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INSIDE STORY

MISSION: IMPROBABLE

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MISSION: IMPROB

You have heard me say it before, but I really do believe that I could write a complete investment textbook solely on the basis of quotes from the 2003 Disney classic, "Pirates of the Caribbean: The Curse of the Black Pearl." (If you have not yet seen the movie, it really is worth the watch. This article will be impactful all the same, please read on.) We have already written about market uncertainty, "Reason's got nothing to do with it," Mr. Gibbs. We could discuss risk management, "There's just one question, how far are you willing to go?" Captain Jack Sparrow. We could talk about contrarian strategies, "This is either brilliance or madness," Will Turner. We could discuss the deadly sin of over confidence, "There is only one rule – what a man can do and what a man can't do," Captain Jack Sparrow. But, without doubt, there is one quote that is the number one core lesson of all investing.

The scene takes place as Captain Jack Sparrow enters the secret cave on the Isla de Muerta for the second time. Captain Barbossa sees him and, after just stranding him on a deserted island for the second time, exclaims, "Impossible!" To which Sparrow simply waives his finger like Barbossa's eighth grade grammar teacher and corrects him with one word, "Improbable." I will admit that my own wife does not understand why this is my favorite scene from the movie, but investment geeks, like all different variation of geeks, have a humor that is ours alone, and ours primarily deals with the general public's misunderstanding of probabilities. Barbossa thought Sparrow's escape was impossible, but any wise investor would have told him that it was simply improbable.

The understanding of probabilities is taught in statistics. If one wants to have a future in the money management industry, he or she had better like statistics. Statistics is to our world what English is to the practice of law, what physics is to architecture, or what biology is to the practice of medicine. Investment professionals must make decisions today about a tomorrow which is, by definition, unknowable. We don't have crystal balls; we simply have the knowledge of today, what is happening, our current trajectory,

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and a long list of probable futures. Our job is to understand those probabilities and position our clients' portfolios in order to manage risk and put the odds in their favor.

This may sound complicated and the work involved is much more intense than most think, but at its essence it is really simple. The best analogy of what investment professionals do is found in the world of sports. Football coaches have to make decisions without the benefit of knowing the outcome. A few years ago my Wake Forest Demon Deacons had the local Georgia Tech Yellow Jackets on the ropes. Tech came back and tied the game to send it to overtime. Wake went first and had to settle for a field goal; Tech was then stopped and their new coach Paul Johnson decided to go for it on fourth down. They made it, scored a touch down and won the game.

Later I was talking to a Tech fan about the game. He was exuberant about their new coach and his bold decision-making. This is the classic response to judging decision making: the layperson waits until the outcome is known and then weighs in on the quality of the decision. The problem with that approach is that it does not separate luck from skill. After all, the best in every field will sometimes be wrong and even a broken clock is right twice a day. One of life's difficulties is that when making decisions about an unknowable future, good decisions can turn out poorly and bad ones can turn out well. I informed my friend that I thought Johnson had made a poor decision. Sure it worked out, but the odds were against him and if one consistently goes against the odds, one will lose more than one wins. Most of the Tech fans I know are now ready for Mr. Johnson to practice his poor decision making elsewhere.

Another football coach who is famous for going for it is LSU's Les Miles. He is known by the LSU faithful as the Mad Hatter because he says things that are crazy and he entirely disregards probabilities. In 2007 Miles led his LSU Tigers to the national championship largely by "going for it" seemingly all the time. He completely disregards the odds, and in many ways he is loved by the LSU faithful because of this trait. For some reason we love the

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risk-takers. However, that risk-taking just cost LSU a loss in the Chick-fil-A Bowl where all they had to do is run out the clock; instead of playing the odds, they came out throwing the ball, stopping the clock and having to punt to Clemson, who then drove for a winning score.

Contrast that model of decision making with the man Miles replaced at LSU, Nick Saban. Saban's teams are not exactly known for taking big risks. They play text book, hard-nosed football and they obsess over process. I'm sure Saban has probably "gone for it" at some point in his career but you wouldn't know it watching his current team, The University of Alabama. Miles has had success, but Saban just won his third National Championship in the last four years, fourth overall. Playing the odds is not endearing – people love to hate Saban – but it works.

This is also true in other endeavors. Take golf for example: crowds adore Phil Mickelson largely because he ignores the odds. We all applaud his boldness when he hits it on the 15th green at Augusta National off the pine straw and behind some trees, but when he fails to pull off a similar shot at Winged Foot causing him to lose the U.S. Open, we call him an idiot. (Actually, he called himself an idiot.) The truth is they were both questionable decisions. In an earlier era Arnold Palmer had a similar outlook and was similarly loved by the crowds. Similarly his go-for-broke, ignore-the-odds style cost him as many heartbreaks as it won him championships.

Contrast these two with their main rivals, Tiger Woods and Jack Nicklaus. They plod around the course, always playing the high percentage shot. They are almost robotic, and while they endeared huge amounts of respect for their talent they have never felt the love like Phil and Arnold. They have, however, won more majors than anyone else and gone down in history as the two greatest of all time. This does not mean that they never lost; they have both felt the pain of defeat, but by keeping the odds in their favor they have won more often than anyone else.

Of course no discussion of probabilities would be complete without discussing gambling. One hears it all the time: investing is really just gambling, Wall Street is just Las Vegas East. There are in fact huge differences between investing and gambling, but they do have one thing in common: probabilities. Like most investors I know, I am not much of a gambler, but I knew a portfolio manager from Boston who liked to play Blackjack. He was what we call a quant, meaning his methodology for investing was based largely on mathematical formulas (mostly statistics). He told me that without counting cards, which Vegas deems as cheating, if one plays Blackjack "perfectly," that player has a 49 percent chance of winning. Those are the best odds one can get at a Casino unless he heads to the poker tables where he plays against other guests instead of the house. His point was that the casino always has the odds in its favor.

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REVIEW *of* ECONOMY

Where did all this growth come from?
The third quarter GDP came in at 3.1% after only 1.3% growth the quarter before. Some of it is probably due to the fiscal cliff causing expenditures to be accelerated but this number is too high to be only that. The fourth quarter was most likely slower, our estimate is for 2% growth, but the fear of a new recession has certainly been eased.

The official unemployment rate has stayed the same at 7.8%. 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.

The Federal Reserve Bank (Fed) has now promised 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 unknown. It seems doubtful to us that it will really help the economy but it should continue to boost equity prices. +

REVIEW *of* MARKET

After shocking us with positive returns for the first three quarters the S&P 500 took a break and finished down 0.38% in the fourth quarter. The market was still up 16% for the year, which is amazing considering the threats that existed.

Bonds were up but barely in the quarter, with the Barclays U.S. Aggregate index up 0.21%. They finished the year up 4.21%. The Fed intervention in the market likely kept rates down and that return positive. Long-term bonds are worrisome.

International markets were the best place to be for the quarter. The MSCI EAFE was up 6.60%. The bounce continued from the relief that a complete collapse of the Euro is less likely due to central bank actions. Economic conditions are concerning in Europe but the worst fears of last year seem to be behind us. +

MARKET *forecast*

We are cautiously becoming more optimistic about the equity markets. We are still in a slow growth economic environment, but the worst case scenario in Europe seems off the table for now and with the tax side of the fiscal cliff taken care of the world seems a little less scary in 2013. We think the S&P 500 will end the year up 8.5%.

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 as China seems to be improving which bodes well for that whole group.

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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This does not ensure always winning – players do win, which of course is what brings them back. However, those big hotels and all those bright lights were not paid for by people winning. The casinos know that as long as the odds stay in their favor they may not win every time, but they will win over time.

For ten years now, Iron Capital has selected winning managers with a more than 76 percent success rate.

As investors, we often get to choose: do we want to act like the players, betting on a hot tip based on price movement, or on a hundred other forms of speculation? Or do we want to act like the casino, always insisting that the odds be in our favor? At its essence this is the difference between speculating and investing. Investors get the odds in their favor by investing in companies that are either a) growing rapidly – the odds are that a fast-growing company will be worth more tomorrow than it is today; or b) in companies whose stock is selling for less than the company is actually worth – odds are that this disconnect will correct itself over time. This is where we get the growth and value schools of investing. Most legendary investors have had the discipline to demand both, which, is the closest thing one can get to a sure thing.

Even with the odds in one's favor no one wins all the time. Investors, though, can choose how they lose: they can risk losing more in a down market or making less in the up market. Most prudent investors choose the latter. It isn't as sexy as going for it all the time like Les Miles, Phil Mickelson or Arnold Palmer, which may bring glory and the adoration of others. It is, however, the way to win most of the time, over time, like Nick Saban, Tiger Woods and Jack Nicklaus.

The tension comes from our human tendency to see not the odds but only the outcome. When a football coach goes for it on fourth and long and makes it, people say he is brilliant. When he goes for it and fails, people say he is an idiot. The truth is that the quality of the decision is not dependent on the outcome; it is dependent on the process by which the decision was made. There have been countless studies saying that investment managers who outperform cannot be identified by their past performance, yet for ten years now Iron Capital has selected winning managers with a more than 76 percent success rate. How is that possible? Looking solely at performance is judging the outcome, but future success is based on making quality decisions that put the odds in your favor. The key to success is having the discipline to judge the quality of the decision-making process divorced from outcomes, especially short-term outcomes.

This will be especially true for investors in the beginning of 2013. 2012 was one of those years that defied the odds. The market was up 16 percent while the average hedge fund according to Bloomberg was up only 2 percent. These are the "smartest guys in the room," and that amount of divergence seems impossible, but actually it is just improbable. Being prudent, managing risk, and keeping the odds on your side does not guarantee success every time, but it is what it takes to be successful over time.

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