WESTPORT RESOURCES

**DIVERSIFIED VALUE STRATEGY – BILL MATTHES Q1**

## LAST QUARTER WAS A GOOD YEAR!

The double digit returns turned in by all the major market averages for the first quarter would be good annual returns by anyone's measure. Even better, this great performance came almost painlessly, as the market took off at a nearly perfect 45 degree angle without so much as a minor bit of turbulence. True, that left a lot of traders on the sidelines as while they earned nothing on their cash waiting for the correction that never came to join the rally, but the market doesn't need traders, it needs investors.

There are several reasons to believe the current rally is being fueled by investors and not traders. For one thing, traders would have taken their five or ten percent return and been gone by now. Investors are a more stable lot. For another, the market has been led by the cheapest stocks, not the stocks with the best momentum going into this year that traders would have favored. The best returns last quarter came from long suffering financial and technology stocks that did nothing last year, but represent compelling value. Nor are those groups just a safe havens or bond alternatives that did well last year. They represent a bet on a better economy and financial stability.

Yet, the headlines hardly supported this leap of faith. Greece defaulted on its debt, Europe went into recession, even the Chinese economy slowed, oil prices hit new seasonal highs, the political party that is supposed to be more business friendly did everything they could to guarantee they won't return to power, and the Middle East looks to be on the brink of war.

The only logical conclusion is that investors believe that the potential for long term returns outweighs the risks posed by current events. JP Morgan might be hit again if there is counterparty risk from European banks, but at a thirty percent discount to book value and six times near term earnings potential, it hard to see how it isn't a good long term investment. Broadcom might suffer a delay in orders for smart phone chips if the world economy slows, but clearly the growth of high speed communications gear can't be stopped for long.

It would be naïve to think that last quarter's performance will continue throughout the year without a pause if not a real setback, but the first quarter certainly is a great start.

## PERFORMANCE

Money managers live and die by performance. Every quarter we report how each of our accounts performed versus the appropriate benchmarks. It's always a little scary. Sometimes it feels like we are back in school again waiting for our report card. Only now we have hundreds of grades every quarter and the results are measured in percentage points and millions of dollars, instead of As and Bs.

Mentally, we still grade ourselves the old fashioned way, but there is no one standard of performance, so our self-administered grade is pretty arbitrary. If we have trouble evaluating our performance, how can our clients know if we are doing a good job or not?

## THE GREAT PROFIT/LOSS CONUNDRUM

Unfortunately, the simplest measures of performance are not very helpful. The first thing clients want to know about their account is how much money they gained or lost. In the long run, that's probably all that really counts, but it is one of the great ironies of investing that in the short run, dollar profit or loss is irrelevant to measuring performance.

***The fact is that you hire an investment advisor to manage your money, but the manager has almost no control over how much money you make or lose on a quarterly basis.***

That's because most money managers serve two masters. On the one hand, they report their results to clients, who despite their sophistication and understanding of portfolio theory, want to see results in dollar terms. However, a money manager's professional standing is determined by relative performance in percentage terms against floating benchmarks.

## MANAGING TO AN INDEX

The only way to square these two diverse measures of performance is to make the assumption that a manager who manages to the market index will outperform a manager who attempts to deliver absolute returns, and no one can do both. But doing both is exactly what most clients would prefer. I would prefer to eat desserts with every meal and never get fat, but I found out to my disappointment that eating junk food has consequences too. .

It would be great if we could meet or beat the market when it went up and not suffer when the market took its regular dips. The only problem is that no one has been able to do that on a long term basis. A lot of people have tried, but so few have succeeded that on a statistical basis, their miserable performance proves the assumption that no one can manage for both absolute and relative performance.

So, why not just manage for absolute performance if it's what most clients want? There are investments that provide a reasonable return and have a low probability of ever losing money. Managers and mutual funds that specialize in this field typically buy very short term bonds, bank loans and alternative investments like secured notes and private debt placements. The only problem is that the world is fair. If these investments were truly risk free, they would carry a yield that reflected that fact. Today the yield on a risk free, short term investments is near zero, leading honest managers to either take additional risk or close their accounts. Anyone who promises low risk, high return investments in this environment is probably running a Ponzi scheme.

***Even when risk free rates are high, their return is usually transitory and almost always illusionary.***

Remember when you could get a one year CD for 8%? Great, but inflation was at 10% so you were really losing 2%. That is the same 2% you are losing today, with short term rates at 0% and inflation at 2%. Getting an 8% CD felt better, but it didn't really make you more money.

Unfortunately, in the real world you have to take risks to make money. Once you eliminate the fantasy that there are risk-free, high return investments, the only question is what kind of risks you want to take. Ideally, you'd like to take risks that are quantifiable, manageable, and appropriate to your objectives.

Managing to an index of stocks and bonds best accomplishes these objectives. Active trading, market timing or thinking you have superhuman investing acumen doesn't. Investors may not like them, but we know what the risks of stocks and bonds are. Knowing what the risks are, we can plan for them. We can manage risks by balancing portfolios with stocks and bonds and we can create portfolios where the risks are appropriate to the time horizon and income requirements of the client.

The other way to try to manage for absolute returns is to try to time the market. Some managers believe they can produce a stable return in a volatile market by predicting the market's swings. Unfortunately, if you rely on a guru to protect your portfolio by trying to trade away risk, you are in uncharted waters. You pick the one portfolio manager out of hundreds that correctly predicted the last correction, but what are the chances of that same manager getting back in the market before most of the market's move is over, and then predicting the next downturn after that?

***There is only one thing dumber than jumping out of a plane at 30,000 feet. It's jumping out thinking you can fly. Save yourself the disappointment of finding out that there is no one who can save you from a stock market crash if you own stocks. You can't fly!***

Unless you believe in gurus, you have no choice but to manage to an index and measure your performance on a relative basis. This means that if your equity account goes up 10%, but the market is up 15%, you deserve an explanation. It also means that if your account is down 10%, but the market is down 15%, you should be happy. Why? Because we assume that the market is your friend. We assume that even though it is totally unpredictable in the short run, if we can do as well, or a little better than the market in the short run, we'll do just fine in the long run, and do better than 99% of the traders and gurus.

So, we report both the absolute return in dollars and the percentage return relative to the market indexes on our quarterly reports. Obviously, we'd like to always beat the indexes, but we don't always get what we want, for a lot of reasons.

## WHICH INDEX

When people talk about the market being up or down they are generally referring to the Dow Jones Industrial Average, which is just 30 stocks. Worse than that, the Dow is price weighted, so the top ten stocks represent 57% of the index instead of 33%. So, what most people call the market is really just ten or twenty stocks.

Professionals use the S&P 500 Index, which sounds better, but it is weighted by market capitalization, which means the index represents the price movement of only about 50 stocks. There is an index that equally weights the 500 stocks and there is even an ETF that trades it, but it's seldom quoted. That's a shame because it has done better than the S&P weighted over the past couple of decades. The past twelve months have shown one of the biggest differences we have ever seen between the Dow, S&P and S&P equally weighted. In a reversal of what had been a long term trend, the Dow did about 7.1% for the past year, the S&P did only about 2.5%, and the equally weighted trailed the cap-weighted, doing just 1.8%.

Whether you made 7.1% or 1.8% is a big difference for indexes that are supposed to track the same market, US large cap stocks. If you made 5%, you would be euphoric if you tracked your performance against the S&P, or depressed if you thought you should beat the Dow.

***The reason for this under or over-performance has nothing to do with your portfolio, and everything to do with the vagaries of the indexes.***

Thanks to investors sudden affection for dividends and risk aversion, last year the biggest stocks massively outperformed their faster growing, but lower yielding peers by a factor we haven't seen since the big cap mania of mid-nineties, or the nifty-fifty mania of the seventies. You could have owned a boring utility portfolio for the past year and made over 10%, but if your job is to own a portfolio of stocks that will grow at a better than average rate for a total return of dividends and appreciation, you don't want to own a portfolio over-weighted in utilities. They have a move like that once in a lifetime.

## YOU GET WHAT YOU PAY FOR

We don't have any two equity portfolios that are the same. Some of our accounts want to be more conservative because they are retired, and some have long time horizons and just want to maximize their returns. We compare both to the major market indexes, but we expect them to perform quite differently.

Generally, but not always, an aggressive account will beat the indexes in a bull market and do worse in a bear market. Since the market goes up more than it goes down, aggressive accounts have a chance to beat the indexes. Conservative accounts have the opposite strategy. Risk averse investors accept the fact that their accounts may trail the market over time, but don't want to see the full effect of market volatility in their portfolios. For aggressive accounts good performance is beating the indexes. For conservative accounts, acceptable performance is something less than the return of the overall market, but they would prefer a smoother ride than the indexes offer.

## VALUE

We manage to the broad market indexes, but with an emphasis on value. Managing to the indexes generally means our accounts should follow the returns of the board market indexes. But being a value manager, we hope to beat the market over time by avoiding what is expensive and buying what is cheap. We don't want to try to be heroes by just owning the deeply depressed dogs that nobody loves. That might work if we had a very long time horizon and a cast iron stomach, but it wouldn't move with the market. We just want a portfolio that generally represents the market, but is light on the current market's darlings, and has a few fallen angels that we can afford to hold until they come back into favor.

***Value managers should come with the following warning label: VALUE CAN BE DETRIMENTAL TO YOUR SHORT TERM PERFORMANCE.***

The problem is we find this stock that has been crushed because of what we think is a temporary event, but guess what? The stock doesn't know we own it! Everybody else still thinks it's a dog. In a good market, investors will buy anything except deep value stocks because they are hated, lack momentum and are thought to be dead money. In a bad market, the last of the tax loss sellers and negative momentum guys can take the stock from cheap to crazy cheap before anybody cares. A more seasoned, larger portfolio may have a mix of stocks that have served their time in purgatory with those that will take time to recover, but often a new portfolio experiences the value investor's curse of poor initial performance.

## ROTATION

Value investors live for rotation and hate sustained trends. Our worst performance came in the mid-nineties when all people wanted to buy were big blue chip stocks that we thought were overvalued. We stumbled again at the end of decade, when the tech bubble was in full expansion. Following each of these events, as the market rotated from the hot sector to a new trend, we were both able to avoid some of the pain by owning less of the high flyers and see nice appreciation on undervalued sectors.

***We tend to have our best performance when markets rotate between sectors, or recover from a general decline. That's when yesterday's trash becomes today's gems.***

We like to say we make our money in bear markets and in sectors nobody loves. That's when we step up and have the courage to buy what everybody hates. In a full market rotation, we would expect to underperform in the last stage of a bull market, but we hope that our accounts go down less than the market when the mania turns to panic. So, depending on where we are in the cycle, we can be expected to beat or trail the market.

## SMALL NUMBERS AND SHORT WINDOWS

We use the same list of about 200 stocks in all our portfolios, but depending on which stock we use, how we weight them and when we buy them in a typical 50 stock portfolio, we get very different results from quarter to quarter. We could solve this by doing one of those computerized systems where all our clients basically get a piece of a giant mutual fund, but that is unappealing to us and seems like a disservice to our customers.

Some of our accounts complain about having 50 securities or more. Some people think they should have a few eggs in the basket and watch them carefully. Or they ask, how can we have over 50 great ideas? If they could see the disparity in quarterly returns that smaller accounts are subject to, they wouldn't ask for a concentrated portfolio.

One or two stocks that do particularly well or poorly in one quarter can make a big difference in the return of a 20 or 30 stock portfolio, when the S&P is up or down just 4 or 5%. In the short window of a quarter or two, the difference in account performance can be great. In the long run, our experience is that this all evens out. We really weren't the geniuses we thought we were in top performing accounts; and if the client has some patience, we weren't as stupid as we looked to be for a few quarters in lagging accounts.

## TIME

We report our performance quarterly, but a quarter is clearly too short of a time period to evaluate the performance of a money manager.  Most text books on the subject say the correct time period to evaluate the performance of a manager is a market cycle.  A market cycle is a full bull and bear market that may last anywhere from three to ten years, typically about five years. That gives the investor the ability to see how a manager does in good and bad markets.

That may be the academically correct answer, but we've never had a client with that much patience.  Understandably, most people want to see some results in months not years.  In a good market, if the account is seriously trailing the indexes, there may be a very good explanation, but it better be a good one, and it should be consistent with the manager's investment philosophy and the client's objectives. If that's not true, there isn't much of a reason for the client to wait to see how the manager does in a bad market.

***We trailed the market during the later stages of the tech bubble.   We had a good reason, we are value managers and we couldn't figure out why tech companies should trade at a hundred times earnings.***

Most of our clients had conservative objectives for their portfolios and therefore, had no business owning a bunch of dot com stocks with no earnings or dividends.  We lost a few clients who figured they could make more money with the Motley Fool's tech portfolio than ours, but most people gave us the benefit of the doubt and were happy to see their assets protected when the crash came.

## BEATING THE INDEXES

Given that the vast majority of money in the equity markets is professionally managed, the chance of a manager beating the market in any given year is about 50%.  Given that between transactions costs and management fees, there is a 1 to 2% cost on an average 8-10% return for the index, that 50% chance of beating the market goes down to maybe 20% in any given year. Calculate the chances of a manager beating the market over a ten year period, with an 80% chance of not doing it every year, and you are down to maybe 1 in 100 managers who can be expected to beat the market.

But, clients want to beat the indexes every quarter and certainly over a decade.  This is probably why the typical investment advisor and mutual fund experiences horrendous turnover rates.  The 80% of investors who don't beat the market every year, and 99% of investors who don't beat the market over a decade, feel cheated and want to find the one manager in a hundred who will do it.

Since Compass started in 1997, the aggregate return after expenses for the equities in our managed accounts has been better than the market (full report available on request). Can we continue to beat the market or was it just a fluke? Statistically, you'd have to say our chances of beating the market are pretty slim.

***Fortunately, our goal has never been to beat the market.***

My grad school professor of finance said anybody who beat the market on a long term basis was just lucky, and I believed him. He also taught me that just doing as well as the stock market was fine, because the stock market would give me the best return available from any major investment class. Why mess that up by doing things that separate my returns from the overall market?

What we have always tried to do was to get a near market rate of return, but smooth the bumps out a bit by not following manias and by buying stocks that are cheaper than most. If that also means that we beat the market over a long period of time, the home run turns into a grand slam. Unfortunately, anybody who just bats for grand slams will spend a lot of time disappointed.

There is a famous story attributed to J. P. Morgan. He is said to have hired a new money manager, giving him a small account to manage as a test. After a short period of time, the young manager presented Morgan a glowing report, beating the indexes by over 100%. The savvy old man listened to the young manager's boastful presentation and then calmly informed him that he was fired.

"My son," Morgan intoned, "You beat the market, but you did not impress me. I am looking for a man to manage a significant amount of my fortune and clearly any strategy that produces returns like you have shown is too risky for me. Good day and good luck."

We would hope to produce returns that are somewhere between those reported by the young genius who got fired and the indexes.

William Matthes