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MANAGEMENT COMMENTARY – JULY 2015
Investing for the Long Haul

Earnings season has been in full swing over the last few weeks as corporate officers kneel before the analyst community and lay bare the fortune or misfortune that has befallen their firms over the previous 3 months. Company reports usher in a period of volatility in the stock market as market participants make their feelings known through aggressive buying or selling shares in response to what the company has to say. This volatility in response to incredibly short periods of performance has caused me to reflect on the long-term nature of our investing philosophy.

I find it remarkable how short-term oriented many market participants are in practice. This goes for investment professionals as well as clients and other individuals who have money invested in financial securities. There seems to be an overwhelming desire to do something at all times. I believe this mindset has deleterious effects on long-term portfolio returns.

Below I will try to highlight some of the areas where I believe our clients are well-served by the long-term nature of our investment operations.

- A long-term approach breeds patience.

Patience is highly underrated in terms of the character traits most important for successful investing. We try to incorporate as much patience as possible into every investment action we take. The stock market is a gold mine for the impatient. There is always opportunity to do something. However, studies have shown that constant activity in the stock market leads to underperformance[1]. To characterize how investors should act in relation to daily stock market fluctuations, Warren Buffett inverted a famous saying: "Don't just do something, sit there!"

The beauty of the stock market is that you do not have to be doing something at all times to be successful. Patience allows us to wait for the high-probability, low risk of permanent capital loss opportunities. There is no rule that requires us to invest in mediocre businesses trading at inflated valuations when we cannot find wonderful businesses trading at fair and reasonable prices. In those situations, we are best served by sitting on the sidelines with dry powder waiting for the best time to invest. Our discipline is to invest in competitively advantaged businesses when the market fails to fully price in the extent to which the business will compound per share business value over the long-term. Those opportunities provide the

[1] For an engaging read on the reasons behind individual investor underperformance, I recommend highly Barber and Odean's The Behavior of Individual Investors, September 7, 2011, accessible through the Social Science Research Network.

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highest asymmetric return potential. They are rare. Most wonderful businesses trade at market prices that reflect fully the potential for compounding. Some even trade at valuations that far exceed rational expectations. We are perfectly comfortable sitting when there is nothing to do, because we know the market will eventually provide us the opportunities we seek.

Patience allows also for clarity and depth of thought within the research process. Buffett argues that investors should act as if they have a punch-card with 20 spots available in their lifetime. When you buy a stock, you punch out a hole on the card, and once all 20 holes are punched, you cannot make any future investments – ever. If we only had 20 investments to make over our lifetime, we would put a substantial emphasis on researching as much about a potential investment as we could, and we would require a significant margin of safety before making a purchase.

We do not chase hot stocks in the hopes of short-term gain. We focus on getting to know the businesses we follow as if we were the sole owner or looking to purchase the entire business outright. When we make an investment on clients' and our behalf, we do so with great reverence for the fact that hard-earned money is on the line. Putting this money to work with incomplete information or because "everyone else is buying" is not part of our investment calculus. If we did not take a patient, long-term approach to investment research, we believe we would be doing a great disservice to our clients and ourselves.

This is the patient, disciplined approach we offer through our investment operations. Because we are long-term oriented in our focus, we believe that market opportunities will be plentiful over time, and we do not feel the need to "do something" constantly. We are able to focus on taking the best opportunities given to us by the market to concentrate our investments in the highest probability positions we can find while ensuring that our potential for permanent capital loss is minimal.

- Long-term investing avoids short-term irrationality.

Behavioral economics and finance is fascinating. The field studies the economic and financial actions of market participants and the emotional and psychological causes and effects of these actions. There is a dichotomy between how an objective, rational actor (given my law background, the *reasonable person*) should act in relation to market events, and how the majority of humans *actually* act in relation to those events. Behavioral economics seeks to explain why most people make irrational decisions contrary to what the rational actor would do.

One of the most widely known phrases in financial circles is the term "irrational exuberance," coined by former Federal Reserve Chairman Alan Greenspan (also attributed to Yale professor Robert Shiller). In response to the "Dot-com bubble" of the 90s, where shares of technology companies traded at excruciatingly inflated prices in relation to any conceivable measure of per share business value, Chairman Greenspan stated that irrational exuberance of market participants could be the cause for the continued inflation of asset prices. Rather than act in a cautious manner in response to excessively high valuations as the rational actor would, most market participants continued to buy shares believing that the euphoria of the market's meteoric rise would continue indefinitely. This is the textbook definition of an asset bubble, and as we know from history, bubbles burst.

One of the most famous quotes on investing is attributed to Benjamin Graham, the father of value investing. To paraphrase Graham, the stock market is a voting machine in the short-term, but a weighing machine in the long-term. The market fluctuates daily. The laws of supply and demand influence greatly the direction of short-term market prices. The more aggressive side among the buying and selling "voters" over the short-term dictates the direction of prices. If either side gets too aggressive in their buying or selling, mispricing happens. Over the long-term, we believe share prices will begin to reflect a measure of per share business value that is dictated by business performance. The trajectory in share prices should follow the trajectory of per share business value over a long enough investment time period.

As long-term investors, we do not believe that the daily fluctuation in market prices bears any relation to the future prospects of the businesses in which we invest. There are many reasons given for selling pressure on particular days; recent events have included the Greek default, the collapse of the Chinese stock market, and increased volatility in commodity prices. Stock prices go up and down. It is a natural law within the stock market. Per share business value, however, does not fluctuate daily, and it is this distinction that allows us to remain invested in wonderful businesses and weather any volatility storms the market may throw at us.

Warren Buffett is known for saying that he wants to be fearful when others are greedy and greedy when others are fearful (i.e., buy stock when others are selling *en masse*, and sell stock when others are buying hand over fist). The goal is to act as the rational actor would, rather than as the emotionally-driven, psychologically-impeded human does. When prices seem irrationally high due to giddy and overly optimistic investors, it is best to proceed with caution and patience for a better, less risky opportunity down the road.

Because we are long-term oriented, we are able to wait out periods of peak optimism for those times when the majority of market participants panic-sell their shares in exceptional businesses with strong and enduring competitive advantages. The housing bubble and financial collapse of 2007-2008 ushered in a generational buying opportunity for those investors with the wherewithal and outlook to look past the fear towards brighter days. Fast-forward six years from the March 2009 market bottom and long-term oriented investors who remained cool, calm, and rational in the face of the panic have enjoyed outsize returns in one of the longest-running bull markets in history.

Much of the day to day activity within the stock market is noise. Very little of what transpires daily has any impact on the per share business value of the businesses we own and follow. Since we invest in those businesses that we believe will be better in 5, 10, and 20 years, we have no reason to allow short-term market noise to interfere with our investment operations. While stock prices fluctuate, sometimes dramatically, over the short-term, we do not believe the same applies to per share business values. Thus, when we have confidently assessed a range of outcomes for per share business value in a competitively advantaged business, we welcome the short-term volatility and noise of the market when it ushers in prices that are fair and reasonable for our businesses. However, we do not manage our investments in response to the daily market noise, nor do we respond and react emotionally to market volatility.

The human brain is wired to fear loss with a greater magnitude than to enjoy gain. In many instances, the first sign of falling market prices causes market participants to sell their shares regardless of business value. The rational actor would be greedy during periods of widespread fear, but most people lack the ability to do so. The sight of declining portfolio values causes a panic reaction in the majority of market actors who rush to dump shares to stop the bleeding. This is precisely the type of activity that leads to underperformance in the stock market over the long-term.

In those circumstances, we find it best, again, to sit tight. No one enjoys the sight of declining stock prices and declining portfolio balances. However, understanding that markets are cyclical and prices fluctuate allows us to remain patient and committed to the long-term view of the businesses we own. We gain also the opportunity to purchase shares for the long-term in those businesses that the market misprices in the short or medium-term. We invest with a view towards eternity, and look to act rationally in the face of widespread irrationality.

- <u>Long-term investing allows for the power of compounding to go to work</u>

Compounding plays a critical role in the success of our investment operations over time, and the only way to allow for the power of compounding to work its magic is to approach these operations over the long-term. Because we invest in businesses, the appropriate measure of success for us is whether the business is able to achieve outsize returns on invested capital, maintain higher than average profit margins, and expand upon increasing runways for business growth. We invest in businesses where the competitive advantages are inherent to the nature of the business, and are likely to expand over time. We look also at the ability of management to allocate capital wisely and effectively in order to satisfy requirements for organic business growth and return the excess capital to shareholders in an owner-friendly way. For this reason we advise our clients that our performance (and the compounding potential of their portfolios) is best judged over a multiyear (minimum 3-5) timeframe.

We counsel against checking account balances and stock performance on a daily, weekly, or even monthly basis. On this point we are steadfast. The urge to check stock prices daily is strong. But the constant review of daily stock prices and portfolio balances plays into impatience and irrational acting. The businesses we own need time to compound per share business value. Although businesses are required to report the results of their operations on a quarterly basis, even focusing on one quarter of performance can cause investors to become irrational in their thought processes and actions.

In the same way that the businesses we own compound per share business value over time, so too does our portfolio provided we remain long-term in our thinking and investment outlook. As our businesses increase per share business value, the long-term value of our portfolio should follow suit. As businesses reinvest free cash flow into their operations, so too we reinvest proceeds from successful investments and dividends from our businesses into the long-term growth of our portfolio. As our businesses grow, and as our portfolio grows, a steady return level will increase the absolute returns we achieve because the base amount to be compounded has increased. Only with our continued devotion to the long-term, what we call our "view towards eternity," will we be able to fully realize the potential that compounding has for wealth generation.

- <u>Long-term investing is cost efficient in terms of taxes and transaction fees.</u>

Transaction costs, brokerage fees, and taxes are very real drags on portfolio performance. Our long-term investment outlook means that we do not trade in and out of positions frequently. When we make a capital allocation to a portfolio business, we do so fully intent on maintaining the position for a number of years. Thus, our portfolio turnover is minimal, and the transaction costs and fees we incur as a result do not significantly impact our portfolio returns. Furthermore, most of our positions are held for longer than one year, which allows us to reap the benefit of paying reduced capital gains taxes on any profits we have made, rather than potentially much higher income taxes. We believe this is an oft-overlooked aspect of portfolio underperformance, and we are committed to remaining long-term in our outlook to make sure our clients' capital is not unnecessarily spent.

With warmest regards,

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President & Chief Investment Officer