

## Investing in an Era of: “Stone Age Emotions, Medieval Institutions and Godlike Technology”

My greatest regret about my time at Harvard was not taking the initiative to meet the renowned biologist E.O. Wilson. Best known for his research on the behavior of ants, Dr. Wilson went on to apply his findings and framework to cover other species, including humans. His seminal works include his 1970s publications – *The Insect Societies* and *Sociobiology: The New Synthesis* – which popularized the discipline of sociobiology: the systematic study of the biological basis for social behavior in all kinds of species.<sup>1</sup> It is closely aligned with the field of evolutionary biology. In an inadequately short summation, Wilson’s work shows that our evolutionary past explains much of modern human behavior. As Wilson covered in his 2012 book *The Social Conquest of Earth*, much like ants, both group cooperation and tribal-like conflict are endemic to the human condition.

Our predisposition toward conflict is the subject of today’s letter. I am drawn to Wilson’s work because I think it maps on well to the realities of human history. Per my lifelong and undergraduate studies, the history of man – especially the written history – is largely a history of conflict. As advanced in technology and morals as we’d like to think we are, I tend to side with the Hobbesian view that the natural state of the world is one of anarchy, or: “the condition of Warre.”<sup>2</sup> The fact we’ve had relative global stability and peace for the past several decades is – as I will return to shortly – perhaps more an anomaly than the norm.

From ants to humans, disorder is the natural order of things. For society to exist and humans to progress, we must construct imperfect institutions reliant on group cooperation. Since the beginning of recorded history, this cooperation has typically manifested itself in some form of government. While I’m partial to liberal (lowercase L) democracies, all ruling bodies share a common purpose and source of legitimacy: keeping their citizenry safe. In the absence of security, there can be no prosperity or progress.

Some might say this is a gloomy view of affairs. There are respected academics – most prominently the Harvard psychologist Steven Pinker, author of *The Better Angels of Our Nature* – who have convincingly argued that life is getting better and more peaceful.<sup>3</sup> I have read Pinker’s work, and it is very good! But I fear that the worldview espousing the human condition is continuously improving – even though based on empirical data – may be becoming somewhat outdated. Particularly on the nation-state level.

Many of us – and especially many policymakers – developed our international relations frameworks over the last 30 years following the fall of the Soviet Union, during which time the U.S. was the unequivocal superpower. But rather than an “end to history,” as stipulated by the political scientist Francis Fukuyama,<sup>4</sup> the last 30 years may be better categorized as a hiatus.

Now I’m just an amateur historian... but my view on conflict is that state vs. state confrontation – the kind Wilson and Hobbes believe is an unfortunate feature of our existence – boils down to one of three broad causes:

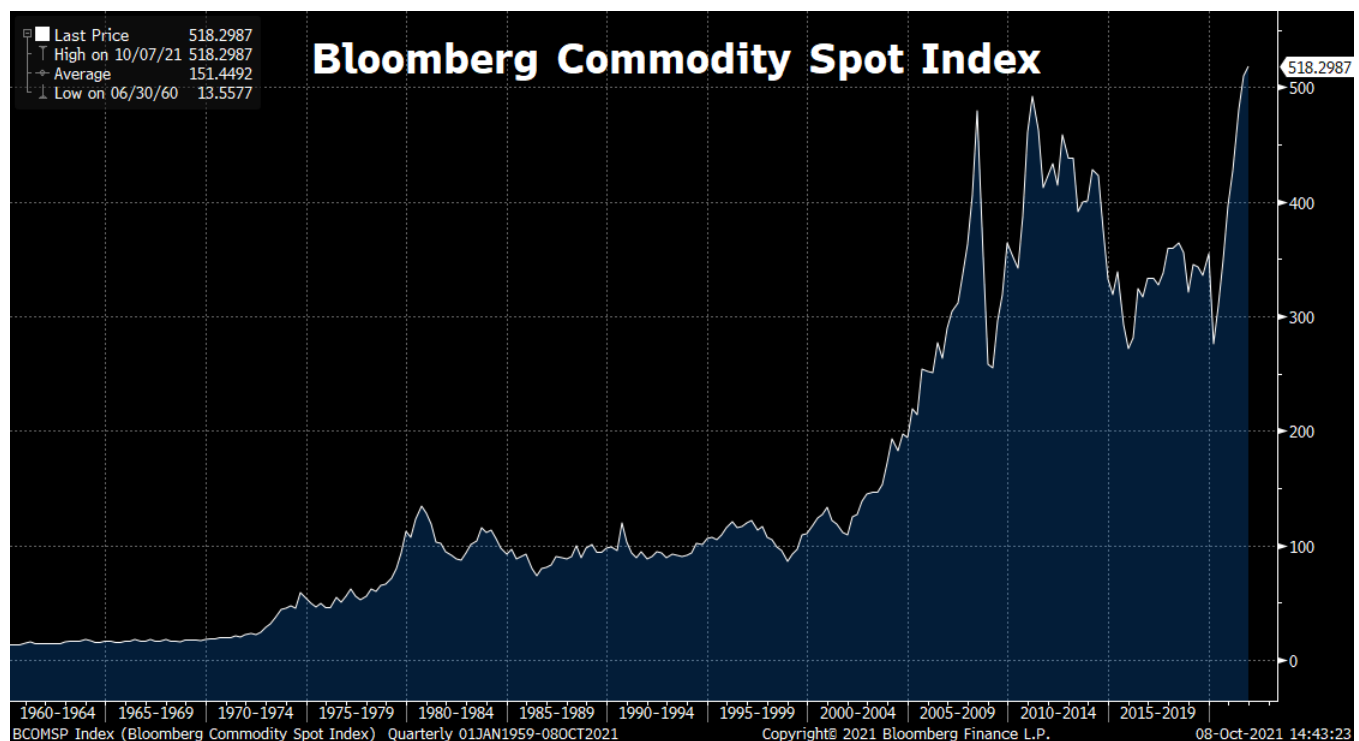
- 1) Resources (conflicts over scarcity),
- 2) Religion (conflicts over ideology), and
- 3) Retribution (conflicts to right perceived wrongs).

When the U.S. acted with the authority of the world’s chief power, these types of conflicts were mostly held in check. And yes, I know there were egregious and regional exceptions, which I’m not seeking to minimize. But over the last several decades, we had nothing close to the scale of wars like WW1 and WW2.

From Pax Romana (27 BC to 180 AD) to Pax Britannica (1814-1914),<sup>5</sup> it's not unusual for large scale conflict to recede during times of unchallenged global hegemony. Without rehashing current events, it's safe to say that the U.S.'s global leadership both militarily and economically is now in question. It's not so bold as to predict that Pax Americana may, in retrospect, turn out to have been a relatively short-lived period.

Now, back to the three causes of conflict and role of government:

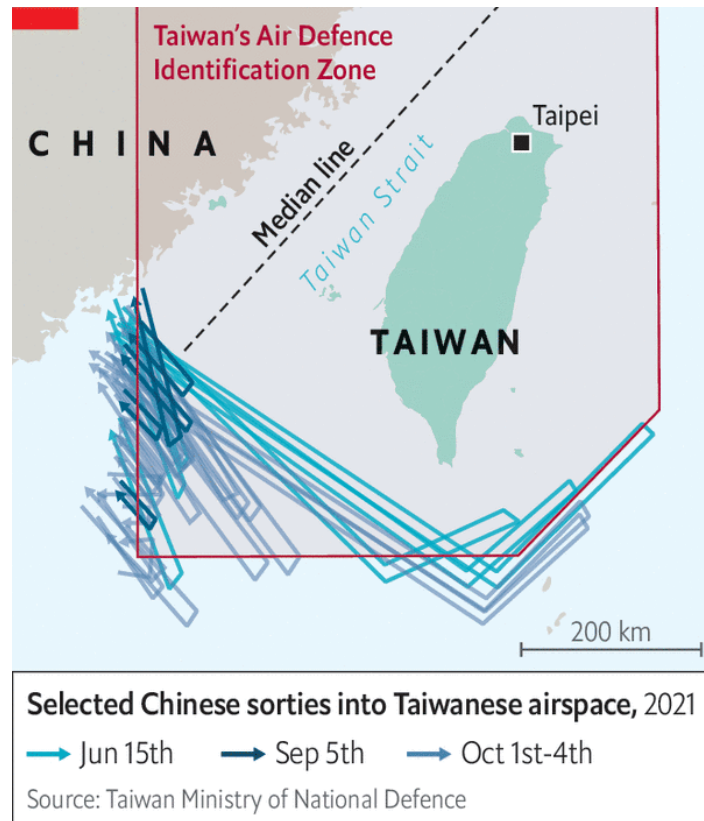
- 1) **Resources:** If you've paid attention to the news lately or prices ranging from energy to food, it's obvious we are in a state of key natural resources deficits. This can be seen by the below chart of the Bloomberg Commodity Spot Index. After sinking in the immediate aftermath of Covid last year, the BCOM Spot Index has surged to all-time highs.<sup>6</sup> In eras of abundance, most people and nations are content. However, in times of scarcity, disputes are more likely to arise. Ominously, conflicts over land, food, materials and energy sum up most of the history of war.



- 2) **Religion:** Wars over religion – or ideology more broadly – have not occurred with as much frequency in modern history. But I fear that social media has helped radicalize a disturbingly large number of the global population, creating multiple tinder box scenarios waiting for a match. The political scientist Samuel Huntington argued in his *Clash of Civilizations* – a rebuttal to Fukuyama's *The End of History* – that following the Cold War, most conflicts would be rooted in cultural and religious identities.<sup>7</sup> Thus far, his prediction has looked prescient.
- 3) **Retribution:** This is perhaps the greatest near-term cause for concern. Russia feels aggrieved over territorial losses in Eastern Europe following the dissolution of the USSR. It is emboldened by Europe's

reliance on it for gas, which it further cemented last week by agreeing to increase exports to help alleviate Europe’s power crisis.<sup>8</sup> Was Crimea a preview of more to come?

In China, the CCP believes Taiwan must be re-unified with the mainland. China’s air force is increasingly flying provocative incursions over Taiwanese airspace (see graphic below).<sup>9</sup> In the sea, its navy is challenging the territorial integrity of Japan, the Philippines and Australia. Russia and China are more prone to act if they doubt a strong U.S. or allied response. Based on the past few years of developments, they regrettably have reasons for their doubts.



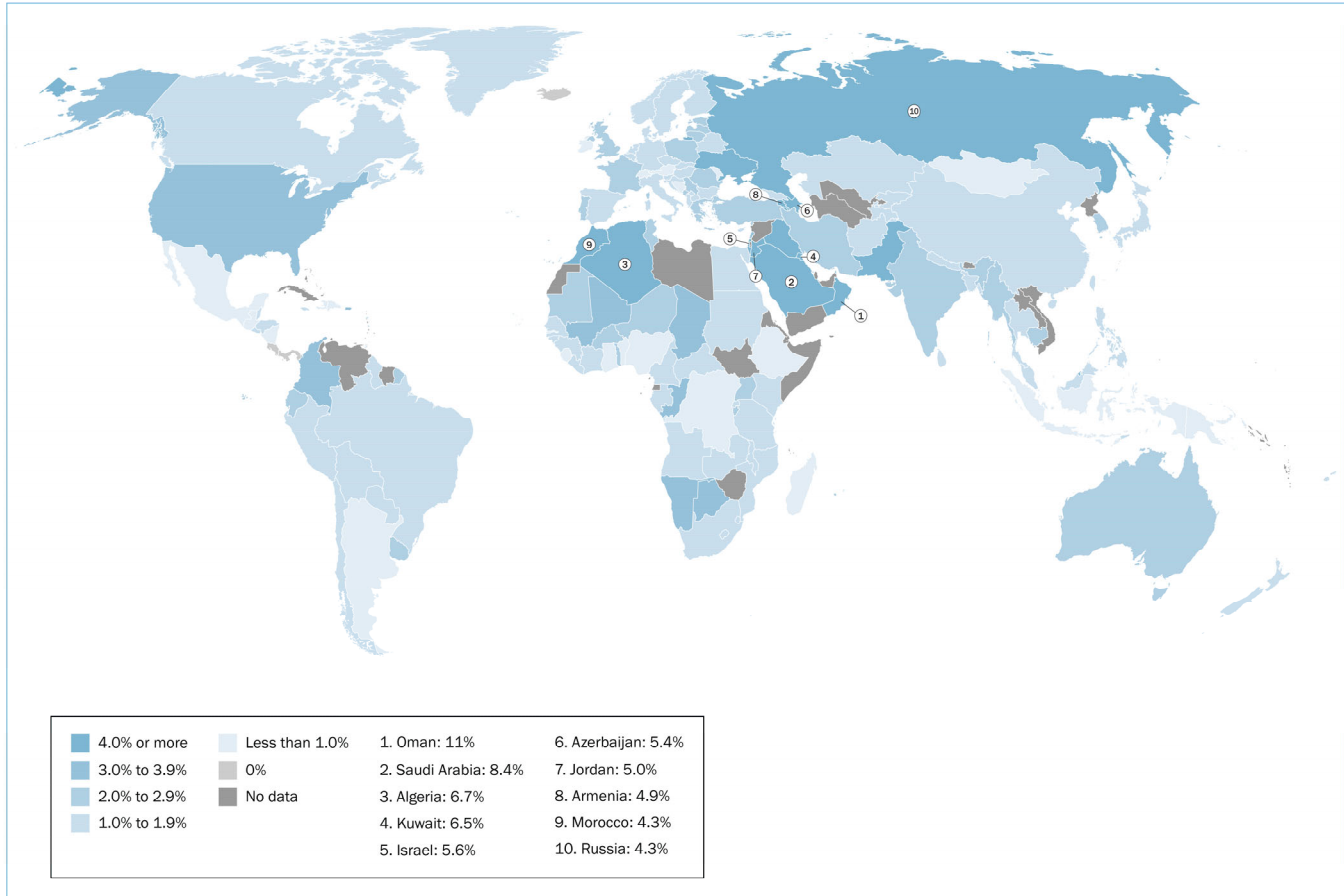
The Economist

Again, the first purpose of government is to provide security. If Pax Americana is eroding and the world is reverting back to its Hobbesian natural state (more prone to conflict), then it follows that security is going to come back into sharper focus.

Now for the investment implications. As we have highlighted in recent communications, the universe of attractively valued public equities is not exactly growing. Conveniently for this topic, one segment of the market with still compelling valuations is defense firms. Given the priority of national security, global governments are likely to step up defense spending in the face of growing threats and doubts over U.S. assurances. In a less stable geopolitical environment, defense spending for many nations is likely to shift from a medium-priority category of discretionary spending to a high-priority mandatory spend category, and a rising one at that.

In 2020, global defense spending amounted to nearly \$2 trillion, or 2.4% of global GDP (note that the percent of global GDP spent on defense rose last year as economic output fell in the wake of Covid).<sup>10</sup> While the U.S. makes up the lion’s share of spending at 39% (\$778 billion, or 3.7% of U.S. GDP), the Asia and Oceania region has driven most of the increase in spending over the last 20 years (with China accounting for much of the growth).

### Defense Spending as Share GDP, by Country (2020)



**Figure 4.** Military spending as a share of gross domestic product, by country, 2020

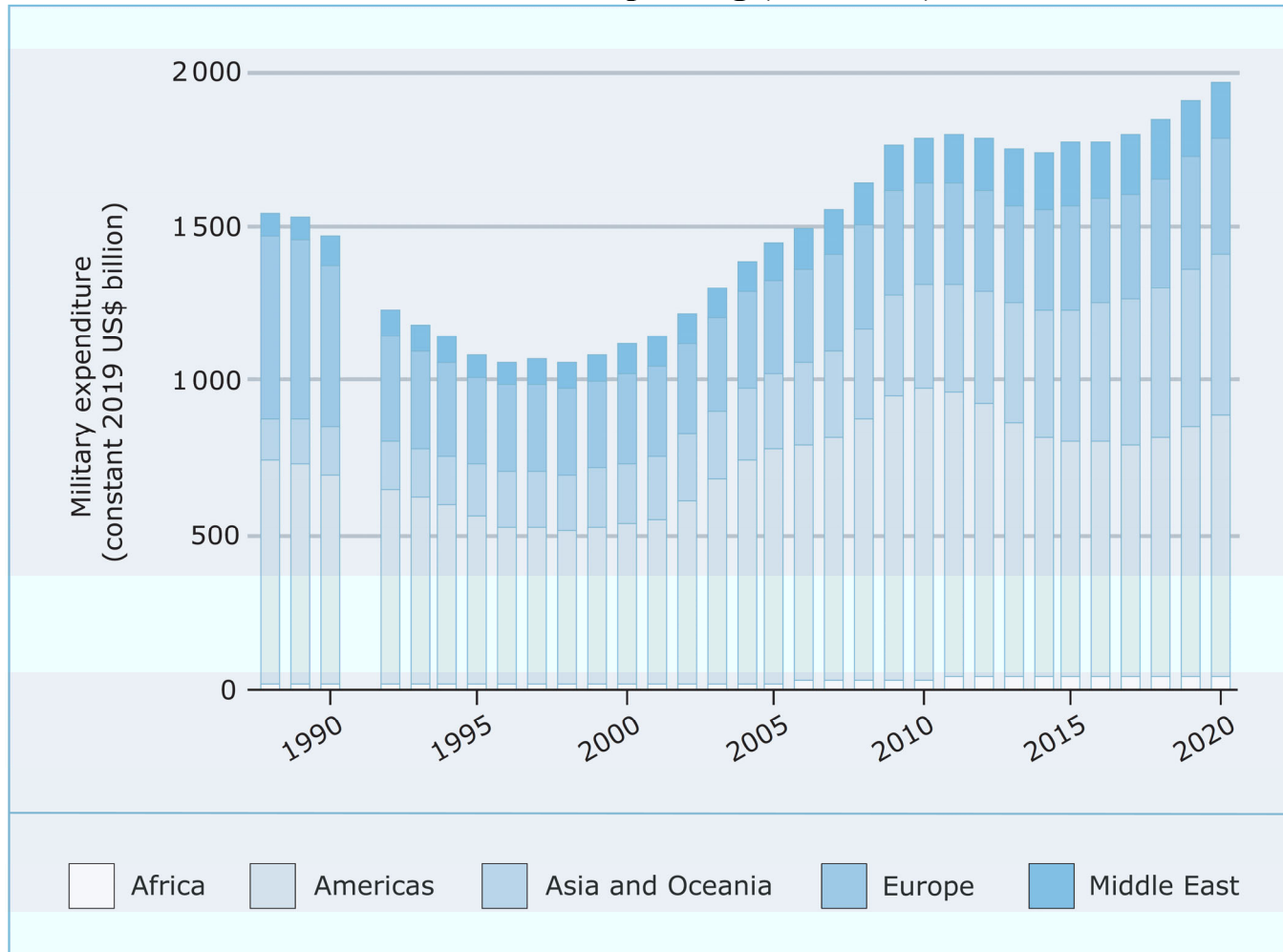
Notes: The 10 countries with the highest military spending as a share of gross domestic product are listed.

The boundaries used in this map do not imply any endorsement or acceptance by SIPRI.

Source: SIPRI Military Expenditure Database, Apr. 2021.

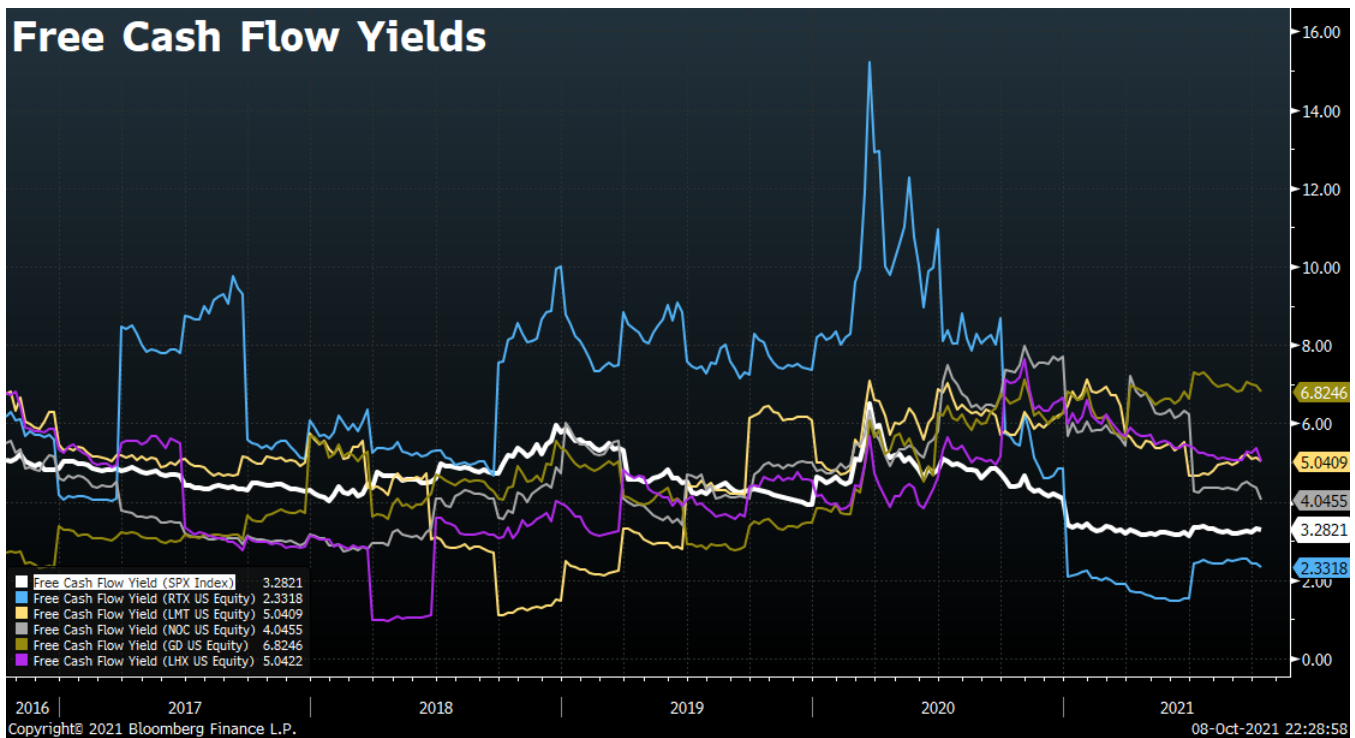
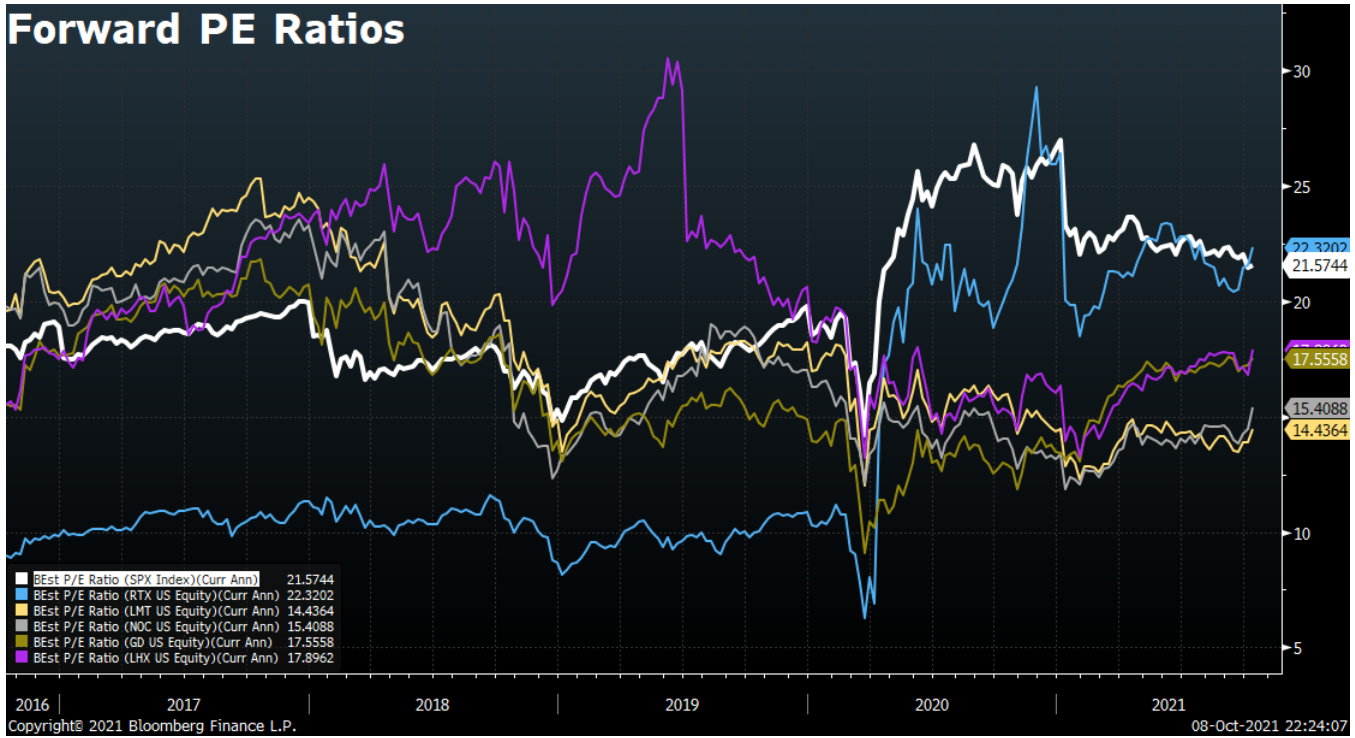
Like it or not, global defense spending has risen almost every year since 2000 (see below chart).<sup>11</sup> In a world where the potential for conflict is on the rise and most developed nations are spending less than 3% of their GDP on defense, military spending is likely to maintain its growth trajectory.

### Annual Defense Spending (1988-2020)



Without recommending any specific securities in this letter, it's noteworthy that the top-5 U.S. defense firms by market cap – Raytheon (RTX), Lockheed Martin (LMT), Northrop Grumman (NOC), General Dynamics (GD) and L3Harris Technologies (LHX) – all trade at or below valuation multiples for the broader S&P 500 despite being perhaps on the cusp of structural growth.

As seen in the charts below, most of these defense firms have lower price to earnings ratios than the S&P 500 and higher free cash flow yields. The discount to the average valuation for the S&P 500 Industrials Index is even greater (26.3x PE and 2.9% FCF yield). Given the consistency of these defense businesses, their importance to the U.S. and its allies' national security and their potential growth, their discount to the broader market seems unwarranted.





As we have written several times in the last year, the upcoming decade's market leaders are unlikely to be repeats of the last. One of the main ways to achieve long-term gains is identifying a promising theme or set of businesses trading at attractive valuations before it becomes a consensus long. The defense industry may fit this profile. Further, the theme fits nicely into the idea we discussed last month that things we truly need are undervalued relative to those we simply just want.

Returning to E.O. Wilson, he noted in *The Social Conquest of Earth* that humanity's problem is that "We have created a Star Wars civilization, with Stone Age emotions, medieval institutions, and godlike technology."<sup>12</sup> This is a recipe for disorder and potential disaster. We have been fortunate in recent history to mostly avoid the worst consequences of our natural inclination toward conflict. Our imperfect, "medieval" governing institutions have kept global order largely in check. But our complicated world is becoming more complex, with American geopolitical dominance arguably waning. While we all should hope for a more peaceful future, history would suggest that we are in for more turbulent times ahead. It may be prudent to position some portion of investment portfolios accordingly.

On that cheery note... we hope you and your families are still doing well. As always, please feel free to reach out to discuss any of the ideas covered in this letter or your portfolio strategy.

Sincerely,



Peter Karmin  
Managing Member



Stuart Loren  
Director

## Citations and Disclosures

<sup>1</sup> See: <https://eowilsonfoundation.org/e-o-wilson/>, [https://en.wikipedia.org/wiki/E.\\_O.\\_Wilson](https://en.wikipedia.org/wiki/E._O._Wilson) and <https://en.wikipedia.org/wiki/Sociobiology>.

<sup>2</sup> Thomas Hobbes, *Leviathan* (1651), see: <https://www.gutenberg.org/files/3207/3207-h/3207-h.htm>

<sup>3</sup> Steven Pinker, *The Better Angels of Our Nature* (2011), see: <https://www.amazon.com/Better-Angels-Our-Nature-Violence-ebook/dp/B0052REUW0>.

<sup>4</sup> Francis Fukuyama, *The End of History and the Last Man* (1992), see: <https://www.amazon.com/End-History-Last-Man/dp/0743284550>.

<sup>5</sup> See: [https://en.wikipedia.org/wiki/Pax\\_Romana](https://en.wikipedia.org/wiki/Pax_Romana) and [https://en.wikipedia.org/wiki/Pax\\_Britannica](https://en.wikipedia.org/wiki/Pax_Britannica)

<sup>6</sup> Bloomberg (as of Oct. 8, 2021). All data cited herein is from Bloomberg as of the date of this letter unless otherwise noted.

<sup>7</sup> Samuel Huntington, *The Clash of Civilizations* (1996), see <https://www.amazon.com/Clash-Civilizations-Remaking-World-Order/dp/1451628978>.

<sup>8</sup> Financial Times, *Gas markets whipsaw after Russia offers to stabilise energy prices* (Oct. 6, 2021), see: <https://www.ft.com/content/e06c3b5d-153d-4c86-8c49-0d5447d58e76>.

<sup>9</sup> The Economist, *China is ratcheting up military pressure on Taiwan* (Oct. 9, 2021), see: <https://www.economist.com/china/2021/10/09/china-is-ratcheting-up-military-pressure-on-taiwan>.

<sup>10</sup> Stockholm International Peace Resource Institute, *Trends in World Military Expenditure, 2020* (April 2021), see: <https://www.sipri.org/publications/2021/sipri-fact-sheets/trends-world-military-expenditure-2020>.

<sup>11</sup> Stockholm International Peace Resource Institute, *Trends in World Military Expenditure, 2020* (April 2021), see: <https://www.sipri.org/publications/2021/sipri-fact-sheets/trends-world-military-expenditure-2020>.

<sup>12</sup> Edward O. Wilson, *The Social Conquest of Earth* (2012), see: <https://www.amazon.com/Social-Conquest-Earth-Edward-Wilson/dp/0871403633>.

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