

ADDING VALUE

Volume 13: Edition 3

Third Quarter 2014

THE ASCENDANCE OF THE ACADEMIC THEORIES

A classic financial theory is the Efficient Market Hypothesis (“EMH”). A cornerstone of the document states that security prices reflect all available information and it is impossible to beat the market consistently. A related model is the Capital Asset Pricing Model (“CAPM”) that says what the return on a security should be, given the market return, the riskless rate, and the correlated risk of the security. In recent years, both of these models have been elevated to proven theories. In fact, they should be viewed more as an imperfect hypothesis, against which we can test our ideas.

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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A Comment from the Crooked Timber Blog

“...With notably rare exceptions, Germany remained largely at peace with its neighbors during the 20th century...With notably rare exceptions, Alan Greenspan has been right about everything...With notably rare exceptions, Russian roulette is a fun, safe game for all the family to play...”

This blog post struck a nerve and got me thinking about how quickly things change or become imbedded as urban legends. At moments of reflection, it is interesting to think about the thought processes and practices that were developed for one reason and which are now imbedded in our thought processes for another reason entirely. Here are some examples:

MODERN PORTFOLIO THEORY

The great innovators of financial theory developed the Efficient Market Hypothesis, the Capital Asset Pricing Model, the Black-Scholes Option Pricing Model and Arbitrage Pricing Theory. It is a powerful body of knowledge. It also has limitations. There are some major doubts about its efficacy. It is imperfect and valuable at the same time. Importantly, it does serve as a useful guidepost against which new theories and conjectures can be tested. Included in this body of knowledge is the formula for standard deviation. Over the course of my career, standard deviation has become the “go to” statistic for investment mavens for measuring risk. The reason it is such a great tool is because it is quantifiable, or “machinable”, and there is no substitute for purposes of mathematical calculations. Academics love things that fit into an equation or a box. It is safe to say that in the lexicon of mathematicians risk equals standard deviation. Like someone with a hammer, every problem looks like a nail. On the other hand, should ordinary people care so much about standard deviation (as defined by the academics)? If an investor is able to hold on to the investment in bad times and come out the other side, unscathed with the number of shares owned the same as before the crisis, does the academic formula matter? Or, should ordinary people really worry about a permanent loss of capital, defined as an otherwise temporary dip that is locked in when an investor sells during a downturn or the investment itself is unable to recover for fundamental reasons. Academics would never have used permanent loss of capital in their ground-breaking work; it is messy and lacks the very thing that standard deviation offers, quantifiability. Here are two examples and how standard deviation may be misleading:

- If you buy something for \$10 and sell it a year later for \$20 was it risky, or not? The novice investor would say that the profit proves it was safe, while the academic would say it was clearly risky because of the large price swing, albeit on the positive side.

- A lot of retirees have been told to “increase your bond allocation as you get older.” The truism was based on using risk as defined by standard deviation. Problems with this generalization is that every retiree has different needs based on many variables, including other sources of income, how much can be drawn from their existing portfolios with respect to their budget, and whether or not an inheritance is probable. One allocation doesn’t fit all! We always want to take our unique circumstance and compare it to the generalization, rather than make the generalization our goal.

WHEN A BENCHMARK BECOMES AN INVESTMENT STRATEGY

Jack Bogle first concocted the idea of index investing in the early 1970’s in his graduate thesis at Princeton. It was a novel concept. It remained that way for many years. As a result, there was very little money devoted to simply replicating the S&P 500, the first iteration of indexing. Exchange Traded Funds (ETF’S) weren’t even a glimmer in the eye of the creator. As the years passed and a growing body of academic research supported the superiority of passive investing (using the classic investment formulas mentioned previously), the scales began to tip toward the “no-think” money management. Roughly 34% of all U.S. funds are now index funds and the trend toward them continues to accelerate. In the Wall Street Journal on August 21 of this year, Vanguard announced that the inflow of funds toward passive investing had pushed the giant to almost \$3 trillion in assets under management for the first time ever. Vanguard now boasts the largest mutual fund in the world.

So are contrarians (active managers) endangered species? Well, anecdotally, when we started in this business in mid-1970 until the late 1990’s, there were only 2 stock market crashes, the crash of 1987 and the Japanese bubble and bust. Since 2000, we have seen a plethora of mini and maxi bubbles, which we all remember too well, such as tech bubbles, real estate bubbles, financial bubbles, financial engineering bubbles, etc. Grant Williams states in his newsletter that “misguided Fed policies would rank high on my list of probable causes, with long stretches of excessively cheap money encouraging multiple episodes of rank speculation, but I think the proliferation of mindless investing is another prime suspect.” We are not sure but sincerely wonder if investors do believe that indexation is both low cost and low risk of loss. Indexation may have created a false sense of securi-

ty, a form of “investor hubris.” We all have to be reminded at times that these financial hypothesis that form the basis of investment research and practice are not universal truths, but rather should only be the starting points of investigation

MISSING OUT VERSUS PROTECTING CAPITAL

There is an elegance and simplicity to indexation that as a marketing tool is unbeatable. But the proven best way to beat the market over time is to buy low and sell high, or alternatively, buy cheap and sell expensive. A discount from fair value provides upside potential, and buying companies at a bargain is even better because there is a further margin of safety. Buying good businesses that are “compounders” at good prices, well you’ve got a perfect winner. It is interesting to look at the returns of active and passive strategies over full market cycles. The chart below shows the good, the index and the bad. (The chart also appears in our blog posting on the website.) While passive strategies are unbeatable during up cycles, active strategies provide significant support during downturns.

Chart 1:

Date	Characteristic	S&P 500 Price Level	Return	"Good"	"Index"	"Bad"
				75% Down 90% Up	100% Down 100% Up	110% Down 115% Up
12/31/1996	Trough	\$ 741	-	-	-	-
3/24/2000	Peak	\$ 1,527	106%	95.5%	106.1%	122.0%
10/9/2002	Trough	\$ 777	-49%	-36.8%	-49.1%	-54.0%
10/9/2007	Peak	\$ 1,565	101%	91.3%	101.4%	116.6%
3/9/2009	Trough	\$ 677	-57%	-42.6%	-56.7%	-62.4%
8/31/2014	Today	\$ 2,003	196%	176.3%	195.9%	225.2%
\$100 invested on 12/31/2006 is worth =				\$ 239.13	\$ 178.95	\$ 187.15

To paraphrase the opening paragraph, “with notably rare exceptions, indices beat active management.” In our opinion, however, there is far too much randomness in the world for future events to be predictable, despite the existence of an elegant equation for “no-think” investing. Just as standard deviation became a cliché to the point where its foundation is no longer questioned when it needs to be. The urban legend that is now ingrained in the mind-set of many individual investors is: “Professional (active) money managers don’t beat the S&P 500 Index. Therefore, it is a waste of time and money to pursue returns through professional managers.” If it is middle-of-the road strategies you are after, it pays to think about when they would be most relevant to your savings strategy. If you are interested in protecting capital, or some sub-section of your total capital especially in retirement, then it is important to know when to hold ‘em (the indices) and when to differentiate with active managers.

In summary, before accepting a blanket statement of the superiority of indexation, one should consider the following:

- Active and passive management each have potential benefits to investors.
- There is a noticeable tendency for the index to perform better than its active peers during friendlier market environments.
- What is a client's personal portfolio benchmark?
- If the portfolio is being used for regular cash flows, how is the cash flow delivered?
- While indexation outperforms during bull markets, the same is not true during bear market cycles.

As a final point, there has been a rising chorus in the financial media suggesting that actively managed equity strategies have lost their potency. As clients, you should know by now that we emphatically do not manage to outperform benchmarks over short periods of time. Instead, our consistent aim is to generate attractive absolute results over full cycles by participating in rising equity markets and protecting capital in declining markets. Charlie Munger in Damn Right! (his biography), written by Janet Lowe, asserted that the vast majority of professionally managed money, after taking into account the impact of fees and transaction costs would be better off in index funds, he ended by throwing out an alternative point of view:

“Does that mean you should be in an index fund? Well, that depends on whether or not you can invest money way better than average or you can find someone who almost surely will invest money way better than average. And those are the questions that make life interesting.”

Charlie Munger was brilliant in his constant use of logic. Logic in planning and investment selection should always prevail. Maybe it makes sense to index, or maybe it makes sense to select managers that will probably outperform. The question relies on the unique individual's decision making ability. We believe our ability is geared toward finding those special managers. We believe we have the right recipe to create lasting portfolios for our clients. As always we are grateful for the trust you put in Wright Associates.

ABSOLUTE SECURITY

Money market funds were introduced into the marketplace in 1980. It was another earth-shattering innovation that allowed investors to earn short-term competitive rates on cash beyond just keeping money

in a checking account. Corporations with excess cash could lend the money to other entities and circumvent the banks. One of the first books published on the nascent industry was by Marcia Stigum entitled The Money Market. At 728 pages long and weighing 2.6 pounds it was a definitive guide to “The Money Market.” I used it extensively at Westinghouse when I managed their \$1Billion short-term cash portfolio. Fast forward twenty years to 2007-08 when too much of a good thing becomes corrupted. We became worried when listening to a conference call by the manager of Schwab's Money Market Fund that some securities were not understood properly. We took the unprecedented move to sell the Schwab Money Market Fund in all client accounts. By getting out early we received the full price of \$1.00 per share on all cash accounts for our clients. In September 2008, the Reserve Primary Fund sparked a panic by “breaking the buck” when its Lehman notes plunged in value. (Schwab was also affected but chose to keep all clients whole). From that time the SEC sought changes that would prevent such a calamity from occurring in the future. They have recently released the new rules for money market funds. The rules total 869 pages, beating Marcia's original compendium by 141 pages!

As far as we can tell, these new rules do three things for retail investors.

1. Require a liquidity fee of 1% on redemption requests if the fund runs low on liquid securities calculated to be less than 10% of total assets.
2. Require an optional liquidity fee of 2% if the liquid assets are less than 30% of its total assets.
3. Funds with less than 30% in liquid assets may also vote to shut down redemptions altogether. Such “gates” can be imposed for not more than 10 days within a 90 day period.

As a result of this new legislation, pursuant to the amended SEC Rule 15c 3-3, you have received a disclosure statement in your August 2014 account statements entitled:

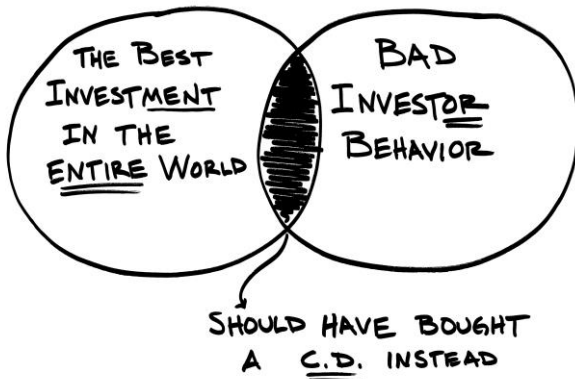
“Changes to Schwab Cash Features Program”

The principal changes are:

- Schwab will automatically enroll all new eligible Advisor Services client accounts into the Schwab Bank Sweep feature at account opening. All other cash feature options will be removed from account applications.
- The required household balance for the Government, U.S. Treasury, Treasury Obligations, and Municipal Sweep Money Funds will increase to a \$500,000 minimum.

- After account opening, if a client would prefer the Schwab One® Interest feature or a Money Fund Sweep feature, and your account is eligible for this preferred feature, you can contact us.

We are working our way through all this documentation and where appropriate will make changes to your accounts for the best cash feature option. Who would have believed cash could be so complicated and require so much time?



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AN ANNOUNCEMENT

We have spent the summer expanding and improving our website: www.kswrightassociates.com

If you have some time, please take a look. We welcome all feedback. If you know anyone interested in our services, directing them to our website may be a way to introduce us! Thank you for your support.

Sincerely,

Kathleen S. Wright
A. Gregory Lintner
Adam K. Wright

P.S. - Be sure to check our website frequently. We will be constantly updating our blog posts, travel blog and book lists. There should be a constant refresh of material for you to enjoy.

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