WILLIS INVESTMENT COUNSEL
Principled Investing

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THE ROAD NOT TAKEN

Two roads diverged in a yellow wood …long I stood and looked down one as far as I could …then took the other, as just as fair, and having perhaps the better claim …and that has made all the difference

Robert Frost's signature poem perfectly captures the choice before WIC five years ago. This memo looks back at the five years beginning in 2009 when the market meltdown was at its worst and investors had to choose which road to travel:

Retreat – the response of those who believed the world had fundamentally changed and the risk associated with investing in companies was unacceptable. These investors chose a road (a strategy) of sitting out the storm in cash and bonds with little allocated to equities; or, alternatively, a strategy of broad diversification away from U.S. equities. Market timing was embraced.[1]

Engage – the response of those who believed economies and markets are resilient, and concluded markets/investors were over-weighting the negatives. These investors chose a road of traditional diversification to balance the risk of further downside with the risk of lost upside opportunity and capital recovery. Some who chose (or maintained) this road emphasized U.S.-based multi-national companies that had the financial wherewithal to survive and prosper; and chose to rely on the lessons of history about economic and market cycles (and about investor behavior). Market timing was rejected.

The equity allocation strategic decision that committees and investors (and their portfolio managers) had to make five years ago about which road to travel is the same decision that had to be made over and over throughout the last five years as an unrelenting parade of negatives remained front page news – *retreat or engage*. Throughout the last five years, WIC chose to *engage* by remaining fully invested in U.S. companies that had the financial wherewithal to survive the storm and compete in global markets. *And that less traveled decision to engage has made all the difference.*

[1] As used here, *retreat* refers to those investment committees, investors, and portfolio managers who chose to either significantly increase cash or bonds (to be more defensive), or who chose a strategy of very broad diversification in an effort to "hedge their bets" by allocating capital across a wide array of strategies, often away from U.S. equities.

Throughout the last five years, WIC was equally concerned about the unusual risks that dominated the investment landscape as those who chose to retreat; but, we viewed risk management differently than most.[2] We believe risk is often increased (not decreased, as many believe) when the portfolio is "over-diversified" with a wide array of strategies that are often opaque and difficult to understand and monitor. Fundamentally, undue complexity increases risk. In addition, market history tells us those strategies that are rapidly growing in popularity (e.g., emerging markets) often have poor risk/reward profiles; and counter-intuitively, those strategies that are declining in popularity (U.S. stocks five years ago) often have superior risk/reward profiles. Therefore, when we revisited the lessons of market history, the behavior of crowds, and most especially the financial strength of the companies in which we were invested, we chose to remain *engaged* because the potential reward appeared to far offset the potential risks. We did not embrace the highly popular and widely recommended equity strategies that emphasized non-traditional equities and non-U.S. markets because we judged them unduly complex, expensive, and their risk/reward efficacy was far from proven. Instead, we chose the road we believed had the best capital recovery opportunity with the most identifiable and manageable risk: multi-national U. S. companies that were not totally reliant on the U. S. economy.

While WIC manages stock, bond, and balanced (stock and bond) portfolios, here we are more narrowly focused on decisions inside the stock component of the portfolio. Generally, portfolio managers have three primary decisions to make throughout a given year:

1. To what extent to be invested in the markets; cash level and market-timing
2. What markets to invest in; and equally important what markets to avoid
3. What securities to invest in; and equally important what securities to avoid

Over the last five years, the corresponding decisions we made that most drove the positive outcomes in our clients' portfolios were:

1. We did not attempt market-timing and we did not retreat to cash
2. We chose U. S. stocks as our dominant investment strategy
3. We rejected non-traditional equities

Why did we choose U.S. equities over non-traditional equity strategies? The choice was deliberate and purposeful, and was driven primarily by valuation and risk-management considerations. We believe risk is best managed by being very particular about the entry price, the transparency of what is being bought, and the understandability of what will drive the expected outcome. We found coming out of 2008 and 2009, and throughout the last five years, the risk-reward trade-off of investing primarily in traditional U.S. equity strategies was most attractive.

[2] Abundant data clearly shows over the last 5-10 years the most popular equity allocation investment strategy with institutional and high-net worth investors has been one that embraces the complexity of multiple-strategy portfolios that include a wide assortment of non-traditional equities, investments in emerging markets abroad, and a move away from U. S. stocks. WIC has not embraced this popular strategy because we believe its complexity, high cost, and illiquidity increases risk, or at least does not necessarily enhance the risk/reward outcome.

The following summary of 2013 clearly illustrates how important these strategic and allocation decisions were.

2013 WAS A VERY GOOD YEAR FOR THOSE WHO ENGAGED

A December 31, 2013 *Wall Street Journal* front page story summarized 2013 very nicely and also captured much of the last five years:

> In the best year for U.S. stocks since 1995 … holding a plain-vanilla portfolio of U.S. stocks did much better than the more complex approaches employed by hedge funds …many funds were left in the dust, alongside investors who use "tactical" timing of the markets' ups and downs and those who spread their bets among a wide variety of assets such as commodities, emerging markets, and exchange-traded funds.[3]

Again, not retreating into cash and bonds (which provided essentially a zero return), and not following the crowd into non-traditional, non-U. S. securities (all providing returns far less than U.S. stocks) made all the difference in 2013 (and over the last five years). The data is clear that throughout the last five years many investment advisors and portfolio managers allocated a substantial portion of their clients' portfolios to the following markets and strategies:

Total Returns through December 31, 2013[4]

	2013	**5 Years**
Cash and money market funds	0.09	0.14
Broad U.S. bond market	-2.03	4.44
Real estate (REITs)	-0.18	13.28
Hedge funds	11.14	3.04
Commodity funds	-6.92	4.93
Emerging equity markets	-5.33	11.04

The above return data is shown as these strategies are very common and are substantial components of many, if not most, portfolios. During 2013, and throughout the last five years, WIC did not invest in cash, REITs, hedge funds, commodities or emerging markets. Instead, our equity strategy remained focused on multi-national U. S. companies. The following table summarizes the returns of a range of markets dominated by U. S. companies:

	2013	**5 Years**
U.S. stock market, S&P 500	32.39	17.94
Broad U.S. stock market, Wilshire 5000	33.98	19.01
Small capitalization stocks, Russell 2000	38.82	20.08

[3] As noted on the preceding page, WIC has not, and does not, embrace the widely-practiced approach to portfolio management of employing a wide array of complex, expensive strategies.
[4] These are annualized total returns gross of fees using indices as a proxy for the indicated markets and strategies. Indices used in above table: Barclays Lehman Aggregate Bond; Vanguard REIT VNG; HFRX hedge fund index; DB commodity index; and for the MSCI emerging markets index the iShare EEM.

In a few weeks, we will expand this memo to include more about WIC's growth as a firm over the last five years. Of course, we will provide details on our clients' returns for 2013 and for the last five years, which will include these WIC strategies: [5]

- Core Equities
- Green Street Fund (small cap value)
- Managed Volatility and Income Strategy
- Fixed Income
- Balanced Core Equities and Fixed Income

As we move into our 35th year, we know the critical role you play in WIC's success. The loyalty and confidence you have shown in our team is much appreciated. You can be assured your portfolio managers here at WIC will continue to invest alongside you in the same strategies in which you are invested.

Thank you.

Robert T. Willis, Jr., CFA
Chief Investment Officer

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