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1001 Uses for Windmills

"Out of necessity comes invention." This quote is attributed to the Greek philosopher Plato – not Aristotle, but close. It is apropos to this quarter's topic on the uses for windmills. The subject came to us as we pondered the horrific recent human tragedies brought on by natural disasters. Our thoughts and prayers go to those affected in Mexico City, Puerto Rico, South Texas, Florida and elsewhere. There was much damage caused by an earthquake in Mexico and flooding elsewhere; that's when we thought of similar circumstances in another land, at another time, far, far away.

> *"The only real failure in life is one not learned from."*
> *~ Anthony J. D'angelo*
> *(American motivational author)*

We learned, giving credit to the online site http://thetravelingdutchman.com, that until the year 1400 AD, "*Living conditions in Holland were far from ideal. The country consisted of wetlands, swamps and marshes separated from the sea by a belt of dunes. Villages were often destroyed by ravaging floods. In 1421, in a particular bad flood, over 70 villages were washed away and thousands of people drowned.*

Enter the windmill. After sea defenses were put up and dams were built to disconnect the water from the sea, windmills were used to drain the many lakes, swamps and wetlands. This drastically increased living conditions. Over the years, numerous windmills were built as they became larger and their water-lifting capacity increased. In the 16th century, due to adjustments to the structure of the windmill, it became possible to use them for several other purposes, such as for the production of oil, paper and to saw timber.

Saw mills played an important role in the shipbuilding industry, enabling the construction of massive fleets. With these ships, Holland was able to reach a very dominant position in world trade during the 17th century, the Dutch Golden Age." From disaster, Holland adapted and became dominant.

In this issue ...

In their simplest form, windmills convert one form of energy (naturally occurring wind) to another. The first windmill is believed to have been invented in Greece around the first century AD. It was named because it used wind energy to "mill" grain – grinding it up so it could be more easily cooked. An example of its use was the milling of wheat to flour so as to make bread. Over the centuries, windmills were used for myriad purposes. From the sawing of lumber to the shucking of pumpkin seeds to the Dutch pumping of water, windmills had great and diverse utility.

The advent of the industrial age marked the beginning of the decline of the use of windmills. Engines (steam, then electric) were more efficient and versatile, rendering the traditional windmill nearly obsolete. In recent years, however, the windmill has made a comeback. By far its greatest use today is the conversion of wind power to electricity. The energy in the wind turns giant propeller-like blades around a rotor. The rotor is connected to a shaft, which spins a generator to create electricity. Simply, a wind turbine is the inverse of a fan. A fan uses electricity to make a home feel breezy; wind turbines use wind to make electricity.

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According to multiple information sources, globally today, greater than 340,000 windmills produce nearly 500 gigawatts of power capable of producing enough electricity to power about 4% of the homes and businesses in the world. Some countries' share of wind power is much higher, particularly those in northern Europe (including Holland).

What investment lessons may be learned from our newfound fascination with windmills?

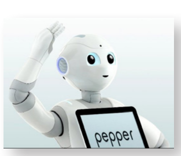
Adaptability … Part II

In *The Essence* of October 2015 entitled "Akihabara," we listed several instances of companies (or entire regions) that adapted their businesses to secular changes in their industries. Texas Instruments, Time Warner and Panasonic were mentioned. This quarter we'd like to follow that up with a Peek into some of our internal ongoing research. It has become apparent to us that just as windmills had to undergo a dramatic transformation of function in order to remain relevant, so too must many consumer-focused companies. With the caveat that we rarely make investment decisions based on what ***may*** happen, still, it takes us time (often measured in multiple years) to understand the likely course of such shifts.

For instance:

➢ In rapid-fire succession, Amazon.com recently began opening traditional "brick and mortar" bookstores, established partnerships for the return of merchandise to traditional retailers, purchased a food retailer and announced other plans for its "real world" (as opposed to virtual or online) ambitions. To us, this may recognize the need for retailers to have <u>both</u> online and brick and mortar presences. Who may best succeed in this new world of the consumer?

Will traditional retailers such as Walmart leverage their store presence into the online world better than Amazon.com, which is attempting the opposite? Perhaps delivery companies such as Federal Express and UPS will benefit as "owners of the last mile?" Will drugstore chain Walgreens be immune to online threats due to the immediate nature of its pharmaceutical businesses – or not?



➢ Many Japanese companies are coming to grips with the fact that the country's population will decline. Witness the birth of "Pepper," whimsical for now, but perhaps the beginning of a real humanoid robot that may assist with everything from greeting customers at restaurants to cleaning dishes. Further automation of all types is being pursued by Japanese companies that may lead the automation revolution as our next big industrial era. Fanuc and other robot companies have a huge lead in their respective industries. But they specialize in industrial automation. What about those requiring "human-like" touches? Our best guess is that (Pepper notwithstanding) those firms may not have been born yet.

➢ Speaking of those recently born, is the "millennial" generation (those persons born in the latter part of the 20th century) really different? Or are millennials still just *young* and likely to "morph" closer to their parents' living habits as have most prior generations? Will millennials rent forever, or begin to buy homes? Will they ever step into a shopping mall for anything other than dinner? … And will they ever put down their electronic devices?

➢ We believe Best Buy is a wonderful example of a business (consumer electronics retail) that has hung on in the face of adversity for years while most (nearly all) of its physical store competitors have seen their demise. Given enough time, could it be that the company will eventually find a way to thrive? The company's latest foray into services (think "Geek Squad") is indeed a microcosm of consumer expenditures the world over that has shifted dramatically from the consumption of "goods" to "services." What will be the ramifications as this trend continues? Particularly, what may happen if productivity continues to advance in goods manufacturing to a larger degree than services (again, "Pepper" notwithstanding)?

➢ Sometimes it is "smarter to be lucky than it is lucky to be smart." Pioneer Natural Resources controls large acreage in the Permian Basin stretching from western Texas to eastern New Mexico. Long considered an ageing oil field that had been heavily worked over, the advent of "fracking" techniques has given new life to the Permian, which is now estimated to be able to produce two million barrels of oil per day. Pioneer is taking advantage of this as the world's fossil fuel stocks (not only oil, but also natural gas) are now thought to be sufficient for the next 100 years of consumption. This estimate does not include the potential diminution of demand from alternative energy sources including wind, as discussed earlier. Changes in the sources and uses of energy are a major topic worthy of our better understanding.

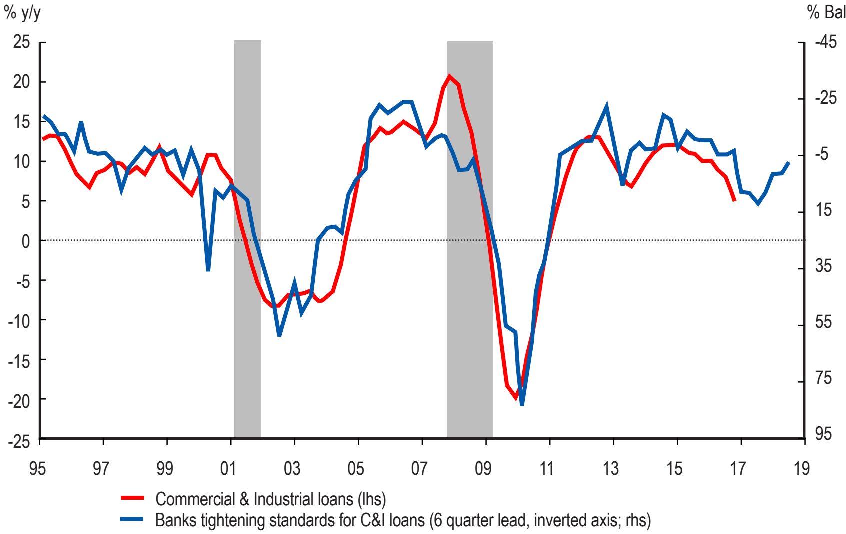
➢ As related to energy demand, what about electric and autonomous vehicles? We could devote several editions of *The Essence* to this topic, yet will simply state it as one worthy of our cerebral focus.

Clearly, there are few "answers" in the examples given; just a list of a few of the questions that we, at Aristotle Capital, ask ourselves. Many industries are in flux; it seems more so than in prior decades, but perhaps not. We see this as an opportunity to gain an understanding of the changes that consumer (and other) behavior will have on industries and individual businesses. We seek out those companies that, like windmills, have shown a penchant to adapt to the changing landscape – always with a longer-term focus.

EQUITIES STRATEGY

Even though the current "bull market" in equities is long by historical standards, we do not necessarily believe that age alone will cause its end. Prior ends to strong financial markets were often precipitated by cyclical disruptions to economic growth. The following graph shows that, for at least some parts of the U.S. economy, growth is only now beginning.

Credit Growth Still to Come?



Sources: Federal Reserve Board; Haver Analytics; DB Research

The blue line above depicts lending standards imposed by banks on corporate business loans (commercial and industrial, excluding real estate). For ease of comparison, the blue line is moved **ahead** by six quarters. Thus, as we are in mid-2017, it shows a reading of -5 for late 2018. As the measure is of "tightening" standards, a negative reading actually means that banks are "loosening," or making it less onerous for, or even encouraging, companies to borrow money. The red line is the year-over-year growth of such loans. Note the very tight correlation of these two lines. If the relationship holds, then we may expect bank lending to increase over the coming 18 months. Also note that the current pattern has not historically been associated with economic downturns (as seen by recessions during the times in the shaded areas).

One reason often cited for the lack of credit growth is the persistence of low inflation. While much of the world seems, at this time, to be past the threat of **de**flation, it remains that price (and wage) increases the world over are subdued. There could be structural reasons for this. A recent edition of *The Bank Credit Analyst* asked if some of the recent changes we highlighted earlier in this quarter's report may result in a decoupling of economic growth from inflation.

"[*Internet commerce*], *Airbnb, Uber, robotics, contract workers, artificial intelligence, horizontal drilling and driverless cars are just a few examples of companies and technologies that are cutting costs and depressing prices and wages…*"

We must point out, however, that some of these "revolutions" are nothing more than the continuation of efficiencies and productivity improvements experienced for much of the past ***50+*** years. E-commerce was preceded by the advent of "discounters" such as Walmart, Target, Ross Stores (or K-Mart and Woolworth before them) and others. Airbnb was preceded by the advent of "low frills" hotels such as Motel 6 (founded in 1982 offering $6 rooms – hence the name). "Contract" workers were preceded by part-time employees. Horizontal drilling for energy (including that found in the Permian) was preceded by technologies enabling the drilling in heretofore overly "hostile" geographies, including deep offshore.

So, while we do not discount the importance of the current low-inflation environment, we do not believe that the rise of the new businesses listed above is its lone cause. While we will continue to analyze individual businesses, typically independent of economic cycles, we are not currently overly concerned about a pending economic decline – geopolitical tensions notwithstanding.

INVESTMENT ACTIVITY

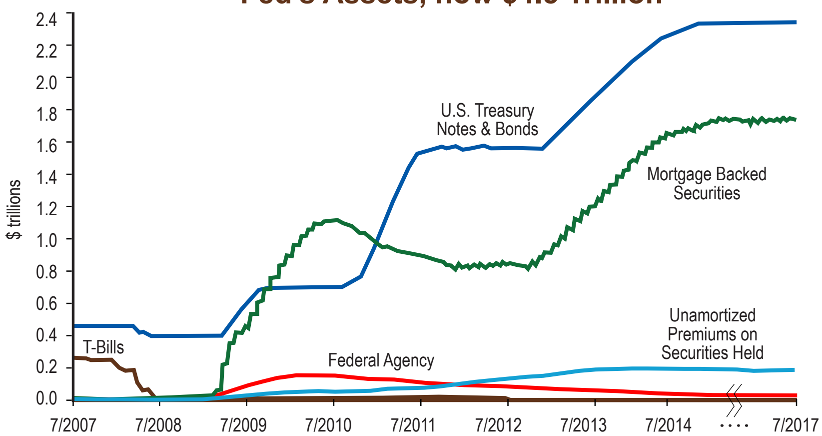
We would now like to highlight a recent addition to Aristotle Capital equity portfolios:

- If they (re)build it, will they come? **Westfield Corp.** is one of the world's largest owners of shopping malls. While based in Sydney, Australia, the company's 35 centers are located mainly in the U.S. and U.K. (with one planned for Italy). As discussed earlier, shopping in malls is not as "in vogue" today as it once was. Westfield recognized this more than a decade ago and has dramatically transformed its malls from those that are "transactional" based (such as department stores) to those that are more "experiential" (including services like restaurants, but also showrooms such as *Tesla*, *Apple* and *Microsoft* and food retail such as *Eataly*). Available *catalysts* are numerous. They include recently opened or rebuilt malls, from the World Trade Center in New York to Century City in Los Angeles to Stratford in London. Westfield is also entering multifamily housing that surrounds its shopping centers as well as technology to help track where visitors to its centers spend their time. This new data is valuable and may be monetized to retailers as well as e-commerce providers. Others may value Westfield using a rear-view mirror, yet we see its transformation as adding value for the future.

FIXED INCOME STRATEGY

The Federal Reserve (FED), led by chairwoman Janet Yellen, has announced that this October it will begin to unwind the "quantitative easing" process that was put in place to stabilize the economy from the financial crisis – now ten years ago. That is, as fixed income securities currently on the Fed's balance sheet mature, they will no longer be replaced and the size of the Fed's portfolio (currently ~$4.5 trillion) will naturally shrink. Meanwhile, the Fed Fund target short-term interest rate remained unchanged last quarter, after being raised one-quarter of a percent in each of the prior two quarters. But the target rate (currently 1.00% - 1.25%) is still expected to gradually rise to close to 3.00% over the coming two years.

Fed's Assets, now $4.5 Trillion



Sources: Federal Reserve; Encima Global (now part of Strategas Research Partners)

This "grand experiment" (duplicated by many central banks around the world) has clearly worked to stabilize the global financial system. Some believe it has been kept in place too long. Perhaps this is another cause of the weak loan growth highlighted earlier. Others see no reason to unwind the policies, as inflation is benign in most countries while economies have yet to hit their full potential. Honestly, we do not know if either view is correct, as for most (all) of our working lifetimes, **in**flation has been an "enemy," not the prospect of **de**flation. But we do know the destructive powers of the latter (witness the 1930s) and are watchful it should not be repeated. Currently we believe that most central bankers, including Ms. Yellen, share our view and will proceed with the utmost caution while unwinding the current policies.

Therefore, repeating from recent editions of *The Essence*, absent unpredictable global economic or political shocks, it seems likely to us that the U.S. (and global) economy is strong enough to withstand additional modest monetary tightening. Over time, both rising interest rates and the unwinding of balance sheets, which had been monetary **tailwinds**, will likely now become **headwinds**. With the primary aim of Aristotle Capital's fixed income portfolios being that of principal preservation, we shall remain conservatively postured.

CONCLUSION

Windmills have had a profound impact on the history of civilization. From the early Greeks to the Dutch and others, each society found new and ingenious methods by which to turn the power of wind to alternative uses. Then industrialization took hold and, like the buggy whip, the windmill found little use. But today, more than 340,000 windmills are back at work throughout the world. Their use was transformed to make electricity, and their place in business is once again well entrenched.

So too can businesses be transformed, even if disrupted by changing societal tastes. We, at Aristotle Capital, study these changes, identifying how they may impact individual companies. While we rarely attempt to "predict" the future, as trends are identified we incorporate such changes into our analyses. Our current thinking around such topics as e-commerce, declining labor forces and electric vehicles has led us to re-examine companies impacted by such potentially dramatic shifts in consumer and business spending patterns. It is at once one of the most challenging, yet most satisfying, parts of our work.

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