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Chairman and Chief Investment Officer

Letter from the Chairman...

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The two items getting the most ink in the financial press of late are the economic impact of hurricanes Irma, Harvey and Maria, and tax reform. With regard to the storms, one must take care not to misinterpret the financial data they generate. Auto sales, for example, are bound to surge, but do not foreshadow a turn around in that industry. Wage and employment numbers will also be distorted, but the hard truth is that recovery will eventually add billions of dollars to the federal deficit. Tax reform presents a much murkier image.

“Reform” may prove to be an inappropriate term, but major alterations of the code are probable. A substantial reduction in the corporate tax rate will happen, dropping federal tax revenues significantly. SALT (state and local tax) deductions are very much in jeopardy as they appear to be the only significant (\$1.3 trillion over the next 10 years)¹ means of offsetting lost corporate tax revenues. The objective is to increase the discretionary incomes of the largest number of consumers possible. If wage growth is meager² and inflation stunted, you are left with reducing their tax burden as the only way to put more spendable income into consumers’ hands. If you take it back by disallowing SALT deductions, the effort to boost the economy may be thwarted. I for one cannot recall a time when a bill that has yet to be written seems destined to produce so much intra-party and inter-party contention. We will have to wait and see, but four things appear certain: (1) it won’t happen until next year, (2) it won’t be revenue neutral, (3) it will make a lot of people unhappy, and (4) President Trump, eager to claim a legislative victory, will sign whatever bill is put before him.

In this environment, a portfolio manager is bound to underperform if they pursue either an all-defensive or all-offensive strategy. They must give both strategies their due, mitigating risk while acquiring the best yields available. The defense demands you pay attention to your credit quality and control your duration. The offense should employ three main components: agility in the secondary markets, skill in vetting non-rated bonds and good judgment when analyzing call probabilities on bonds that will significantly overperform when not called. It is not easy, but there is a way forward.

A case in point is presented by the problems facing the Royal Air Force’s attempt to destroy the Ruhr dams during World War II. At that time, bombing from altitude was so inaccurate that it did not stand a chance of destroying the dams. A well-delivered torpedo could do the job, but the Reich had anticipated that vulnerability and installed anti-torpedo netting. The solution was a spinning barrel-like bomb that would skip on the surface several times before hitting the dam, then sink to a depth of 30 ft. where it would explode. The task for the “Dambusters” was to fly at night to the precise release point, arriving at an airspeed of 220 mph exactly 60 ft. above the water. The air speed was not a problem. With notoriously inaccurate altimeters, however, the height above the water was. How were they to know, at night, when they were 60 ft. above water?³

Like the “Dambusters” of that time, how are we to know when the recoveries of the U.S., Japan and Europe, coupled with the removal of accommodation by their central banks, will finally lead to higher interest rates? It is probably still a long way off. Innovative solutions must be found now that keep portfolios performing while maintaining the flexibility to take advantage of higher rates when they become available.



¹ According to FTN (Financial Economic Weekly) 9-29-17

² Those that are sure less unemployment will push up wages would do well to look at Japan’s stagnant wage growth with an unemployment rate of only 2.4%.

³ The low tech solution was to attach a light beam at each end of the bomber’s wings pointed inward at an angle that would have the beams cross 60 ft. below the bomber. If the beams cross and continue on, the plane was too high; if they disappeared before crossing, the plane was too low. Genius coupled with incredible courage got the job done.