STRATEGAS
ASSET MANAGEMENT

August 16, 2019

In this month's Insight, Dan Clifton and Nicholas Bohnsack examine the importance of public policy on investment outcomes and portfolio construction.

Dan Clifton is a Portfolio Manager at Strategas Asset Management and a Managing Director of Baird.

Nicholas Bohnsack is the President & Chief Executive Officer of Strategas Asset Management and a Managing Director of Baird.

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 wanted to take 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 and portfolio construction. Of course, public policy has always had an influence on corporate outcomes. Though investors' attention to this variable have largely been trained on backward-looking corporate reforms like the 2002 Sarbanes-Oxley Act (audit and financial reporting following the bursting of the Tech Bubble) and the 2010 Dodd-Frank Act (which addressed Wall Street malfeasance in the wake of the 2008 Global Financial Crisis). While this type of legislation is substantive and important, our focus at Strategas has zeroed-in on the growing impact that government policy activity has increasingly had, not just 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 the impact legislation – and the legislative process – 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 their business models*. As a result, in recent years, a sizable allocation of corporate financial resources has shifted from research and development towards lobbying.

Investors, however, have not fully realized this change. To address this change we created the Strategas Policy Opportunities Portfolio ("POP") that uses an analytical architecture to identify and capitalize on the mispricing of policy-driven benefits accruing to U.S. 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 companies identify in their quarterly filings and found the number of S&P 500 constituents citing "government" as the top risk doubled to 52 percent from 26 percent prior to the Financial Crisis. This trend of growing government risk has continued to increase consistently over the last ten years and as recently as 2016, the percentage of companies citing "government" as their top risk was just 43 percent.

Companies are responding to the ever-growing presence of government in their affairs by mobilizing rather sophisticated lobbying efforts to position themselves before a shift in public policy or, to fend off challenges from legislative initiatives that pose a risk to their business models. According to company filings, since 2001 corporate spending on lobbying has more than doubled to $3.65 billion from $1.63 billion. Perhaps not surprisingly, a recent study from James Bessen, Executive Director of the Technology & Policy Research Initiative at Boston University's School of Law, found that R&D expenditure and capital investments explained a substantial amount of the rise in corporate profits and stock valuation during the 1990s. But since 2000, political activity has accounted for a considerable amount of the growth in U.S. 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 had to adapt their business models quickly to both 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 the construction of most analysts'

investment models. (When it is accounted for, we believe that the earnings benefit derived from corporate lobbying activities is often mispriced.) Strategas' Policy Opportunities Portfolio is designed to capitalize on this mispricing by identifying the companies, which could have the highest earnings benefit from lobbying.

We will be 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 or the composition of government power (GOP Executive & Democratic Congress, as we have now; Democratic Executive & GOP Congress, etc.). As the issues being debated in Washington change, so do the companies lobbying for and against them. 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 on political volatility. In the seven elections since the Financial Crisis, U.S. voters have removed the party on six occasions (and in eight of the past ten elections since 2000). There has not been as much political volatility in the U.S. in the last hundred years as there is today. The constituents of the Policy Opportunities Portfolio constantly change to reflect the governance structure and the policy initiatives of the moment.

An example of this adjustment occurred in the quarter following the Republicans' takeover of the Senate in the 2014 midterm election. We sold out of fourteen positions in our fifty stock Policy Opportunities Portfolio that were leveraged to a Democratic Executive/ Democratic Senate regime in favor of the shares in fourteen companies who had immediately stepped-up efforts to address the changed threats and/or opportunities presented by a Democratic Executive/GOP Senate (Congress) mix. While that degree of turnover is atypical, it is also telling: companies facing regulatory threats under the Democrats (such as energy drinks and biotech companies) were moving out of the fund and companies facing new risks and/or opportunities from Republicans (such as companies losing Export-Import bank

financing) were coming in. Companies know their political risk and opportunities profile better than analysts do. It is critical for investors to incorporate this dimension into their portfolio construction. The policy opportunity architecture is one way to picks these changes up.

Digging deeper, tax reform provides another interesting illustration of how understanding changes in public policy strategy can have a meaningful impact on corporate results and investment outcomes. Investors assigned a very low probability of tax reform passing in 2017 due, in large part, to the Republican Congress' failure to change the Affordable Care Act earlier in the year and the distraction presented by messaging crosscurrents, personnel turnover, and a general lack of confidence in the Trump Administration. Beyond the headlines, however, corporate lobbyists were hard at work marshalling support for tax reform; over the course of the year, using publically filed corporate lobbying disclosures, the portfolio became levered to the 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 tax reform focused "thematic" stock strategies based on traditional party-affiliated industry biases.

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 businesses. The Policy Opportunities Portfolio architecture is attractive given its leverage to an increasingly important variable in investment analysis and the resulting exposure to multiple policy themes simultaneously while limiting impact from increased political volatility.

IMPORTANT DISCLOSURES

This communication was prepared by Strategas Asset Management, LLC ("we" or "us"). Recipients of this communication may not distribute it to others without our express prior consent. This communication is provided for informational purposes only and is not an offer, recommendation or solicitation to buy or sell any security. This communication does not constitute, nor should it be regarded as, investment research or a research report or securities recommendation and it does not provide information reasonably sufficient upon which to base an investment decision. This is not a complete analysis of every material fact regarding any company, industry or security. Additional analysis would be required to make an investment decision. This communication is not based on the investment objectives, strategies, goals, financial circumstances, needs or risk tolerance of any particular client and is not presented as suitable to any other particular client.

For investors subject to MiFID II (European Directive 2014/65/EU and related Delegated Directives): We classify the intended recipients of this communication as "professional clients" or "eligible counterparties" with the meaning of MiFID II and the rules of the UK Financial Conduct Authority. The contents of this report are not provided on an independent basis and are not "investment advice" or "personal recommendations" within the meaning of MiFID II and the rules of the UK Financial Conduct Authority.

The information in this communication has been obtained from sources we consider to be reliable, but we cannot guarantee its accuracy. The information is current only as of the date of this communication and we do not undertake to update or revise such information following such date. To the extent that any securities or their issuers are included in this communication, we do not undertake to provide any information about such securities or their issuers in the future. We do not follow, cover or provide any fundamental or technical analyses, investment ratings, price targets, financial models or other guidance on any particular securities or companies. Further, to the extent that any securities or their issuers are included in this communication, each person responsible for the content included in this communication certifies that any views expressed with respect to such securities or their issuers accurately reflect his or her personal views about the same and that no part of his or her compensation was, is, or will be directly or indirectly related to the specific recommendations or views contained in this communication. This communication is provided on a "where is, as is" basis, and we expressly disclaim any liability for any losses or other consequences of any person's use of or reliance on the information contained in this communication.

Strategas Asset Management. LLC and Strategas Securities, LLC are affiliated with Robert W. Baird & Co. Incorporated ("Baird"), a broker-dealer and FINRA member firm, although the firms conduct separate and distinct businesses. A complete listing of all applicable disclosures pertaining to Baird with respect to any individual companies mentioned in this communication can be accessed at http://www.rwbaird.com/research-insights/research/coverage/third-party-research-disclosures.aspx. You can also call 1-800-792-2473 or write: Robert W. Baird & Co., PWM Research & Analytics, 777 E. Wisconsin Avenue, Milwaukee, WI 53202.