# ADDING VALUE

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*There are a lot of reasons to sell a position in a mutual fund, but only rarely is it because of past performance. Surprising? Please read this newsletter carefully for an understanding of our reasoning. Meanwhile, keep in mind that business cycles can last a long time (especially when they are manipulated by Central Banks). There should always be a winner and a loser in every portfolio we design and there are (it just seems as though losers are a greater part of the portfolio). Finally, we should always be thinking 10 steps ahead (not just 10 years past) with a plan for every probability and contingency.*
*The point is: some part of your portfolio should be working all the time. At certain times, however it may seem the not-working ("cheap") portion greatly outweighs the working piece ("expensive").*

## PALINDROME

A Palindrome is a word, phrase, number or other sequence of characters that reads the same backward or forward. One of the oldest palindromes known to man is the Sator Square, which was found in the ruins of Pompeii (79 A. D.), an UNESCO World Heritage Site that we visited this summer. The five words in the Sator Square may be read top-to-bottom, bottom-to-top, left-to-right, and right-to-left. 2015 is the last binary palindrome year until 2047 and the most beautifully crypted in binary language with a zero in the center- 11111011111. Indeed, in 2015, people who write their dates in the m-dd-yy format were treated to 10 consecutive days of palindromic dates (every day from May 10 to May 19). Our DNA even forms a palindromic symmetrical sequence. For those who enjoy solving puzzles, creating an intelligible palindrome phrase is an intellectual feat. Peter Hilton (the famous code breaker of Bletchley Park whose character is the lead in the movie *The Imitation Game*), constructed a 51-letter palindrome, "Doc note, I dissent. A fast never prevents a fatness. I diet on cod." Here is another: "A man, a plan, a canal- Panama!"

So on a hot Italian summer day wandering through the crowds of humanity in Pompeii, you might wonder why anyone would make the connection between an ancient square and its value to decision-making. Thinking both backward and forward is not a common human skill. Looking backward we can pull from our experiences and from past performance. Looking forward we are led emotionally by hopes, dreams and fears and by straight-line projections about what happened in the past will continue in the future. Our backward and forward-looking biases instinctively **skew** our decision-making both in data analysis and time frame. Poor investment problem solving is often the result of how skewed information is processed and applied, not the lack of information. Thinking backward is quite intuitive and easy. It involves looking for patterns, making links between unconnected events and forming theories to influence forward-looking decisions.

*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.*

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In investing, one of the most common ways that we think backward is our reliance on past performance tables. We find it very useful to seek out performance even as far back as 10 or 15 years. These data are essentially meaningless as a predictor of what will happen in the future. Indeed, they only measure performance for an investor that held the fund for the exact dates measured. Unless we consciously and unremittingly train ourselves that **"past performance does not guarantee future results,"** we are doomed to make the same mistake over-and-over again and never crack the "code" or refine our palindromic decision-making.

The single best illustration of this thinking backward principle that is occurring in the portfolio today is its application to the past performance of four "dog" funds in some of your portfolios: FPA Capital Fund, Longleaf Partners Fund, Goodhaven Fund and Beck, Mack and Oliver Fund. At least one of these funds is in your portfolio today and we are fielding a lot of specific questions about them. All of the managers of these funds follow certain tenets: absolute value, benchmark agnostic, bottom-up, downside protection, research- based, concentrated and shareholder aligned. They are the antithesis of the current market focus on passive S&P and ETF strategies. Because the makeup of these funds is materially different than a benchmark indices, the returns are diverging from the indices sharply and negatively. *These wild and wide performance swings impact not only short-term returns but can create an end point that weighs on the longer term relative results as well.* We don't deny that past performance at this point in time through the past 5 years or even 10 years is abysmal (see adjacent table) when compared to a common index, like the S&P 500, but it doesn't answer the most basic of symmetrical questions, where are we going from here? It only answers one-half of the question – where we have been.

Thinking forward employs a more mathematical and investigative process. The decision maker must assess variables collected in the backward looking exercise and assign weights and probabilities to arrive at a forecast. We will spare you some of the more complex mathematics, but let's take an example company in the portfolios of some of our managers on 6/30/15 and apply palindromic thinking. Let's also compare the return patterns of these managers during the various phases of the last two bubble periods (1998-2002 and 2005-2012).

**Trailing Returns as of 6/30/15**

| | One Year | Five Year | Ten Year |
|---|---|---|---|
| FPA Captial | -15.21% | 11.04% | 6.18% |
| Longleaf Partners | -5.97% | 12.53% | 5.50% |
| Goodhaven | -15.75% | NA* | NA |
| Beck, Mack & Oliver | -10.11% | 13.27% | NA** |
| S&P 500 | 7.42% | 17.34% | 7.89% |

*only 4.25 years of history on 6/30/15

**only 5.6 years of history on 6/30/15

*Precision Castparts*—This company makes highly sophisticated products for various industries including the oil and gas and the airline industries. Management had big plans for the oil and gas business and in one of its businesses it concentrated on making very large diameter pipes that are highly resistant to corrosion. Precision is the only company on earth that can make this pipe. Unfortunately, the oil and gas market collapsed, profitability suffered, and the stock price went down. Probably the best palindromic thinking team in the investment universe is Buffett and Munger, they salivated at the opportunity to buy a monopoly at a rock-bottom price. Unlike others who walked away from a sinking stock price, Buffett took advantage of the "blue light" special and bought the entire company for cash on August 10, 2015. He was not focused on the recent past, but instead assessed the weights and probabilities of the value of a monopolistic business based on what might be five or ten years out, and ideally even further. It is common to compare performance for the past 10 years and extremely uncommon to make an investment decision based on a realistic and comprehensive mindfulness of the future, especially for as far forward as 10 years.

*FPA Capital Fund*—This mutual fund seeks to find genuine bargains among small and mid-cap companies and to hold cash when opportunities are scarce. Their average holding period is 7+ years. As shown in the previous Trailing Return Table, they have been underperforming the market as measured by the S&P 500 over 5 years through 6/30/15. FPA Capital's five-year performance compared unfavorably to the S&P 500 performance (11.04% vs. 17.34%).

The question is: Should this manager be fired for such "consistent", long-term underperformance? One way to answer this question is to examine the COMPLETE market cycle performance for FPA Capital for the last two downturns in 2000 and 2007. A table with these results follows:

| | Irrational Exuberance Period | Crash | Full Market Cycle |
|---|---|---|---|
| **TECHNOLOGY BUBBLE:** | **(1998-2000)** | **(2000-2002)** | **(1998-2002)** |
| FPA | 9.84% | 33.36% | 46.52% |
| Russell 2500 | 31.63% | -5.71% | 24.04% |
| **HOUSING BUBBLE:** | **(2005-2007)** | **(2007-2009)** | **(2005-2009)** |
| FPA | 17.85% | -9.24% | 6.69% |
| Russell 2500 | 35.18% | -24.05% | 1.91% |
| **ZIRP BUBBLE:** | **(2012-?)** | **(2015-?)** | **(2012-?)** |
| FPA | 9.05% | NA | NA |
| Russell 2500 | 18.66% | NA | NA |

In all past periods of irrational exuberance FPA Capital significantly underperformed its preferred benchmark. The value of this fund is most apparent during the "down" market/crash period of the market cycle.

We do not know what will happen in the future; we do not know when the Federal Reserve will terminate its zero interest rate policy (ZIRP); we do not know how long the momentum of passive equity strategies will continue.

We do know that for most common investment ratios, the businesses held by FPA Capital are much more attractively priced than those in its primary benchmark (Russell 2500) as shown in the following table.

**Equity Summary Data**

**June 30, 2015**

| | FPA Capital | Russell 2500 |
|---|---|---|
| Average P/E Ratio | 13.5x | 28.9x |
| Average P/BV Ratio | 1.7x | 2.4x |
| Median Market Cap (billions) | $3.3 | $1.2 |
| Weighted Average Market Cap (billions) | $4.9 | $4.1 |
| Weighted Return on Average Equity (ROAE) | 10.2% | 11.0% |
| Weighted Total Debt to Total Capital | 30.7% | 46.9% |

We do know that the portfolio managers of this fund exhibit strong palindromic thinking. We do know that we can replicate by our own mathematical computations the compelling attributes in both absolute and relative terms of the businesses they own. So should we sell a "cheap" portfolio of businesses and exchange it for a passive strategy that costs 2-3 times more money because the institutional imperative is to always be in the top quartile of past performance? (We are hopeful that you recognize the advantage of retaining FPA Capital). Although the numbers are not presented in this newsletter, similar patterns hold for Goodhaven, Longleaf Partners and others in your portfolio. These managers win by not losing through a full market cycle. (It may seem that these managers have been underperforming for a long time but the measurement period should not be assessed on chronological time, but on the length of the market cycle).

For the better part of the past six and a half years, markets have moved steadily upward. Some of this can be attributed to the extraordinary accommodative monetary policy (in the history of man) by the Central Banks around the world to keep interest rates low. Those skeptical of the health of the underlying global economic recovery as it unfolded, or wary of the potential unintended consequences of the Fed's monetary policy, have been left at the station. Insisting on a margin of safety in today's marketplace is, at best, old-fashioned. This has been the whole point of the massive intervention - - to force us into riskier investment decisions than we would otherwise choose to make. The distant pain in-

flicted by the financial crisis seven years ago has been forgotten. We have seen an extraordinary rise in the importance of a unique class of investors, generally referred to as “price-insensitive buyers.” These investors include monetary authorities, developed market central banks, defined benefit pension plans, and passive index investors. They simply don’t know, or care, that the higher the price one pays for a business, the lower the future expected return.

All of the managers in your portfolios have excellent track records of compounding wealth. Unquestionably the long-term return stream has been lumpy with numerous periods of underperformance followed by periods of outperformance. We believe it is important for all of our clients to be aware of the general pattern sequence and composition of investment returns for the many smaller periods of time that comprise a successful long-term investment track record. We have tried to illustrate this in the newsletter. Investors rarely receive a plain text message on what the future holds. Those investors who buy businesses at a discounted entry point where business values are growing at 8-13% per year will be winners in the long-term. This concept is what really matter in investing.

When we are uncertain about how things will turn out it pays to diversify. Everyone is dissatisfied with the underperformance of certain funds, but no mention is made of those funds which are doing well. (Hint: we do have some of those also!) Today we are making sure not to be so over-weighted in any asset class, not to be so enamored to those parts of the market that have done so well for the past 6 years, and to add a few “dogs.” We are hoping that in the very near future….

“Dog, as a devil deified, lived as a god!”

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