



November 11, 2011

Conviction

It should be clear that among the causes of the recent financial crisis was an unjustified faith in rational expectations, market efficiencies, and the techniques of modern finance. ... All the seeming mathematical precision that was brought to investment, all the complicated new products, including the explosion of derivatives, that were intended to diffuse and minimize risk, did not work as had been claimed.

Paul Volker,
NY Review of Books, Nov. 2011

Like our clients, we spend a lot of energy examining the value proposition of our work. How much better off is the portfolio from our involvement, and is there a better alternative? This is no idle question, it is existential, both career-wise, and because a goodly portion of the funds we manage are our own. Recall that a principled investment advisor builds wealth alongside his clients, not off of them.

Our central focus is on activity. While diligence is explicit in the role of a fiduciary, could we expect better results from a more passive approach – a handful of low-cost index funds, arranged in a textbook pie? The answer should not surprise you.

Over the past five years, an indexed portfolio of Stocks, Bonds, Gold and Cash in rather conventional proportions would have shown forty percent less volatility than the S&P 500 with roughly one hundred thirty times the return.¹

Fig 1. Five Year Performance November 2006 Through October 2011	Initial Allocation (%)	Ann. Std. Dev. (%)	\$ Weighted Cumulative Ret. (%)
iShares Barclays Aggregate Bond Fund	30	3.7	10.53
iShares MSCI Emerging Markets Index Fund	15	28.5	4.83
iShares MSCI EAFE Index Fund	15	22.5	(1.77)
iShares Gold Trust	10	20.7	18.00
iShares Russell 3000 Index Fund	20	19.6	0.45
Barclays Capital U.S. Treasury Bills 1-3 Month Index	10	0.6	0.79
Total	100	11.2	32.84
S&P 500	100	18.9	0.25

If it's that simple, then why have so few investors seen their portfolios grow by one-third over the past five years?

Why, In the Morningstar database of over twenty four thousand mutual funds, **only nine funds** with stock exposure delivered a comparable return at a comparable level of risk? ³

The answer lies in human nature. Although the above *portfolio* had modest volatility, *constituent parts* were central cogs in the meatgrinder market we've seen over the past few years. Gold, the greatest single contributor to the above model, as well as to our own portfolios, fell from over \$1,000/oz in March of 2008 to under \$700/oz that November. Emerging Markets lost half their value in 2008, and even the Lehman Aggregate Bond Index was off 16 percent peak to trough that year. It's hard to remain dispassionate when the market mauls equally your hedges and speculations.

Our stay-put behavior reflects our view that the stock market serves as a relocation center at which money is moved from the active to the passive.

Warren Buffett
Berkshire Hathaway 1991 Report

Buffet wrote this ten years into the greatest bull market of our generation, well before "irrational exuberance," the internet bubble, the housing bust, and several sovereign debt crises. Yet it still rings true.

Terry Odean of U.C. Berkeley has spent the past 20 years describing the substantial underperformance of active traders, finding the shares investors sell on average far outperform those they buy in exchange. And it's no better with mutual funds -- an oft-cited study by Dalbar Inc. found over a seventeen year period ending in 2001, **the average stock fund investor earned less than six percent of the gain of the S&P 500!**

But do we want the returns of the S&P 500? 2008's forty percent drop was not at all improbable. Recall Statistics 101: there is a 47 percent likelihood of a two standard deviation outcome. Heads – we win; tails - our million dollars is now \$600K.

The goal is not to beat the market; the goal is to avoid having the market beat us –that is to maintain a portfolio of securities which *collectively and individually* inspire confidence to stay the course.

Charles Ellis describes this process of winning by not losing in a 1975 essay "The Loser's Game."³ He contends that investors prevail like amateur tennis players: by giving up fewer points, not through aggressive shot-making. Former Chairman of the Yale Investment Committee, Ellis later expanded these ideas in a book "Winning the Loser's Game," well worth a read. Above all, Ellis tells us:

The hardest work in investing is not intellectual; it's emotional.

Notes:

- (1) Does not reflect fees or trading costs. You cannot invest directly in an index. Source data: www.iShares.com.
- (2) All funds with equity holdings with cumulative 5 year returns in excess of 32.84 pct and standard deviation less than 11.2 pct. Source data: www.morningstar.com
- (3) *The Financial Analyst's Journal*, July/August 1975.

What to Do

Tasked with ensuring security for our families as well as a dignified retirement for ourselves, what is to be done?

Our solution is to own shares of high-confidence firms, tempered with funds invested in harder to access markets, such as Corporate and Foreign Bonds, Emerging Markets or Commodities. Less elegant than textbook indexing, we feel this approach improves an investors likelihood of staying invested through full market cycles.

A focused selection of high-quality stocks can be central to a responsible portfolio. **The contribution these shares make is as much emotional as financial.** To own shares in a representative slice of industry engages the investor in a far richer manner than the ticker of an index fund. So engaged, we may be less prone to react rashly to the inevitable short-term disappointment.

The central guidepost is price. A superb firm, overpriced, has modest promise as an investment. For example, the nation's largest retailer has tripled earnings over the past decade, but as its price to earnings ratio fell by two-thirds, investors have seen little return beyond a modest dividend.

What not to Do

While forever may be the preferred holding period, as elsewhere in life, at times we must acknowledge something as not working out. **Cutting losses is the hardest part of investing.** It is far more gratifying to sell a winner, banking a capital gain, than to recognize a thesis as wrong, or that conditions have changed, and then to act positively.

The extreme volatility of today's markets makes selling decisions harder. Price only fleetingly reflects the value of an investment, and extremes are most pronounced. Butterflies in the Cyclades can cause a trillion dollar moves overnight. High-frequency trading and other manipulations have cheapened the information value of a price quote, rendering the stop-loss, a classic selling rule based on deterioration in price, unreliable as a risk management tool.

So we return to conviction. If the facts supporting an investment remain true, and the costs of being wrong are sustainable, investors should accept that over the short-term their account balance may not reflect the value of what they own.

We must understand the human element: the gap between theory and practice because one's financial security depends on it. Newsletter writers and internet touts may crow hypothetical returns; investors with capital at risk inevitably experience a different outcome. Accepting ones humanity is a prerequisite to successful investing.

Your Portfolio

Aside from an obscure reference to the Greek Isles, we have avoided a rehash of the relentless media flow. Sure, the world economy is in crisis, 45 million Americans rely on Food Stamps to eat, and the Great Bank Robbery continues, with a former U.S. Senator looting \$630 million of customer accounts, with apparently no personal consequence. Life goes on. As a German girl told us once, after three weeks of rain in Frankfurt: **there's no such thing as bad weather, just the wrong clothing.**

We continue to invest in **high-quality blue chips**, emphasizing Consumer Staples, Energy and Utilities. On the whole, valuations have come down smartly from the highs of the past decade, and the long-view investor faces much better prospects than those of the recent past. Marquee technology shares show promise and reasonable value. **Wally Weitz**, Omaha Nebraska's second-most respected investor, said recently "if you told me ten years ago I'd own these stocks I'd have laughed at you.

Foreign Markets are no longer foreign to industry or to investors. The Emerging consumer will brush and floss, have a beer, and plug their refrigerator into the grid just like us. They've much more experience with debt crises and sovereign risk, so it's conceivable they won't abuse credit as we have. Certainly growth and profits can be found in these regions, and our investments reflect this, in the sales mix of US firms, and in Foreign shares and funds.

Bonds continue to play a role in our portfolios, as much an anchor to the windward as for income or gain. With interest rates at year 29 of an epic decline, longer-dated bonds are more volatile than we've seen in, well, 30 years. We continue to invest in a Foreign Bond fund, mostly as a dollar hedge, and a Corporate and Mortgage Bond fund run by one of the industry's brightest minds.

Gold has made a terrific contribution to portfolios over the years. If three decades makes a bond bull market long in the tooth, one decade may be too early to write off the barbarous relic. We've long discouraged wanting a run-up in gold, as it implies something else is very wrong. It's not gratifying to be right, but it is to be long. We hope the world is getting better; but we are not selling gold.

What to Expect

Expect effort from your advisors. Expect prudence and expect discipline. We are committed to the intellectual and technical side of investment, yet mindful of the emotional core. Above all, we are committed to you.

Frank J. Ruffing CFP



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