Getting to Good Decisions

Our 2016 Intellectual Capital Conference

1919 INVESTMENT COUNSEL

About 1919 Investment Counsel

Our name reflects our focus: to provide counsel that helps families, individuals, and institutions achieve their financial goals.

In a financial world increasingly populated by small boutiques or huge conglomerates, 1919 Investment Counsel is a rare, if not unique, entity. We have retained the high-service culture and flexibility of a boutique, while utilizing the resources of Stifel Financial Corp. 1919 Investment Counsel is a registered investment adviser.

Firm Facts: 16 portfolio managers who average 31 years of experience … Proprietary, independent research team for the sole benefit of our clients … Offices located in Baltimore, Birmingham, Cincinnati, New York, Philadelphia and St. Louis.

www.1919ic.com

One of the great traditions at 1919 Investment Counsel is our annual Intellectual Capital Conference. This year marked the eleventh year of gathering our entire investment team offsite for the pure purpose of learning and then discussing what we have learned. The conference is geared toward broadening our horizons and deepening our insight, the ultimate goal of which is to help us make better decisions with and for our clients.

This year's conference was titled *Getting to Good Decisions,* a follow up to the theme set by our last few years' conferences which have had a heavy focus on the decision-making process and making us better investors.

On the pages that follow, our investment team provides a brief analysis of each of our sessions, with the goal of informing as well as stimulating further discussions if a subject interests you. This year we pursued three broad themes. The first, an overview of our industry, was meant to inform us as to major themes and trends in the financial services space. The second theme revolved around topical and controversial issues of the day, energy, China, the U.S economy, the Middle East, the EU and Brexit. The third theme focused on better decision making, which is a continuation of a multi-year inquiry that is on the top of our minds.

As always, the sessions were highly informative and fast paced. We remain committed to the broad pursuit of knowledge as we believe it ultimately results in making us better advisors to our client base.

I invite you to read through the pieces that follow- pausing on those that most catch your attention. As in past years, we welcome your calls, should you wish to discuss or learn more about any of the topics presented.

Harry O'Mealia, Chief Executive Officer

Christopher Guith, *Senior Vice President for Policy, Institute for 21st Century Energy, U.S. Chamber of Commerce*

State of American Energy - Opportunities and Challenges

Mr. Christopher Guith provided a comprehensive overview of the opportunities and challenges faced by the energy sector in the United States. Energy security is central to U.S. national and economic security. This is particularly important as global energy demand is projected to increase 56% by 2040. It is estimated that 90% of the increase will come from countries in the Developing World, such as China and India. There are still 1.4bn people in the Developing World living without any electricity and country leaders there are strongly committed to providing affordable and reliable sources of energy. In comparison, the U.S. energy demand is expected to increase 9-11% by 2040.

The U.S. has the largest energy resource base in the world and currently has the most fossil fuel out of any other country worldwide (1,324 billion barrels of oil equivalent). Mr. Guith believes a great misunderstanding exists regarding the energy resources available in the United States. He used some statistics to illustrate the tremendous size of our resources – the U.S. has 120 years of natural gas; 206 years of oil and 464 years of coal in technically recoverable resources and 586 years of natural gas, 536 years of oil and 9,844 years of coal of in-place resources. Mr. Guith pointed out that 90% of the world's oil reserves are owned by the national oil companies of Russia, Brazil and China. Publicly traded companies, such as Exxon Mobil, control less than 8% of the world's oil reserves.

Mr. Guith discussed the current supply and demand environment for liquids and provided some details on the significant changes in the supply and demand balance over the last 18 months. Crude production has increased 77% since 2006, but it is down 9% year-over-year through May 2016. On the other hand, global and U.S. domestic demand are both up year-to-date. U.S. refinery throughput hit a record 17.2MMb/d in July 2015 and natural gas production increased 50% since 2006. The declining oil prices over the last 18-24 months have had a profound impact on the industry. The oil rig count has dropped 80% (1,283 rigs) since November 2014 and the gas rig count by 76% (271 rigs). The total U.S. rig count is down 79% (1,527rigs) since November 2014. Mr. Guith is seeing the supply and demand curves finally converging, as a result of which oil prices are starting to stabilize. Mr. Guith explained that the United States has a product mismatch. The country produces one of the highest quality crude oil in the world, light and low in sulfur content. The U.S. refineries, however, utilize the cheaper and much thicker type, which the U.S. subsequently imports. The Brent-WTI spread controls the export equation. In general, Mr. Guith shared that producers are looking for a consistency in the spread of around 2-2.30 USD/bbl before they export. Mr. Guith provided detail of the regulatory headwinds in the industry. He discussed the obstacles the industry is facing both upstream and downstream. The regulatory headwinds in the upstream space pertain to the offshore well control rule, offshore leasing plan, fugitive methane rule, venting and flaring rule, BLM fracking rule and the reduced access on federal lands. Mr. Guith elaborated further on several of the newly proposed rules.

The offshore well control rule requires rigorous testing of equipment and provides for continuous oversight of operations, all with the goal of improving the equipment and systems' reliability to protect workers' lives and the environment from the potentially devastating effects of blowouts and offshore oil spills.

The offshore leasing plan focuses on potential lease sales in areas with the highest resource potential, greatest industry interest, and established infrastructure. At the same time, the proposal removes other areas from consideration for leasing, and seeks input on measures to further reduce potential impacts to the environment, coastal communities, and competing ocean and coastal uses, such as subsistence activities by Alaska Natives.

The fugitive methane rule pertains to actions taken by the Environmental Protection Agency ("EPA") to reduce methane emissions from the oil and natural gas industry. Methane, the key constituent of natural gas, has a global warming potential more than 25 times greater than that of carbon dioxide. Methane is the second most prevalent greenhouse gas emitted by human activities in the United States, and approximately one third of those emissions come from oil production and the production, processing, transmission and storage of natural gas.

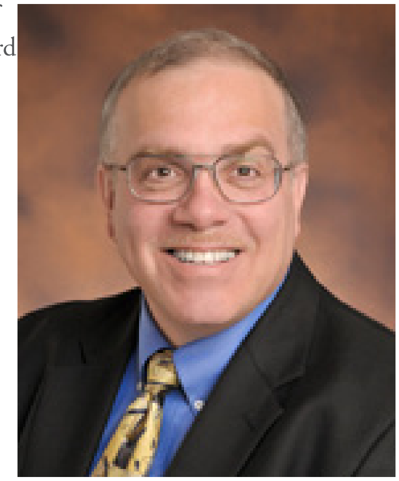
The regulatory headwinds in the downstream space relate to the Mercury and Air Toxics Standards ("MATS"), designed to reduce emissions of mercury and other so-called air toxics from generating units that burn coal and oil; the Ozone standard, established to monitor the air quality; and lastly the new greenhouse gas regulations, limiting greenhouse gas emissions from new power plants.

Mr. Guith concluded his presentation with the Carbon Limits and Energy for America's Renewal ("CLEAR") Act. The goals of the CLEAR Act are to establish a clear, predictable, and economy-wide price on carbon that will accelerate our nation's urgently needed transition to a clean energy economy and allow market forces to find the most cost-effective ways to reduce greenhouse gas emissions.

*Our thanks to **Dessie Locher, CFA, Senior Investment Associate, 1919 Investment Counsel**, for her report on Mr. Guith's presentation.*

Howard K. Gruenspecht, PhD, *Deputy Administrator, U.S. Energy Information Administration*

Oil and Natural Gas: Market Outlook and Key Drivers



We had the honor of hosting Dr. Howard K. Gruenspecht, Deputy Administrator of the U.S. Energy Information Administration since March of 2003. "The U.S. Energy Information Administration (EIA) collects, analyzes, and disseminates independent and impartial energy information to promote sound policymaking, efficient markets, and public understanding of energy and its interaction with the economy and the environment." (eia.gov)

EIA's Role and Present Outlook

By way of introduction, Dr. Gruenspecht reminded attendees that the EIA's job is to provide data and analysis, not recommendations or policy positions. The EIA collects its own data from market participants and does not rely solely on state level data. Dr. Gruenspecht began by updating attendees about the present state of oversupply in global crude oil markets and the recent history that led to this outcome. Underscoring the notion that small swings in supply or demand can have significant impact on the price of oil, Dr. Gruenspecht evoked the words of Wilkins Micawber "Annual income twenty pounds, annual expenditure nineteen pounds nineteen and six, result happiness. Annual income twenty pounds, annual expenditure twenty pounds nought and six, result misery." (David Copperfield, Dickins).

The period of 2011-2013 saw markets that were more or less in balance with small moves in inventory builds or draws, while in 2014 supply began to outpace demand consistently and relentlessly. The lower oil prices that began emerging in late 2014 signaled to producers that production curtailments were in order and curtail they did but to date those cuts were still insufficient to balance markets. While emphasizing that predicting oil prices is challenging at best, he shared the EIA view that by the 2nd half of 2017 supply and demand will be back in balance and for prices to trend toward $60/bbl by year end.

Oil Supply and Demand and the Role of Shale

Without a doubt, a significant contributor to supply growth in the past decade has come from U.S. shale and unconventional drilling and completion techniques. U.S. natural gas production from shale grew from approximately 5 billion cubic feet per day (bcf/d) in 2006 to nearly 45bcfd in 2016. Oil production from shale gained traction a bit later but in the period since 2010 it has grown from 0.5 million barrels per day (mmb/d) to over 4.5 mmb/d recently. The Marcellus shale in the Northeast stands out on the gas side while the Permian and Eagle Ford basins in Texas, and the Bakken region in North Dakota stand out on the oil side. This production has begun to decline in response to lower prices but other regions, including Federal offshore waters in the U.S. Gulf of Mexico continued to grow as projects launched 5+ years ago came into production.

As U.S. production is now clearly in decline, the rest of the world is delivering essentially flat production in the near future. Beginning in 2017 and beyond, the EIA expects to see significant declines taking hold outside the U.S. as well as the impact of natural field declines continue while the backlog of new production fades as the lagged impact from currently low oil prices and drilling activity begins to become more apparent. Coupled with the EIA demand scenario, this should help tighten up balances and drive prices higher.

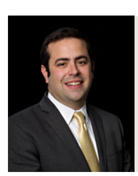
EIA is expecting oil demand to remain essentially steady in 2016 and 2017 with 1.4mmb/d and 1.5mmb/d of demand growth in 2016 and 2017 respectively. This view incorporates a lowered expectation of non-OECD (i.e. emerging markets) growth relative to views from recent years.

U.S. Energy Market Outlook and Clean Power Plan (CPP) Impact

The recent updated EIA outlook for the U.S. includes a reference case (incorporating Clean Power Plant) and a non-CPP scenario looking at projections from 2016 to 2040. Total U.S. primary energy consumption grows slowly in both cases as reductions in energy intensity offset the impact of GDP growth, with slightly higher growth in the No CPP case than in the Reference case. In the CPP scenario renewables go from representing 8% of U.S. energy supply to 14% by 2040 while in the non-CPP case that amount would be 12%. Solar and wind account for nearly all of the projected increase. In the CPP case natural gas would see its share grow from 29% to 33% by 2040 where in the non-CPP case that would be 32%. Coal's share would decrease in both cases. In the CPP case it would go from 16% to 10% and in the alternative it would go to 14%. Finally, nuclear generation remains close to its current 9% share as the impact of new plant additions is offset by retirements.

Natural Gas Outlook

In the U.S. natural gas supplies, in the wake of unconventional drilling, appear to be abundant, and therefore gas production is likely to be more a factor of the pace of demand growth than anything else. The EIA expects natural gas prices to remain below $5 per million British thermal units (mmbtu) for the foreseeable future while rising steadily from the current levels below $3/mmbtu as growth in export driven demand in the form of liquefied natural gas (LNG) begins to grow.



Our thanks to ***Shaya Berzon, Equity Research Analyst, 1919 Investment Counsel****, for his report on Dr. Howard's presentation.*

Derek M. Scissors, PhD, *Resident Scholar, American Enterprise Institute*

With a Whimper not a Bang, China Fades into the Sunset

China is confusing. China has a debt problem. China is headed towards financial disaster. In recent times, almost every piece of news related to China has echoed the same general conclusion – China's debt problem will (if it hasn't already) spiral out of control and eventually bring about the next global financial crisis. It's clear that the only thing that the media is more certain of than the impending global disaster is the "fact" that China and its actions are unpredictable. While economists around the world are left scratching their heads in an attempt to understand the enigma that is China, Derrick Scissors, the chief economist of the China Beige Book, has apparently figured it out. According to Derrick, China is not confusing, quite the opposite, China is easily predictable. Derrick predicts that China's debt problems will be contained and that financial collapse in China is neither imminent nor likely. His argument that China's economy will not collapse should not be confused with an argument for growth. Instead, Derrick goes on to explain that while the debt problem will be contained, a period of stagnation is certain to follow unless China undergoes pro market reforms.

Derrick breaks down his argument for slow growth and the need for reform into four parts – capital, land, labor, and innovation. In order to understand Derrick's argument on capital some history is needed to provide perspective. Too much investment and not enough consumption pretty much sums up most of China's current issues. While it may be tough for most to remember that far back, China did not always have this problem. Derrick points out that the imbalance between investment and consumption was created in 2002 by Hu Jintao and Wen Jiabao's poor policies and expansion of state bank lending. This imbalance did not exist prior to the Hu/Wen government and is not a necessary part of the Chinese economy as some might believe. According to Derrick, these issues would have worked themselves out or at least been exposed in 2008 if we had a normal correction. Instead, we had a sharp downturn and the Hu/Wen government was able to quietly double down on their poor policies further exacerbating the problem. In 2008, the Chinese government initiated the biggest stimulus in world history by ordering a 30% increase in state bank lending. From 2009 to 2015 Chinese national debt increased by at least $15 trillion dollars.

To put things into perspective, the US federal debt increased $7 trillion dollars during that same period. By now, two things should be clear - China has a debt problem, and it's only getting bigger. The debt problem all but guarantees that growth from capital in the medium term will be low to nonexistent.

The outlook for growth stemming from either land or labor also looks bleak. While China has made efforts to curb pollution and promote more environmentally friendly means of production, reversing the damage that has already been done will take some time. Furthermore, China's rapidly aging population, courtesy of the one child policy, suggests a sharp decline in the labor force. With land, labor, and capital out of the picture, China's only avenue of growth is innovation.

Innovation just so happens to be extremely hard to measure. For ease of understanding, Derrick uses the word innovation and invention interchangeably. He argues that true innovation can only take place where safeguards for individual property rights exist. Innovation is difficult and most innovators are attracted to the rewards of innovation as much as they are attracted to the greater good that it may bring to the world. In a government system with a lack of intellectual/personal property protection, the party most likely to reap the rewards of innovation is the state. With individuals not being incentivized to innovate and invent, China's last avenue of growth slowly slips away. Unless China undergoes pro market reforms, all avenues of growth will be closed off and a period of extended stagnation will come to pass.

After a full discussion on the lack of growth prospects for China, Derrick completes his argument for the containment of China's debt problem. The argument is simple – China does not have a commercial financial system. It may look like one and feel like one, but it isn't one. To drive the point home, Derrick poses the following question: Are Chinese banks more like the US government or a US bank? While you are all free to form your own opinions, Derrick's answer is the US Government. A rough estimate of the liabilities over the assets of the US Government is $12 trillion. Drawing a parallel between the US government and Chinese banks, Derrick states that neither will fail because of insolvency. The argument for a China contained crisis is strengthened by comparing the nature of Chinese debt and its economy to other countries that have debt problems in the past. Debt issues that have had an impact on a global scale (think Arab Spring and Mexico in the 80s) generally had two things in common – a young labor force and foreign creditors. This particular mix causes issues because foreign creditors want assurance against default in the form of cost cutting or austerity while the young labor force wants the government to create jobs through spending. Fortunately, China does not have any of these problems. With an aging population and mostly internally held debt, China's current situation resembles that of Japan in the 90s. In the absence of true market reform, China's outlook is most likely a period of extended stagnation. Given the choice of inflicting upon China the pain of reform, or to muddle along for the foreseeable future with little to negative growth, it is unclear what choice the party would make. Either way, if we have followed Derrick's argument to completion, the crisis will be contained.

*Our thanks to **Sean Hung, Investment Associate, 1919 Investment Counsel**, for his report on Derek Scissors' presentation.*

JOHN H. JOHNSON, PHD, *President and CEO of Edgeworth Economics*
The Misinformation Hidden in the Little Data You Consume Every Day

We have all read that headline that makes us do a double take: Is that really a magical diet? Will that really make me more successful? Will I really find love if I try this? With continuing advancements in technology, we are lucky enough to have the world at our finger tips. You can read about breaking news without waiting for the 5 o'clock airing on your local news station or tomorrow's paper. Any lingering question


Photograph by Cameron Davidson
CAMERONDAVIDSON.COM

can be answered with a quick Google search on your smart phone and no longer requires a trip to the library's encyclopedia section. There is a plethora of timely information available at the click of a mouse or a scroll through your Twitter feed. But is this information accurate? Can you trust every headline you read or website you stumble upon?

John H. Johnson, PhD challenges the data that floods our daily lives through his book EVERYDATA: The Misinformation Hidden in the Little Data You Consume Every Day. As investment managers, we face an endless amount of information and are required to make timely decisions with the goal of outperforming the index over a complete market cycle. When analyzing a specific company, stock, bond or even the market as a whole, there are numerous factors that need to be considered related to data. Dr. Johnson's first point was to know the sample selection. While this brings back memories of college statistical courses, it is important to know what data was used and if the results can be applied beyond that specific study. If you are comfortable with how the data was collected, Dr. Johnson challenges his audience to next consider if there is anything that could be skewing the data. Identify outliers and consider using other measurements that could be less impacted by those numbers on the far ends of the spectrum.

Another challenge in interpreting information is to make sure you are considering all of the facts, not just those that support your case. Cherry picking in a data set can lead not only to those commercials that claim "4 out of 5 dentists recommend" but also to potentially disregarding important information. If an analyst's stock selection seems like a no-brainer, we need to ensure that those unimpressive earnings results weren't ignored. Further, will the supporting data lead to actual outperformance? Determining the difference between correlation and causation is critical in investment management. Assuming something is the cause when it could just be a correlation or coincidence is problematic. Asset class allocations and weightings are strategic to balance sectors that are correlated and those that are not, but it is also important to consider what could impact those historical relationships.

It cannot be denied that data impacts every decision we make, especially as it applies to investments. On April 23, 2013, the S&P 500 dropped dramatically when The Associated Press' Twitter account was hacked claiming that there were two explosions in the White House and President Obama was injured. The market corrected once it was determined to be untrue, but reacting impetuously to such headlines could result in poor investment decisions. The first step in avoiding any impulse reactions is being aware of how data can be misconstrued. As of the time of Dr. Johnson's presentation, 90% of the world's data was created in the last two years. Having so much data readily available is enlightening but it doesn't end there. Analysis and further research continue to be imperative to decision making, as evidenced by Dr. Johnson's work on EVERYDATA.

*Our thanks to **LAUREN KRIEGER**, **Sr. Investment Associate**, **1919 Investment Counsel**, for her report on John H. Johnson's presentation.*

KAREN FIRESTONE, *Co-Founder, Chairman and Chief Executive Officer, Aureas Asset Management*
Practical Risk Taking

We all take risks every day. Buying a stock, driving over the speed limit, ordering dessert, quitting your job – these are all risks, though with vastly different consequences. Having a consistent approach to risk taking can help you make better personal, professional, and financial decisions. Karen Firestone founded Aureus Asset Management after a twenty-two year career at Fidelity Investments, and she has developed a robust framework for assessing risk that is presented in her book, Even the Odds. For decisions large and small, Firestone highlights four criteria that can aid in sensible risk taking: right sizing, right timing, relying on knowledge and experience, and remaining skeptical.

Right Sizing

Buying a house is a common risk that involves right sizing. How much house can you afford? How large is your family? Do you expect more children in the future? Right sizing involves balancing risk and reward and is summarized in the old adage, "don't risk more than you can afford to lose." In investing, it means understanding the potential downside of an investment and sizing your position appropriately.

Right Timing

Is it better to launch an ice cream business in May or December? When is the right time to quit your job? Right timing simply means being patient and taking risks at the appropriate time. Many successful investors utilize a watch list of potential investments. These are securities that are worth owning but perhaps high valuations or political uncertainty mean now is not the best time to make a new investment.

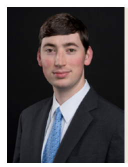
Rely on Your Own Knowledge, Skill, and Experience

Crowd psychology and 'group think' can be a dangerous phenomenon, especially when making investment decisions. Relying on your own knowledge and experience can help you avoid this type of poor decision making. Personal experience can, at times, be more valuable than research reports or financial statement analysis. Mrs. Firestone recounted her decision to sell a long held position in construction company Harsco Corporation following a trip to Dubai. After seeing the massive scale of the new construction boom in the city, she had an epiphany and realized it would be almost impossible for these new buildings to reach full occupancy in what was once a modest desert town. Upon returning from her visit to Dubai, Mrs. Firestone promptly liquidated her firm's position in Harsco before it declined over 50%. Peter Lynch, one of Mrs. Firestone's mentors, summarized this rule as "know what you own and why you own it."

Maintain a Healthy Skepticism

If a friend tells you they can outperform the stock market every year, be skeptical. But being skeptical extends beyond your initial decision making. It also means you should constantly revisit and reassess your ideas. In particular, don't fall in love with an investment idea. Mrs. Firestone's firm follows a specific 'sell discipline' for securities that decline in value. If a security is down 25% from initial purchase, the portfolio managers must reexamine the company's prospects and either buy more of the company or sell it completely. This type of rule promotes a healthy skepticism and prevents poor investments from simply being ignored.

Risk is an unavoidable part of life, but remembering these four core tenets of risk-taking can help you make prudent decisions in the face of uncertainty.



Our thanks to ***Miller Kreider, Investment Associate, 1919 Investment Counsel****, for his report on Karen Firestone's presentation.*

Thank you to our 2016 Speakers and their Organizations

The speakers at our annual Intellectual Capital Conferences are respected thought leaders who represent the nation's premier financial, academic, policy, research, and government institutions. At our 2016 conference, these organizations were represented:

Institute for 21st Century Energy
Solutions for Securing America's Future

AEI

AUREUS
ASSET MANAGEMENT

eia

1919 Investment Counsel Contributors

Shaya Berzon, CPA
Sean Hung
Lauren Kreiger, CFA
Miller Kreider, CFA
Dessie Locher, CFA

The opinions expressed may not reflect the views of 1919 Investment Counsel or its employees. Any data cited have been obtained from sources believed to be reliable. The accuracy and completeness of data cannot be guaranteed. All investments involve risk, and past performance is no guarantee of future results.