ADDING VALUE

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Everyone wants to match their life to some standard. We compare almost everything - how big our house is compared to our neighbor's house, whether we are driving a new, snazzy car or a used car, if our vacation plans are exotic or not. It seems as if this is human nature and we always want to have a slight edge compared with our nearest competitor. "Keeping up with the Jones's" is the great American pastime.

PERFORMANCE COMPARISONS

In our 30 years in the investment industry, including periods when our sole job function was to calculate how portfolios kept up with the Jones's, two issues are quite consistent: 1. Clients and advisors both care deeply about investment performance and 2. Investment performance is rarely evaluated from the proper perspective.

This newsletter is an attempt to deliver some of the missing perspective about investment performance, by examining three different areas: historical returns, the influence of Modern Portfolio Theory ("MPT") on investment management, and how returns can be easily misinterpreted by both client and advisor. We conclude with a historical review of how we have managed your assets and reported performance over the years.

Historical Returns

Past performance guarantees one thing: you cannot have that past performance. Why not? Because it is in the past! History only provides a statistical picture, it says nothing about the fundamentals or valuations of the companies currently in a portfolio. We write this knowing no matter **what** we say or write, the concept of extrapolating past returns of an investment into the future **will persist**.

The area where this reliance on past performance is most noticeable, currently, is in the evaluation of "balanced portfolios" that mix stocks and high-quality bonds. The simple fact is that any portfolio strategy that includes a significant position in bonds has been "juiced" in the past three to five years by aggressive Federal Reserve interest rate policy. Do the math: how much future return can you expect when you start from a 10-year U.S. Treasury Bond yielding 1.7%? (In bonds the lower the yield, the higher the price.) Millions of retirees and older individuals in America hold bonds and other fixed income securities believing they are investing "conservatively". Considering that the U.S. broad bond market produced a total return of 8.8% per year on average during the past 10 year period, projecting anything close to the same historical pattern for these balanced portfolios going forward is somewhere between a stretch and damn impossible. The idea that cash and low yielding government bonds are "risk free" is one of the most dangerous fictions there is.

Modern Portfolio Theory ("MPT") and Classic Asset Allocation is not working well

MPT says that you can pick a portfolio on an "efficient" frontier that most closely optimized your risk/return profile. MPT and the beliefs about what produces a solid balance of reward and risk have been largely accepted as "the answer" by advisors. Investors classify themselves as risk-averse, conservative, moderate, or aggressive. This has spawned an ever-expanding universe of balanced portfolios, multi-asset class products, lifestyle, and target date funds, volatility-reducing alternative strategies, among others. This may be the

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latest incarnation of the Wall Street pattern of taking a reasonable concept (and one that feeds the emotions of the investors), and creating another "pop" investment product. Almost all investors over 65 years of age question whether they should be more "conservatively" invested. Conservative allocation in retirement has been internalized by all investors through terrific marketing ads aided and abetted by volatile markets over the last five years. Articles about balanced portfolios are as much a product of its time as the articles in 1999 trumpeting internet stocks.

This is simply not the truism that it is touted as being. Rather an asset allocation decision is always a function of the level of your net worth, the existence of supplementary forms of income, the ability to control spending levels, future estate planning issues, among others. In our opinion, age is probably the least influential of the variables that determine the asset allocation decision of a high net worth individual. To prove the point, the asset allocation for my oldest client was 80% equity and she kept this portfolio in sound mind until she died at 103 years of age. This decision could have resulted in the proverbial family feud—because the individual was my mother-in-law! It was the right decision for my mother-in-law and for my family, because she never had the need for the money from this portfolio and her family inherited the assets "in-kind" at a stepped-up cost basis to everyone's benefit. In our opinion, conservatism does not mean buying "conservative" securities, but it does mean constructing a portfolio most suitable to your individual circumstance.

Choose your benchmarks and evaluation period wisely

Most money managers actively try to outperform each other and the market. The standard way to compare results of an active manager's portfolio is to provide a comparison to a benchmark. It is important to consider the construction of BOTH the benchmark and the portfolio in making judgments. Why should we want a stock index that commits capital in direct proportion to a company's share price (we call this capitalization weighted), so that the more expensive the stock, the more we rely on it and compare our portfolio to it? This is exactly how the S&P Index is constructed—and the stock that has the most weight currently is Apple. This is the reason that it is so difficult to beat the S&P Index today and the reason it was so difficult to beat the NASDAQ Index during the technology glory days. Similarly, why would we choose a bond index that commits capital in direct proportion to a borrower's appetite for debt, so that our investments are concentrated in the most debt-addicted borrowers?

In addition to selection of a benchmark, time is also an important variable in wise use of performance evaluation. "One Year Trailing Returns" represent literally a moment in time. For instance, if you look at a one-year return from January to January, versus from April to April, the result could be **very different**. History is littered with examples of how, by simply shifting the evaluation point by a few months or a few years, you get an entirely different picture of what past performance has been generated.

Many professional managers feel tied to their benchmarks. If they invest differently from the benchmark and give the portfolio an opportunity for outperformance, it comes with the risk of substantial underperformance, and client consternation along the way. We call this "tracking error". Stocks simply do not and never will follow a linear, upwardly sloping trajectory. In a world that often punishes benchmark-lagging performers over relatively short time periods, this is a big business risk to take. So we see "closet" indexers where portfolios are structured so that they are very similar to their benchmarks, avoiding the tracking error. The belief is that it is much better to fall with the crowd than to stand alone. This approach ignores important market realities. There are times when asset classes and sectors clearly become misvalued relative to each other. In the past 10 years, we have numerous examples of these over-priced anomalies—tech stocks, housing stocks, bank stocks, Treasury bonds. Clients accept tracking error when it has a positive effect and absolutely hate it when it works in the opposite direction. In general, we do not consider short-term returns versus an index to be particularly meaningful. Most managers in your portfolios are more focused on finding companies that offer the best current value. It seems to us that it is better to consider returns over the medium to long-term and to focus on the quality of the companies and the margin of safety they offer.

Review of Client Performance

We think that there are four primary requirements for assessing investment performance:

- A relevant benchmark

- A significant length of time
- A period that includes both good and bad years and,
- A mutually acceptable agreement between the client and ourselves as to what is a good yardstick.

When we started our careers, there were not many benchmarks. The Standard & Poor's 500 Index (S&P 500) was virtually the only standard used by institutions to measure market returns. It was the comparative measure of success. In those *ancient* days, the portfolios of most institutional managers (and most mutual funds) were dominated by a blended list of large-cap stocks in the S&P 500. Moreover, it was understood that the benchmark's primary value was for performance measurement over a multi-year period. In this *modern* day and age, other styles have developed, some with extreme emphasis on value or growth, or on medium- or small cap stocks, or on developed and developing country stock. Today the information explosion and the advent of numerous benchmarks that are easily accessible in real time have changed the game. Performance is now measured over shorter and shorter time frames, often to the detriment of the manager/client relationship.

At the launch of our business in 2002, we constructed portfolios that looked different than the classic reliance on mainstream U.S. stocks and bonds that dominated traditional client portfolios. We felt strongly that these portfolios over the long-term would offer higher returns than those offered by mainstream markets while aiming for risk comparable to that of classic balanced portfolios. We saw three paths to improved returns: first, broaden our opportunity set by embracing the full spectrum of non-correlating asset classes; second, seek value- added performance within each asset class; and third, actively manage the asset mix by concentrating in the unloved asset classes that we believe offered superior return potential.

No one could have predicted the precise journey of the capital markets in the last 10 years. For example, the 10-year Treasury note offered a yield of approximately 6.5% at the beginning of the period compared to today's 1.7% yield. In 2002, emerging market debt was considered a volatile asset class, whereas now a credible case can be made that emerging markets are more creditworthy than much of the developed world. In 2002, the alternative strategies world consisted of hedge funds that were available only to a select group of accredited individuals, now there is a whole plethora of funds (440 to be exact) offered to the mass market. The dedicated allocation to real estate funds was also not a mainstream solution. We were always willing to use a far wider toolkit of asset classes than other managers.

Wall Street is loaded with mythology and advertising, which is created by ideas' getting so deep into the mainstream that people stop questioning their validity and usefulness. Our job is to make sure that we always have our eyes open for different paths to take for the benefit or our clients. We always want to preserve and build on what net worth each client has, while minimizing big losses along the way.

Overall we don't worry too much about day-to-day volatility (today's "risk") that is the basis of the academic MPT theory nor do we worry too much about tracking error. Instead our worry beads have a full-time job preventing permanent loss of capital (the real risk). We make every attempt to invest in companies that are selling at large discounts to business values and we use this cushion as our margin of safety.

We also much prefer to buy a go-anywhere fund, rather than a "closet" index fund. The manager in a go-anywhere fund can buy across the capital structure, asset classes and market caps. They can buy common stocks and preferred stocks, performing credit, distressed, bank debt and an odd smattering of smaller private equity. There are only a few funds that have that kind of girth—but we think we have found some of them. They include: FPA Crescent, FPA Capital (now closed to new investors), Sequoia Fund (closed to new investors) Third Avenue Value Fund, First Eagle Overseas Fund, Loomis Sayles Bond Fund to name a few.

In summary, those clients who have been with us since the beginning of our business have been rewarded. However, those clients who started with us in 2006 have not been as happy. Timing and, in particular, the selection of the beginning point and end point for studying the performance record – plays an incredibly important role in perception of success or failure. Just a slight shift in beginning or ending evaluation point can be the difference between average and stellar grades even without a change in the investment structure. This is a very hard concept to understand in practice.

As Warren Buffett states in his 1961 partnership letter, *"You will not be right simply because a large number of people momentarily agree with you. You will not be right simply because important people agree with you… You will be right, over the course of many transactions, if your hypothesis is correct, your facts are correct, and your reasoning is correct. True conservatism is only possible through knowledge and reason."*

Portfolios that we construct for you may not look "conventional" by the standards of most current pundits. On the other hand, the portfolios which are constructed using objective fact gathering and knowledgeable interpretation are conservative, with respect to downside protection. No strategy works all the time, but defensiveness and conservatism seems to be prudent almost all the time. The challenge is that short-term results are highly dependent on the vagaries of timing and on some largely unforeseen events.

The portfolios we construct for you are conservative but not conventional; long-term oriented, but not always positive in the short run; low turnover but sometimes affected by high-frequency traders. Management of your portfolio involves a very complicated set of individual and macroeconomic decisions that combine over long periods of time to produce long-term performance. All of our decisions are made with the best information available at the time and with the most conservative viewpoint on valuation. Thank you for your trust in our judgment and work ethic. We remain committed to providing continued superior, long-term, risk-adjusted absolute returns.

Sincerely,
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