Bulls vs. Bears – Pragmatism in a Margin of Safety

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"Investing is not a game where the guy with the 160 IQ beats the guy with the 130 IQ … Once you have ordinary intelligence, what you need is the temperament to control the urges that get other people into trouble in investing." **Warren Buffett**

Executive Summary

This regular update is intended to be used as talking points with your clients.

- Bears are bearish – this generally causes them to lose less during downturns and make less during recoveries (or even suffer losses)
- Bulls are bullish – this generally causes them to lose more during downturns and to make more during recoveries.
- Individual investors listen to the bears after a downturn and the bulls after a run and suffer poor performance as a result. This also happens to advisors of individual investors. Particularly after periods of crisis and mania, investors and advisors extrapolate the past into the future with great detriment to their investment portfolios.
- Pragmatism means looking for a Margin of Safety in all industries, in companies of all sizes, everywhere in the world across the capital structure (stocks and bonds). This has led to predictable results for investors with other three year time horizons.
- Our strategy is to lead clients in a direction where they get ALL OF THEIR ASSETS working toward their long-term goals by making them comfortable with the ride and embracing volatility when it occurs.

The Bears are (almost) always Bearish

Nouriel Roubini, Economist from NYU, counseled investors to avoid equities in 2007 and 2008. This sagely advice proved prescient. However, he also told investors to avoid equities in the Spring of 2009. This advice had a huge opportunity cost. Perhaps more importantly, many investors who ignored him in 2007 heeded his advice in 2009, much to their dismay. A number of other economists have made similar dire predictions, economics after all is the "dismal science." Alternative investment managers and bond managers are also generally bearish. Their mandate is to reduce risk and are more concerned about losing capital in the short run than they are about making good returns over the long run. We use carefully selected managers with this orientation to reduce volatility in our portfolios. These managers generally missed out on much of the downturn but also missed much of the recovery. The question is how they perform over the long run. For example, a number of long/ short funds lost less than 5% from peak to trough in 2008 to 2009, but did not participate in the recovery beginning in March of 2009.

The Bulls are (almost) always Bullish

Jeremy Siegel, Wall Street analysts, and most growth investors are almost always bullish. They told us stocks were cheap in 2007 and 2008 and were even cheaper in Spring of 2009. The funds more bullish investors manage generally experienced market like losses or worse during 2008 and market like returns during the recovery. A quick analysis of 3 funds (selected from the largest 50 funds), Fidelity Magellan, Templeton Growth, and American Funds Growth Fund of America shows they lost about the same amount as the S&P 500 from market peak in 2007 to trough in 2009 (50% give or take) and then recovered about 55%-66% from the bottom to the end of April 2011 (also highly similar to market returns). This leaves these funds still nearly 20% below their peaks. We believe this is unacceptable.

Individual Investors Chase Performance

Individual investors do not look at fundamentals, instead listen to pundits who are generally always bullish or generally always bearish. They also look at short-term performance and move money into funds that did well recently. In 2009, investors poured money into bond funds and alternative strategies and soon after really began chasing Exchange Traded Funds that had done well. Over the last twenty years, the average equity investor, per Dalbar, made 3.8% per year when the S&P 500 made 9.1%. Similarly, the average fixed income investor made 1% p.a. when the Barclays Aggregate Bond index made 5.9%. Investors in equities and fixed incomes left most of the possibe returns on the table. There is no reason to believe they have changed.

Pragmatism in a Margin of Safety

What we want to do is to avoid the losses the bears are worried about and get the gains the bulls see possible. The problem with the future is that it is uncertain. With a high degree of confidence, and based on the weight of strong historical evidence, we can predict that the Margin of Safety approach to investing will continue to yield fruit as long as investor time horizons are considered and investors fully understand their objectives and embrace imminent volatility as a means to making long-term returns. We can also predict that over the very long run, risky assets will rise in price more than inflation.

When things are getting better, asset prices generally rise. When things are getting worse, they generally fall. Over time, things generally get better, but over short time periods we often experience economic growth slowdowns and recessions. If you can invest with a Margin of Safety, then you will make money in the long-run (3-5 years plus) by taking advantage of events that change prices but have little effect on intrinsic values. The next event may be more like the 2000-2002 bear market, where many of our managers generated positive returns *during* the crisis, or it may be more like what happened during the nearly unprecedented crisis (worst since Great Depression in terms of asset price drops) of the 2008-2009 bear market when our Long Term Portfolio experienced about 2/3 of the losses of the broad market but our Retirement Spending Portfolio experienced losses similar to those experienced by investors of investment grade corporate bonds.

No one can predict the future with high accuracy. While there are a number of problems looming, being bearish all the time does not yield fruit because over the long-run things get better.

Implication for Investors

When we have a dialogue with investors, explain to them the effect of time horizon on their decisions AND we get them to agree on objectives, we can create a lower-risk pool of funds, the (Retirement) Spending Portfolio and a higher-return pool of funds, the Long-Term Portfolio so that we can get **ALL OF THEIR ASSETS WORKING FOR THEM** and help them realize their heretofore unstated goals.

If you refer your clients to us, we will do our best to make sure they take actions in their long-term best interest by slowly and steadily educating them on the consequences of their choices and leading them to a strategy that is rewarded by the imminent volatility we all know we face at some point in the future. We are happy to show you performance of our strategies on request.

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