Third Quarter 2012 Commentary

The third quarter showed a continuation of the uncertainty that has been plaguing the markets for some time: America's fiscal and political uneasiness, the European debt crisis, slowing growth in China, and geopolitical conflicts in the Arab world.

So how did the market react to all this uncertainty? It went up.

Many investors, especially those that focus on making investment decisions based on macro-economic forecasts, try to make sense of the stock market behavior in times like these. We, on the other hand, spend most of our time focusing on individual companies and their ability to navigate through any type of sea. As this quarter demonstrated, you could be right about how certain "big picture" situations will turn out, only to be wrong about how stocks will react under those conditions.

For the quarter, the S&P 500 increased by 6.4%, while the Dow fared less favorably, showing a total gain of 5.0%.

The Perils of Value Investing

We have examined the records of scores of investors through the years, and it is evident that value investing is one pathway to investment success. So why aren't there more value investors in the world? That is an interesting question that deserves some attention. Before we delve into the why, let's consider some real world numbers

Below are the returns of a certain money manager from some years back, as compared to the Dow Jones Industrial Average (Dow):

	Manager	Dow
Year 1	+ 8.3%	- 15.7%
Year 2	+ 37.5%	+ 19.0%
Year 3	+ 27.0%	+ 7.7%
Year 4	+ 21.3%	- 11.6%
Year 5	- 0.1%	+ 8.7%
Year 6	+ 20.6%	+ 9.8%

For those six years, if you had your money invested with this manager, you would have earned a total return of 176%, as compared to just 14% if you had invested in a broad market index that roughly matched the Dow. Over this six year period, an investment of $10,000 with this manager would have grown to $27,638; the same investment in the Dow would have grown to just $11,399.

Let’s now look at what happened over the next three years:

	Manager	Dow
Year 7	+ 7.3%	+ 18.2%
Year 8	- 31.9%	- 13.1%
Year 9	- 31.5%	- 23.1%

The next three years showed a wide reversal of fortune. Not only did the manager under-perform the market in each of these three years, but in two of them he lost substantial amounts of money. Over the entire three year period, an account with the manager would have declined by 50%, as opposed to just 21% for the Dow.

Let's examine one more year, though, so we can compare returns over a full ten-year period:

	Manager	Dow
Year 10	+ 73.2%	+ 44.4%
Total Growth	+ 139.6%	+ 30.0%
Average Annual Growth	+ 9.1%	+ 2.7%

Even with that disastrous stretch from Years 7 through 9, this manager was able to lead his clients' accounts to a 140% increase in ten years, as opposed to a mere 30% if the clients had used a market-based index. That is some serious added value.

The actual manager behind this record was none other than Charlie Munger, Vice Chairman of Berkshire Hathaway and Warren Buffett's right hand man. Mr. Munger actually ran a hedge fund back in the day, and the returns shown here are the ones he earned over that fund's final ten years of operation (1966-75).

It Works Because It Doesn't Always Work

And that, in a nutshell, is why not everyone in the investment world is a value investor like Messrs. Buffett or Munger. Value investing works because it does not always work. The long-term results speak for themselves, but there will almost inevitably come a time—perhaps a year, perhaps two, maybe even three—when the value investing style will be so out of favor that it will suffer, and maybe suffer badly. And not everyone has the stomach for it.

Though we have not personally verified it to be true, we have been told that there is more than one way to skin a cat. Similarly, there is probably more than one way to long-term investment

success. But the surest bet as far as we are concerned is the value-based long-term investing approached practiced by the likes of Benjamin Graham, Warren Buffett, and Charlie Munger.

If every investor under the sun immediately converted to this philosophy and rationally applied it to the portfolios they manage, then it would quickly lose its utility and probability of out-performing the market. But it is precisely because of the associated stretches of under-performance that most investors eschew the value method, making it possible to work for the rest of us.

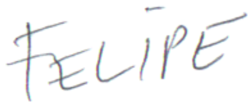
Conclusion

One must be able to endure the short-term pain of under-performance in order to achieve the market-beating returns that derive from successful long-term investing. Most investors can't do that, though. That's why "intestinal fortitude" is such a vital component of any successful long-term investment manager, and that's why we ask our clients to judge our results on at least a five-year horizon.

We count ourselves lucky to have like-minded clients, willing to gut out any short term turbulence. Thank you for blessing us with the ability to manage your account for the long haul.

We look forward to reporting to you again in three months.

Sincerely,



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