The Quarterly Report

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Where Do We Go From Here?

INSIDE STORY

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Where Do We Go From Here?

“Yet each of us defines the long run with a different time span in mind, which means that yours will be appropriate for me only by coincidence. No matter how we figure it, the long run means more than shutting your eyes and hoping that some great tidal force will bring your ships home safe, sound, and laden with just the right merchandise for the occasion.” ~ Peter L. Bernstein

The investment world lost one if its shining stars this quarter with the passing of Peter Bernstein in June at the age of 90. The author of numerous books on economics and investing, most notably *Against the Gods: The Remarkable Story of Risk*, and founder of *The Journal of Portfolio Management*, Bernstein certainly belongs in the investing hall of fame. He spoke often about the misunderstood concept of long-term investing. He wrote: “The long run smooths the data by averaging out the wild volatility we experience in the short run. Therein lies its fascination. But therein also lies a mass of wishful thinking and oversimplification.”

Wall Street is broken – I believe we have made that point clear in our last two newsletters – but, what now? How do we get back to where we were and then on from there?

The first step is to understand the wisdom of Michael Price, legendary investor and founder of the Mutual Shares family of mutual funds, who said, “Wall Street is in the business of generating fees for Wall Street. Period. It is not in the business of getting good investment results. You have to separate from Wall Street to do that.” Wall Street also has dominated the communication to and education of the average investor over the last twenty years or more. That education is primarily marketing and while not un-true, it is filled with a mass of wishful thinking and oversimplification. Let’s debunk some of those oversimplifications.

I have not actually lost money until I sell. This idea has become so ingrained in investor behavior that psychologists have created a name for it: the ‘break-even effect.’ People hate to admit a mistake, and holding onto losers until the value comes back makes one feel as if nothing was ever lost. We saw this in our clients last year and earlier this year as many questioned why we were reallocating their accounts, causing them to realize losses. We hear this from prospective clients, who wish they had been with us last year but don’t want to move until they have regained at least some of their losses.

This doesn’t impact just the lay person; many professionals fall into the same trap. In his book *Your Money and Your Brain*, Jason Zweig cites a study of mutual funds that got new managers. Researchers ranked the funds’ holdings from the best to worst return. On average, the new manager sold 100% of the worst-ranked securities, which implies the old manager was paralyzed by his own mistakes. The funds that cling most desperately to their losers underperform by up to five percentage points annually.

When Warren Buffett was a young man he spent a lot of time at the race track. On one particular day he lost money in the first race, so he decided to double down on the second race. He lost again. The trend continued all day until he had lost all of his money. The lesson he learned, which he says he still uses to this day, is that you don’t have to make it back the same way you lost it.

This does not mean you should simply sell out any time a price goes down – that would be another oversimplification. Sometimes a price drop is an opportunity, while other times it simply means what you own is not worth what you thought. The wise investor must be able to discern the difference.

One should simply “buy and hold.” This is the fallacy that Bernstein was debunking in the quotes cited earlier. Investing for the long term is, in our opinion, the correct way to invest. In the history of the market there is not one credible account of anyone who has been successful at rapidly trading in and out of positions for any prolonged period of time. That is not from a lack of data. Countless people fall for the allure of thinking they can beat the market by various timing

strategies, but this is a loser's game. It is wiser to invest for the long term. Warren Buffett once said, "Don't own a stock for ten minutes if you don't intend to own it for ten years." This is a principle that we adhere to at Iron Capital.

Nevertheless, just because you intend to own a stock for ten years when you first buy it does not mean you should bury it in the back yard and forget it. I will bet my home that Warren Buffett would sell a stock two days after he bought it if someone came along and offered far more than Buffett thought it was worth, or if some new information came out that forced him to question the original decision. There does come a time to sell.

Asset allocation determines returns is another favorite oversimplification. People who promote this idea often quote a study by Brinson, Hood and Beebower, published in 1986, which examined 91 pension plans and concluded that asset allocation decisions determine more than 90% of the variability of returns. Financial advisers love this study and oversimplify it to the point that they will tell clients that it really doesn't matter what funds you use… therefore those C-class shares that pay them handsomely are just as good as lower-cost, better-performing options.

Asset allocation, or more broadly portfolio construction, is indeed hugely important. The level of importance, however, is dependent on how you invest in the various assets. As David Sewensen, chief investment officer of Yale's endowment, states in *Pioneering Portfolio Management*, asset allocation is the most important factor in the performance of large institutional portfolios largely because they have chosen to make it so. Most institutions use several managers per asset class and they prefer managers who don't stray too far from their index. Those constraints greatly limit any value an active manager could add, therefore any value added must come from asset allocation. The smaller and therefore more concentrated your portfolio, the more important security selection becomes.

With all the talk in the investment world about portfolio construction, it is shocking to me how few practitioners actually understand how to build a portfolio. This is without a doubt the number-one flaw we see in portfolios we inherit from other advisers. I can only recall one prospective client who has ever come to us with a portfolio that had a coherent strategy evident in its construction. Although the strategy was different than ours at the time, I told the prospective client that he had an adviser who obviously knew what he was doing and that he should stay with him.

Usually what we see is a hodge podge of funds, stocks and ETFs, with no coherent theme whatsoever. It is what a former

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REVIEW *of* ECONOMY

THE ECONOMY CONTINUES TO SHRINK. GDP decreased in the first quarter by 5.5% and while second quarter is believed to be better the forecast is still negative. We are anticipating a 1.6% decline in GDP growth for the quarter. Yet there are signs of growth ahead. We believe we will see positive economic activity in the second half of 2009.

Unemployment, however, continues to get worse. The June unemployment rate was 9.5% and it is still climbing. While the economy as a whole is improving there is no sign of the employment situation getting better any time soon. Coupled with this we still are in a deflationary environment. The Consumer Price Index (CPI) indicates that prices have declined 1.3% year over year through May. Much of that is due to energy and core CPI, which excludes food and energy, was up 1.8%.

The stimulus has not stimulated any jobs thus far. In fairness, relatively little of the stimulus has actually been spent. This is one of several reasons that fiscal stimulus of this sort has never worked in the past. There is talk of more stimulus but we think that would be a big mistake. What we need are policies that will lead to lasting economic growth. Unfortunately that is the opposite of what we are currently getting from policy makers. +

REVIEW *of* MARKET

THE MARKET TOOK OFF LIKE A ROCKET THIS QUARTER. The S&P 500 was up 15.93%. There is a lot of talk about whether this rally is the real deal or not. The pundits seem to be fixated on the March lows of the market and how much the market has bounced. I believe there are two factors at play here. The first is a psychological phenomenon known as 'reference points' – people are fixated on the March lows as if they were the "correct" value of the market. They worry about a market being up over 30% from those lows. However, the reality is those market values are no more or less "correct" than the market value on any other random day. The second factor is the extreme short-termism of Wall Street. Yes, we are up dramatically from the low. But, we are down 26.21%, as measured by the S&P 500, over the last twelve months. When you put it in those terms it does not sound like such a roaring bull market now does it?

High yield has been the best place to be domestically. Year to date the Merrill Lynch High Yield Master index is up 28.99%. However, it has been emerging markets that have really shined. The MSCI Emerging Market index is up 36.22%. +

MARKET *forecast*

WITH THE S&P 500 UP 3.16% YEAR TO DATE, we are still pretty comfortable with our 9% forecast. It will, though, continue to be volatile. Volatility is at its lowest point since last September, but it is still high from an historic basis.

We are sticking with the U.S. as the best place to be. International has done well lately, but over the last twelve months it has been pretty even. We have shifted to an overweight to Growth over Value and that has helped returns. We are now overweight Small Caps as we expect them to lead the rally.

International stocks remain a mixed bag. Europe looks awful and getting worse. The current strong returns only make us more concerned about the future. The emerging markets are attractive. We may see some retraction from the strong run year-to-date, but we think the longer term looks good.

We still believe the opportunities in bonds are in the corporate and high-yield bond market. Bonds as a whole are no longer more attractive than stocks. Treasuries, usually the safe haven, continue to look dangerous. The record spending spree raises the fear of inflation which does not bode well for bonds. However, we do not think it is time to pile into inflation hedges yet. We do think inflation is coming, but we think it will take longer than most expect for it to get here. +

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This is a time for active management. It is a time when it is critical to understand what we own, and what is happening to those businesses.

colleague of mine used to call 'the front page Wall Street Journal approach,' because it looks like the investor got up every morning and put money in whatever happened to be on the front page of the paper that day.

So how do you construct a portfolio? The basic premise is simple. At any given time you want to have the most money in the area of the market that has the highest probability of performing well going forward. You must, however, balance that with the risk that you could be wrong, so diversify with investments that all have promise but are unrelated to one another.

So what does that mean for today? We must understand the world we are in, and realize that this is most probably not the world that we wish it to be. Focus on quality, as this economy is a long way from recovery and many weak companies are yet to fail. Realize that government intervention is here to stay for the foreseeable future. Vote how you will, but do not fight Washington with your portfolio – you cannot win that battle. Also understand that Washington's backing may guarantee survival, but it does not guarantee success. Be wary of unproven industries propped up by their political popularity, since such popularity can change quickly. Realize that the world does not revolve around the U.S. and that while the last century was certainly ours, the odds are that this one will not be.

This is a time for active management. It is a time when it is critical to understand what we own, and what is happening to those businesses. We must be able to recognize the difference between short-term market volatility and actual deterioration of a security's real value.

We are entering a period where the broad market may go nowhere as the broader economy goes nowhere, yet there will be clear winners and losers. We are entering a period where portfolio construction will really matter, and those who understand that should do well, but those who simply close their eyes and hope that some great tidal force will bring their ship home safe, sound, and laden with just the right merchandise for the occasion will most likely be very disappointed.

CHUCK OSBORNE, CFA, *Managing Director*