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Cuba: Open for Business

Stemming from disagreements during the Cold War, the United States has had an embargo on Cuba for over 50 years. However, over the last few years, relations between the U.S. and Cuba have begun to thaw, culminating in President Obama being the first sitting president to visit Cuba in nearly 90 years. Now that the end of the embargo seems like a matter of "when" rather than "if," here is how the U.S. and Cuban economies could be impacted once political relations are fully restored.

Impact on Cuban Economy

The Cuban economy is largely dependent on external revenue. According to a study done by Texas A&M, international visitors and tourism generated $2.0 billion for Cuba in 2010. If the travel restrictions between the United States and Cuba are lifted, the International Monetary Fund estimates an increase in American visitors from 700,000 annually to 10 million.

However, U.S. tourists are not the only ones who are interested in the embargo being lifted. U.S. companies are also looking to establish or expand their presence in Cuba. Airbnb, Netflix, and Verizon currently have operations in Cuba, and Carnival Cruise and Starwood Hotels are among those looking to start Cuban operations. The increased presence of U.S. companies in Cuba will lead to more employment opportunities for Cuban locals and inflows of money and resources towards rebuilding Cuba's crumbling infrastructure.

Current living standards in Cuba are incredibly low, with the average worker living off about $20 per month. According to a study from 2015, private sector employment in Cuba represented 33 percent of all employment in Cuba, which is up from 23 percent 15 years ago. These privately owned and operated companies will be exposed to millions of new potential customers from the United States. Given the influx of American dollars to the Cuban economy, the standard of living for Cubans could see a rapid rise in quality.

Impact on the US Economy

On the U.S. side, the Texas A&M study found that lifting the embargo with Cuba will create an estimated 6,000 jobs and $4 billion in the agricultural industry alone. Many Cubans who receive remittances from their work purchase food imported from the United States. If more Cubans were to obtain positions that supplied remittances, the Cuban government would need to increase imports to meet demand. Even with the current embargo, the United States is still Cuba's second-largest food supplier, amounting to around $800 million of trade each year.

The automotive industry for the United States will also see a boom, as most Cubans only have access to American cars built in the late 1950s and early 1960s. The ability to buy American-made cars once again will be mutually beneficial, stimulating both U.S. automotive companies as well as the Cuban market for new cars and vehicle servicing.

Cuba also has a vast and advanced biotech industry with pioneering treatments for diseases. Every year, around 80,000 American citizens get amputations due to diabetes. Cuba has developed a medication that reduces the risk of amputation by around 80 percent. Access to this medication would spare American citizens lifestyle difficulties and costly medical procedures for diabetes-related issues.

Provided that relations continue on their current trajectory, the long-standing embargo will be lifted sooner rather than later. While the extent of the new trade policies remains to be seen, it safe to say that there will be significant impacts on both the Cuban and U.S. economies.

the market at a glance

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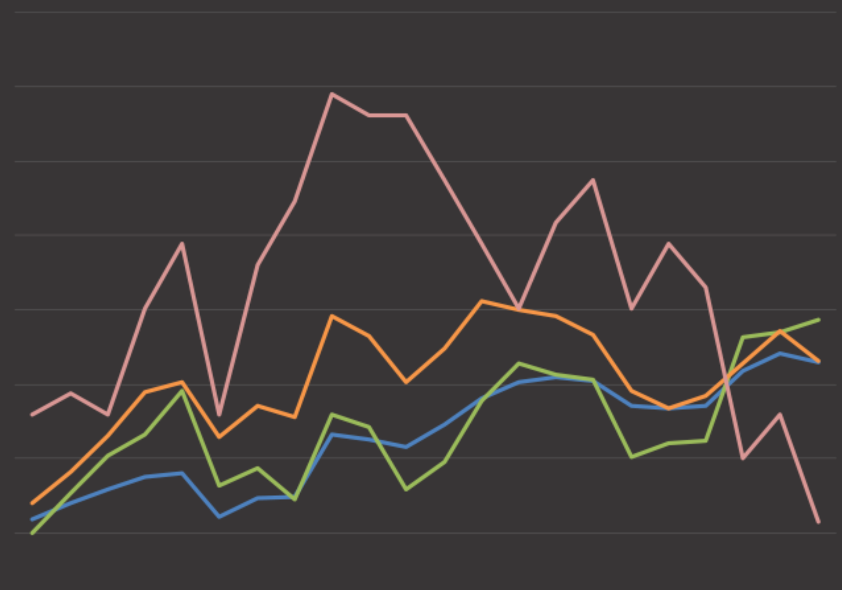

Past performance is no guarantee of future results. Indices are unmanaged and cannot be invested into directly.

The market in action

- As part of its continuing effort to spur economic growth, the European Central Bank lowers it overnight funds rate to -0.4 percent and increases its quantitative easing program to 80 billion euros of monthly bond purchases.
- Saudi Arabia seeks an external loan for the first time in over a decade. The loan, which may be as high as $8B, will be used to fill government deficits created by low oil prices.
- Boeing Company makes plans to cut as many as 8,000 jobs by the end of 2016. Boeing's cuts will affect jobs at all levels, from executives to floor workers.
- European stock exchanges Deutsche Boerse AG and London Stock Exchange make a $30B agreement to link their trading systems. The deal is designed to help the two European exchanges compete with the United States.
- Credit rating agencies Moody's and Standard & Poor's downgrade their outlook on Chinese government debt to "negative," citing potential problems with growth and reform. However, the agencies did not downgrade the country's credit rating.
- The U.S. Bureau of Labor Statistics reports that 242,000 jobs were created in February. This marks 72 consecutive months of net job growth in the United States.
- Avon Products, Inc. announces plans to cut 2,500 positions and relocate its headquarters to Great Britain. The move is expected to save the company approximately $50M in payroll and operations expenses in the United States.
- Athletic retailer Sports Authority, Inc. files for bankruptcy and announces it will immediately begin the process closing up to 40 percent of its stores and distribution centers.
- Taiwanese electronics giant Foxconn agrees to buy Japanese tech company Sharp Corp. for $3.5B. It is the largest foreign acquisition of a Japanese technology company in history.

Social Pressure and Financial Decisions

People like to fit in; it's one of the simplest laws of human nature. Although we value the things that make us unique, most of us are careful to not let them make us social outsiders. There is strength in numbers, and conformity reassures us that we are making the right decisions.

Unfortunately, comparing ourselves to others can lead to real problems. Our egos can become sensitive—even irrational—when trying to protect the public image of our wealth and status. If left unchecked, the fear of falling behind our peers can destroy our financial security.

Meet the Neighbors

In a paper published by the Federal Reserve Bank of Philadelphia, economists tested and analyzed the social behavior of "keeping up with the Joneses" and the impact it could have on personal finances.

In their study, economists used six-digit postal codes to divide Canadian cities into micro-neighborhoods (13 households on average). They then observed financial changes in the neighborhoods after one of the households had won a lottery prize.

Whereas many researchers have documented the Sudden Wealth Syndrome of lottery winners (many of whom end up in financial ruin), this study instead focused on the winners' closest neighbors. The researchers wanted to know how people responded when someone else suddenly had more money to spend.

The results were clear: for every 1,000 Canadian dollar increase in the size of the lottery prize, the number of bankruptcy filings among close neighbors increased 2.4 percent in the three years following the lottery win (the base rate was .46 bankruptcies per neighborhood). This effect was greater in low-income neighborhoods where prize values were higher relative to average incomes.

What happened? When the asset sheets of the bankrupt neighbors were reviewed, researchers found that the houses had increased their "conspicuous consumption," spending more of their money on visible signs of wealth (rather than investments that go unseen). Accordingly, the ratio of visible to invisible assets rose with the size of the lottery winnings, suggesting that individuals were willing to spend more when their "Joneses" had won more.

Irrational Groupthink

While the study may simply confirm what many might have suspected, the irrationality of the situation is striking. Winning a lottery is not a reward or promotion—it says nothing about a person's value or rank. Why would neighbors, who know the wealth was won by luck, compare themselves to a situation they can't possibly copy? Furthermore, why try to emulate the neighborhood's one winner, when "fitting in" should mean behaving like all the other non-winning households?

The problem is that wealth and status are relative to each person. Everyone has his or her own "Joneses." When one house receives a windfall of cash and begins spending, it can set off a chain reaction. Our egos would rather let us spend too much than risk falling behind.

This arms race mentality is why the housing bubble of the last decade became so severe. It wasn't just the opportunity to make money off real estate; it was the visibility of the changing wealth. Every day, people watched their neighbors buy and improve properties, knowing that they would have to do the same just to maintain the status quo.

Forgetting About the Joneses

A little social pressure isn't necessarily a bad thing. It often provides a nudge towards positive action and helps us make good choices. But when it comes to money habits, trying to match (or exceed) those around you can lead to serious problems. Everyone's financial situation is unique, and each person defines success differently. As difficult as it is, you need to shut out the social noise and ignore what others do with their money. After all, you're trying to accomplish *your* financial goals—not theirs.

Your Money with Greg Tull

Even the world's most talented active fund managers experience volatility, pullbacks, drawdowns, and periods of underperformance relative to the market and to their peers. For example, Warren Buffett is often cited as the most talented active manager living today. And yet, when you examine his 50 year Berkshire Hathaway track record (http://www.berkshirehathaway.com/letters/2014ltr.pdf) you will see that Berkshire underperformed their benchmark, the S&P 500, by a notable margin in 11 of their first 50 years (1964-2014). In more than 1 out of every 5 years, the Oracle of Omaha came up short relative to the index by amounts ranging from 7% to 41%! And yet, he has compiled what is probably the best 50 year track record in human history. By compounding at 21.6% over 50 years, a Berkshire investor on January 1, 1964 would have made 18,262 times their initial investment as of December 31, 2014. By comparison, the 9.9% compound annual return for the S&P 500 over the same period would have made the investor 112 times their money. In other words, a $10,000 investment in Berkshire would have grown to $182 million in the same 50 year period as $10,000 grew to just over $1 million in the S&P.

It's also important to be aware that the more aggressive a manager is, meaning the higher they are aiming in terms of market beating returns, the more volatile the fund will typically be. In order to benefit from the manager's skill over time, and enjoy the benefits of the compounding returns, it's crucial to have the resolve to ride out a talented manager's rough patches. One way of doing this is to not have too many active managers in your portfolio, and to have a real diversity of focus and strategies that your active managers are pursuing. And always remember, even the world's most skilled living investor tends to have at least one bad year out of every five. Read on to discover the rollercoaster ride that research shows you would have to endure, with the benefit of perfect hindsight, to achieve the blockbuster returns described in the "Perfect Investment."

Could You Stomach the Perfect Investment?

Suppose a fund manager knew for sure which 10% of the largest U.S. companies would earn the highest returns over the next five years, over each upcoming five-year period. You'd invest in that fund and hang tight, right?

A research company called Alpha Architect recently posed this as an interesting thought experiment. It divided all of the 500 largest U.S. stocks into deciles, and imagined that a hypothetical fund was investing in only the upper 10% returning stocks in the first five year period, starting on January 1, 1927, and every five years it would switch the portfolio to the future top 10% of all stocks. (Hindsight makes it a lot easier to model what would happen if we were blessed with perfect foresight.)

Okay, so now you're invested, and if you could have bought and held this magical fund, then at the end of the year 2009, you'd have earned just under 29% a year. What could be easier?

But, not knowing that this fund had a workable crystal ball, would you have held on while it was experiencing a 75.96% downturn during a particularly bad bear market starting in 1929? Or might you have been tempted to bail to safer bonds at some point during that catastrophe? This perfect fund fell more than 44% during a one-year period starting at the end of March, 1937, and overall it experienced drops of 20% or more nine times during your holding period—plus an additional 19% drawdown that took it within a whisker of bear market territory.

Some of the times when you might have been sorely tempted to jump ship: the 2000-2001 downturn, when your marvelous fund lost 34% while the S&P 500 was only down 21%. Or a precipitous 22.11% downturn starting at the end of 1974, when the S&P 500 was *gaining* 19.94%. Or the 19.91% drop from the end of September through the end of November 2002, at a time when the S&P 500 was sailing along with a 15.28% positive return. The long-term returns were terrific, but it took a lot of stomach to hold on for the full ride.

The authors also looked at an even more marvelous manager, who not only bought only the 10% of stocks that would go up the most in the subsequent five years, but also shorted the 10% of stocks that would experience the worst 5-year performance. The mechanics of this fund are a little more complicated, but the results were even more dramatic: the fund experienced enormous losses at times when the S&P 500 was experiencing gains—as you can see from the accompanying chart, which shows this perfect fund's biggest losses compared with S&P 500 returns during the same period. You really had to be intrepid to hold on and claim the fund's remarkable 39.74% annualized returns.

The point? The authors say that even if God (who presumably has perfect foresight) were running a mutual fund, He would have lost a lot of investors who lost faith in His management skill during those times when the markets experienced rough patches. It's fundamentally a lesson in humility and patience; great long-term track records are not immune from pullbacks, and our all-too-human tendency is to lose faith in the face of adversity.

-Bob Veres

Source:
http://blog.alphaarchitect.com/2016/02/02/even-god-would-get-fired-as-an-active-investor/#.VrD5akrsaMY.twitter

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