ADDING VALUE

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SUMMARY:

Data are our industry's raw materials. Our challenge is to "add value" by transforming them into meaningful and actionable information. Too narrow a focus on a "scientific" approach exposes us to the risk of overquantification. Too broad a focus exposes us to oversimplification. In order not to be fooled by randomness, we have had to develop a "humanist or Renaissance" approach which demands creative, qualitative, and interpretive skills; an awareness of human and social psychology; and a contrarian style that forever questions the "obvious."

ADDING VALUE is mailed 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.

First Quarter Investment Review and Outlook

Fooled By Randomness

It's simple. Past events will *always* look less random than they were. In business and finance, especially, a discussion of past events lends itself to backfitted explanations concocted ex post. (Another less scientific name for this, of course, is Monday morning quarterbacking.) As investors, we spend a lot of time understanding this phenomenon and trying not to be fooled. This quarterly newsletter, influenced by Nassim Taleb's best selling book, Fooled by Randomness, addresses this topic and gives suggestions on how our clients and friends can avoid the abundant traps in journalism, market newsletters, and other sources that are exploiting the misunderstanding of probability theory.

Market newsletters: An example

One example used in Mr. Taleb's book is as follows:
Imagine receiving a letter in the mail predicting the direction of the U.S. stock market for the next month. You are mildly intrigued, you watch the market, and lo and behold, the prediction turns out to be correct. The next month another market prediction letter arrives. It is also correct. Your interest is piqued. Over time, you end up getting six consecutive monthly letters, all of which correctly predict the market direction for the next month. After six months, you're impressed with the predictive skills of the writer/investment manager. You have seemingly been following the letters for a long time (six months in our hectic lives **is** a long time!) The anonymous writer then asks you to invest in his special offshore fund. You pour a substantial portion of your life savings into this perceived opportunity (hey, it certainly looks like a better deal than you have with most financial advisers, and it is cheaper). You are wiped out in two months.

Seeking sympathy, you confide in your best friend who says she also received the anonymous letter, but it stopped after the second month. She said the first month's prediction was correct, but the second month's prediction was wrong. The letters then stopped. What's going on?

Here's the trick. Pick out 10,000 names out of the telephone book (there are services that sell mailing lists if that is easier) and send half a positive market prediction and half a negative prediction letter. Next month, send a bullish letter to 2500, half of the 5000 that you sent a correct prediction letter the previous month and 2500 bearish letters to the other half of the same group. Repeat this each month for the correct prediction group. Stop sending letters to the group where the prediction was wrong. You get the list down to about 500 names. Probably about 200 of the "lucky" folks will be victims. At the cost of a couple thousand dollars in stamps, an unscrupulous operator can make millions. You have just been ***tricked by randomness***.

Professional luck or skill?

One of our most difficult tasks as investment advisers is to determine whether it is luck or skill that contributes to the performance of a CEO of a company or an investment manager of a mutual fund. In a word, our professional world is "randomness-laden." The link between skill and results is tenuous. In certain professions, it is easier to identify skill. The skills of a good dentist are visible with a smile (or at least an X-ray). The skills of a good cook are visible with a plate of tantalizing food. The skills of an electrician are visible with the flick of an electric switch. These professions are built on repetition of tasks with relatively minimal complexity and a short time frame to completion. It is easy to measure results. Contrast these professions with the chief executive of a major corporation or an investment manager. His or her decisions are not repetitive, external factors play a large role in the results, and it takes years for the outcome to be known.

For better or worse, there are an abundance of examples today of CEOs of large corporations who were in final analysis: "empty suits." Investors today face a tsunami of noise. We are assaulted with streaming quotes and dedicated financial news television, websites, radio, newsprint, Internet search engines, and magazines. There is no end to the data. In addition, companies have become masterful at manipulating the media. Marketing messages are more cleverly designed. It is not easy to sift through the hope and the hype to find the true value of the company.

Out of many examples to choose from, let's look at a recent article by J. Graham in the Motley Fool on media noise. "Krispy Kreme is a first-rate example of media saturation. Between newspapers covering the block-long lines at newly-opened franchises and the minute-by-minute coverage of every price move, there was no escaping the hype. On November 7, 2003, Krispy Kreme traded at $44.17. On May 7, 2004, 20 million shares changed hands and the price dropped almost $10 from the previous day's $31.80. Was our hopeful investor who bought at the much-hyped $44.00 then caught up in the stampede out of Krispy Kreme? Or perhaps he waited, hoping for a turnaround, but finally selling at $5.56 on March 2, 2005, unable to resist the steady media drumbeat of accounting fraud and bankruptcy worries." In the midst of all the media hype, did you know that the secret recipe for Krispy Kreme doughnut was actually formulated in 1933? As you secretly took a bite of your hot donut, did you think that the national headquarters was established in 1941 in Winston-Salem? As you added a pound or two a year from eating the donuts, did you know that in 1995, franchises were funding the expansion, with only 20% of the new stores opened being company owned. (Singer Jimmy Buffett acquired the franchise rights in Palm Beach County in 2000.) With so much market noise, it was extremely difficult for the average investor to determine an accurate price for the company. With an average P/E ratio of over 100x in 2003 (more than 4x the overall market), the average investor clearly was focused on the noise. In fact, the investor was ***fooled by noise.***

Focusing now on investment managers, investors are reminded time and again that past performance is a poor guide to future performance, in no small part because of the

dominant role noise plays in the markets. Signal-to-noise ratios are almost always so small that performance numbers rarely have any statistical significance; they are just as likely to have occurred by chance. *For almost all managers in almost all sectors, this means that investors need to wait more than **50 years** to have a statistically acceptable degree of confidence that the mutual fund manager's outperformance was attributable to skill rather than luck.* Not only can investors not wait that long, but the degree of outperformance needed to ensure significance probably would not persist for that long. The combined effects of assets under management, dependence on individual skills, and imitative competitors would erode any statistical significance. Investors should also know that once numbers, analysis, and output appear on a screen, in the paper and on TV, they often develop an unjustified legitimacy. Once they have the authority of the printed word, we tend to believe in them too much. Even clean data, numbers and measurement are of minimal value by themselves. They are commodities easily and cheaply produced. Our task as advisers is to transform them into meaningful and actionable information through the value-adding process of structuring, analyzing, and interpreting. Otherwise, investors are prone to being ***fooled by perceived certainty.***

Black Swans

The 9/11 Commission has a mandate to "provide a full and complete accounting of the attacks of September 11, 2001, and recommendations as to how to prevent such attacks in the future." Fundamentally, this mandate has to be flawed. It's trying to review history as though it were lived with the perfect knowledge we have of the past, which we obviously cannot have of the future. It's that ubiquitous Monday morning quarterback again. Nassim Taleb, coined a term for the 9/11 catastrophe. He called it a "black swan." A black swan is an outlier, an event that lies beyond the realm of normal expectations, a surprise. Nevertheless, people tend to concoct explanations for them after the fact, which makes them appear more predictable, and less random than they are. Our minds are designed to retain, for efficient storage, past information that fits neatly into a compressed narrative. For instance, how could our understanding of the world on June 27, 1914, have helped anyone guess what was to happen next? How could our understanding of the world on September 10, 2001, have helped us to understand what happened next? Similarly, we can apply this thought process to understanding the world before the stock market crash of 1987 or the Long-Term Capital Management meltdown in 1998. The greatest flaw in the commission's mandate or in analysis of any of the above events, regrettably, mirrors one of the greatest flaws in modern society: ***it does not understand risk.*** Black swans are vicious, and they fool all but the lunatics. After all, anyone who predicted 9/11 would have been considered a lunatic before the event.

Conclusion

Probability and chance are more than a mere computation of odds on a dice. *Rather it is the acceptance of the lack of certainty in our knowledge and the development of methods for dealing with our ignorance.* But in our society today, who wants to admit that we are uncertain? Uncertainty doesn't sell newspapers or attract clients. However, the role of chance in this world is so much more significant than we may think, especially in business and finance. The French mathematician and philosopher, Rene Thom, argues that understanding does not require elaborate, quantifiable models and precise measurement. Rather, understanding means identifying analogies between different areas and elaborating on them in qualitative ways. For instance, the behavior of the weather bears a strong analogy to the behavior of the stock markets; both exhibit elements of short-term randomness, long-term stability, and extreme sensitivity to initial conditions. Weather forecasters and market forecasters are notoriously poor at predicting unexpected extreme results such as the bursting stock market bubble of 2000 or

the incidence of three major hurricanes in Florida in 2004. This is not an attack on forecasting, but a plea to recognize the very human biases and prejudices that quantitative analysts, CEOs, investment managers and forecasters have. Our task in investment management is to transform data and market noise into meaningful and actionable information through the value-adding process of structuring, analyzing, and interpreting. We try always to remember that the measure itself is of far less significance than the ***meaning*** behind the quality shortfall and the ***process*** of trying to measure it.

Sincerely,

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