2Q 2013 Market Insights
Wait For Your Pitch
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"The stock market is a no-called-strike game. You don't have to swing at everything--you can wait for your pitch." – Warren Buffett

The end of the first quarter not only brings us to the end of the first marking period for investment portfolios but also the unofficial beginning of springtime in the northeast. It is the time of year for new life, warm weather and the beginning of the season of our national pastime, baseball. Aside from my love affair with the game, I find a fascinating connection between baseball and investing; in fact, the parallels between baseball and investing are endless. The connection is of course through numbers and statistics. Hitters, pitchers and fielders all have averages or percentages that describe their rate of success, as do capital markets in their average rates of return. The term batting average is used to describe both the success rate of a hitter in baseball, as well as the success rate of a money manager in outperforming their benchmark.

Many years ago Ted Williams, arguably the greatest hitter in the history of baseball, described in the *Science of Hitting*[1] his view of the strike zone. He pictured the hitting area as being 7 baseballs wide and 11 tall. For each position in the strike zone Ted estimated his rate of success, his batting average. For those portions of the strike zone where he was less likely to be successful (low batting averages or probabilities), Ted avoided swinging at those pitches. With investing, as in baseball, we are fed a wide variety of pitches, some bad, some so-so and some fat pitches right down the middle that just beg to be hit. The problem is that the fat pitches in investing present themselves at the point where most investors are so paralyzed by fear that they won't swing. By contrast, at the point that you hear your barber, grocer or kid's baseball coach talking about the hot investment, it's probably not so hot.

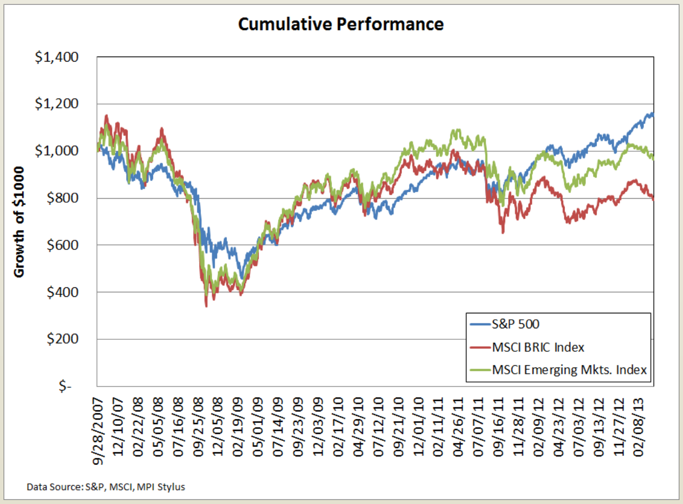
<u>Lay Off the High Ones</u>

In the 1992 movie *A League of their Own (Penny Marshall)*, Dottie Henson shouts to her sister "lay off the high ones" only to receive in response "I like the high ones." There you have it. Ballplayers (even those in film) can be the victim of their own personal preferences and beliefs. That eye high fastball looks inviting, a fat pitch to hit, and to most it's nothing more than a pop-up or a strike-out, a low probability event. At iCM, we would argue much of the same about asset classes, figuratively shouting advice from our seat in the dugout, lay off the high ones! Thankfully many listen, some begrudgingly while sadly some don't. It seems obvious, I've got to own what has done so well for others. Chasing performance and buying expensive assets, much like a high fastball is usually a strikeout waiting to happen. While we have dozens of examples across history, there are many we have studied and observed as they've occurred. In baseball, your results are instantaneous. Swing at a high pitch, success or failure is immediately observed by all. With investing, the results typically don't appear for some time, in many cases, years.

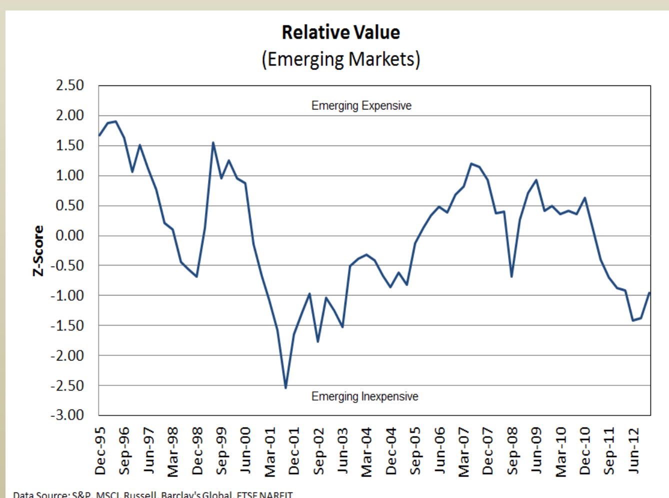
In October of 2007 on the heels of a historic rally that began in late 2001, emerging markets equities finally reached a level where the price could no longer support the lofty expectations placed on the asset class. In those days, China and the BRICs (Brazil, Russia, India, & China)

[1] The Science of Hitting, Ted Williams, John Underwood, Published by Simon & Shuster

were all the rage. Why wouldn't they be? From late 2001 to September of 2007, emerging markets equities advanced by 430% and the BRICs by 658%. By late 2007, theories of emerging markets domination were everywhere ranging from wild growth expectations fueled by shifting demographics to emerging nations being relatively debt free. As a result, the rally could continue indefinitely, right? Wrong. Price and valuations are the great destroyers of many investment theses. What sounds great probably is, but if everyone knows this, the price will be bid to levels where current success creates future destruction. So emerging markets toppled? No. They continued to advance and outperform from late 2007 through the balance of 2011. It wasn't until late 2011 that in total the S&P 500 had performed better than both the broader emerging markets and BRICs indices. From October 1, 2007 to April 8, 2013 the S&P 500 has advanced by 15% while the MSCI Emerging Markets index has fallen by 3% and the BRICs index has declined by 20%. What was the clue? In late 2007, emerging markets equities became overvalued relative to domestic equities at a statistical level of 1.5 standard deviations. There was no crystal ball. The probability of a 1.5 standard deviation event continuing to stretch further was only about 7%. Mean reversion, or a snap back in the valuation relationship (and corresponding underperformance) became more statistically likely the farther the valuation rubber band stretched. It took nearly four years for the snapback to begin. It was painful at first as emerging markets continued to outperform but ultimately proved to be the correct decision. Owning expensive assets is like a tight rope walk without a net. It can work for a short time, but eventually the wind will blow or for that matter someone may sneeze!



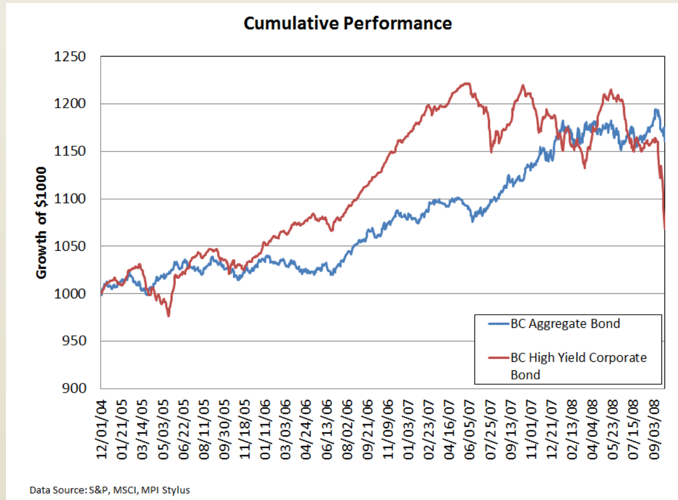
Expensive assets can continue to outperform for a time. These periods are often supported by very convincing arguments as to why the results can continue. Even the best arguments and stories can be derailed by valuations. All bubbles coincide with great stories. This chart above demonstrates the performance of emerging markets and BRICs (Brazil, Russia, India China) indices during one of these feel good times. The chart below demonstrates the valuation framework that caused these results to occur.



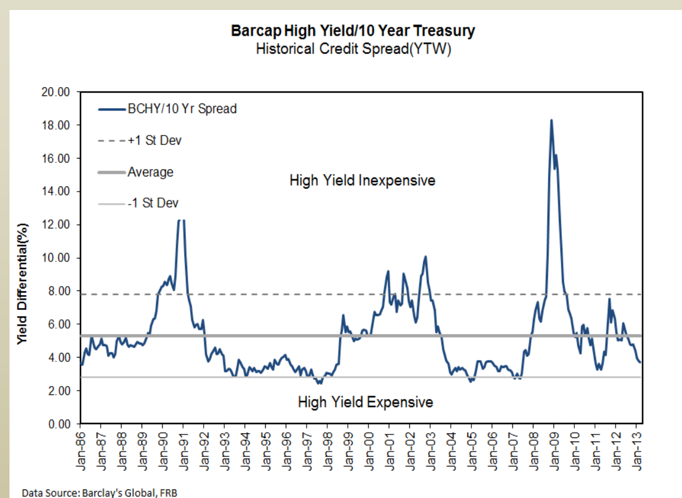
Fixed income assets are not immune to this phenomenon either. Beginning in late 2004, high yield bonds on the heels of extraordinary performance in the prior two years became overvalued. In December 2004 high yield bonds reached 1.15 standard deviations overvalued relative to the broader bond market. The probability of valuations continuing to stretch and the asset class continuing its out performance was only 12%. Again, there was no crystal ball, just a low probability. Much like emerging markets, high yield continued to outperform for 2 ½ years before performance leveled off and ultimately collapsed trailing the broader bond market by 16% between May of 2007 and September of 2008. In total from December 2004 through September of 2008, despite the early outperformance, high yield trailed the broader bond market by nearly 10% during this period while adding a significant amount of uncompensated risk to a portfolio.

The moral of this story is patience. Mean reversion in relation to asset class valuations is the tendency of inexpensive assets to get more expensive and pricey assets to fall in value. However, just because something is expensive doesn't cause it to correct immediately. Mean reversion happens on its own time, not yours or mine. When it happens, it is swift and usually quite severe.

As we began this article we spoke about the similarities between baseball and investing with the connection being math, specifically statistics. We mentioned how Ted Williams knew as a hitter which portions of the strike zone offered him the highest probability of success and he focused on swinging at pitches within those areas. Ted Williams finished with a lifetime .344 batting average, 521 home runs and is a current member of the baseball hall of fame all while missing 5 years of playing time for military service (3 in the prime of his career). The title of this article *Wait for Your Pitch* is appropriate in



A second example relates to the performance of the high yield bond asset class relative to the broader US bond market. Despite the overvaluation seen below, high yield outperformed for 2 ½ years before beginning its fall in late 2007. In total, despite the early outperformance, investors would have benefitted by avoiding high yield during this period.



many regards. In baseball, a hitter can only be so patient. By the third pitch on the edge of the strike zone, you'd better be swinging like it or not. With investing, there is no clock or strike three. The only limits are our own personal abilities to stand still and be patient. Today this applies to REITs, small cap stocks and high yield bonds to name a few. This is ultimately why we are steadfast in our conviction of not owning (or owning in de minimus amounts) each of these and other expensive assets. All continue to do well while bearing the burden of lofty valuations. We've seen these eye high fastballs before. We prefer to wait for our pitch. Thank you for your trust and confidence.

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