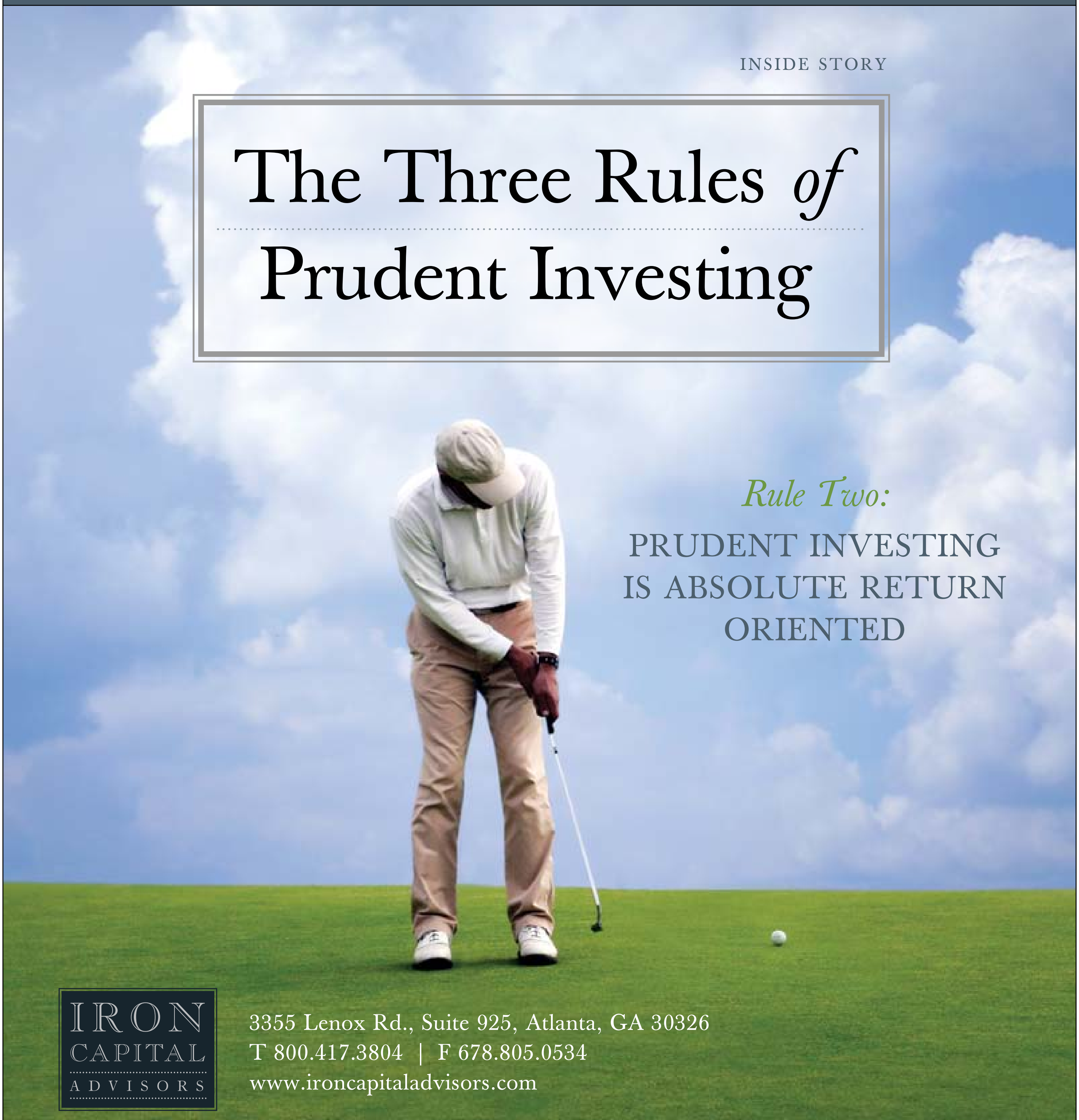
The Quarterly Report

A QUARTERLY PUBLICATION OF IRON CAPITAL ADVISORS | Summer Issue | July 2013



INSIDE STORY

The Three Rules *of* Prudent Investing

Rule Two:

PRUDENT INVESTING IS ABSOLUTE RETURN ORIENTED

IRON CAPITAL ADVISORS

3355 Lenox Rd., Suite 925, Atlanta, GA 30326
T 800.417.3804 | F 678.805.0534
www.ironcapitaladvisors.com

RULE TWO: PRUDENT INVESTING IS ABSOLUTE RETURN ORIENTED.

I LOVE GOLF. Growing up I loved just about any game. I have fond memories of playing gin rummy with my father when I was as young as eight years old. We had a ping pong table and the family tournaments could get intense. I was never a star, but I played "all the sports," according to my mother, and for her generation that means football, basketball and baseball. I played tennis and golf in addition to "all the sports." What I lacked in actual athletic ability I usually made up for with heart and competitive fire. I loved being part of a team and I loved competing. A young person learns a lot of life lessons on the athletic field. Sports are great.

I remember my uncle taking me aside when I was still in junior high and telling me that I should spend more effort on golf. His reasoning was that golf, unlike the other sports I participated in, could be played for the rest of my life. At the time I didn't listen; after all, high school football players were a lot cooler than high school golfers. Now, well into the "rest of my life," few days go by when I don't regret ignoring that advice. All sports teach life lessons, but there is something special about golf. One of the unique things is that golfers don't actually play against each other, at least successful golfers don't. Their real opponent is the course and, as Bobby Jones famously stated, old man par.

> *"No-one will ever have golf under his thumb. No round ever will be so good it could not have been better. Perhaps this is why golf is the greatest of games. You are not playing a human adversary; you are playing a game. You are playing old man par."*
>
> ~BOBBY JONES

The same is true about investing, which brings us the second of the three rules of prudent investing: Prudent investing is absolute return oriented, not relative return oriented. We live in a relative return world; it is all about beating your market benchmark and/or beating your peers. Prudent investors, however, are interested in returns only insofar as they relate to the achievement of their own investment goals. In other words, beating old man par.

Prudent investors are investing for some higher purpose. They invest to fund retirement, or college for their children. They invest to endow a worthy charity or to provide a legacy for their children and their children's children. They do not hold assets for the sake of having assets; there is a purpose, even if that purpose is shallow and dare we say greedy. Warren Buffett is known as the greatest investor of our time, at least in part because that was his purpose. By most accounts Buffett wanted to be wealthy and famous, and his achievement of that status is no accident. There are actually a handful of other investors who have achieved long-term track records similar to Buffett's, but most of them remain completely unknown to the general public, largely because they wanted it that way.

Buffett is a great example of the focus on absolute returns. We have short memories in our society today, but almost twenty years ago the conventional wisdom was that Warren Buffett was washed up, a dinosaur out of touch with our modern world. We were in the midst of what we now know as the dot-com bubble, but at the time no one was calling it that. Buffett, who had done so well on a relative basis for most of his career, was underperforming the market and other money managers by dramatic amounts. He didn't care. He was still growing his nest egg year in and year out, and he knew what a bubble looks like. Today he is once again considered a genius.

Buffett had stated his goal early in his career before Berkshire when he was still managing what today we would call a hedge fund. His stated goal was a nine percent return. Similarly, all prudent investors should have a stated goal – after all, we have to know what old man par is. This gets investors focused on what's important: achieving your actual purpose. So if retirement income is one's goal, then we need to calculate what return must be achieved, based on the size of one's portfolio, saving rate, and time to and/or in retirement, in order to reach that goal. This is the financial planning process and it is the same process for the average worker saving for retirement as it is for the wealthy family or college endowment or large corporate pension plan. There may be more moving parts for some investors and less for others, but ultimately it boils down to a number. In order to achieve one's goal one must get a six percent return, or maybe it is eight, or only four. Whatever it is, that is your personal par. It is the return you need to get for all of your goals to be achieved, and that is the only return that matters. Not what the market does; not what your neighbor says he did (he's lying by the way – not just to you but to himself – but that is a whole other article); but your old man par.

If your number is six percent, then the prudent action would be to build a portfolio that maximizes the probability of achieving that return and minimizes risk. (In practice it is wise to give some room for error so one may actually aim slightly above what is actually needed). This means if you can get the desired return from Treasuries, then you should have most if not all your assets in Treasuries. If you can't, which is likely the case, then you should make prudent investments that will hit that mark with a reasonable amount of certainty over a reasonable holding period. This brings us to another big advantage of an absolute return focus: Investors who are thusly focused tend to be very patient. They care about achieving their return over their time frame and because, as we discussed last quarter, they have selected investments prudently from the bottom-up and know what they own, they have great confidence that everything will work out over time.

Relative result focused investors, on the other hand, are constantly comparing their results to the market, to other investment managers and to the inflated bragging of their neighbors. They are like the person stuck in traffic constantly changing lanes just to see the lane they had been in start to move. We all know that this is not the right thing to do, but it is a very hard habit to break. The financial world reinforces this view in almost every way. Wall Street firms are in the business of making transactions, and in order to get investors to transact, one must convince them that they could do better elsewhere. So Wall Street has created an atmosphere of what I call competitive investing: They have convinced people that the right thing to do is to constantly compare your return to what else is out there, and why not - after all, there will always be something that did better; which means investors must constantly transact; and that is how Wall Street makes money.

It isn't just Wall Street though. CNBC and similar channels always celebrate whoever is doing well at the time, which is always fleeting – even for the best in the business. So-called consumer experts often tout indexing, and indexing may very well be the ultimate form of relative investing. If you are constantly comparing yourself to the market and other investors, ultimately you are just going to look like the market. The problem is that this focus on return and ultimately short-term return is that it ignores risk. It ignores prudence. Markets outperform

» *Continues on next page...*

REVIEW *of* ECONOMY

The economy stinks and according to the polls we are all really happy about it. First quarter 2013 GDP has been revised down from the original 2.5% reading to 1.8%, and second quarter GDP is now expected to come in at less than 1%. But, there is a bright spot and that is housing. Housing prices are finally heading upward and this has the consumer saying that they feel better – thus far they have yet to come through with actual spending but hopefully that will follow now that everyone is so happy.

The official unemployment rate has stayed at 7.6%. There are some positive signs on the employment front as jobs are being created but the pace of growth remains too slow to make meaningful progress and unfortunately labor force participation remains the lowest it has been since 1979.

The Federal Reserve Bank (Fed) disturbed markets at the end of the quarter with news that if (big if) the economy gets better they will eventually stop their quantitative easing project. Interest rates on mortgages shot up approximately one full percent. It will be interesting to see the impact on housing in the third quarter. Is the rebound real or just Fed induced? We may find out soon. +

REVIEW *of* MARKET

Some have said that this is the most hated bull market ever, and for good reason. The S&P 500 finished the quarter up 2.91% and is up 13.82% year to date. However, if one breaks it down and looks underneath, the 50 companies with the weakest analyst reports have seen their stocks go up 22.7%. Junk led in the second quarter and as the old adage goes, "When they start running the dogs, it's time to start looking over your shoulder."

Bonds were down in the quarter, with the Barclays U.S. Aggregate index down 2.32%. Much of this loss came in the last week of the quarter as the Fed spooked investors and caused a run on treasuries.

International markets have been a completely different story. The MSCI EAFE was down 0.73% and the MSCI Emerging Markets index was down 7.95%, as the global economy continues to slow. +

MARKET *forecast*

We remain cautiously optimistic about the equity markets, but the market is a little ahead of itself and while we have had a couple of false starts, we have yet to have a real correction.

U.S. large-cap stocks are the best place to be for the long haul, as they should survive the slow growth new normal. Emerging markets also look attractive on a valuation basis but the momentum remains negative.

Bonds remain our biggest concern over the long term. Just a few ill-chosen words from Ben Bernanke sent rates skyward. Stocks may actually be safer. +

» *Continued –*

prudent investors usually during times of bubble creation, and bubbles eventually pop. Warren Buffett once again looks like a genius, and those who wrote him off are forgotten.

Ultimately the relative return culture is about coveting what we perceive others to have. Wall Street is in the business of selling things, and coveting is a powerful force in making people purchase whatever it is one is selling. However, there is a reason coveting made it on God's top-ten list, right up there with murder and adultery. Coveting will ruin one's life. Nowhere is that more obvious than in investing. Studies show that investors buy high and sell low. To be more accurate investors tend to buy high, then ride the investment all the way down until they finally capitulate, and this isn't just unsophisticated retail investors.

When one is constantly worried about being compared, one does imprudent things. Earlier this year we received a paper written by one of the largest and most respected fixed income managers in the industry. The paper was on what to do when interest rates begin to go higher, and they listed different options and their potential risks. There was one strategy that they deemed to be the most effective should rates rise, but the risk of that strategy was tracking error. They went on and on about not looking like everyone else and the problem that would cause should it take longer than expected for rates to begin to rise. Today investors in these funds have done worse than need be because the managers were more worried about being different than about getting the best absolute return.

For much of my career I was part of this problem. I was trained in the institutional mindset of beating the benchmark and peer group. Early in 2009 I had lunch with my former boss from Invesco. He was retired and enjoying it, and I looked forward to updating him on our success. I knew he would ask how we did during the downturn and I couldn't wait to tell him: our core equity strategy had outperformed its benchmark, the S&P 500, by ten percent. No one does that in the relative performance world. If one compared our strategy to the entire Morningstar domestic equity universe regardless of specific style, we were in the top ten percent; better then ninety percent of our peers. I told him all of this and he just looked at me and said, "So you were down thirty percent or so? That isn't very good is it?" No, it wasn't.

That day and over the days that followed my eyes began to open and I began to realize that our industry has it all wrong. We need to be focused on achieving clients' goals and not beating one another. Or perhaps this realization just comes once one has enough experience. Arnold Palmer has said he didn't get good at golf until he finally realized that you play the course not the man. There is a great story about Jack Nicklaus in the first round of the 1967 U.S. Open. He was partnered with a rookie and they were both right around even par on their first nine holes. As they made the turn they looked at the leader board and the leader was in the clubhouse at five under par. The rookie turned to Nicklaus and said we better get going the leaders are already five strokes ahead. Nicklaus responded by saying this is the U.S. Open and four under will win, we are doing just fine. He finished that day at one over par, six strokes behind the leader. Three days later Jack Nicklaus won the U.S. Open with a total score of five under par; four under would have been good enough indeed.

It is easy to be absolute return focused when you are steady and the market is going down, but when the leaders seem like they are so far ahead it becomes difficult to just stay the course. That is human nature. That is when one must channel their inner Jack Nicklaus and remember that this is equity investing, and ten percent is what the market does over the long-term. Eventually everyone comes back to old man par. Prudent investors choose to get there taking the least amount of risk, and that is next quarter's lesson.

Chuck Osborne

CHUCK OSBORNE, CFA, *Managing Director*