



Embrace Change

By Jeff Otto, CFA

Heraclitus, an ancient Greek philosopher, inspired the quote “Change is the only constant in life.” Often, change occurs rapidly and at unexpected times leading to feelings of exuberance, fear or sadness. Change can also occur slowly and unbeknownst to the naked eye until it becomes painfully obvious. As an investor, change occurs every day in the markets as news is quickly disseminated and priced into stocks and bonds either positively or negatively. Sometimes, though, there

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are subtle shifts that emerge and can take many years to play out. As long term investors, we are focused on identifying these subtle changes at an early stage in order to position client portfolios for long term success.

Microsoft's Image

Anyone who was around in the 1990's knows that Microsoft was a “must own” stock. The creator of Windows had a virtual monopoly on personal computer operating systems while the growth of home and office PC's was exploding. However, despite a profitable business and increasingly cheap valuation, Microsoft's stock traded in a sideways pattern for over a decade after the Internet bubble burst in early 2000. During this period Bill Gates stepped down as CEO and Steve Ballmer took over just as the seemingly never ending growth of PC's slowed. Unable to sustain previous growth, their image had somehow become that of a plodding, bureaucratic organization that made more headlines for their legal battles than the innovation that built the company.

The Cloud

Satya Nadella, the head of Microsoft's burgeoning cloud

business, was named the new CEO in early 2014. As PC's began to cede market share to laptops and tablets, consumers and corporations also began to rethink the way they purchased and consumed software and services. On premise licenses and their expensive upfront fees were being replaced by software-as-a-service delivered via the cloud. Nadella made the bold decision to completely change the way Microsoft's traditional products were sold and delivered, undergoing a multi-year shift to the cloud that initially led to declining sales. Cultural changes were also evident through the elimination of business unit silos allowing for a cross pollination of new ideas. Investors, and probably some employees and board members, were skeptical at first. It was easy to dismiss these changes taking place when one could invest in other up and coming technology stocks like Google and Facebook that were in the early stages of growth. This process of change at large organizations like Microsoft, or the U.S. government, is akin to turning an ocean liner.

Politics & Business

It is quite clear that President Trump wants to instill a different culture in Washington too. His recent creation of a new White House office to make government more efficient using business ideas is counseled by such business titans as Tim Cook, Bill Gates and Elon Musk. They will attempt to infuse new ideas into a complex government and economy that has stagnated, similar to what Microsoft had become much of the last decade before sweeping changes occurred. There will be setbacks, of course, as the inability to pass health care reform shows. One interesting similarity about these leaders is that they or their companies have all failed into success. What does that even mean? Well, they were not afraid to constantly seek change and iterate towards the search for better outcomes, even if it also meant risking failure or embarrassment along the way.

Time Arbitrage

In the short term, there will likely be increased volatility in the markets associated with supposed policy wins and losses. As long term investors, we don't get too caught up in the 24 hour news cycle that can lead to investment misfires. One benefit of being a long term investor is that we can choose to view successful investment performance over

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many years while others simply cannot or will not. This is a form of time arbitrage. Investors who understood Microsoft's path

have been rewarded with outperformance of over 12% annualized versus the S&P 500 for the past three years. The valuation investors placed on the shares of Microsoft in 2012 reached an all-time low at a 30% discount to the S&P 500's PE multiple. Today they trade at a 20% premium. Many investors missed this change until it became obvious, as the memory of the preceding 10 years mistakenly shaped their view of Microsoft's future. In a show of their successful makeover, last quarter Microsoft reported their commercial cloud business hit a remarkable \$14 billion sales run-rate and increased 49% year over year.

Stay the Course

At FCI, we follow a disciplined, long term investment process that can stand the test of time. Over our 50 years in business we have seen various market cycles and have adapted to changing environments. Our aim is to create diversified portfolios, inclusive of stocks and bonds, which can flourish alongside changing government policies or company strategies. Just over a year ago, the stock market had its worst start to the year ever and the yield on 10-year U.S. Treasuries eventually fell to 1.36% as fears over an impending recession unfolded. Whether from the cyclical nature of the economy or a new pro-growth administration, economic prospects are brighter now. We did not change our process, and thankfully that allowed client portfolios to stay the course for better days. As the path ahead will surely not be linear, this reminds us to embrace change and not hide from it.

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