First Quarter 2014 Commentary

After a very strong 2013, stocks struggled in the first quarter to maintain their upward trajectory. At one point in February, the major averages were down between 5% and 6%, only to recover by the end of the quarter and remain near all-time highs. For the first three months, the S&P 500 increased 1.8%, while the Dow Jones Industrial Average was mostly flat, posting a decline of 0.2%.

How to Live Forever

Philip Seymour Hoffman died earlier this year. Perhaps you heard about his tragic story. He was a relatively young actor, just 46, with seemingly many professional years ahead of him, three children, and recent critical acclaim which included a Best Actor Oscar. He reportedly died from a self-inflicted overdose of heroin.

When he died during such a dangerously selfish pleasure-seeking event, he brought devastation upon everyone close in his life. He robbed himself of all the future movie roles he could have had, he caused pain and sadness for his friends and family, and—worst of all—he created possibly lifelong emotional hardship for the children he left behind.

Perhaps you are wondering what this melodramatic tale from Hollywood has to do with investing. And the answer lies in the realization that struck us upon hearing the news of Mr. Hoffman's passing: though we regular folk may not be tempted to partake of hard-core illegal substances, we are each of us just two or three stupid decisions away from ruining our own life.

Our Own Worst Enemy

Think about that. You are just a few steps away from ruining your life. Each day you have the choice of whether or not to do drugs, or drive at an unsafe speed, or cheat on your spouse, or eat fried chicken at every meal, or otherwise live recklessly. Somewhere close to 100% of the time, you make the right choices, the choices that will lead to a safer life for you and those you love, that will ensure you live to see another sunrise.

But the possibilities are there. We each have the capability to wreck life as we know it for ourselves and those we love, in possibly a very short span of time.

And the same is true in investing. In constructing a portfolio, there are potential dangerous outcomes that could wipe an investor out in a short amount of time. The trick for us as your portfolio manager is to avoid those traps while still seeking to expand the value of your portfolio in a safe and sensible way.

In other words, while working to earn a decent return *on* your investments, we need to be mindful above all else that you will see a return *of* your investments. As an Indianapolis 500 winner once said: "To finish first, you must first finish."

Don't Dabble in the Margin

Here is one good piece of advice for not wrecking a portfolio. If you can help it, try not to ever become a wealthy Texas oil man. Or his brother. For some reason, that seems to make people greedier than they need to be. At least, that's the way it would seem based on two similar stories.

The Hunt Brothers, billionaire sons of a billionaire Texas oil man, decided to try their hand at investing in silver. They bought a bunch, and we mean *a bunch*, of it, and they used margin to do it. When the price of silver collapsed by about 50% one week in 1980, the Hunts were devastated.

What exactly is margin? It simply means borrowing money to invest. Let's say you only have $100,000 to buy a particular stock, but you'd really like to invest $500,000 in it. You simply call up your broker, ask to borrow $400,000, and then put the full $500,000 to work. If the stock goes up, it's great. You simply pay back the $400,000 to the broker, but the return on your investment is multiplied by 5, because you had 5x as much money invested. If the stock in question went up by 40%, then your return (ignoring the interest cost of the $400,000 loan) would have been $200,000. A $200,000 return on a capital base of $100,000 is, to use the technical financial term, *really good*.

But what if the investment doesn't go up 40%? What if it goes down 20% instead? Well, that's a horse of a different color. Now you're completely wiped out, because a 20% loss on $500,000 is exactly equal to how much money you started with: $100,000.

Not learning the lesson from that history, the Bass Brothers, also billionaire sons of a billionaire Texas oil man, used margin in their stock portfolio. When the market took a big swoon back in 2000 after the Internet Bubble, the Basses' broker issued a margin call, forcing them to sell some of their most cherished holdings, quickly and punishingly reducing their wealth.

Now why, if you were a billionaire, would you ever buy something using margin? The only answer we can come up with is greed. So, even though you are probably not a billionaire Texas oil man (or even the brother of one), at Inkwell we follow this one simple rule: we don't use margin in your account.

Financial Dynamite

When Alfred Nobel invented dynamite in the 1800s, he did so with good intentions. Dynamite can be a very useful tool in earthworks engineering projects, such as building tunnels or dams. In the wrong hands, though, dynamite and its explosive kin can have terrible consequences for its users or the people those users wish to harm.

The investment world has similar tools. You may remember reading about some of the more exotic ones in our most recent bubble and recession: Collateralized Debt Obligations and Credit Default Swaps, to name just two. There are also other tools used more regularly such as option spreads or short selling. In the right hands, these tools can mitigate risk and/or deliver substantial

returns. Used incorrectly, though, they can wreak havoc on a portfolio. So it's best to steer clear of such powerful objects unless you are a trained expert.

Obviously, we have only talked here about two specific examples, but there are myriad other dangers lurking in the financial realm. A good basic rule of thumb to avoid them is simply to invest in what you understand, and never risk more than you are willing to lose.

The Secret to Live Forever

But back to the topic at large: we want to share with you the secret to living forever. Here is what to do, in three easy steps:

1. Find someone with perfect vision into the future, perhaps a genie or an especially gifted astrologer.

2. Ask that person to tell you the name of the city in which you will die. You don't need to know when you will die, or how, or anything like that. Just where.

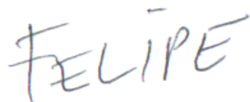
3. Once you have that piece of information in hand, here is what you do: *never go there*.

That's it. If you never set foot in the city in which you know you will one day perish, then you can ensure that you will continue living indefinitely.

Conclusion

We try to do the same thing with your investments. We don't bother with using margin. We don't go all-in on one idea, and we don't play around with powerful financial instruments that most investors don't have any business in owning. Could we do those things? Sure. After spending two years studying finance at one of the top business schools in the world, along with three years devoted to completing the grueling Chartered Financial Analyst curriculum, we certainly have the training to be able to do those things. But for some things in life, it is much better to be safe than sorry, so we have made the conscious choice to avoid them in your portfolio.

After all, one of the best ways to increase your odds at winning in the investments game is to first make sure that you don't lose.



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