the whims of the economic cycle or the availability of credit. Even though Apple's stock was crushed in the downturn, their fundamentals were not. The company continued to innovate by creating new products for entirely new markets where no competition existed before. The rewards of its success are no debt and a cash balance of over $75 billion today, more than the US Treasury was rumored to have in reserves in recent days. To be sure, even companies that out innovate can become a danger to investors as valuations in the technology bubble showed us a decade ago, but at just 15x trailing earnings and a product roster that continues to look promising, Apple does not appear to be in that situation today.

Of course, one cannot create a diversified portfolio by just owning Apple or a small handful of similar companies. However, by focusing on innovation as a unique driver of wealth creation in the current economic and credit cycle environment and marrying that with other more mature companies that can generate decent long term earnings growth, we believe investors can create a portfolio that is both diversified and capable of outperformance.

In closing, if you are just looking for that next great trade, then by all means keep CNBC blaring in the background, gun for your Green Sprinter's Jersey and then, if successful, call it a day. But, if you have a longer term time horizon in mind, decide what dangers you can afford to take and then invest accordingly.

While leading economic indicators of the economy did tick down to territory that smells of stall speed velocity, we don't believe we'll likely fall into another recession. As we've discussed before, many of the events that likely contributed to the decline in indicators were exogenous and one time in nature, factors which we view as temporary.

To be sure, we're facing an uphill climb of slower than expected growth for as far as the eyes can see, but if you're in the race for a yellow jersey, keep on peddling. Victory isn't just over this mountain or even the one after that, but far, far down range, where today's problems simply become new foothills to tomorrow's new climbs.

Embrace the journey and you'll be just fine.

Kindest Regards,

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