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INSIDE STORY

The Three Rules of Prudent Investing

Rule One:

**PRUDENT INVESTING
IS DONE FROM THE
BOTTOM UP.**



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The Three Rules *of* Prudent Investing

RULE ONE: PRUDENT INVESTING IS DONE FROM THE BOTTOM UP.

My brother-in-law loves to ski. He and my sister had a winter wedding and honeymooned at a ski resort. Both were inexperienced skiers at the time but they thought it would be good fun to learn together. My brother-in-law took to skiing like a duck to water; my sister, not so much. My sister loves to tease about their “romantic honeymoon” with her groom skiing by every once in a while to see how she was doing on the bunny slopes. In my brother-in-law’s defense they have been happily married for 27 years so it couldn’t have been that bad. Their kids fell in love with skiing too, and later snowboarding as they grew up. Year after year they went on family ski trips where everyone had fun except for my sister, who just couldn’t get it. She tried, and would take lessons, but somehow it just didn’t click. Then about five years ago my whole family went on a ski trip together and my wife convinced my sister to take one more ski lesson together with her.

That evening when we all circled back together my sister was overjoyed. This instructor, for whatever reason, was able to communicate the art of skiing to my sister in a way that finally clicked (to this day neither my sister nor my wife has revealed his “secret”). She got it, and she finally had a great time skiing. I can only guess what the secret is – seriously, they won’t tell – but I suspect he didn’t say anything that the dozen or so other instructors hadn’t said. He just had a way of saying it that resonated with my sister at that moment.

It is funny how those things happen in life: Someone says something in a different way and it unlocks your understanding of a subject with which you had struggled. Or, sometimes you may be the teacher and you hear or read someone else’s description and you say, “Yes! That is exactly what I have been trying to say.” I had one of those moments earlier this year.

A friend loaned me the book, “Margin of Safety,” by Seth Klarman. Klarman is as famous as most investors ever get – with Warren Buffett being the glaring exception. He has an extraordinary track record of success with his firm, The

Baupost Group, and he wrote this book about his investment philosophy in 1991. The book is famous not only because of Klarman’s reputation but also because he has refused to approve any more printing runs after the first, so it is hard to get and can sell for as much as \$2,500. (Yes, I returned it.)

Klarman, like Buffett and many other very successful investors, is hugely influenced by Benjamin Graham and David Dodd; in fact the name of the book is directly borrowed from Graham, who coined the phrase “margin of safety.” As I suspected there was nothing in Klarman’s book that was actually new to me. However, just like my sister’s ski instructor, Klarman had a slightly different way of saying the same thing, and in one of his chapters in particular I heard something I have always known in a way I had never heard it.

Chapter seven: “At the Root of a Value-Investment Philosophy.” In an attempt to clear up some investment speak I am going to refer to it simply as prudent investing. There is a bit of editorial in that description but beyond that I think it is important to distinguish the difference between a value philosophy and “value style” which is often discussed. I have written about this in past newsletters, but for our purpose here let’s just say Klarman is describing what he and I would both agree is the prudent way to invest, which could accommodate various “styles.”

This bottom-up philosophy is almost universal among successful investors.

Klarman defined three central elements to this philosophy. First, prudent investing is a bottom-up strategy entailing the identification of specific investment opportunities. Second, prudent investing is absolute return, not relative return oriented. Finally, prudent investing is a risk-adverse approach where,

as Klarman says, “attention is paid as much to what can go wrong (risk) as to what can go right (return).” Over the next three quarters I am going to discuss Klarman’s three rules, starting here with prudent investing always being done from the bottom-up.

The easiest way to understand what it means to invest from the bottom up may be to first understand the opposite approach, investing from the top down. Top-down investors start with economic analysis. They project what the big picture is going to look like; how the environment will affect specific industries; and then how an industry’s environment will impact the company in which one might invest. Today many of these types of investors don’t even invest in companies; instead they choose exchange-traded funds (ETFs), which represent industries or sectors of the economy. These investors must be correct about their economic forecast, which is nearly impossible; then they must correctly assess how that forecasted environment will actually impact any particular sector of the economy. Then they have to pick which specific industries will be the real winners, and if they still own stocks they have to pick which companies within the industry are best positioned. Not only do they have to do all of that without having any errors along the way, but they must do it faster than anyone else, otherwise the whole opportunity will be lost. Sound impossible?

Well there is a better and much easier way. The investor can look for quality companies one at a time, from the bottom up. We have often referred to this strategy as being owners of companies instead of traders of stocks. The common sense of this approach is pretty clear: It is much easier to understand a single company, its track record of results, the products it sells or services it provides, the strength of its balance sheet etc, then it is to know how much the entire global economy will grow. Once a company is understood it may be difficult to pin down an exact value for that company, but certainly one could come up with a range of what that company is actually worth. Then all one has to do is have the patience and discipline to buy the stock of that company when the stock is selling for less than the actual value of the company, and the further patience to wait for the market to realize that value. As Klarman puts it, “The entire strategy can be concisely described as buy a bargain and wait.”

This bottom-up philosophy is almost universal among successful investors. In fact, John Maynard Keynes, the famous and still controversial economist, was a fantastic investor and he paid no attention to his own economic forecast when managing the endowment of King’s College, Cambridge. Peter Lynch, the famous manager of the Fidelity Magellan Fund, is quoted as saying that “if one spends thirteen minutes reading a market forecast than he has wasted ten minutes.” True investing success is about making prudent investments from the bottom up.

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Back to the new normal. The last half of 2012 averaged out to approximately 1.5% GDP growth and having survived the fiscal cliff there seems to be some acceptance of the new normal. The feeling of the first quarter seems to be the mass acceptance that anemic growth and manufactured political crisis is just the way of things and it is time to finally get over it and press on. It doesn’t matter if it is the fiscal cliff, sequester or Cyprus; the crisis du jour just doesn’t have the same fright factor anymore.

The official unemployment rate has come down to 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 is the lowest it has been since 1979.

The Federal Reserve Bank (Fed) has thus far kept its promise to continue their quantitative easing program until unemployment gets back to 6.5%. This brings us to a situation where every major central bank in the world is now undertaking unlimited quantitative easing. The long term effects of this are un-known. It seems doubtful to us that it will really help the economy but it should continue to boost equity prices. +

REVIEW of
ECONOMY

Record breaking performance marked the first quarter. The Dow and S&P 500 both went into record territory with the S&P ending the quarter up 10.61%. Much of this rally seemed to be based on the idea that economic growth is much better than it is, so don’t be surprised if there is a pull back. Still, stocks remain attractive in the long haul.

Bonds were down in the quarter, with the Barclays U.S. Aggregate index down 0.12%. With interest rates near record lows, bonds are likely to be under negative pressure.

International markets were also positive for the quarter. The MSCI EAFE was up 5.23%. However, economic conditions are concerning in Europe so while the worst fears of last year seem to be behind us we still like U.S. stocks more. +

REVIEW of
MARKET

MARKET *forecast*

We remain cautiously optimistic about the equity markets. Our 8.5% prediction for the S&P now seems overly conservative. The market is a little ahead of itself but after a short pull back we think the bull run will continue.

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 even with the rough first quarter.

Bonds remain our biggest concern over the long term, although it is hard to imagine a real collapse as long as the Fed is buying roughly 80% of all treasuries. The long term returns seem likely to be below inflation rates. +

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Doing so, however, is far more difficult than one might imagine. All of Wall Street is geared towards a top-down approach, and for good reason: top-down economic forecasts change almost constantly, meaning those who use these forecasts as reasons to invest must trade constantly. Wall Street is in a transaction-oriented business; constant trading pays their bills, so they are more than happy to provide everyone with top-down oriented research. Bottom-up investing, on

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the other hand, involves patience. The market could recognize value shortly after one makes an investment (remember being a long-term investor is a mindset, not a timeframe), but usually one must wait for the value of a company to be recognized. While the prudent investor is waiting, Wall Street is not making a dime.

Bottom-up investors have little use for CNBC or any of the other 24 hours-a-day investing channels; what they say is of little value unless they happen to be talking about the specific company you have invested in, and the odds of that are fairly slim. Moreover, the fundamentals of a company really do not change very quickly, and things that do not change quickly make for bad television. Economic data, on the other hand, can bring excitement, and the more they can convince you that every piece of data is vital, the longer you will watch and boost their ratings. Yet most of what comes from these sources is really noise, not news.

This is not to say that economic data has no value; even Peter Lynch thinks that forecasts are worth three minutes of your time. Knowing what is happening in the economy gives one a better frame of reference when judging how well an individual company is performing. For example, Apple has grown at a rate of nearly sixty percent a year over the last five years; knowing that the last five years have been marked by anemic overall economic growth makes that accomplishment stand out all the more. Many technology companies saw that kind of growth in the roaring 1990s, but for a company to do that during the Great Recession is far more impressive.

At Iron Capital, we take it a step further. Our top-down forecast is actually built from the bottom up. While we track the macro economic data, what we pay the closest attention to is the fundamental valuation of various assets and the current dynamics being reported by individual companies within the various sectors. Are the mutual fund managers we like finding opportunities in their space or are we finding bottom-up opportunities? We have found this ground level data, so to speak, to be far more valuable in making asset allocation decisions than any economic or market forecast. We try to be prudent in everything we do, and the first rule of prudent investing is that it is built from the bottom up.



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