ADDING VALUE

Volume 10: Edition 3 Third Quarter 2011

MULTIPLYING WOES

The Wall Street Journal on September 26, 2011 called it the "Pivot Point". Economic fragility world-wide is causing investors to retreat from stocks. Within this context, some of our largest equity positions in Yacktman, Sequoia, Akre Focus, First Eagle, FPA Capital, and IVA International are reporting year-to-date returns at breakeven levels. As we write this newsletter, Warren Buffett announced the buyback of shares, an unprecedented event. For long-term investors utilizing managers with fundamental value skills (which we do), there are still opportunities in the stock market.

The extraordinary surge of stock market volatility during August cannot be explained by conventional theory. On Thursday, August 4, the market as measured by the S&P 500 index, fell by almost 5%. The next day, the market was quiet, until S&P announced their historic downgrade of U. S. long-term debt after Friday's market close, foreshadowing a very chaotic week ahead. True to expectations on Monday, August 8, the index dropped by almost 7%. In successive days during that week, the S&P Index rose by 4.7%, fell by 4.4% and then rose by 4.3%. For the first time in history, the Dow Industrials either rose or fell by at least 400 points four days in a row. It is tempting to think that the market has been responding *rationally* to economic developments and it seems as though there is a "cause and effect" between macroeconomic news and investor reaction, yet to our knowledge no one has a clear, mathematical understanding of the volatility's source. (One culprit, which we have mentioned previously, may be the "high frequency" traders that now represent more than 70% of daily exchange volumes and encompass what the SEC calls "momentum ignition" end of day trading and "order anticipation" trading. Share volumes on days that stocks fell 600 points was an astounding 9.7 BILLION shares!) To put this volatility into further context, since 1928, the daily change in the market has usually been no more than half of a percent. Wouldn't it be a shame if these traders pushed the economy into another recession because of their frenetic, ADHD behavior?

In 1936, John Maynard Keynes wrote "The General Theory of Employment Interest and Money." In this book, he compared the stock market to a beauty contest. (Little did he anticipate the effect of powerful computer trading programs on the beauty contests!) He stated that the best strategy isn't to pick faces that are your personal favorites. It is to select those that you think others will think prettiest. Or as Ben Gramham succinctly stated, "The stock market is a novelty to watch for those with long-term investment horizons."

There is much angst and dismay among stock market investors today. Each day the market seems to be conducting a Keynesian beauty contest, and reassessing what others think that still others are thinking. On days without much news the market is simply reacting to itself. For instance, one explanation for a market upswing was that Hurricane Irene did not inflict as much damage on New York City as was expected.

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.

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The market seems to be working on a negative feedback loop at the present time. Feedback loops are usually effective tools for changing behavior. The basic premise is simple. Provide people with information about their actions in real time (or something close to it), then give them an opportunity to change those actions, pushing them toward better behaviors. Action, information, reaction. But let's just think about the reaction of S&P's downgrade of U.S. debt. Sensibly and with unanimity, a downgrade should raise the yield demanded on U.S. debt. However, the downgrade of Treasurys made people so worried about the elevated risk in the world that they ran to Treasurys for safety…So much for the rationality of markets. Feedback loops and beauty contests just do not work in investing.

Most of the mutual fund managers in your portfolio resist feedback loops and beauty contests. They disparage high frequency traders. Here is a sampling of their thoughts on the current market situation.

Bill Nygren/ Oakmark Funds: "Comfortably Contrarian"

This manager's focus is on three primary equity attributes: stocks trading at a large discount to business value, with business values that grow over time and with management teams whose interests are fully aligned with shareholders. Generally, if they buy a stock at 60 cents on a dollar, they can find a full and well-diversified portfolio of ideas. They also like to invest in companies in which people are paying attention to the wrong things (in their opinion), where long-held perceptions about the company can be slow to change, and where there is an overreaction to poor earnings reports. As with most type A, competitive people, Oakmark Fund managers want to achieve positive returns and to outperform the market. It is interesting to note that of the 40 quarters in the ten-year period ended 12/31/10, only EIGHT quarters qualified Oakmark as a winner by this definition. However, for that same period, the fund earned 74% vs. 15% in total return for the S&P 500, beating over 96% of the competing funds! As in baseball, some of the best teams lose more than a third of their games and endure extended losing streaks, but still end the season at the top of their game. Stocks in the portfolio today include: Dell, Capital One Financial, Comcast, and TE Productivity—which are bound to be categorized by some in the beauty pageant as losers. Success in almost any endeavor, including the management of assets in the Oakmark Fund, requires having the freedom to think differently than others do; it requires making decisions that fly in the face of conventional wisdom. Don't forget patience!

Mason Hawkins/ Longleaf Funds: "Reliant on Determination of Business Values"

Business appraisals are the core of the analysis of this manager. They have developed three methodologies that they use to determine business value. The first approach is balance-sheet oriented and determines what a business would be worth upon liquidation. The second methodology attempts to assign a value to a business' free cash flow generation. The third methodology, comparable sales of like businesses, is a check on the first two practices. They are methodical and precise in their analysis and if they can't calculate a conservative assessment of the business's value, they pass on a purchase. Very presciently they state: they practice their business in a culture of thoroughness, i.e., no seat of the pants stuff and a spirit of humility and cohesive teamwork. What they perceive is that investors tend to follow

trends and fashion rather than taking the trouble to look for value. Investors seem to be unwilling to do valuation work and this occurred before the development of 24/7 business networks and "always on" connectivity. Instantaneous reaction and speculation dominate stock swings today. Longleaf notes that 57% of advisors who were bulls in early April fell to 37% in mid-June, while fewer than 16% started as bears but grew to 28% over the same period. The difference between bulls and bears, therefore, went from over 41% to under 10% in fewer than three months. This dramatic short-term mispricing of securities offers opportunity for long-term investors. 2008 was the worst return year in their 35-year history. However, it may have been the best in terms of establishing a foundation for long-term compounding. Today, the top ten holdings in the large cap fund are 58% of the total portfolio and include names such as Chesapeake Energy, Dell, Bank of New York Mellon, and Yum! Brands.

Bob Rodriguez, et al/ FPA Fund Distributors: "Stupidity of Political Pundits"

Outspoken, independent, idiosyncratic, and eclectic, Bob Rodriguez has been voted as Manager of the Year from Morningstar in both the equity and fixed income categories. He is the only manager to receive this accolade. He periodically holds big slugs of cash, can range across the capital structure, and has as his number one objective to preserve client capital. Like many of the other managers in your portfolio, he has lost nearly half of the assets under management in the fund for doing the right thing…buying good companies at low market prices. He is one of the old breed that is not willing to pay to play. As you can imagine, he doesn't follow the herd. He is very careful in his selection of assets. He would never participate in "electronic quantitative money management," such as ETFs, index funds, etc. Today, the top ten holdings in the FPA Capital Fund include: Rowan Companies, Ensco PLC, Rosetta Resources, Arrow Electronics, Trinity Industries, Avnet, among others.

Bob states in his recent interview: "If I make one good investment every five years, my return versus risk goes straight through the roof….how many clients are going to wait five years for performance gratification?

Bruce Berkowitz/Fairholme Fund: "Uncomfortably Agnostic"

We could use the same adjectives as stated in the last section to describe the manager of this fund. His primary objective is to seek bargains and to have the courage to go against the crowd. "We're value people. We go toward stressed areas of the market." He's not kidding. Of late, he's put nearly 75% of the fund in beaten down financials such as Bank of America, Citigroup, Goldman Sachs, and AIG. He also is an activist and recently became the chairman of the St. Joe Co., which represents only a 3% position in Fairholme. Over the past decade, this fund has beaten 99% of its peers. Most of the volatility during this period has been on the upside, and everyone, including us, has been happy. With a concentrated fund, however, there are inevitably periods of short-term underperformance. One of these times is occurring right now. We are watching this situation closely.

In general, there has been very little portfolio turnover in any of the manager's portfolios in the last three to six months. In fact, there is not much meaningful change in the outlook for the companies themselves. So, as is often the case, the dramatic swing that we've had is more in psychology than in fundamentals. The positives of June are diminished, forgotten or eclipsed and investors are now preoccupied with the negatives. Unlike the positive feedback loop, the "investment" negative feedback loop goes like

this: psychology is positive and people are willing to bear risk, something takes a turn for the worst and there is a confluence of negative events, worrisome elements take sway, disillusionment replaces sanguinity, money flows out of the markets.

It will never cease to amaze us the way investors flip-flop-focusing on just the positives at one moment and just the negatives at another-and the speed at which they do it. Nobody waves a banner when assets are cheap enough, and because most investors are still bogged down with the negativity of the macroeconomic morass at such a moment, they do not think opportunistically. It is incumbent on investors to recognize these times and react appropriately, rather than follow the herd. We strongly believe that despite (or even because of the pervasive gloom), the stock market (and our managers in particular) should produce improved returns in the decade ahead. Furthermore, if history is any guide, we will be long into a stock market recovery before the press, talking heads, and public feel more confident. There is a lot of truth in the old saying: "the stock market climbs a wall of worry."

Sincerely,

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