ADDING VALUE

Volume 15: Edition 3 Third Quarter 2016

COLLECTIVE SOLIPSISM

Collective Solipsism is the voluntary abdication of empirical and independent thought. It is when you annihilate your own thoughts, education and training and replace them with "state" sponsored thoughts.

We have spent a lot of time in this century conjuring up justifications for collective thoughts – the tech bubble, the belief that a nationwide decline in U.S. home prices is unthinkable, and now, the belief that the performance of an index can outperform the growth of economy indefinitely.

In each of these 21st century examples, an enormous societal bubble was created that purported to be a solid thing, a triumph of science (including Greek letters, Mathematics and Nobel prizes), an example of Man's mastery over the invisible vagaries of nature. It is a scary time of magical thinking. We need (want) a stock market that goes up, not down. We need financial asset price inflation. We want it all so badly that we support the magical thinking crew. We always do.

Despite the prevailing belief, there exist investors who have a proven process to select stocks that are wealth compounders after all fees. They are a subject of a study "What Works in Investing". We practice their approaches.

At some points in time, it may seem as though indexation is the only way to invest money. One of those time is now. These times occur because there is an exogenous event that is controlling the free market: (interest rates). In today's market place, it is important to understand the influence of the interconnectedness of these variables.

We always live in interesting times, but today seems more convoluted than usual. We have ISIS, Russia and Brexit. We have a reality TV Presidential Election. We have South Africans getting up at 2:00 a.m. to watch another "episode" of the U.S. Presidential debates. We have the Zika virus. We have a stalled economy and a super-heated U.S. stock market. We have negative interest rates in most parts of the world. Dozens if not hundreds of start-up companies are valued at more than a billion dollars. Japan is threatening to do a "helicopter drop" (helicopter money is a theoretical construct conceived by the economist Milton Friedman who postulated that a central bank could create inflation whenever it desired just by handing out money to everyone, seemingly from a helicopter) and cancel its significant outstanding debt. We had the Summer Olympics held in a country where 40% of the population does not have indoor plumbing. Pittsburgh has a restaurant touted as one of the "Best New Restaurants" in the USA in 2016 (Morcilla in Lawrenceville). We have the absolute belief that active investment management is dead. We have access to instantaneous information worldwide. It is the hottest July on record. It is a crazy time out there.

We thought that it was important to take a deep breath and examine our little piece of the world. Our primary intent is to separate fact from fiction. To try to make sense of the tsunami of sound bites in order to understand what does work in investing and what doesn't. To separate the actual, important news, from the 24/7 news cycle noise.

In 1999 Warren Buffett warned investors that their rearview mirror view of the future would likely leave them sadly disappointed. Acknowledging that "markets behave in ways, sometimes for a very long stretch, that are not linked to value". He was unequivocal when he stated that, sooner or later, VALUE COUNTS. Prices do not exist in a vacuum, but are tethered to something, even if by a bungee cord. In the simplest, mathematical terms, above–average returns in the "flood tide years" were compensated for by below-average returns in the "ebbing ones". The inflation adjusted total return from the S&P 500 (including dividends) – which averaged 6.5% from 1900 until 2014 – cannot exceed (or fall behind) indefinitely the **rate of intrinsic value growth in the businesses themselves**. The adjacent table from Martin Capital Management, LLC shows real returns (after inflation) separated into the ebbs and floods. Clearly, the vast majority of market participants experience AVERAGE returns. Market participants investing a basket of securities (like the S&P 500) will experience AVERAGE returns over time.

S&P 500 Real Annualized Total Return w/ Dividends Reinvested

Time Span	Ebb	Flood
1900-1921	2.6%	
1922-1929		26.9%
1930-1949	2.7%	
1950-1965		13.9%
1966-1981	(1.0%)	
1982-1999		14.4%
2000-2014*	2.0%	

*Not necessarily indicative of low tide, but simply the latest date for which data is available.

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.

Wright Associates
2589 Washington Road, Suite 410
Pittsburgh, PA 15241
(412) 854-2100 (Phone)
(412) 854-2550 (Fax)
www.kswrightassociates.com

Like death and taxes, there is no escaping this fundamental truth. To repeat, if you invest in the S&P 500 or a similar index you will receive average returns over time. It is this very important point that investors are not recognizing as the S&P 500 reaches new highs on a daily basis. We will reach average in one of two ways: a significant stock market collapse from these levels or a flat " no return" world for an extended period of time.

Is active management dead?

So, why does it seem different this time? Why is the S&P 500 an unbeatable performance benchmark? Why would any sane individual pay good money for active management and fall behind the performance benchmark (primarily the S&P 500) which can be had for practically free through Vanguard index funds? Is active management really dead?

There is a strong drumbeat to this effect going on in the industry right now. The amazing growth of index funds, at the expense of active equity funds, reinforces this notion. It is a temporary triumph for the efficient market hypothesis.

Going against this mass migration to low-to-no-cost indexation, we would contend that within the equity mutual fund arena, active management is alive. Active equity managers, are **superior stock pickers**. The value-added that the active managers bring to the table more than compensates for the higher fees. It just requires patience and time.

So why haven't most of these skillful, educated managers beaten their passive, robotic counterparts from 2009-to the present?

As in any complex situation, we think the answer is more complicated and multi-dimensional than is being reported in the news media. Essentially, it is a combination of many factors, the most important of which (in no particular order) are:

1. Portfolio management decisions.
2. Short-termism.
3. Availability bias.
4. Interest rates.

PORTFOLIO MANAGEMENT DECISIONS

An educated, experienced, methodical individual who is research oriented, objective, and unbiased can usually pick a company whose stock price will go up over time. They can usually continue this process for the next stock, and the next and so on. Eventually, there will be a limit to the amount of stocks that will deliver outperformance. Each manager has to come to some realization that they have reached the maximum number of stocks and/or assets under management to permit continued outperformance. Oh, how we wish that some active managers have the intellectual honesty and corporate support to just close the fund when that tipping point is reached…

But, alas, the demands of the industry does not permit them to stop picking stocks—they have to satisfy the demands of their corporate Boards and the rating agencies. So the funds keep growing because they are compensated based on assets under management, the extra fees from higher levels of assets lets them do more marketing. They start to manage to a benchmark because consultants and advisor platforms demand it in order to be considered for new asset flows, and they overly diversify because they need to have more places to spend their AUM.

They may have once been excellent investment managers, but after some initial success they turn into businesses where the goal is to not get fired. How do you not get fired? You do what everyone else does. The industry is structured to incent funds to become closet indexers and the pressure today on eclectic managers is ENORMOUS. In the investment world, it is better to fail conventionally than succeed unconventionally.

Benjamin Graham, the guru of security analysis in a 1963 speech, listed two conditions that make it "…possible for a minority of investors to get significantly better results than the average…" One is that they must follow sound principles of security selection which are related to the value of the securities and not to their market price action. The other is that their method of operation must be basically different than that of the majority of security buyers. The fund managers that you have in your portfolios are intelligent, concentrated, passionate, engaged, individualistic, long-term partners for generations of wealth compounding. They are by standard definition, different. Over the long-term, we hope that they will avoid major portfolio management pitfalls (more on this later) and provide permanent growth of capital to your portfolio. We believe that associating with these individuals will deliver returns that are greater than AVERAGE after all fees. We believe that they will be much greater than average and exceed all-in fees on your portfolio by about 50 to 75 basis points. Not a promise - but a goal. We can't make promises about the future but if we continue to follow our time tested due-diligence process, we will keep the odds in your favor.

Ten years ago, we would have said that the biggest future challenge to our firm was finding a talented pool

of managers in which to invest. The surprising fact (to me) is that our universe is much more robust than we expected. A lot of our managers have lost so much money in this indexation craze that they now have a much stronger competitive edge (they are leaner and meaner), there are new mutual funds opening that meet our selection criteria, and there is a lot of talent coming into the market from hedge fund managers whose fees were just too high. The silver lining to the mass inflow to passive strategies is that it is causing fee compression for all managers. We're getting the same managers but at lower costs. This helps **all** investors.

SHORT-TERMISM

We live in an age of push the button for instantaneous answers. We want it NOW. We want constant reinforcement that we are making the right decision and we want this to continue, perfectly, forever. Businesses do not work that way. Life, in general, does not work that way. As they say, we are always just one test away from a life-changing event.

Managing investment portfolios is a PROCESS. Decisions made today may not come to fruition until five years from now. Planting a sapling today doesn't mean that we will wake up tomorrow with full shade. At any point in time, measuring progress is erratic. We are constantly monitoring our managers and the stocks that they are buying to have confidence that they remain fully functioning with a defined process. Consistency in process is paramount which is not the same as consistency in returns. We all need a little patience sometimes.

We have been in this business for over 40 years and it is important to emphasize that if you are a focused or a concentrated active manager, you are going to go through periods when you are out of sync with the market, sometimes significantly. This is happening right now. There is an old piece of research titled: "Are Short Term Performance and Value Investing Mutually Exclusive: the Hare and the Tortoise Revisited" written by Eugene Shahan. Eugene Shahan described a cohort of value investors who outperformed their benchmarks over multi-decade periods. But these same investors under performed in any individual year **roughly one-third of the time**. This is a staggering and important statistic. For what it is worth, this current period is one of the longest, deepest periods of underperformance that we have witnessed. We do not think that it is sustainable. We don't sell simply because the price goes down; we sell when something goes wrong. It's this non-panicky, stick-to-it-ness that leads to reaching one's long-term investment goals.

AVAILABILITY BIAS

In investments and other areas of behavior, we define an availability bias as a self-reinforcing process in which a collective belief gains more and more plausibility through its increasing repetition in public discourse, i.e., "repeat something long enough and it will become true".

What is the easiest piece of information to discover about a fund? FEES. What is the hardest piece of information to discover about a fund? SKILL. What is the easiest marketing sound bite to disseminate to the largest group of people quickly? **No one is skillful enough to beat the index after fees, so just buy the index**. The funds with the largest asset bloat, thus the greatest portfolio drag, will have the lowest fees, but will be unable to generate superior returns over time due to size. As they say, it is hard to sneak around with $50 or $100 billion dollars. There's a reason thieves are not called "elephant" burglars. If you include the US Department of Labor's fiduciary rule, robo-advisers, the class action lawsuits that are starting against 401k plans for charging fees that are too high, Vanguard's sweepstake winning flow of funds, there is ever more emphasis on costs. Where will this all end? When **you pay** Vanguard to invest your money in an index fund? When the index mania tanks? We don't want to be average!

INTEREST RATES

We are in the midst of a grand experiment that has never been attempted in the developed world. Interest **rates in the US are approaching zero and have already turned negative in other developed countries.** This is unprecedented and not to be taken cavalierly. All assets with long durations (stocks, 30YR bonds, private equity, real estate, etc.) have benefitted by the drop in interest rates to near zero, i.e., they are all more expensive now than they were in 2007. This is a fairly complicated idea to grasp and I have tried to find a way to explain it. Ben Inker's, an investment manager at Grantham, Mayo, and van Otterloo, example is probably the best:

> *"Let's say that you will need, with absolute certainty, $1 million in 2026. The safest way to reach that goal is to buy a $1 million face value 10-year zero coupon Treasury bond maturing in 2026. Such a bond currently has a yield of 1.625%, which means it will cost you $851, 127 to buy it today. Assume that tomorrow the yield falls by 1% to 0.625%. Your brokerage statement will declare the value of your bond to be $939,596, a gain of over $88,000. Whoopee! You've just made over half of the necessary return over the next 10 years in a single day. But the value of the bond in 2026 has not changed at all. It has a fixed maturity value of $1 million. The only thing that has changed is the discount rate being applied to that cash flow, not the cash flow it-*

self. Assuming you still need $1 million in 2026, there is no windfall to spend. Economically, nothing has changed for you, whatever your brokerage statement says."

Here is another example. The iShares International Treasury Bond ETF has only a 0.26% yield to maturity. It has an expense ratio of 0.35% (already a losing proposition). Its weighted average time to maturity is 9.9 years. At these ultra-low interest rates, bonds possess incredible convexity characteristics. This means they can be incredibly volatile. The fund's performance this year through July 7th is 12%. Just think about how incredible this is: It is up 12% with only a 26 basis point yield to maturity. There is only one word for those investors who are buying the security based on past performance - SUCKER!

It is easiest to illustrate what happens when interest rates keep going down on fixed income securities because they have a fixed annual income (hence their name), but the same process holds true for stocks, except, the cash flow of the company is more volatile and the discount rate applied to that cash flow can vary widely. **In other words, the present value of the cash flows changes materially if the discount rate applied to those cash flows changes.** As the Fed kept lowering rates, it allowed the discount rate applied to equity cash flows to drop lower and lower, which in turn allowed stocks to be valued higher and higher. If your numerator stays the same, and denominator decreases, then your value goes up! If you believe that interest rates are too low and will go higher, then it follows that stocks are too expensive and will go lower. We don't know when the tipping point is (we couldn't forecast the exact moment that technology stocks collapsed or when the mortgage bubble collapsed either), but when that point is reached, indexation will collapse. It is important to realize that the strong returns to the assets that have done well over the last seven years are at best a one-off benefit, and more plausibly, will have to be given back over time. Indexation has no margin of safety; many people will be very surprised at the results, especially those that are ill-equipped to suffer such losses. Somehow this message is not being communicated at all to investors. If many investors are all doing the same thing, be very worried. Avoid the in-crowd.

Investing in long term bonds at a zero or negative yield is simply the worst risk-return tradeoff we have ever seen. You are relying on the greater fool theory to provide price appreciation and, of course, with a negative yield, you lose money every single day in nominal terms. If the fixed income landscape sounds grim, it is. As an asset class, it has lost its ability to provide meaningful return in either real or nominal terms. In short, the fixed income market is broken and it is affecting the pricing of all assets, including stocks, especially those stocks in an index. Would you agree to lend $100 today with the promise of getting back $90 in two years? I hope the answer is no, but this is what it means to own negative coupon bonds.

In the middle of the 19th century, bloodletting was used to address just about any health problem. One of the most notable blood-letters was Dr. Francois Broussais, a French physician who often recommended a treatment of 30 to 50 leeches at a time. The Appleseed Fund's manager wrote in his semi-annual letter: "According to the New York Medical Journal, in 1833, France imported 41.5 million leeches, more than 10 times the number of leeches imported just a decade earlier." Today, this seems like sheer madness. One cannot help but wonder if today's centrally planned economic policies with record levels of indebtedness and record low interest rates will evoke the same incredulity, much as modern physicians looking back at 19th century health cures.

Eventually, all things that are too good to be true, end. We have ample financial evidence of this in the 21st century from the technology bubble to the housing bubble to the current interest rate bubble. The only way to consider indexation "fairly valued" is if you are an academic or an algorithm (think robo adviser) using the framework of a dividend discount model - **meaning that low interest rates justify high stock valuations**. Indexation will not have a happy ending for many unsuspecting people. Meanwhile, we are trying to do just the opposite in our portfolio construction with the purchase of out-of-favor managers, out-of-favor markets, and cash reserves. These are such interesting times that sometime in the future, they will probably be the focus of a Harvard Business Review Case Study….

We don't want our portfolios to be a footnote to the case study. We want to protect your hard-earned assets. We care much more today for the return **of** your capital than the return **on** your capital.

Kathleen S. Wright
A. Gregory Lintner
Adam K.Wright
Daniel J. Bartosh