

This letter is dated January 2019

Predicting rain doesn't count; building arks does.

- Warren Buffett

A young woman recently engaged to be married told me that she and her fiancé were the perfect match: “We’ve never had an argument, not so much as a quibble.” She giggled as she said “quibble.” I smiled politely, congratulated her on the engagement and wondered to myself how long the no-quibbling phase would last. I have been married long enough to know that disagreements are inevitable and that learning how to work through them is vital to making a marriage last. Arguments come with the territory just as volatility comes with investing in stocks. Investors are inevitably tested and, when they are, most do not fare so well. This letter is about our strategy for dealing with market volatility and uncertainty.

First, we believe investors should always be in a position to be a buyer—both financially and emotionally. I have stressed the importance of maintaining reserves in nearly every letter that I have written over the last twenty years. Embarrassingly repetitious, yet here I go again: In my experience, reserves are crucial to long-term investment success. They help provide emotional balance, protect against having to sell at distressed prices and make bargain buying possible. We primarily use Treasury bills for reserves to maintain the highest level of safety and liquidity. Of course, there is a cost. Treasury bills just inch along earning a bit of interest, which feels like opportunity lost when equity markets are surging. The benefit is that they also inch along earning bits of interest when stock prices are falling.

The amount of reserves we recommend holding varies from person to person. In our experience, there are two key considerations. The first is personal cash flow. Investors with income that exceeds expenses have the ability to add to investments after market declines and thus have less need for reserves. Investors using their portfolio to fund expenses, on the other hand, need to maintain much higher reserve levels. In our view, setting enough money aside to fund three to five years of expenses is a useful guideline. Bear markets can last a long time (and feel even longer) and

investors need to protect themselves from having to sell at low prices. Selling in a market slump can turn a temporary condition into permanent financial damage.

The second consideration in setting an appropriate reserve level is emotional sensitivity to market fluctuations. Part of learning how to handle disagreements with your spouse is not letting emotions run too hot. As a kid I spent a lot of time outside shooting basketball. Every so often a newly-married young woman living across the street would burst out the front door of the couple's house yelling and screaming (presumably at her husband), storm out to her car, jump in and speed away. I am guessing that marriage did not last long.

Behavioral finance studies indicate fear is more often the driver of regrettable selling than financial pressure. Losing money, according to studies on investor psychology, is about twice as painful as making money is pleasurable¹. That is an average of course; the more emotional an investor is about market price swings, the higher the pain ratio and the higher the recommended reserve level. Those rare investors who do not get excited when market prices make big moves can reserve less. Investors that check stock prices more frequently need higher reserves than those who rarely look at their accounts. Reserves can cushion the emotional impact of market price swings, helping the investor stay on course.

A couple of weeks ago I was on a call with clients that have been married for a very long time. Over the two decades I have known them they have amazed me with their ability to debate two sides of almost anything. It was cold in Louisville, and I asked them about their weather down south. The wife replied that it was 82 but partly cloudy. The husband said yes, it was 82, but it was actually partly sunny. She responded by saying that is the same thing. He countered, saying no it wasn't— partly cloudy meant mostly sunny... Well, I will not try to relate the whole thing here but I can tell you I was glad when she ended the back and forth by saying with a smile in her voice: "Phil, I hope it's sunny where you are." While they debate with each other almost constantly and may annoy each other often, their emotions do not run so hot that one of them storms out the front door yelling at the other. Over-heated emotions increase the risk of breaking up along the way. Strategies that dampen emotions can make all the difference.

Recently, market price swings have been testing investor emotions. If the volatility near the end of the year caused you to lose sleep, get angry or feel vulnerable, you may have too much of your money in stocks. Your reserves may be too low. Loss aversion inflicts the most pain on frequent market checkers. Market watchers were on an emotional rollercoaster during the week of Christmas and likely felt harried even though the Dow was actually up more than 2.5% on the week². Down 500 points one day and up 500 the next nets out to no change, but this kind of volatility can cause stress and even lead to poor decisions. If December was traumatic for you, it may make sense to reduce your exposure to stocks.

Financial and emotional strength at a personal level is not enough. Selecting sound investments is as crucial to long-term financial success as choosing a good partner is to a lasting marriage. An unstable spouse can make marital success impossible. Individuals who invest in companies with low reserves weaken their own personal financial position. Investors are only as strong as the assets they own.

Assessing the financial strength of companies requires some work. Superficial labels such as “blue chip” should not give investors much comfort. There is a long list of large and well-known companies that overspent in good times, leaving shareholders with huge losses when times turned tough. Even the best known and most respected companies can suffer permanent damage when corporate financial reserves are too thin. To be successful, investors need to look beneath the surface to assess how management is allocating capital and evaluate the company’s financial capacity to weather market storms.

The unpleasant reality is that even companies in a strong financial position can see their share prices plummet, just as strong marriages inevitably go through rough patches, stresses and strains. The key is that financially sound companies are better able to weather tough times and ultimately recover. Amazon founder and CEO Jeff Bezos was asked in a recent interview how his company survived the dotcom crash that led to the demise of so many technology companies. Bezos noted that the company’s share price fell from over \$100 to \$6 during the market bust and that he started his annual shareholder letter that year with a one-word sentence: “Ouch.” He then went on to say that the problem with a financial market bust is that it makes it really hard to raise capital. Since Amazon already had the money it needed, they could move forward.

Our portfolio management approach is built to help clients weather the volatility of the financial markets and achieve their long-term financial goals. We strive to invest in quality businesses we understand, run by people we have confidence in, at prices we think offer enough return potential to justify the risk. We invest with the idea of owning for a long time rather than buying to sell when shares hit a near-term price target. We work to be more disciplined and patient than the crowd rather than attempting to be quicker and smarter. We are focused on building portfolios of businesses we believe can weather downturns and emerge even stronger, with stock prices ultimately rebounding to make new highs. We recognize that such recoveries can take years and the process can test even the most patient investors. Warren Buffett³, Jeff Bezos⁴ and Jamie Dimon⁵— three of the world’s most successful and admired business people— each saw the value of their company decline more than 50% during the financial crisis of 2008. In our opinion, those who think they can avoid declines are as naïve as a person expecting no quibbles in a marriage. While we cannot avoid tough times, we believe we can build portfolios that will endure them, helping clients achieve their long-term goals.

We build each portfolio in a separately managed account and, as a result, positions, position sizes and asset class exposures can vary from one account to another. The primary differences stem from factors such as when the account was opened, tax considerations, client withdrawal rates and risk tolerances. We prefer to build each portfolio over time rather than fully investing new accounts on day one. Accounts that we have been managing for a long time generally have higher equity exposure than newer accounts. In our portfolio construction process, we make relatively equal-weighted investments, letting investment performance drive weightings over time. We believe this approach puts us in a better position to make more when we are right and lose less when we are wrong, as successful investments naturally grow to become a larger part of the portfolio over time. We generally hold successful investments as long as the company’s business is performing well and we are comfortable letting positions grow to be a relatively large percentage of a portfolio. Most of our selling is driven by company problems as opposed to taking profits when shares hit price targets. For example, we will sell shares when a company is losing customers or we disagree with management’s use of corporate capital.

Our aim is to own shares in growing companies for many years. We believe this is a different mindset and an important distinction from those who are buying to sell. We are ownership focused rather than transaction

oriented. We believe that long-term ownership of assets is a more effective and more tax efficient path to wealth building than trading securities in an attempt to outsmart the market. There are a countless number of traders who are smarter and quicker than we are and we have no interest in taking them on at what we view as their game. Our strength is in patient long-term ownership of well-managed, growing companies, and we believe our approach offers potential advantages that can make a significant difference when compounded over long periods of time.

We look ahead to 2019 with a focus on understanding the environment and preparing rather than attempting to predict a specific outcome and then betting on it. To put our view simply, we think uncertainty is high. The Federal government, corporations and investors hold record-high debt loads⁶, suggesting to us that risk levels are elevated, especially in a time of tightening monetary policy. Quantitative easing (the Fed putting dollars into the economy) and near-zero short-term rates provided a strong tailwind for the markets and economy for years coming out of the great recession. It seems reasonable to expect that quantitative tightening (taking dollars out of the economy) and higher short-term rates will serve as a headwind going forward. While it is tempting to try to avoid a market decline with the idea of selling everything just before prices fall and buying it all back when the market bottoms, in our view that is a fantasy, not a strategy. Our approach is to be aware of risks and reserve for them as best we can. We work to capitalize on volatility incrementally, knowing that things can always get worse and prices can always fall further. We work through troubled times rather than attempting to somehow circle around them.

We believe that realistic expectations, not grand predictions, are key to making sound decisions and achieving investment goals. They can also make the journey more pleasant. My wife likes to joke that the key to a happy marriage is low expectations. Like so many funny jokes, there is an underlying truth to it. We think a realistic average annual return expectation for equity investors over the next several years is 4 to 6%. Current interest rates, equity valuations, and our view of where we are in both the market cycle and economic cycle all factor into our return expectation. While we expect relatively low returns, we also expect continued high volatility. Clearly, this would be a difficult combination for investors, especially for those without adequate reserves in place.

Given that our mindset is one of preparing for potentially turbulent times, it is reasonable to ask why we should bother investing in equities at all. Well, first of all, like marriage, equity investing is not for everybody. It is not all upside, but we believe volatility creates opportunities for the well prepared. We are confident that if we choose our investments carefully and remain committed to a sound plan, the rewards will be well worth it. We believe that a quality portfolio of equities provides investors with an opportunity to benefit from the future growth and progress that we see as inevitable in our economic system over the longer term.

Phil McCauley III
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¹ Kahneman, Daniel and Tversky, Amos, Prospect Theory: An Analysis of Decision Under Risk, Journal of Risk and Uncertainty, 1979 March

² Bloomberg, 2018 December 24 – 2018 December 28

³ The Telegraph, "Warren Buffet Loses Billions", Richard Tyler, 2009 February

⁴ MacroTrends, "Amazon Market Cap 2006-2018", data from 2007 December to 2008 November

⁵ Reuter, "FACTBOX: U.S. Bank's Market Capitalization Shrinks", 2009 January

⁶ Bloomberg, "Global Debt of \$244 Trillion Nears Record Despite Faster Growth", Chibuike Oguh and Alexandre Tanzi, 2019 January 15

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