

The Second Oldest Way to Enhance Return

Now that we are safely ensconced in the home stretch of 2004, it might be time to get far ahead of the year-end prognostication crowd and present both a view and review of the intermediate-term outlook for the financial markets.

The current calendar year has been terribly “boring” on both an absolute and relative basis on a number of counts and it has been suggested that we might as well get used to it, as the outlook for equities remains dim or at least muted according to many leading lights of the equity world (more from them later.) As the market is generally unchanged since we opined nine months ago that our new idea well had run almost dry, one might suppose somewhat correctly that we continue to lack a deep reservoir of new and value-rich ideas and not be far from the truth. The last three quarters of generally terrific corporate results have moved the needle in the healthy direction of fair value for the equity markets, but fundamentals remain in the catch-up mode after the wonderful equity returns of 2003.

Therefore, the big question remains: is the equity investor in particular or the global asset allocator in

general doomed to wallow in the “mediocrity” of low-to-mid single digit returns for some years to come and what, if anything, intelligent can be done about it?

The first two issues to confront are the oddly entwined definitional and behavioral views. It has come to our attention through client contact and a wide breadth of popular press that many folks do not quite understand what constitutes an appropriate set of expectations about returns on their assets. Expectations are extraordinarily important in both life and the financial markets, as they not only set up the psyche for the possibility of happiness and satisfaction, but also provide important direction for the investor as to what asset classes or securities they should be looking to achieve satisfaction and happiness.

When an investment advisor who possesses even the slightest element of common sense meets a new client for the first time, it is highly recommended that expectations of future

performance are set at the lowest reasonable benchmark; for the key to a good client relationship, like a good marriage, is to start with low expectations and therefore minimize disappointment. On a practical basis, starting with modest expectations is possibly

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“I know I said I would marry you, but that was four hundred points ago!”

THE crucial element in successful value investing. If a stock has fallen so far from the good graces of the investing world that it is available at a price that incorporates little or no expectation of success in the future or even negatively values the future, then it does not take much of a positive change in thinking to create a disproportionately northward move in price. Intelligent use of modest expectations also helps individuals and corporations to act rationally in allocating capital; the perfect example being the dumb.com boom, whereby an unhealthy number of individuals and companies avoided saving money for their retirement/long-term goals because they hoped/prayed that would be bailed out by their expectations of earning 20% on their stock portfolio for eternity.

Hoping and praying can be positive personal activities, but we would suggest a highly inverse statistical relationship between prayer and investment results that eventually comes home to roost. There are simply forests full of easily accessible data to assist any lay or “professional” investor in coming up with some general and reasonable expectations. While there seem to have been ancient scrolls dug up in some academic cave during the past two years that allow statisticians to present conclusions on equity returns going back centuries, we will stick to the post-1926 Ibbotson world and present an oversimplification which will make most of the same academic points without resorting to Greek lettering and mathematical hieroglyphics, although the “new” old data confirms much of the same thing: “real”(after inflation) returns for equities have been hovering for a remarkably long time around 6 to 7%. (That’s 8.2% to 9.2% on a current nominal basis.) Let’s make our forecasting life easy and assume that fixed income returns are simply the coupon of a 10-year bond, which is presently 4%. Using the conventions of a 60% equity/40% fixed income asset allocation, the math works out to a 6.52% expected nominal (including 2.2% inflation) return, which should represent the middle of an investor’s expectations curve.

Under the heading of “wonderful returns don’t create big problems,” we will ignore the positive scenarios and focus on the other side of the probability curve. Over the past five years, a vociferously more negative

outlook has been postulated than that noted above and given the intelligence and articulation of those carrying its banner, not to mention that one of its major proponents happens to be the current head of the largest financial analyst publication and thus has a forum to drum it into our heads on a monthly basis, it pays to review it in some detail. We will come right out and say we have reviewed this viewpoint over the past years in strategy letters, most notably at the bottom of the 2002 market decline (*No Dow 5000*, December 2002 – email us for a copy) and cannot give it its full due within our limited space.

This “bear case” can be neatly summed up as follows: future equity returns are driven by some proxy for earnings growth, the annual dividend payout, and the end-of-period change in the valuation accorded these earnings. In other words, if average corporate earnings growth in America has been remarkably stable at less than 2% in real terms (this is 4% in nominal terms and yes, on average this appears to be a fairly legitimate and sticky number, contrary to what every growth-oriented money manager claims his stocks can do for the next 20 years), and if dividend yields are now less than 2% nominally, to make up the difference between this baseline 5.5% and your 20th century long-term average of close to 10%, the average valuation accorded to the stock market must go up.

While our ability to foresee the future has not materially improved since our last writing, it is this last point that sticks for us. The ideal investment candidate is one where the value “growth” is greater than expected and the valuation accorded to it at the exit point has also shown a greater than expected growth since purchase. This is the proverbial “double whammy:” a higher valuation on a higher base of value.

We are highly doubtful that any real productivity miracle has occurred during the last decade. We find it difficult to imagine, mathematically or strategically, that interest rates will move materially lower. We are willing to accept the notion that the world is likely to be a lot messier over the next twenty years than the prior twenty years. We find it difficult to get very excited over the values we are currently seeing in the overall market. Therefore, it seems to us unlikely that

an investor should "expect" the average stock to be accorded a higher valuation multiple ten years from now than today. This leads one to believe that returns will be more weighted toward growth and that implicitly argues for lower expected equity returns.

We will get to strategies for squeezing more lemonade out of the current stock of lemons shortly, but our point is that there is nothing inherently wrong with working with a base case 6 – 8 percent return on your average equity for the intermediate future vs. the accustomed double digit returns of recent history. It is still likely to handily beat bond returns; and the risk of putting your head in the sand and being over-optimistic can be painful. (Someone please notify corporate America, much of which is STILL using 9% expected returns for a balanced pension plan.)

The faults in setting intelligent expectations, which can then guide personal or corporate policy, lie not in the lack of analyzable historical data, but in our own behavioral biases. It has been proven time and time again that we collectively stink at processing data and intelligently extrapolating its usefulness into the future. Quoting noted investment thinker and economist Peter Bernstein in a recent edition of his Economics and Portfolio Strategy (where he does a nice trick for \$800 a year of quoting himself ten years prior for the entire issue!), the collective public has "an overwhelmingly stubborn reluctance to accept change even when it is right under our nose. The awful consequence of this feature of human behavior is that it is inescapably self-defeating. The habit of making decisions whose origins are so heavily weighted with retrospection is part of the process of change itself and of the forces that shapes the future. Life is not a smooth series of returns, earnings reports etc.; it is full of random and step function events that turn our world upside-down."

So what can rationally be done today to improve future returns if indeed we are stuck in low to middle single digit mud? The first positive item for nearly everyone reading this is that these "expectations" are on average. The blessing of not being Bill Gates is that by concentrating smaller amounts of money in a patient fashion it is entirely possible to outperform averages. Yes, every money manager comes to work

every day with the expectation of being better than the next guy. But just from the enlightened height of our self-interest, value-oriented strategies with some degree of concentration have historically (decades worth) done better than "average." So hiring better managers who are not imprisoned by the destiny of managing \$20 billion portfolios is one way to assist in the cure of mediocrity.

Another valid issue involves diversifying into new areas. Almost EVERY asset class has had a huge run over the past 18 months and in our opinion there is simply not a compelling asset, equity or otherwise, about which one can really get excited and put a lot of money behind. This argues for spreading your bets across different managers, different asset classes and different currencies.

This naturally leads us to the question "what about hedge funds?," which is a non-starter in that it is really a trick question because there is no valid and practical "definition" of a hedge fund. As noted in a prior letter, if you have found a money manager in any asset class who can consistently add value with a 2% fee and 20% of the profits, don't tell anyone! I read a wonderful quote from a speech by money manager Cliff Arness who cleverly noted something to the effect that "all alpha becomes beta with the passage of time." "Alpha" for those without the benefit of classical schooling either in Greek Studies or institutional investment management double-speak, refers to amount by which a money manager can add value through "skill" versus "beta", which in Woody Allenesque fashion, relates to the amount of a manager's return produced by simply showing up in an asset class. We would argue strongly that ANY asset class which has had hundreds of billions of dollars thrown at it over a relatively short period of time has materially narrowed the possibilities of a manager adding value. Thus, even a skilled manager's alpha puts him heavily at risk of simply becoming an average performer at best.

Speaking of fees, that would also seem like a logical area in which to increase net returns. How many managers run way too much money in vehicles that suspiciously look like index funds for 100 basis points more in fees? For high net worth investors, cutting

taxes is probably the easiest way in which to boost net returns. We do our absolute best to be tax efficient, as there is compelling math to compounding \$1 at 6% versus a starting point of 75 cents. This is an extraordinarily worthwhile place to spend time.

What a successful, risk adverse, value investor is attempting to do on a day-to-day basis is gauge the risk/reward of the opportunity cards being shown by Mr. Market. What we have been shown for the better part of twelve months has not been terrifically exciting and thus we are patiently waiting for things to get interesting/inexpensive again. What we are very confident about is the certainty that we will get plenty of chances again. Contrary to what Fannie Mae has tried to show and for what our human nature yearns, life is sloppy. The history of mankind and financial markets is a history of unexpected, step-function changes that take apple carts and dump them on conventional thinking with great force. The strategy for any environment and any investor is to position themselves against the possibility of being hellaciously wrong if the markets take an unexpected turn in any direction and to develop appropriate expectations. Thinking and preparing for the “what if I am wrong” scenario should be the bedrock for any investor or strategy.

However, an investor must also be ready to act decisively when opportunity knocks and our ability to do so is one of the reasons for the success of our long-term performance. During our firm’s history, we have never experienced a successful instance of a client taking money from us because we temporarily had a higher cash position and telling us to “just call for it when you need it.” When and if the market goes down, and we call for the cash, it is HIGHLY unlikely for us to receive it in the timely fashion to take advantage of the opportunities at hand. It seems to us that this is part of what we are paid for: steering capital away from risk, not just skillful security selection.

Oh yes, and there is \$50 oil, a presidential election, a possible disaster involving the largest domestic debt holder and issuer outside of the U.S. government, and an impressively frightening array of geo-political

negatives. In other words, it is simply macro business as usual for an investment manager seeking undervalued securities. What worries us most is the inability to find an entire portfolio of attractive stocks, not indecision as to which of the over-documented headline issues will or will not come home to roost.

In closing, we would like to refer to the advice of a legendary and now semi-retired investor, Ralph Wanger, who had nearly a generation of success running money for the Acorn Fund and was a thoughtful, funny and articulate writer to boot. In a recent interview with the Financial Times, when asked about ways in which investors could add return given the possibility of an extended flat market, he replied, “Well, people are marrying rich people.” Now that is finally a piece of incontrovertible advice from a money manager with which we can all agree.

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