2Q 2014 Market Insights
Uncommon Clarity through Value Eyes
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"It was never my thinking that made the big money. It was always my sitting. Men who can both be right and sit tight are uncommon. I found it one of the hardest things to learn. But it is only after a stock operator has firmly grasped this that he can make big money."

\- *Jesse Livermore*[1]

A friend and business coach to our firm, Steve D'Annunzio, repeatedly reminds us that, "value lies in the mind of the client." The point he is making, of course, is that free markets for goods and services will determine what they are worth. Develop a powerful offering with the client/end user in mind and the market will pay top dollar for those goods and services. Look no further than Apple and their iPhone franchise. Let us step back 20 years and imagine someone saying they sell telephones for $600 each. Can you honestly envision anyone paying $600 for a telephone? If we are honest, I think most would answer no. Yet they are everywhere today. At the end of the day, the product is still a telephone, but they brand it as an experience or a way of life. The iPhone experience is what consumers value, not the telephone. It is also the part that is difficult to envision or project ten or twenty years into the future.

For every Apple franchise, the road to success is littered with shattered dreams. Investing in hot growth or feel good stories is rarely a viable strategy. The reason, markets are efficient in processing all known current information. If a story is really good, the current stock price will be high. It is only to the extent that a future reality is better than today's story that will move the stock price upward. How easy is it to over achieve a great growth story when the bar is set so high? Not impossible, but difficult (remember, Wall Street tends to be pretty optimistic). If it was obvious two decades ago the iPhone would change the world, wouldn't everyone have owned Apple stock? Yet, Apple traded at $7 per share as late as 2003. The road ahead is never quite as clear as when looking through your rearview mirror.

Acting as a visionary, anticipating the technology, expecting a massive response from the consumer and projecting the financial results is exceptionally difficult many years into the future. So what matters? We would humbly offer three variables matter more than any others. ***Valuation***, ***current investor sentiment*** reflected in that price, and ***time***. Each variable is an observable rather than projectable data point. The purpose of this quarter's Market Insights is to drill down on each of these variables in greater detail while providing examples of value based investments at the asset class level.

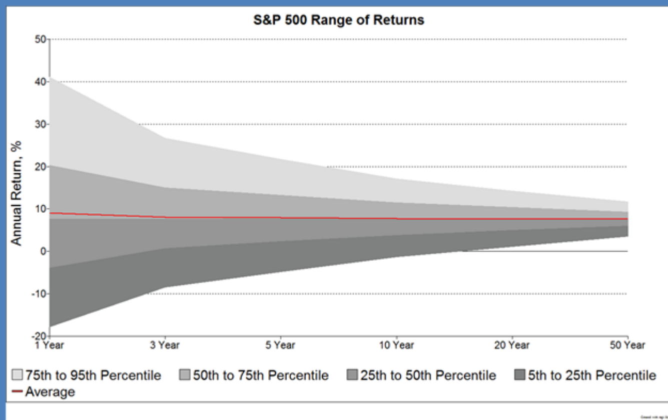
<u>Be a Long Term Investor - Time Period Arbitrage</u>

At just about every turn, newspapers, magazines or financial journals, we are told that we must maintain a long-term investment horizon. This section isn't about that, exactly. Yes, longer intervals make things much easier. However, our answer goes a bit deeper than the typical, "Hang in there, everything will be ok." Our question is why does it help to be a long-term investor?

Before I get into the details, allow me to set the stage by using an analogy. Think of investing as baking a cake. In a cake, we combine eggs, sugar, flour, water, oil and voila, we have the beginnings of a cake. We then take this mixture and put it in an appropriately heated oven and bake for approximately 30 minutes. Without knowing what the end result of how cake looks and tastes, how appetizing is a mix of raw eggs, milk, water, flour etc.? Not very. How does the cake taste if you bake it for 15 minutes instead of 30? The same goes for any investment

[1] Jesse Livermore was an early 20th century investor known for correctly shorting the 1907 and 1929 stock market crashes.

strategy. In value investing, the necessary ingredients are valuation and investor sentiment imbedded in that valuation. We then must bake this investment cake for an appropriate amount of time. What amount of time is that? Each strategy varies. Generally speaking, any investment strategy should be evaluated over the course of a full market cycle, although each will have its own time horizon that is usually equal to or shorter than that. Market cycles are generally accepted to be the amount of time covered from peak to peak of the business cycle, or 5-7 years.



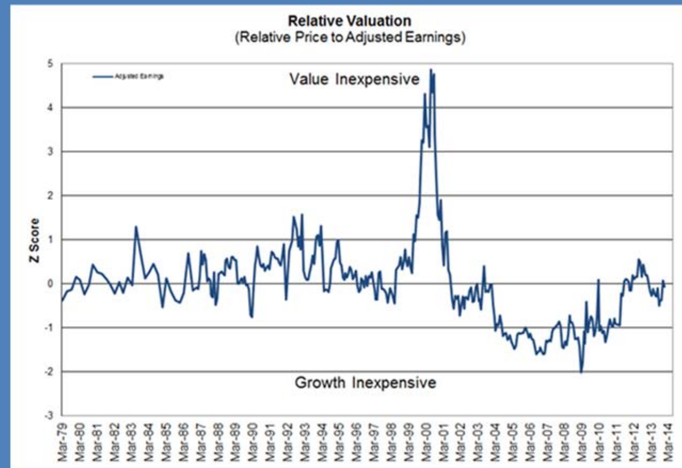
Time is an investor's biggest ally. A sequence of less than certain events becomes increasingly less likely as they compound on one another. If the probability of a coin toss is 50/50 with each toss, what is the probability of three successive tosses each resulting tails? The answer is only 12.5%(.5x.5x.5). If each year, has a standard deviation of +/-20, the fact that it could be plus or minus tends to shrink the range of return possibilities over extended periods.

Source: S&P, iCM Capital Markets Research

Time is so important to all investment strategies, especially value-based strategies that it is often described as time period arbitrage. It is an interesting anecdote but what exactly does time solve? For those who are not familiar, arbitrage is a riskless profit opportunity. In that sense, the statement is false since there is risk and uncertainty in everything. But anecdotally, the label is actually very telling and on point. In essence, it means that because the value investor has a longer term time horizon or evaluation period than the seller, he/or she can look past any temporary imperfections that may be depressing the current value. If I am not suffering from starvation, why would I remove a cake from the oven in 15 minutes when the cooking time is 30? Frankly, I would not. Someone who must eat now would act differently. In the example, the time horizon for needing to consume food is different. By waiting, you can achieve a completed cake and a better tasting dessert. My extended time horizon afforded me that option. In the case of value as a time period arbitrage, time allows asset classes or organizations to work through cyclical economic influences. That is, to experience all points of the business cycle, some of which may be more conducive to the underlying investment in question.

Seasonal and cyclical businesses such as construction companies may experience volatility in their stock price based on perceived disruptions in revenue due to weather or supplies. In the long run, those disruptions will have little impact and more realistic revenue growth will be realized. The example is simple at a small scale, but very real. Companies and asset classes face this with regularity. We will discuss this in greater detail in the next section.

The time horizon argument can also be made from a quantitative perspective. The chart on this page depicts the difference between a single-period standard deviation and a multi-period standard deviation on the S&P 500. If we take the average five year annualized return every five years from 1929-2013 and calculate the standard deviation of these five year blocks, we get 9.43%. If we take the same data from 1929-2013, the one year standard deviation is 20.18%. The difference, much of the volatility is muted within the five year block. This is seen above. While one year results can range from almost -20% to +40%, 50 year results range from +6% to +12%. The range is the point here, hence the time period arbitrage anecdote. Longer periods simply have a narrower range of possibilities since a few outliers can hardly budge the larger data set. In the real world, extreme and rare movements in capital markets like 2008 can happen. Over a one year horizon, 2008 was devastating. Over three years including 2008, unpleasant but manageable. What about over ten, twenty or fifty years? It will be about as noticeable as adding water to the ocean from an eye dropper.



At its peak, growth stocks reached a level of nearly 5 standard deviations above fair value. Said differently, the probability of growth continuing to outperform value in the late 90's was about one in 3.4 million. By contrast, in 2006 value stocks were no longer cheap enough relative to their high octane growth counterparts. The probability of them winning from a 2 standard deviation event in 2009 was only 2%.

Source: Russell Investments, iCM Capital Markets Research

<u>Valuations & Investor Sentiment</u>

We have long believed that markets tell amazing stories, some completely true, some mostly true and some truly enormous whoppers. The whoppers are the stuff from which bubbles are made. Although, they are difficult to see one step at a time until you end up in a completely unreasonable destination. Imagine if I told you that I created a car that can travel from the east coast to the west coast on one hundred gallons of gas. That's 3000 miles over 100 gallons or 30 miles per gallon. Good, but hardly revolutionizing. Now imagine having the same technology today but we are on the cusp of doubling the performance within the next year and doubling it again within 5 years. That would be 120 miles per gallon. What about traversing that distance on 1 gallon? That company would surely be worth something. This is the path that bubbles follow. Until the last step to 3000 miles per gallon, the story was plausible. Bubbles form one seemingly logical step at a time. Allow me to let you in on another little secret. Bubbles form in the other direction as well. That is to underprice assets.

We all know about the great growth stock rally that culminated in the internet bubble. Growth stocks had outperformed value stocks so badly in the 1990's that it would literally be a statistical anomaly, a rounding error, if they were to continue to do so in the years immediately after the turn of the century. This is seen in the chart above where the relative valuation of growth stocks compared to value stocks reached almost a 5 standard deviation event. This equates to a probability of .00002% or a one in 3.4 million outcome. The rubber band was stretched to and beyond extreme, and had virtually nowhere to go but snap back. However, there is more to this story. That is, what did this valuation imply or what story did it tell about growth stocks as compared to value stocks? To understand this comparison, allow me to first explain the source of return for both growth and value assets.

Growth stocks are the glamour stocks. They create their return by organically (with little use of debt or leverage) growing their revenues and, as a result, their earnings stream well into double digits. Additionally, this earnings stream tends to be fairly stable. That is, it isn't as susceptible to the ups and downs of the business cycle. So what you have is a beauty pageant contestant; high growth of earnings, a sexy and compelling story and, as a result, a high price. Investors pay up for these characteristics. By contrast, the value universe includes companies that have taken their lumps and/or have now matured to the point where adding leverage to their balance sheet is the only way for them to deliver earnings growth approaching double digits. As a result of the flaws, value stocks normally trade at a discount to the market and to growth stocks. Ironically, in most environments, the less than perfect value universe outperforms the glamour growth stocks. In fact, from any point where value is normally priced to inexpensive relative to growth, value has won more than 77% of the time historically. Now here is the trick. Investors have a way of taking what is happening today and pricing that into markets on a linear basis. That is, what is happening today good or bad is assumed to stay on a straight line from here and get either perpetually better or worse. Remember the gasoline example, 30 miles per gallon vs. 60 vs. 120 vs. 3000? Well, value stocks rely on this. The temporary imperfections of these businesses tend to be priced in at an overly pessimistic level making the discount larger than it should be. By contrast, the euphoria around growth causes them to be systematically overpriced. Therefore, as the reality ends up being just a bit better than the very low bar set for value, prices move up. The reverse happens for growth. The bar is set so high that when the reality is even slightly worse than the overly euphoric story, prices fall just enough to drag on the earnings driven performance. This tendency adds to the returns of value stocks that when coupled with a higher dividend are enough to overcome the headwind that the overpriced growth stocks face. But what happens when value stocks aren't cheap enough? That is, what if they sell at the same price as growth? Aaahh…very interesting. Given that these assets have similar risk profiles, they should provide similar returns. From an identical valuation it implies that the growth rate and stability of earnings is the same. It isn't even close. This is akin to a dump truck racing a Ferrari. Without a head start, value has no chance. This is what happened in 2006 and continued until 2011. From April of 2006 to late 2011, the point where value stocks had become expensive, growth stocks outperformed value stocks by more than 20%. The point here is that the market was telling us a story. It was expecting the value dump truck to outrun the growth Ferrari in an earnings growth race with no head start. How would you rate the story that the market was telling; likely to be true, only partially true or an enormous whopper? I'm going with the whopper. In fact, in 2009 at 2 standard deviations below the mean, growth stocks stood a 2% probability of underperforming value. The market is always telling a story. We just need to listen.

We opened this letter by stating that we believed successful investing is accomplished by understanding valuations, investor sentiment implied in those valuations and time. The collective animal spirits of investors have a way of running rampant. That is, pricing markets to levels of both excessive exuberance and deep despair. All of these are yarns that this master story teller weaves like an intricate tapestry. Some are true, some are mostly true and some are truly enormous whoppers. To determine which is which, all you need to do is listen and be patient. Thank you for your trust and confidence.

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