The Law of Unintended Consequences

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The Law of Unintended Consequences

“Man has almost constant occasion for the help of his brethren, and it is in vain for him to expect it from their benevolence only. He will be more likely to prevail if he can interest their self-love in his favor, and show them that it is for their own advantage to do for him what he requires of them. Give me what I want, and you shall have this which you want. We address ourselves, not to their humanity, but to their self-love.”


In 1776, Adam Smith tried to describe the mechanism by which economic society operated – a society in which, in the pursuit of one’s own gain, individuals unintentionally promoted an end they never had in mind, i.e. public interest. As if there were some “invisible hand” at work, consumers would choose based on the lowest price; entrepreneurs for the highest gain; and, by making their respective excess or insufficient demand known through market prices, consumers would inadvertently “direct” entrepreneur’s investment money to the most profitable industry and the economic well-being of all would increase.

As a result of the phenomenon, one of the most positive outcomes of “capitalism” is that it forces people to think about what other people want.

But the notion of honestly and openly acting out of one’s own self-interest – and how it might actually serve, rather than harm, the common good – was taken even further by Ayn Rand, author of The Fountainhead and Atlas Shrugged, when she sought to redefine “self-interest” within the confines of right and wrong. “If some men,” she said, “are entitled by right to the products of the work of others, it means that those others are deprived of rights and condemned to slave labor. No man can have the right to impose an unchosen obligation, an unrewarded duty or an involuntary servitude on another man.” Instead, she urged people to live by a code of the free individual, in celebration of self-reliance, integrity, rationality and productive effort in the belief that one person’s happiness should never come at another’s

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1 “Man’s Rights: The Virtue of Selfishness: A New Concept of Egoism,” by Ayn Rand
expense. “No one’s rights can be secured by the violation of the rights of others. The end does not justify the means.”

Our culture is founded on the notion of productivity – of creating value from the raw materials around us or, through the application of reason, by finding solutions to our problems. Economically, we flourish through the voluntary exchange of money for goods while, socially, we form friendships; join associations; and invest our time and energy in relationships for shared enjoyment or for the advancement of a common cause. The only real threat in this country to our ability to live freely and independently is the threat of force that would seek to make one person accept another's dictates over his or her own judgment, as it would in a totalitarian regime.

There must, of course, be a military force for defense against external enemies. And a system of legislation, with courts of law to establish the rules under which we operate and to adjudicate disputes in which force might otherwise be used. And there must be a system of enforcement backed by police to make sure that the laws are observed and are not just empty words. But, in a true “republican” system, no one would have the right to force their personal preferences on anyone else because free markets are not merely a system of economic freedom. They also provide a platform on which to make choices and, consequently, to take responsibility for our own lives and happiness. As Ayn Rand said, there must be a separation of economy and state – as much as of church and state – because each person deserves the right to think and live as his or her own conscience dictates given the fact that we all benefit from everyone having this freedom in the first place.

Beyond this, it is my opinion that the role of government should be as limited as possible. If should be limited because, according to the “Law of Unintended Consequences,” the actions of people frequently have effects that are either unanticipated or “unintended.” And nowhere is this more obvious than within the world of regulation.

In 1936, in an article titled “The Unanticipated Consequences of Purposive Social Action,” American sociologist Robert K. Merton identified five sources of this phenomenon. The first two were ignorance and error. The third, which he labeled “the imperious immediacy of interest,” referred to instances in which an individual wants the intended consequence of an

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2 “The cashing-In: The Student Rebellion,” Capitalism: The Unknown Ideal, Ayn Rand
action so much that he purposely chooses to ignore any unintended consequences, as in the case of abortion. Without getting into the relative merits of Pro-Life versus Pro-Choice, banning abortion would likely result in an increase in the number of unwanted children that would be born as result of the policy. Ethics aside, if a young mother chooses not to be responsible for and/or to raise her unwanted child, that child will likely become a dependent of the state, both for its upbringing and education. My point is that, if people are truly determined to have such incredibly divisive and difficult debates like this within the public domain, they should also deal with the issue of who will pay and be responsible for the children.

Unintended consequences are, of course, common. It is simply that some of the consequences impact society more than others. In medicine, there are the inevitable “side-effects” which can sometimes be worse than the cure. The “War on Drugs” was meant, for example, to suppress the illegal drug trade – and it did drive many small-time drug dealers out of business. But, ultimately, it consolidated the hold of large-scale organized crime in the process. Or the CIA tactic of supporting foreign regimes, based on the notion that our enemy’s enemy is our friend. Certainly in the cases of Noriega and Saddam Hussein, it wound up backfiring as our “allies” turned and used the weapons and resources we had given them against us.

It’s just that, when it comes to legislation, the “unintended consequences” can be so much more... devious. It is so easy to bury costs which, because they are hidden, can balloon to the point where they unwittingly make a worthwhile program – even ones that achieve their stated objective – unwise. I refer to the so-called “Pork Barrel” or special interest bills that are often added to a given piece of legislation to secure the votes needed for passage. But another, equally vivid example is Quotas, which the government will sometimes impose on things like imported steel to protect American companies from lower-priced competition. The quotas do, indeed, help the targeted industry. But they also make, in this instance, steel more expensive for other sectors, like U.S. automakers, which then face a higher cost of manufacturing than their

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4 “Pork Barreling” refers to bills that are added to unrelated pieces of legislation in order to win the necessary votes from key politicians. The problem with this and similar tactics is the temptation and opportunity for special-interest groups on either side of the “Aisle” to form and lobby the government to provide taxpayers’ money to groups and individuals in the form of subsidies. From a cynical perspective, politicians find the prospect of buying the loyalty of such groups attractive. But, wouldn’t we be better off if no one got subsidies, since subsidies, by definition, are only needed for unprofitable activities that people evidently don’t value enough to pay for with their own money? The problem is that, if other people seek and gain subsidies, anyone who doesn’t will end up subsidizing the others while receiving no subsidies themselves. And so they do and, inevitably, it becomes an infinite, self-perpetuating loop, calling to mind that famous paradox known as the “Prisoner’s Dilemma.” As a result of this phenomena, large numbers of people spend their time lobbying for government subsidies instead of simply being more productive and, because the process is permitted to remain unexposed, the costs are rising at a time when our country can least afford it. * “Adam Smith and the Invisible Hand,” Helen Joyce, Millennium Mathematics Project, University of Cambridge, March 2001
foreign counterparts and the policy, while protecting one industry, often causes injury to another.

When John Kerry blames George Bush for the ‘damage’ being done by “outsourcing,” it is, in my opinion, an attempt to rally support within our country’s heartland where much of our basic manufacturing is based. It is costing American jobs, he says and, to a certain extent, his point is irrefutable. On the other hand, if a new administration were indeed successful in stemming this trend, another equally irrefutable result would be that the cost structure of these companies would once again rise. It would make these companies less competitive than their overseas competitors and, since the consumer – given comparable quality and features – will inevitably seek the lower-priced alternative, the revenues and profitability of our domestic companies would be squeezed. In time, if they’re no longer competitive, our companies could end up going out of business and the Unintended Consequence, under this scenario, is that American workers would inevitably lose their jobs anyway. In fact, even more people might lose their jobs if whole companies go out of business and not simply restructure, as they are doing today, to focus on a core competency or differentiating advantage.

The point is that companies outsource for three reasons: to get the job done cheaper; to get it done sooner; or because it offers them greater flexibility to shift production as tastes, trends and technologies change. Firms that offer these outsourcing services gain two advantages: by combining similar tasks for many businesses, they foster economies of scale, thereby lowering their cost per unit; and, by specializing in certain areas of expertise, they attract the best talent and capabilities available. It’s a win-win situation. And to think that such a trend might only be a passing fad, or one which can be reversed, misses the point of why companies go into business to begin with: they do so to make a profit. It is only through making a profit that companies are able to grow. The more profitable they are, the bigger they grow. The bigger they grow, the more people they hire, offering their employees a competitive wage, improved benefits, or both – not because it is the “moral” thing to do or because it is their duty. It is in their self-interest to do so. The solution, as I suggested in an earlier article,⁵ is not to fight outsourcing but, instead, to educate and re-train our employees so that their skill-sets remain competitive and in demand over time. No President can put this “outsourcing” genie back in the bottle and we must not seek to do so out of the erroneous thinking that our Nation can somehow go back in time and stem the tide of progress in a globally competitive economy. We can try; but if we do, it will only hurt us more down the road.

⁵ “Is the U.S. Losing Its Competitive Edge,” Barnaby Levin, Smith Barney, February 1, 2004
In the meantime, our economic attention is, once again, getting diverted. I’m thinking about the story of the little boy who throws a rock through his neighbor’s window. As a result of his action, the boy’s father must go out and buy a new window, thereby giving business to the glass man. But, instead of this being an indication that the demand for glass is suddenly on the rise (a claim which the subsequent month’s economic survey will undoubtedly show), it is really only a shift in demand. The money that was spent to buy the new pane of glass could have been used to buy a new suit or a watch or a gift for the man’s wife, which in my household, at least, would have scored more points.

Today, the same is true with regard to the price of oil. We cannot simply minimize inflation, as some economists do, by qualifying it “ex-food and energy” on the basis that food and energy prices are more volatile and supposedly reflect temporary conditions of supply and demand more than they do a sustained rise in prices.

First of all, I cannot comprehend anyone excluding food and energy, since each is a part of our daily consumption and, as far as I’m concerned, they are not “discretionary.” If it’s simply a matter of semantics, let’s call the price of oil something else, like a “consumption tax.” Either way, it is going to have the same impact on consumer spending as that rock did on the father’s pocketbook. Also, comparisons with the inflation-adjusted price of oil in the late 70s don’t make a lot of sense either. Certain industries – whether because of overcapacity, poor management, unionization, excess competition, or all of the above, as seems to be the case with many airlines – having been unable to pass this increased cost on to their customers, will be put into or at risk of bankruptcy. For them, who cares what the price of oil was thirty years ago.

Finally, with regard to the notion that prices only reflect a “temporary condition,” I challenge the assumption that it will ever return to the mid- or upper-twenties. According to the International Energy Agency, oil demand over the past years has grown by 2.3 million barrels per day (or 2.9%) to 82 million, while “the world’s margin spare production capacity appears to have fallen below 2% of demand.” It is not simply because Iraqi, Saudi, Nigerian or Venezuelan output – due to political or terrorist attacks – has become erratic. Nor because of the highly publicized problems at Russia’s largest oil company that are putting Yukos at risk of bankruptcy by its own government for alleged back-taxes. It seems unlikely that the Russian government would allow or want such a thing to happen and that, with oil prices high, they’d be keen to keep the pumps

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primed. But who knows? Perhaps they want the company back for themselves. Nevertheless, as unbelievable and disruptive as these issues are – and I certainly hope they’re soon resolved - all of the Gulf producers are already running flat out and despite promises to the contrary are producing every drop of oil they possibly can.⁷

Certainly, within the last month or so, politics have begun to play an increasing role in the markets as they digest the very real possibility that Kerry might unseat Bush and, within his first 100 days, try to undo many of Bush’s market-friendly policies, like the reduced income-, capital gain- and dividend-tax cuts. Whether such changes would truly have any lasting or meaningful economic impact, campaign promises do play their part in the polls. But, if Kerry does win – if he does eliminate Bush’s tax cuts for the top 1%⁸ and somehow rebates that money back to the remaining taxpayers – each household would receive about $613.⁹ In other words, not much, and I don’t believe that it would make much of a difference. But I do expect that the uncertainty of this fall’s election will continue to have an ongoing, disruptive impact on the markets until November when we’ll once again be able to get on with our lives.

To be sure, the problem with our markets isn’t poor earnings or, according to First Call, valuation:

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<th>S&amp;P 500 Operating EPS¹⁰</th>
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<td><strong>SAAR</strong></td>
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⁸ 13D Research, March 2004. According to the IRS, the top 1% of taxpayers for 2001 earned an Adjusted Gross Income of $292,913 or more and paid 33.8% of Federal Income Taxes paid, while the bottom 50%, earning less than or equal to $28,529 only paid 3.97% of the bill. The latter earn less, but they also contribute less, and there are a lot more of them if they’re to receive any meaningful benefit from such trickle-down policies.
At 1100, the S&P 500 is trading at a reasonable 16.3 times trailing Q2 2004 earnings and companies are still exhibiting strong year-over-year growth in excess of 20%. Sequential growth will likely slow and this will be one of the things to worry about going forward; but earnings should continue to shine through year-end and to grow in the year ahead.

But there is one other Unintended Consequence that I came across in a July 26th Wall Street Journal article titled “Foreigners Seem to Be Souring on U.S. Assets” and about which I am more concerned than anything else at the moment. The article mentions how “foreign purchases of securities in the U.S. in May came to $56.4 billion. While that was large enough to finance the current-account deficit, it was down 26% from April. It also marked the fourth consecutive monthly decline of such purchases by foreigners.”

We know that Chinese and Japanese central banks have become an increasingly important support for the U.S. Treasury market because their large surpluses with us, at least until recently, have resulted in excess dollars to invest. “These banks,” the article said, “are concerned less about a high rate of return than a stable and easily tradable investment.” But losing principal is quite another matter. Starting last summer as our rates began to rise, it made sense that foreign purchasers would begin to slow and, ultimately, reduce exposure to our debt markets, in turn causing even more downward pressure on the price of bonds as they sold. Throughout this process it would make sense, I thought, to keep maturities in our bond portfolios short. But it did come as a bit of a surprise, however, that foreign appetite for our stocks might also wane because earnings at our leading companies were healthy and improving. Perhaps, as Tobias Levkovich suggests, there were those who had hoped to see even greater capital spending, or who were disappointed by the lack of a “killer application” which evidently led to a more modest recovery than these investors would have liked. The fact is that as rising oil prices caused them, like us, to spend more of their reserves on energy, foreign countries began pulling their dollars home from every asset class and, again in the case of Japan and China, to invest locally to take better advantage of their own strong economies. I’m not sure if knowing this any earlier would have really changed my strategy, which had already become increasingly conservative and value-driven as the year wore on. At the same time, it is a bit comforting to finally figure out what I think is the final factor underlying the recent weakness in our equity markets. At this point, we’ll just have to see what it’s like without much help from overseas, and for Supply and

Demand to find their level. But we’re not there yet. Two months ago, 10-year bonds were yielding 4.89% and oil was at $38 a barrel; on August 23rd, bonds were at 4.24% and oil was at $48.12.

The point is that China is finally having the economic impact that most people have long expected and (if they’re exporters) hoped for, and there are consequences that come with this.

In 2003, China accounted for nearly “one-sixth of worldwide economic growth.” And now that Beijing’s efforts to cool the country’s blistering 9.1% growth rate have finally met with success, their actions may indeed trim global growth for the balance of 2004. I suppose this is “bad.” But it does seem ironic that, only last March, people were begging China – not only to enact curbs and to tighten their unfettered lending policies in order to avoid a hard landing – but also to devalue the Yuan to help us out with our balance of trade problems. The bottom line is that a relatively short-term summer slow-down should not only have been expected; it should now be seen as a positive. We should want to avoid another Bubble at almost any cost and to support a stable Asian engine of growth that we hope will continue to drive global GDP for the balance of this decade – and not just this year.

Again, the rate of growth will likely slow; but the key word is “rate.” We may “only” grow at 3% in 2005, but it does seem likely that the U.S. and global economies will grow. At the same time, risk clearly remains high on a number of fronts and, for us to share in further appreciation, it behooves us to stay cautious at least until after elections. My focus will be to identify companies that are growing at a rate faster than their peers; or that are growing just as fast, but whose stock is trading at a PE less than or equal to that rate so that, going forward, the stock can rise at least in line with earnings and without the benefit of multiple expansion. Given the probability of rising interest rates – and because all financial assets are essentially on a “yield curve” – PE’s tend to stay flat or to contract as the “risk free” rate of return offered by U.S. Treasuries begins to rise. If, however, we can buy stock at a PE less than or equal to the company’s growth rate; and if we then add a dividend of 1.5% or better – whether it’s taxed at a reduced rate or not – that will add to total return and should increase the odds of our outperforming the broader S&P.

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12 “Economy, Money & Markets,” Ed Hyman, ISI, August 23, 2004
13 “China Threatens World Growth As Slower Economy Reduces Demand,” Art Pine, Bloomberg News, July 6, 2004
15 “The Duration Dynamic,” Ed Kerschner, PaineWebber, January 27, 1997. Equities may be thought of as the “ultimate zeroes” because equities, unlike bonds, have no maturity; may or may not pay a “coupon;” and never repay principal.
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