Cohen Strategic Consulting
Michael A. Cohen, Principal
17 Highview Lane • Yardley, PA 19067 • Phone (215) 595-7259 • Fax (215) 493-4031
www.cohenstrategicconsulting.com • mcohen@cohenstrategicconsulting.com

Great Expectations, And The Increased Willingness To Take On Significant Risk to Achieve Them

There is a considerable amount of frustration in the United States about the level of growth in the economy. In any political season, especially this one, candidates tout many ideas they have about how to achieve stronger economic growth, and point fingers at others deemed to be at fault for levels of economic growth far below the period immediately following World War II. Further, and quite troubling, unfulfilled expectations of growth have been met with riskier strategies to achieve levels of growth from that bygone era. This newsletter explores three themes:

1) It is unlikely that the U. S. will be able to achieve the economic growth levels seen following World War II, and perspectives are provided as to why that is so.
2) Pursuing riskier strategies to strive for increased economic growth may unfortunately produce the opposite result
3) Increasing productivity in a targeted manner is a sound approach to increasing economic growth, and several solutions are identified; pragmatic risk management is proposed as a tool to increase the likelihood of success of these endeavors

Retrospective: Economic Growth Since World War II

Over the past 40 plus years, since 1973, the U. S. economy has grown at an appreciably slower pace than during the previous 26 (going back to 1947) as measured by the real gross domestic product (GDP). In the 50's and 60's the average annual growth rate was above 4 percent, and in the 70's and 80's dropped to around a 3 percent annual rate. In the last ten years, the average rate has been below 2 percent and since 2000 has never reached the 4 percent level, only surpassing 3% in two years (2004 and 2005). The following chart displays the trends in real U. S. GDP growth in the post World War II period from 1947 to 2015. Growth rates for four separate periods were broken out from three periods of contraction (with two being the oil crisis of 1974-1975 and the financial crisis of 2008-2009). As the reader can see, the compounded annual GDP growth rates for the four periods of growth, factoring out the periods of contraction, have trended steadily downward. The compounded annual GDP growth rate for the 2010 – 2015 period was barely one-half of that during the 1947 – 1973 period.

Growth In U. S. Real Gross Domestic Product (GDP): 1947 - 2015

Period	CAGR (*)	Years of Negative Growth	Comments
1947 - 1973 (26 years)	4.0%	3	
1974 - 1975 (2 years)	**-0.4%**	**2**	**Oil Crisis**
1976 - 1990 (16 years)	3.4%	2	
1991 (1 year)	**-0.1%**	**1**	
1992 - 2007 (16 years)	3.2%	0	
2008 - 2009 (2 years)	**-1.5%**	**2**	**Financial Crisis**
2010 - 2015 (6 years)	2.2%	0	

Notes:

CAGR - Compounded Annual Growth Rate

Three negative periods were broken out (bolded) from the other growth periods

Business and government leaders have sought a vast range of solutions to achieve greater levels of growth over the past few decades, and have often been frustrated in doing so. In the absence of significant economic and financial growth, many countries (and companies) are pursuing strategies and tactics with increased levels of risk to enhance prosperity. In visual terms, this involves seeking a point on the Efficient Frontier further out to the upper right hand corner. I believe that by understanding how our collective expectations came about and how our willingness has increased to endure greater risk to be more prosperous, focusing on the drivers attributed to increasing growth (most importantly improved productivity) as well has how to focus on mitigating the most impactful risks we face, it will be possible to implement national and business strategies to increase prosperity at a greater pace than that of the past decade. Whether it is possible to achieve economic growth at the pace seen beginning around the middle of the 20th century and for the two decades following remains to be seen.

Great Expectations

In the Saturday/Sunday, October 15-16, 2016 edition of the Wall Street Journal's Review Section, Marc Levinson shared an essay adapted from his new book, "An Extraordinary Time: The End of the Postwar Boom and the Return of the Ordinary Economy". Mr. Levinson posits that the economic growth experienced in the post-World War II period cannot be duplicated without major ongoing improvements in productivity and innovation, and that unfortunately they are unlikely to occur. There are several perspectives why this is likely be so, drawing in part from several themes in his essay:

1) The U. S. Economy grew at an unprecedented pace in the 25 year period from 1948 through 1973, spurred on by many developments related to the aftermath of World War II:
   - Pent-up demand, stimulus from the post-war baby boom
   - A vastly more educated workforce
   - Virtually zero unemployment
   - Technological innovation, most importantly in communications and computing
   - Greatly expanded transportation
   - The devastation of the economies of many countries, now world leaders, that rendered them as less formidable competitors (Germany, Japan, France, and Great Britain)

2) Many of the factors that drove increases in productivity cannot be replicated with anywhere close to the impact realized in that unprecedented 25 year period:
   - Educational increases will at best be far more modest. In fact, in spite of the theoretical availability of higher education to all, the increasing dysfunction of public schools in many parts of the U. S. and the foreboding cost of higher education combined with the college loan crisis, many Americans in the upcoming years will be <u>less</u> educated than they have been. As a secondary school teacher as a young man and as a part-time university professor now I find this trend extremely troubling. Further, the modest extent to which our higher education system focuses on several key subject areas driving productivity, for instance 'STEM' … Science, Technology, Engineering and Mathematics … is also troubling.
   - Enhanced communication capabilities, as amazing as they have been in the past two decades, haven't driven productivity growth ***to the extent*** that the wide-ranging availability of the telephone did in the 1948-1973 period, even with the near-universal usage of cell phones, computers and the Internet. While social media has been, and continues to be a world-wide phenomenon (obsession?), I question whether following one's thousands of friends' daily activities on Facebook or sharing pictures from last Saturday's party on Instagram have made any contribution to increasing economic productivity.
   - Transportation improvements are far more modest than they were during the quantum leap seen in the 1948-1973 period. By the mid 1970's, one could utilize automotive, train or plane travel freely around the U. S. and the world, but with the considerable (and necessary) safety and security concerns of the past 15 years, transportation may have actually turned into an impediment to productivity growth.

3) Innovation surely plays a significant role in increasing productivity, but as Mr. Levinson points out it is both difficult to stimulate innovation and predict which innovations will lead to higher productivity. In a less favorable economic environment, investments in innovation are unfortunately less they have been in rosier times.

Managing Risk More Effectively

During the past two years, I have written extensively on the need for pragmatism in enterprise risk management. Theories and quantitative analyses abound, and while I fully support them when used effectively they too often are used in place of business horse-sense. Focusing on the most impactful risks a company faces, those that can prevent successful execution of its strategy, meeting its corporate goals, not being exposed to a level of adverse risk impact greater than what the organization can comfortably tolerate, and satisfying its various stakeholder groups is at the core of my 'mantra' … pragmatic enterprise risk management. I strongly believe that this concept would enhance the effectiveness government programs as well. An article I wrote late in 2015, "Pragmatic ERM For Insurers" explores this mindset.
(http://www.cohenstrategicconsulting.com/assets/Pragmatic_ERM_For_Insurers_Cohen.pdf)

Fundamental to pragmatic risk management is having realistic, attainable goals, and as importantly goals that will be seen as appropriate by a business' and government's stakeholders. Is it possible that without the significantly increasing productivity of the 1948 – 1973 time frame that Mr. Levinson suggests will be very hard to replicate, expectations across the board will be unrealistic? Can governments in the developed world achieve 4% or greater GDP growth? In addition to the paucity of productivity growth, has the structural and psychological damage that occurred during the financial crisis created a growth 'hurdle' too high to surmount? As is displayed in the earlier chart, compounded annual GDP growth in the 6 years following the financial crisis (2010 – 2015) is barely half that achieved during the post World War II period. For most of my 40 year business career, a 15% ROE was the standard for strong corporate profitability. Is that, too, an unrealistic benchmark at this point in time?

For those of us of a certain age (we 'Baby Boomers'), having grown up in the 'Prosperous Age' surely created an expectation that substantial and predictable growth was the norm. Many corporate and government leaders today are Baby Boomers. As such, we expected that great business and national economic success was achievable, and sought strategies of many kinds to meet those standards. With a less favorable economic environment (and the benefit of hindsight), it could well be that achieving these standards in recent years was not possible. Try as we might, and pursuing strategies that were … again with the benefit of hindsight … riskier, businesses and governments alike were increasing their exposure to risk and its adverse consequences and not achieving the desired results.

As I peruse the business landscape, viewing the political/regulatory component as an element of the business landscape, there are several areas of risk that I find to be particularly volatile as many companies are pursing strategies with greater risk in general. Each is potentially powerful and unpredictable, and are noted as follows:

Economic/Financial: Interest rates that are too low (currently) or too high (early 1980's); Unemployment rates above those thought to be structural; International economies (how they are managed, currencies, exchange rates, tariffs, competition among them), with ever increasing globalization exacerbating the level of risk; Commodities prices, impact on sovereign economies; Liquidity unavailability, with the most dangerous example being the freezing of the financial markets in 2008

Competition: A tautological comment I am extremely familiar with is “Competition is always getting more intense”. I don’t think that has ever been not true. What makes the competition for any business increasingly more challenging is that competition often morphs in unpredictable, non-linear ways.

Contagion: Problems at one firm (most likely a financial services firm) triggering significant issues at another. The financial crisis was greatly worsened by several instances of meltdowns at high profile firms (AIG, Washington Mutual, and Lehman Brothers most notoriously) causing substantial damage at others.

Concentration/Diversification: (1) Where the company is a specialist (and hence potentially too concentrated) … in a product, a market, a process … and possesses some competitive advantage(s), proprietary technology or patents or favorable image in the marketplace, imperiled by a large, powerful, well-capitalized competitor deciding to enter this business; regulations changing, materially restricting its operations, rendering the company without enough viable businesses to operate profitably; or a new business concept (technology-driven being a likely scenario) may cause it to be obsolete, or (2) Where a company is overdiversified (defined here as one with too many disparate operations to be managed successfully), and as such it could face a (i) lack of focus on all aspects of its operations; (ii) lack of necessary resources (human, financial, operational) to manage all of its activities successfully; (iii) lack of agility in decision making and execution; or (iv) customers determining that the company's 'lesser business lights' are not desirable product/service providers relative to established leaders in the particular segment

Fiduciary/Advice: Losing credibility as a provider of quality and objective 'answers' could well devastate a company (Ineffective or self-serving advice, losing credibility with customers and potentially triggering E&O claims, divulging confidential information … insider trading being the most conspicuous example …, illegal advice, advice givers not certified or credentialed to give particular advice)

Cyber: The security of information is under siege world-wide, with hackers seemingly more sophisticated and clever than businesses, governments and organizations in general are in protecting it.

Political/Regulatory: Unpredictable or unnecessary regulations (and it is broadly debatable what regulations may be unnecessary); policies that protect unproductive or outdated businesses/industries and end up stifling competition and innovation, and consequently productivity

International: Given the interconnectedness of the world economy and the widespread tensions across sovereign borders, vastly different national priorities present an enormous, uncertain mosaic of risks that every government faces. The same is true for its corporations, whether they compete internationally or not.

What Lessons Have Been Learned From The Financial Crisis?

An ancient proverb goes something like: "Forecasting the future is impossible. Why, predicting the past is extremely difficult". It has been less than 10 years since the financial crisis devastated the U. S. and world economies, and there are many theories as to what caused it. Several factors are widely agreed upon (e.g. the real estate bubble, the contagion effect across financial services firms and sectors, political and regulatory infighting and myopia, failures in securitizations and the ratings of them), and others seem to be entirely plausible 'contributors'.

Frightening questions abound:

"Are there instances where the same mistakes are being repeated all over again?" More specifically, "Are significant financial firms taking similar risks now to those they took leading up to the financial crisis?"

"What is the appropriate extent of regulation?"

"Have egregious practices been curtailed?"

"Are there certain industries that could melt down (reminiscent of the tech and real estate disasters)?"

"Are there risks that can put us out of business, or almost as bad impair us so severely that we cannot fully recover"? (i.e. Fatal Risks)

Looking Forward – Finding The Route To Prosperity

The million dollar question (the late Senator Everett Dirkson would have said 'Billion', and in 2016 it is possibly more accurate to say 'Trillion') is **"What strategies and tactics can governments and businesses pursue to achieve prosperity while at the same time managing them with acceptable levels of risk"?**

Creating enduring value – Government initiatives such as infrastructure, energy and safety/security; business strategies dedicated to long term consumer needs such as housing, food, financial security

Technological advances in the fields of information and analysis, communications, safety and security. I cheerfully acknowledge that I am not the person to drive these advances; given that my first college computer science course involved programming with punch cards, and that I still remember my family's phone number growing up … Osborne 5-

3315, dialed with a rotary phone … I leave this critical area to greater and younger minds than mine! Punch cards do have a viable use in 2016 … as bookmarks.

Responsibility to one's stakeholders – governments and businesses alike operating to provide sincere solutions to satisfying those who we provide products and services to

Education and empowerment – this is a critical domain of government, and many businesses have valuable roles to play. 'Learning organizations' can gain a significant advantage over their competitors by developing and encouraging their workforces.

Transparency, honesty, full disclosure – no explanation required, and no compromises accepted

Pragmatic risk management – Focus on the most central risks to strategic and financial success, and utilize 'hands-on' experts in relevant areas as opposed to theorists