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Slow In, Fast Out

During the course of 2015, retail investors have poured a record amount of money into equity index funds.[1] These passively managed products may pose more risk in the current environment than many investors realize. For one, they are by definition 100% invested and therefore, in an important sense, "all-in." Secondly, large money flows into equity index funds can have a dramatic impact on the prices of the underlying positions themselves—the heavier the weighting, the larger the potential impact. Record index fund inflows may go a long way to explaining why this year the 10 most heavily weighted companies in the Standard and Poor's 500 index are up over 20 percent as a group while the remaining 490 stocks are down 2.6 percent.[2] This striking divergence, combined with studies on individual investor behavior which indicate that they are typically more aggressive at the wrong time is, in my view, cause for concern, as the performance data associated with these studies suggests that while retail investors win some battles, they most often lose the war.[3]

There are times, and 2015 was one of these, when our portfolio discipline may cause us to appear a bit out of sync with the market. In some ways this year reminded me of another such time, 1999, when our performance trailed the S&P 500 as we avoided the popular technology stocks of the day. (Our client letter that year was entitled *Sometimes Careful Looks Stupid*.) In this year's letter I will use my recent experiences in high-speed performance driving to illustrate the thinking behind our investment strategy and hopefully provide a helpful context for our recent performance and current positioning. I believe the racing principles of *eyes up* and *slow in, fast out* are as important to investment success as they are to winning races.

First perhaps I should explain just how I got into high performance driving. Most of you know that for years I have preached the wisdom of using a risk-reward framework to make decisions. I am embarrassed to admit that I have cleared out entire cocktail parties and nearly ruined birthday celebrations with my drab monologues on the virtues of risk-reward decision making. My sons could probably recite some of the speeches

verbatim. To those that know me, race car driving just does not sound like my kind of thing. That is true but my oldest son Nathan’s enthusiasm for a father-son high speed track experience was enough to get me to agree to give it a try despite my considerable trepidation.

The high-speed driving weekend that we attended was held at Mid-Ohio Sports Car Course— a track that includes 16 turns, a few of which are "blind." I had never driven on a track before and as I sat in pre-driving class in the track tower my anxiety started to get the best of me. The sound of speeding cars roared from the track as the instructor said things like "if you feel your back-end getting light get on the gas, hitting the brake could send you spinning into the wall." I understood the physics behind his instructions but worried I might panic in the heat of the moment. About thirty minutes into that first class someone sitting near the window looking over the track jumped up and yelled "there’s a wreck." I suddenly felt sick with fear knowing Nathan was out on the track while we first-timers were sitting in class. I ran to the window and saw that his car was involved. It felt like my heart stopped as I was trying to see if he was okay. As it turns out he was fine— his car's coolant reservoir had cracked, dumping fluid on the track and sending him into a dangerous spin with cars flying up from behind. Thankfully no one was hurt. Nathan’s instructor told me that he handled the dangerous situation perfectly, steering into the spin and then jamming both feet to the floor (brake and clutch) thereby minimizing the risk of spinning further out of control. I was impressed and proud that Nathan handled the emergency so well. I also desperately wanted to call off the weekend but Nathan would not hear of it.

The roar of speeding cars, the intimidating pre-track instruction, and Nathan’s 360-degree spin all combined to raise my anxiety level to red alert. By the time I finally climbed into the car I was a nervous wreck (pun intended). I was stressing so much that I had trouble even putting on my helmet. I did not know how I would react if a critical situation arose out on the track.

Thankfully I had a great instructor in the passenger seat. He could tell my fear was getting the best of me. The white knuckles on the steering wheel and profuse sweating probably tipped him off. I was breathing so heavily inside my helmet my glasses fogged up and I could hardly see. Somehow my instructor kept his cool as I drove those first harrowing laps doing most everything wrong. He only showed his emotions once. I’m still not sure exactly what I did wrong but I could tell I alarmed him when the car

shuddered in a turn. At that moment I heard the distinct sound of fear in his voice as he asked me to confirm that the car's stability control feature was engaged.

Somehow my instructor hung with me, patiently explaining and re-explaining high speed driving principles. Amazingly, he managed to turn me from a fearful, reactive, herky-jerky driver, endangering other drivers on Saturday into a much faster, much smoother and much safer driver on Sunday. My instructor managed this transformation by convincing me to buy into two crucial driving principles. The first was keeping *eyes up*. In racing that means looking up and further ahead on the track and resisting the temptation to let your point of focus drop down just beyond the hood. When drivers let their eyes drop, seeing only the track just in front of the car, they experience a harrowing feeling racers refer to as *road rush* which can trigger late and panicked reactions to the road. With *eyes up* everything seems to slow down and the right adjustments feel natural.

I think the *eyes up* principle is just as critical in investing. Setting one's sight further ahead, two to three years or even more, helps to prevent over reacting to daily news and noise. Getting caught-up in day-to-day price changes tends to heighten anxiety and can trigger rash decisions. Public companies announce results every three months while share prices change minute-to-minute every business day. Price moves between major announcements are often driven more by changes in investor sentiment (and the consequent fund flows) than anything else. I am not suggesting that all price movements should be ignored, I am simply cautioning that getting caught up in the ups and downs of daily fluctuations can cause an investor version of road rush, making life more stressful than it needs to be and financial goals more difficult to reach. For me, it was fascinating to experience the great power of essentially the same phenomenon in racing as *eyes up* made smoother, faster and safer results come more naturally. It was an exhilarating feeling when I got it right. Studies consistently show investors who check prices less frequently and trade less often tend to experience less anxiety and better performance.[4] Now that is a wonderful combination.

The second racing principle that I think applies to investing is *slow in, fast out*. In racing this refers to hitting the brakes hard at the end of a straightaway, abruptly shifting the car's weight onto the front tires before steering into the turn. The driver's eyes should be up and focused ahead, first on the turn's apex and then further up on the optimal point to hit the

gas for maximum speed and momentum exiting the turn into the next straightaway. This may strike you as counterintuitive. Most people would naturally assume that the fastest way around the track would be to enter the turn as fast as your car and your moxie can handle. Professional racers know different. For a faster, safer trip, drivers enter the turn slowing sharply with weight forward and exit fast, accelerating with weight back.

While driving speed laps during my second high-performance driving weekend (yes I went again— I am afraid I may be hooked) I found myself catching up to more experienced drivers as they entered turns, sometimes right on their tail feeling like I was in a great position to overtake them, only to see them zoom away as they exited the curve much smoother and faster than I could as I was left struggling to slow down enough to hang on in the turn.

Going into turns too fast and out of position is both the most dangerous and the slowest way around the track. I got carried away once trying to catch a friend ahead of me and went into a turn with too much speed. I can tell you the only thing on my mind as I got into the turn was braking as hard as I could in an effort to save my skin. In a matter of seconds, I went from being an overconfident racer thinking "I've got this" to a panicked rookie praying that the brakes were powerful enough to save me from paying dearly for being too aggressive as I entered the turn. As I desperately mashed the brake pedal to the floor and the back end of my car started to swing around all I could think about was avoiding a collision with the wall. Catching the car in front of me— the motivation that got me into that dangerous position— no longer mattered.

Just as inexperienced drivers can get caught up in the excitement of the chase, investors can be vulnerable to getting sucked into popular (often momentum-driven) investment strategies that are on a hot streak. So far this year retail investors have poured $365 billion dollars (net) into passively managed index funds and have withdrawn $147 billion from professionally managed funds.[5] In my view, equity index funds are well suited for bull market "straightaways," as they are 100% invested and benefit from momentum, given the vast majority seek to mimic the performance of market capitalization weighted indices. In market capitalization weighted indices a position receives a heavier weighting as its price increases and a lighter weighting as its price declines. Heavy flows into investment products that mimic the S&P 500 may explain at least some of the outlier performance of the most heavily weighted companies I

referenced earlier: The top 10 stocks in the index are up over 20% percent this year, versus a loss of 2.6 percent for the remaining 490. This 24 percentage-point spread between the 10 biggest stocks in the index and the other 490 components is the widest since 1999, heading into the dot-com bust.[6]

A crucial difference between driving and investing is that on the track drivers know exactly where the next turn is. Experienced racers know precisely where they need to jam on the brakes in order to shift their car's weight onto the front tires for better turning grip in the curve. In investing, of course, we do not know exactly when markets will turn. Our approach is to prepare rather than attempt to predict. To us, part of being prepared means holding a portion of the portfolio in cash so that we can fund future purchases without selling holdings when market stress presents opportunities. Raising cash is a form of taking off speed and positioning to take advantage of opportunities that may come down the road. There is a price to holding cash, of course, as it serves as a drag on performance in rising markets. This is a price that we are willing to pay given that market volatility can happen so quickly that it rarely allows time to raise cash as events unfold. Market prices tend to fall faster than they rise; it is the nature of markets. To be clear, I am not trying to get you to worry about the market. My goal is quite the opposite. Our eyes are up and we are prepared. Market corrections occur from time to time and, while they hurt performance when they happen, they also can present valuable opportunities to enhance future performance. Just as experienced drivers use turns to set up for speed in the next straightaway, successful investors use market corrections to help improve their position and increase their future income.

Now I would like to move on from discussing strategy to touch on a couple of disappointments in our portfolio in 2015 and what we learned that I think will help us improve going forward. This year we liquidated two small positions that performed very poorly— a mining company and a mechanic training school. While we did not get caught up four or five years ago in what we thought was an over-investment in both mining and for-profit education we did initiate two small positions after those sectors fell out of favor and prices fell to what we thought were bargain levels. Share prices for both the mining company and the vocational school were down more than 50% from levels they had traded at when their sectors were popular. Both had strong balance sheets, impressive earnings growth potential and above market dividend yields. Declining silver and gold prices hurt the

mining company's results while negative publicity in the for-profit education industry and lower levels of U.S. unemployment hurt enrollment at the vocational school. We sold each at a loss shortly after their respective management teams announced poor results and capital spending plans that exceeded what we thought was prudent. To us, increased spending in the face of declining revenue is dangerous—akin to accelerating into a turn. The poor performance of each serves as a humbling reminder that just because a stock is trading for less than half its former price does not necessarily mean that it is a bargain or nearing a turnaround.

Our positions in both were limited in size thanks to our portfolio management discipline helping us achieve respectable performance over all. We have been managing portfolios for many years and know that even with thorough due diligence, from time to time we will make mistakes. Effective portfolio management, in our way of thinking, is about making a lot when we are right and only losing a little when we are wrong. With this in mind we do not "double down" when company results are faltering even when prices appear tempting. It is rare, at least in our experience, that a company with deteriorating fundamentals is cheap enough to be a good investment. Over the years this discipline has proved useful in mitigating portfolio risk. We prefer that positions grow large through appreciation, rather than through big, bold purchases.

As we look forward, with *eyes up*, we are mindful of the fact that we live in an uncertain time and we are working diligently to be prepared to capitalize on opportunities that may come our way. We understand that financial markets will go through plenty of ups and downs along the way and are more confident than ever in our ability to help you navigate the twists and turns. While the news is too often filled with frightening headlines and political infighting we must not lose sight of the fact that we live in a world of continuing progress and growth. Market turmoil represents opportunity for those who are prepared to capitalize on it. As 2015 comes to a close we feel like we lost a couple of battles but are in a great position to win the war.

Thank you for your trust and confidence.

Phil McCauley III
December 2015

[1] Bloomberg Business, "Vanguard's Gain is Wall Street's Pain as Billions Leave the Financial Industry", Eric Balchunas, 2015 December
[2] CNBC, "It's Back: A Bad S&P 500 Data Point Last Seen at Dot-com Bust", Tim Mullaney, 2015 December
[3] Wall Street Journal, "Just How Dumb Are Investors?", Jason Zweig, 2014 May
[4] Wall Street Journal, "Keep Stock-Market Apps Off Your Phone", Shlomo Benartzi, 2015 November
[5] Bloomberg Business, "Vanguard's Gain is Wall Street's Pain as Billions Leave the Financial Industry", Eric Balchunas, 2015 December
[6] CNBC, "It's Back: A Bad S&P 500 Data Point Last Seen at Dot-Com Bust", Tim Mullaney, December 2015

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