ADDING VALUE

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We celebrate our 10th anniversary this year. Such an exciting event warrants a review of what we have learned, how our clients have fared with our investment management, and how we have met our business goals. The purpose of this newsletter is to address these topics.

WHAT WE HAVE LEARNED

The original intent behind the formation of our business was to invest our client's assets alongside our own and treat our clients as we would expect to be treated. We wanted to be an independent, fee-for-service, investment research (not marketing) oriented firm. In the 1980's as these ideas were developing there was surprisingly very little competition to this business model. We were able to take significant advantage of the fact that we had direct access to over 1,500 investment managers through our professional positions as investment consultants, which provided the basis for our research. Rather than follow the "Bank Trust Department" model or the "Brokerage" model, we were at the forefront of the newly conceived "Registered Investment Advisor" model. The retail investment industry saw rapid growth in firms supporting this model including, Schwab, Fidelity, TD Ameritrade, Advent, Morningstar, among others. Retail investors should have been the gratified recipients of these positive changes, but there are some "sticky" behavioral issues that continue to plague investment outcomes. When it comes to investment decision making, objectivity is crucially important, but we are all human beings and in the investment business bias presents itself in various ways, including:

- <u>Investors tend to forget the cyclical nature of the investment markets, thus ignoring the likelihood of the regression to the mean.</u> (Put another way – they buy high and sell low). A study done by Dalbar Inc. shows that the average equity investor's return trailed the S&P 500 Index by 4.32 percentage points on an annualized basis and the average fixed income investor trailed the Barclays Aggregate Bond Index by 5.56% over the past 20 years. It seems fairly ludicrous to us that so much discussion time is devoted to the high cost of active versus passive management when the "cost" of poor timing decisions by individual investors completely *swamps* the effect of the active management fees.

- <u>Investors extrapolate past trends to excess</u>. (Put another way – they fail to <u>look behind</u> the numbers). The phrase "past performance is not an indicator of future outcomes" can be found in the fine print of most mutual funds. Yet either due to force of habit or

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conviction, investors consider past performance to be important in fund selection. It is hard to find a single instance when an investor does not take a "peek" at past performance before making a decision on whether to make a new investment in a fund. That small peek almost universally results in a selection of the manager with the best, most recent short-term performance. Most investors are strongly biased to invest in recently outperforming funds. In our humble opinion, most investors do not have any other way to make investment decisions and this lack of training results in sub-optimal decisions on a forward – looking basis.

- Investors are most comfortable when they can validate their behavior compared to "the herd". (Put another way - they are uncomfortable as contrarians). Jeremy Grantham, the Chief Strategist of GMO, has this to say about herding: "There are many inefficiencies in market pricing, but this is by far the largest. It explains the discrepancy between a remarkably volatile stock market and a remarkably stable GDP growth (which is highly correlated to the stable growth in "fair value/intrinsic value" for the stock market). This difference is massive—two-thirds of the time annual GDP growth and annual change in the fair value of the market is within plus or minus a **tiny** 1% of its long-term trend. The market's actual price change is within plus or minus a humongous 19% two-thirds of the time. Thus, the market moves 19 times more than is justified by the underlying engines!!"

Most of the managers that we use to implement your portfolios have experienced the extremes of these behavioral tendencies epitomized by the withdrawals of assets from funds during periods of under-performance. At one time or another, Bruce Berkowitz (Fairholme Fund), Bob Rodriguez (FPA Capital Fund), Jean-Marie Evelliard (First Eagle Overseas Fund), Don Yacktman (Yacktman Fund), Bill Nygren (Oakmark Fund) among others have seen outflows of over 50% of assets under management. There is a reason that we use such managers—they care more about increasing capital long term for their clients (and going against the tide of opinion) than about their own career risk. Doing the right thing, which is to prevent the permanent loss of capital (but appearing wrong by CNBC standards) was and is the correct decision.

As with the effect on the managers mentioned above, Wright Associates has not been immune to the behavioral disruptions of the last several years. Theory assumes that investors are clinical, unemotional, objective, unbiased, independent observers. Theory has no answer for the impact of these behavioral forces and the absolute magnitude of the disparity. As some mutual fund managers will lament and as we have seen first-hand, 2.5 years of bad performance after 5 good years is usually tolerable to clients, but 2.5 bad years from start-up, with 5 previous good years shown, (but helped someone else), is absolutely not the same thing!!!!

We always construct client portfolios to give some protection in market downturns. We do this by selecting managers who have an investment process that emphasizes margin of safety, global diversification, independence, contrarianism, and strong analytical skills. In almost all market conditions, this process has been successful. One startling exception was the financial meltdown of 2008. In this instance, nearly all investments suffered large declines. Investors still continue to withdraw assets from the equity markets and reinvest the assets into fixed income. It seems fairly certain to us that a well-diversified portfolio of dividend-paying blue-chip stocks purchased at moderate multiples will vastly outperform 10-year Treasuries over the next 10 years.

HOW OUR CLIENTS HAVE FARED

We started Wright Associates in 2002. In 2002, there were approximately 6,700 mutual funds in the universe in which to invest. We considered

our investment philosophy to have four major points:

1. Construct portfolios that had virtually no chance of a permanent loss of capital.
2. Diversify each client portfolio with a group of at least 10 non-correlated mutual funds.
3. Adjust each allocation to the client's individual situation and risk tolerance.
4. Select managers a priori that we believed would subsequently rank in the top of their peer group category.

Our research is heavily focused on process, expense ratio (price), manager philosophy (people), and future performance. We seldom, if ever, select funds based on past performance. Interestingly, in 2011 Morningstar launched a new "Morningstar Analyst Rating" system to compliment its existing "star" system. Their intent is to rate 1,500 of the large universe of funds into 5 categories: Gold, Silver, Bronze, Neutral and Negative. These analyst ratings should be more forward–looking and comprehensive than the original star ratings which did rely on past performance. Of course, we were interested in reviewing this information to assess how our fund selection fared based on the decisions we made 10 years ago.

Of the ten holdings that comprised 55% of the assets under management when we started - all are rated in the top echelon by Morningstar, with 5 of the 10 receiving the coveted Gold Star accolade, 2 receiving Silver, 1 receiving Bronze one of the 10 funds is not yet rated and the other is Berkshire Hathaway, an individual stock. Excluding Berkshire Hathaway, 88% of our original selection went on to receive medals!

This is a laudable statistic, since very few funds manage to repeat top-half or top-quartile performance consistently. As reported by S&P Index Research and Design, for the five years ending March 2012, only slightly more than 5% of large-cap funds, of mid-cap funds and of small-cap funds maintained a top-half ranking over five consecutive 12-month periods. Looking at longer-term performance, 5.97% of large-cap funds with a top-quartile ranking over the five years ending March 2007 maintained a top-quartile ranking over the next five years. It would appear from this research that our selection of funds (before any of the research became available) and the persistence of these funds in generating good returns over the next ten years is fairly significant.

For the most part the original top 10 managers have remained heavily weighted in the portfolio, but we have had some excellent additions to the portfolios during the ten year period. Funds were added to portfolios when they became available on the Schwab platform for various reasons, such as a fund eliminating and/or lowering its expense ratio, opening to new investment after long years of closure, or a new fund forming. Some examples of fund additions include: Sequoia Fund, Akre Focus Fund, Beck Mack and Oliver Partners Fund, Touchstone Sands Fund, Fairholme Fund, and Yacktman Fund. We are hopeful that these additions will also rank highly in the subsequent 10 – year period.

Most of the managers in your portfolio would support the statement that risk control (and consistent success in investing) requires an understanding of the fact that high returns don't just come along; others must create them by making mistakes. As Howard Marks of Oaktree Capital states so well: "Risk control requires that we avoid the analytical and psychological errors to which others succumb. In particular, risk control requires that we temper our belief in our opinions with acceptance of our fallibility. In the end, superior investing is all about mistakes…and about being the person who profits from them, not the one who commits them." We consider a mistake a permanent loss of capital (which we can partially control), versus capital market volatility (which we have a hard time controlling affordably and with regularity).

It is our sincere desire that we can continue to exploit the mistakes of others (even when it appears that we are going against the thundering

herd) for the ultimate benefit of our clients. In fact, it seems fair to say that our focus will always be on solid long-term performance, consistent with a client's objectives, risk tolerance and in the context of the market environment.

HOW WE HAVE MET OUR BUSINESS GOALS

We have always wanted to be a boutique investment firm with the following characteristics:

- Clients have direct access to a decision-maker
- Portfolios are individually created for each client's individual circumstance
- The business focus is on investment management, not asset gathering
- Ratio of clients to owners is low and manageable
- The firm employs intellectual honesty with an awareness of the human tendency to over-confidence and bias
- Our firm remains independent with the freedom to think without skewed self-interest
- There is focus on risk control through preservation of capital rather than reduction in volatility
- There is straight forward communication with clients

We are grateful that we have been able to deliver outperformance relative to the benchmarks over the past ten years, and even more, we are grateful for the lasting confidence you have shown in us. We expect the coming years to be challenging in the world financial markets. We hope that your confidence will continue knowing that you have hired a firm that is committed to excelling in areas that it can control and to putting clients' interests first.

Sincerely,
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