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Policy Matters: The Arbitrage Hiding in Plain Sight

With the August Congressional recess upon us and (believe it or not!) the 2020 presidential election cycle not yet in full swing, we are taking a step back from our regular monthly commentary on the fundamental health of the economy and markets to explore the growing influence of public policy on investment outcomes. Of course, public policy always has had an influence on corporate outcomes. But in general, investors' attention to this variable largely has been trained on backward-looking corporate reforms such as the 2002 Sarbanes-Oxley Act, with its audit and financial reporting reforms following the bursting of the Tech Bubble, or the 2010 Dodd-Frank Act, addressing Wall Street's malfeasance in the wake of the 2008 Financial Crisis. Although these reforms are substantive and important, our focus at Strategas has zeroed in on the growing impact government policy activity has increasingly had—not just on the mechanics of business and larger macro issues, but on specific industries and individual companies. This ramp in legislative impact has increased markedly over the past twenty years, but it remains underappreciated (and even misunderstood) by conventional money managers.

Companies and their trade associations, however, have come to realize quickly the impact legislation has had on their business, and have responded by bulking up their presence within the Beltway and in the corridors of power in state capitols across the country. The resulting lobbying efforts have been both offensive—as a way to benefit from—and defensive—to fend off changes to companies' business model. As a result, in recent years, the allocation of corporate financial resources has shifted from research and development toward lobbying.

Investors have not fully realized this change. We created the Strategas Policy Opportunities Portfolio, using analytical architecture to identify and capitalize on the mispricing of policy-driven benefits accruing to US corporations. Said another way, Wall Street continues to struggle in pricing the financial benefits of corporate rent-seeking. Corporations, not surprisingly, are much more adept than the Street at identifying the risks and opportunities that government policy poses. Strategas recently completed a study examining the risk factors ranked by companies in their quarterly filings, and found the number of S&P 500 Index constituents citing "government" as the top risk doubled to 52% from 26% since the Financial Crisis. This growing government risk trend has not abated in recent years: As recently as 2016, the percentage of companies citing "government" as their top risk was only 43%.

Companies are being forced to respond to the ever-growing presence of government in their affairs, and are now using lobbying, either to position themselves before a shift in public policy or to repel challenges to their business models. According to company filings, corporate spending on lobbying since 2001 has more than doubled to $3.65 billion from $1.63 billion. Not surprisingly, a recent academic study from James Bessen found that R&D expenditure and capital investments explained a substantial amount of the rise in corporate profits and stock valuation during the 1990s. Since

2000, however, political activity has accounted for a considerable portion of the growth in US corporate profits and, in turn, stock-price appreciation. In other words, starting with the Tech Bubble in 2000, government regulation has increased substantially, and companies have been forced to adapt their business model to account for this trend and to position themselves from policy changes affecting their industry. Despite this change, corporate "lobbying" remains an afterthought (or not considered at all) in how most analysts construct investment models. (When it is accounted for, we find that the earnings benefit derived from corporate lobbying activities is often mispriced.) Strategas's Policy Opportunities Portfolio is designed to capitalize on this mispricing by identifying the companies that could have the highest earnings benefit from lobbying.

We are the first to suggest that politics and investing should not be mixed. The architecture of our Policy Opportunities analysis, however, makes no distinction between political party and the composition of government power (Republican Executive & Democratic Congress, as we have now; Democratic Executive & Republican Congress, etc.). As the issues being debated in Washington change, so also do the companies lobbying for and against these issues. Our approach continuously adjusts to the current political environment. Accordingly, we view this approach, and the Policy Opportunity Portfolio that results from it, as a hedge against political volatility. Since the Financial Crisis, US voters have removed the party in power in six of the past seven elections (and in eight of the past ten elections since 2000). We have not had as much political volatility in the US in the last 100 years of the modern political system as we have today, yet the constituents of the Policy Opportunities Portfolio constantly reflect the changing governance structure and the policy initiatives of the moment.

For example, in the quarter following the Republicans' takeover of the Senate in the 2014 midterm election, our 50-stock Policy Opportunities Portfolio had 14 companies we had owned in a Democratic Executive/Democratic Senate regime turnover, replaced by 14 names representing stepped up efforts to address the changed threats and/or opportunities presented by a Democratic Executive & Republican Senate. Although that is a lot of turnover, it is both atypical and telling. Companies facing regulatory threats under the Democrats (such as energy drinks and biotech companies) moved out of the fund, and companies facing new risks and/or opportunities from Republicans (such as companies losing Export-Import bank financing) moved in. Companies know their political risk and opportunity profile better than analysts do. It is vital for investors to incorporate this dimension into their portfolio construction. The policy opportunity architecture is one way to capitalize on these changes.

Digging deeper, tax reform provides an interesting illustration of how understanding the changes in public policy strategy can have a meaningful impact on corporate results and investment outcomes. Investors assigned a low probability to tax reform occurring in 2017, due to the Republican Congress's failure to repeal and replace the Affordable Care Act earlier in the year and the distraction presented by the messaging crosscurrents from personnel turnover and a general lack of confidence in the Trump Administration. Beyond the headlines, however, corporate lobbyists were hard at work marshaling support for tax reform. Over the course of the year, using publically filed corporate lobbying disclosures, we levered up the portfolio with companies that would benefit the most financially should tax reform pass. In mid-November, the probability of tax reform surged, boosting performance of the portfolio more than even "thematic" tax reform stock baskets.

Investors would be wise to consider increasing their familiarity with this constantly evolving issue set and the impact it is having on how companies manage their business. The Policy Opportunities Portfolio architecture is attractive, given its simultaneous leverage to an increasingly important investment analysis variable and the resulting exposure to multiple policy themes, while limiting impact from increased political volatility.

About Strategas

Strategas is a global institutional brokerage and advisory firm. The Firm provides macro research, capital market and corporate advisory services, and investment management solutions to institutional investors and corporate executives in more than twenty countries around the world.

Founded in 2006 by Jason DeSena Trennert, Nicholas Bohnsack, and Don Rissmiller, the Firm was acquired by Baird Financial Group in 2018. Strategas operates independently as a wholly-owned subsidiary of Baird and offers institutional securities services through Strategas Securities, LLC, a broker-dealer, and investment management solutions, including this commentary, through Strategas Asset Management, LLC, a registered investment advisor.

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Index Overview & Key Definitions

Fed, The Fed or FED refers to the Federal Reserve System, the central bank of the United States. **Fed Funds Rate**, the interest rate at which a depository institution lends funds maintained at the Federal Reserve to another depository institution overnight. The **Gross Domestic Product (GDP)** rate is a measurement of the output of goods and services produced by labor and property located in the United States. **Real Gross Domestic Product (GDP)** is an inflation-adjusted measure that reflects the value of all goods and services produced by an economy in a given year. **Nominal Gross Domestic Product** is gross domestic product (GDP) evaluated at current market prices. The **S&P 500 Index** is an unmanaged index comprised of 500 widely held securities considered to be representative of the stock market in general. The **Russell 2000 Index** is an unmanaged index considered representative of small-cap stocks. The **PCE (Personal Consumption Expenditure) Index** of Prices is a US-wide indicator of the average increase in prices for all domestic personal consumption. Using a variety of data including U.S. Consumer Price Index and Producer Price Index prices, it is derived from personal consumption expenditures; essentially a measure of goods and services targeted towards individuals and consumed by individuals. The **Producer Price Index (PPI)** program measures the average change over time in the selling prices received by domestic producers for their output. The prices included in the PPI are from the first commercial transaction for many products and some services. **FAANG** is an acronym for the five of the market's most popular tech stocks, namely Facebook, Apple, Amazon, Netflix and Alphabet's Google. The **North American Free Trade Agreement (NAFTA)** is an agreement signed by Canada, Mexico, and the United States, creating a trilateral trade bloc in North America. The **Seasonally Adjusted Annual Rate (SAAR)** is a rate that is adjusted to take into account typical seasonal fluctuations in data and is expressed as an annual total. SAARs are used for data affected by seasonality, when it could be misleading to directly compare different times of the year. The **Atlanta Fed GDPNow** forecasting model provides a "nowcast" of the official estimate prior to its release by estimating GDP growth using a methodology similar to the one used by the U.S. Bureau of Economic Analysis. GDPNow is not an official forecast of the Atlanta Fed. Rather, it is best viewed as a running estimate of real GDP growth based on available data for the current measured quarter.

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