First Quarter 2013 Commentary

The recent global economic theme of anemic economic growth at home accompanied by sovereign-debt and banking woes abroad have continued into 2013. The latest culprit in the European saga was the small Mediterranean island nation of Cyprus, which is the latest Eurozone member to seek a bailout, as its banking sector has been all but destroyed. Against this backdrop, equities did their best Alfred E. Neuman impersonation ("What? Me, worry?") by overcoming these seeming obstacles and sailing to all-time highs.

The Dow Jones Industrial Average hit a new record close on March 5th, and from there climbed another 2.3% through the end of the quarter. The Dow's total gain of 11.9% was its best first quarter performance in 15 years. Not to be left behind, the S&P 500 managed to close at a new record on the final trading day of the quarter, eclipsing the previous high reached five and a half years ago. For the quarter, the S&P returned 10.6%. At its quarter-closing level of 1,569, the S&P was up 132% from its March 9, 2009 low of 677. With only a quarter of the year finished, the Dow has already exceeded its entire 2012 performance, while the S&P is two-thirds of the way there.

In light of all this record-breaking, it is worthwhile to compare the current economic and market scenario to the one in 2007, at the time of the previous records. Back then, the economy seemed to be on a more secure footing, with the housing market peaking and unemployment hovering below 5%. While today's environment seems relatively bleaker, there is one important difference: valuation. In 2007, the S&P's price-to-earnings (P/E) ratio was in the 20s; today, the P/E is around 15 times, which, while not exactly screaming-bargain territory, is lower than the long-term average.

Sessa and the King

Legend has it that the game of chess was invented by an ancient Indian mathematician named Sessa. When Sessa presented his invention to the king, the ruler was so pleased that he asked Sessa to name his reward. Sessa said that he would like 1 grain of wheat for the first of the sixty four squares of the chessboard, 2 for the second, 4 for the third, 8 for the fourth, 16 for the fifth, 32 for the sixth, and so on, doubling on each square.

The king, irritated by the seemingly puny and miserable reward, ordered Sessa to leave and instructed his servants to deliver to him his requested sack of grain. Later that evening, the king inquired whether the "foolish" inventor had received his reward, only to be told that sages were still calculating the amount of grain to give to Sessa. Not understanding what was taking so long, and not accustomed to seeing his commands fulfilled so slowly, he demanded an answer in the morning.

The next morning the sages had an answer for the king: it was more wheat than was available in the whole kingdom; in fact, it was more wheat than was available in the whole world. When the awestruck king asked for the actual amount of grains of wheat needed, he was greeted by a giant number: 18,446,744,073,709,551,615[1].

To illustrate the magnitude of this amount, imagine a cubic meter of wheat, which contains about 15,000,000 grains. Sessa's reward would require a granary of approximately 1,200,000,000,000 cubic meters. Taking a granary of 4 meters in height and 10 meters in width, its length must be 30,000,000 kilometers, or more than 78 times the distance from the earth to the moon.

The Joys of Compounding

"Compounding is the eighth wonder of the world." —*Albert Einstein*

The quote above illustrates that Albert Einstein discovered what Sessa had already found more than 15 centuries ago: the magic and joy of compounding. And it is this magic and joy of compounding that drives our enthusiasm for owning stocks over the long term and our aversion to other strategies like market timing. Timing the market, by constantly buying and selling, incurs costly transaction costs and taxes that hamper the compounding effect. Additionally, oftentimes the returns experienced over a small number of days may overshadow months of returns. For instance, every one of our clients (and probably most equity investors) made more money on January 2nd than they did in last year's second and fourth quarters combined; so, this one day was better to your portfolio than those other 6 months.

The table below shows the growth of $100,000 under different rates of return and holding periods. We never cease to be amazed at the dramatic sums that can be achieved by small changes in rates over a long period of time.

	5%	**10%**	**15%**
10 years	$ 162,889	$ 259,374	$ 404,556
20 years	$ 265,330	$ 672,750	$ 1,636,654
30 years	$ 432,194	$ 1,744,940	$ 6,621,177

At Inkwell, our preference is to buy good business selling at attractive prices. These are businesses that we can hold for a very long period of time —preferably forever—so that we can take full advantage of the power of compounding.

[1] The total amount is calculated by taking the sum 1+2+4+8+16+32…, which can be expressed as $2^{64} - 1$. For those semantically curious, this number is expressed as "18.4 quintillion."

Conclusion

Compounding is a wonderful thing. We focus every day on finding investment opportunities that will compound your hard-earned assets for a long time. Advancing your portfolio further and further along "Sessa's chessboard" is a worthwhile goal that we strive for.

Thank you for your referrals, confidence, and support. We look forward to reporting to you again in three months.

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