ADDING VALUE

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The investing herd today is fully engaged in the philosophy and practice of indexation. When will this prevailing notion change?

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This is one of the longest words in the English language—it is defined as the action or habit of estimating something as worthless. (The word itself could be included in the definition!) In today's debate between active and passive management, active management is also being categorized as worthless. But one shouldn't be so hasty to make this decision. In fact, this is the third time in the last three decades that indexation has been so dominant. The first time was in the mid 80's, when indexing was first making its ascent. The second time was in the late 90's, when active management performed poorly because the indexes were largely filled with tech companies. The most recent instance occurred after the 2008 financial crisis when the risk-on/risk-off environment made stock picking in the short-term very difficult.

The logic for passive management (indexation) is almost irrefutable. It is simply based on the observation that most equity managers who make discretionary stock selections do not outperform the indexers, since the market is believed to be efficiently priced; therefore, one should use an index, which costs less and is less subject to security specific risk. In other words, if we look at the market as a whole, it is a zero sum game. For every winner, there is a loser. After management fees and transaction costs, the investor cannot beat the market, so why try? This idea has almost universal academic acceptance. Virtually all academic finance involves only the study of markets and market prices; for academics the study of companies and the securities they issue tends to be somebody else's business. In fact, most business schools only teach efficient market theory and don't even have in the curriculum any courses on fundamental security analysis. Thornburg Investment Management calculates in a recent newsletter, that in 2010, just over 50% of the U.S. equity mutual fund assets were actively managed, down from about 65% a decade earlier. In addition, they state in the same newsletter, that in 1980, 60% of the U.S. mutual funds were more than 80% active (meaning that more than four-fifths of their holdings differed from those of their benchmark). Today, only 20% of U.S. mutual funds are more than 80% active.

Here are the ways in which we take exception to the "easy, breezy, slam-dunk, highly-marketed" index approach:

ADDING VALUE is mailed and posted on our website quarterly to our clients and friends. The intent of this publication is to share some of our more interesting views and research with our clients.

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1. If investors collectively were rational and markets efficient, price bubbles and their subsequent bursts wouldn't happen. History is replete with examples of "irrational exuberance," including in modern times the tech, housing, and financial bubbles. During periods of market bubbles, speculative investment inflates the valuations of securities above the intrinsic value of the company that issued them. Stocks in the sectors that are inflated, see their weightings in the index grow disproportionately. Pop goes the bubble, the crash occurs, and the investor is given no downside protection.
2. Most market participants are just not in a position to make determinations about intermediate to long-term fundamental values, which requires a detailed study of companies and the securities they issue. Students are no longer taught fundamental analysis. Most market participants are very short-term oriented. Marty Whitman calls it the sudden death syndrome. "Sudden death" exists where an investment situation will come to a definitive end in a relatively short period of time, such as options, warrants, risk arbitrage, short maturity credits, heavily margined portfolios, etc.
3. There is a belief that top-down considerations, such as predicting a business cycle, inflation, interest rates, etc. are far more important investment considerations than are bottom-up factors such as price discount to intrinsic value, strength of corporate financial positions, access to capital markets, etc. There are only about 8 years when top down considerations were more important than bottom up considerations and they include: 1929, 1933, 1937, 1969, 1974, 1987, 2000, and 2008.
4. The efficient market theory states that prices for securities are always correctly interpreted and will change only when the market digests new information. Marty Whitman succinctly exclaims: "What nonsense." Prices are wrong most of the time. If you are a high frequency trader who makes ten trades a day, how can you possibly have fundamental knowledge about the securities you are trading? The simple answer: you can't.
5. Another problem with indexation is that it is backward looking, and constructed by those who consider a company only after its share price or market capitalization have qualified it for inclusion in an index. In this regard, perhaps the world's most powerful stock-picker is the governing body of the S&P 500 Index? Today more than $5.14 trillion is linked to it.
6. Our final bugaboo with this whole indexation craze is the belief that it is quite scientific and has academic grounding. As Murray Stahl at Horizon Kinetics states: "Investing, though is a human activity, occurs in the marketplace, and is therefore a phenomenon of social, not physical science." In the social sciences, reality is affected by belief. The reason to pay attention to universally accepted views is not to implement them, but to think about them and implement or make use of the valuation paradoxes they create.

We are not proponents of passive management. We do not blindly adhere to Modern Portfolio Theory. In our careers, we find plenty of examples of extremely strange behavioral idiosyncrasies. Two studies are especially important in countering the forces that now pervade the market on indexation.

The first study is one conducted by DALBAR. It is now in its 20th year and the direction of the results has never changed. This year's study concludes, as have all the previous studies, with the following statement:

No matter what the state of the mutual fund industry, boom or bust: Investment results are more dependent on investor behavior than on fund performance. Mutual fund investors who hold on to their investments have been more successful than those who try to time the market.

Since the inception of the study in 1984, investor returns in equity funds has been 3.69% compared to S&P 500 return of 11.11%. Similarly, investor returns in fixed income funds has been 0.70% compared to the Barclays Aggregate Bond Index returns of 7.67%. Over a 20-year period, these are simply outstanding differences. Moreover, the gap actually widened in 2013. This was the first gap expansion since 2010 and only the 3rd in 10 years. The most common reason investors fail to achieve satisfactory results over the long term has more to do with temperament than ability. Quite simply, people often want to do today what they wish they had done five years ago. Time and again investors choose to buy after prices have gone up and to sell after prices have gone down. So it seems to us that the neat and tidy, easily marketed, package of investing through indexation either by funds or ETFs, despite their cheapness in reduced fees, still has no effect on helping investors achieve their goals because of the behavioral biases in people's actions.

The second study was concluded in 2009 by researchers at the NYU Stern School of Business. Antti Petajisto and Martijn Cremers published the study "How Active is Your Fund Manager? A New Measure That Predicts Performance," that presented the idea of active share as a way to identify skillful mutual fund managers in advance. Active share measures the percentage of a fund's stock holdings that is different from the fund's benchmark index. An active share of 0% means there is no difference between a fund and a benchmark, whereas an active share of 100% means the fund shares no holdings with the benchmark. There are a great deal of technical mathematical equations in this relatively simple title, so please don't extrapolate without understanding the nuances, but an important conclusion is as follows:

The entire universe of the funds examined had a return after fees and expenses of a negative 41 basis points per year relative to the underlying index for each fund. So, the overall argument for passive remains intact. The difference between the stock pickers and closet indexers is significant, however. The net return for the stock pickers after fees was 126 basis points a year above the benchmark, while the closet indexers lost 91 basis points per year after fees relative to the benchmark.

As in life, there are zealots in both directions in these arguments. Academic finance has clearly abandoned all efforts to teach fundamental analysis and focuses instead on efficient market theory. Those fundamental managers that still exist succumb to the pressures of growing assets under management and dare not deviate too far from the index for fear of losing clients. It is a mad world.

However, we believe and have always conducted our business with the following tenets:

1. **We try not to buy closet indexes, choosing instead either indexation or active investing. The onus is still on Wright Associates to research and determine which "stock pickers" are truly skilled and which are not. We continually work on our skill set to keep this advantage.**
2. **Active management does not consistently, year-in/year-out add value relative to passive management (we are in one of those cycles right now). So you need to have a long-term, multi-year outlook in order to effectively utilize active management.**
3. **Finding the right managers and putting together the appropriate mix of these managers is an important task.**
4. **It is possible to choose active managers who generate a positive relative return. We have done it.**
5. **Always buy institutional funds, if possible. They are cheaper.**
6. **Over long periods of time, simply accepting market index returns will not achieve intergenerational equity at an annual spending rate of 4-5%.**

So we get it. Managers that have a "secret sauce" do exist and it is very beneficial to find them. We have trained ourselves quantitatively through continuing education, advanced degrees with honors, and the CFA designation to be able to be "know something" investors. We have

trained ourselves, or had a predisposition, to be behaviorally responsible. As Warren Buffet says: "Be fearful when others are greedy and greedy when others are fearful." We are patient. We HATE having a permanent loss of capital. We love looking for a margin of safety just to protect ourselves against the inherent market uncertainties and give us the staying power to weather occasional but inevitable economic storms. We invest our money alongside your money-100%. As Mr. Shahan, a Columbia University Business School alumnus and portfolio manager at U. S. Trust wrote in 1986:

Unfortunately, there is no way to distinguish between a poor three-year stretch for a manager who will do well over 15 years, from a poor three-year stretch for a manager who will continue to do poorly. Nor is there any reason to believe that a manager who does well from the outset cannot continue to do well, and consistently.

So our conclusion is that, despite a marketing blitz, indexing is not the only portfolio strategy. You can be an indexer and beat the closet indexer through lower fees, or you can use some sweat equity and intellectual capital and provide even more value – added by creating a portfolio of concentrated, but non-correlated mutual fund managers. We concentrate in accomplishing the latter goal.

It is a constant amazement to us that with all the noise, assertions, opinions, short-term investment thinking, marketing programs that you, our clients, were able to discern our message. Thank you for your continued support.

Sincerely,

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