WILLIS INVESTMENT COUNSEL
Principled Investing

April 24, 2019

40 YEARS OF DISCIPLINE, LEARNING, AND ADAPTING

This quarterly report cover letter commemorates WIC's 40th anniversary. Instead of commenting on the first quarter of 2019, we look back over WIC's 40 years of working with clients and managing risk and return.

APRIL 9th MARKED THE 40th ANNIVERSARY OF WIC'S INCORPORATION

On April 9th, Kelli, Giovanna, Jay, and Bob traveled to Bainbridge to celebrate WIC's 40th anniversary with its founding clients. Most of our original clients are still clients today, including second generation. Ten of our original clients that retained us during 1980-1985 attended a dinner to mark the founding of WIC 40 years ago. Our initial clients were pension funds, trusts, agri-business corporations, and professional practices. Coincidentally, given the importance of the poultry industry to WIC today, not only was our very first client an agri-business corporation, one of our earliest corporate clients (and still a client today) has been a trusted source of feed supplements to some of our current poultry clients. We want to again thank those clients who retained us four decades ago, and all those who joined them along the way. It is deeply gratifying to be trusted with your savings, your retirement funds, your pension and 401k funds, your family's trust funds, your endowment and foundation funds, your corporate working capital reserves, and with your private concerns.

This letter looks back at what we did well, and not so well; at what we have learned, and are still trying to solve; at how investment management has changed, and how it is still the same.

Perhaps the most important axiom we have learned over 40 years is this:

> *Extreme patience is critical to capital preservation and growth; but the necessary degree of patience is so elusive, it is uncommon.*

Later herein, we will explain why patience is so difficult to practice; why it is counter intuitive; why impatience is the primary reason so many firms and investors fail; and why psychology, cognitive science, and investor behavior are so prominent at WIC.

WE HAVE MADE SOME GOOD DECISIONS; AND PLENTY OF NOT SO GOOD DECISIONS

Starting with where we went astray, we now know the following are traps to avoid:

- Risk cannot be calculated; we too often believed we could mathematically quantify risk
- Valuation models only provide clues; we too often *saw* precision that was non-existent
- Valuation was over-weighted; we too often under-weighted company quality
- Premature selling based on math; we often over-weighted valuation math and sold early
- Cyclical stocks seduced us; we were often the moth-to-the-flame
- Contrarianism; the valuation of financial stocks and bonds in 2007-2009 seduced us

Portfolio managers, including the really good ones, are wrong about 40% of the time; it just goes with the territory. Because such a high percentage of our investment decisions are unproductive, it is important to employ a disciplined, methodical process to minimize the number of inevitable misjudgments. Fortunately, we got enough decisions right to effectively protect and grow our clients' capital. Looking back over the last four decades, we made some good decisions along the way:

- Education; we have been serious students of our craft; reading occupies much of our time
- Academic grounding; we have infused academic principles and research into our processes
- A *value* philosophy; this has kept us grounded in a disciplined security selection process
- *Clients* not accounts; there is a big difference; we have never been a sales-centric firm
- *Counsel* not products; we don't sell products; we provide advice, education, and counsel
- Skepticism; deep skepticism of Wall Street and the strategy de jour
- Psychology; as important as economics, finance, and accounting combined

Deciding **not** to invest is a critical decision. It is often under-appreciated that those markets and strategies WIC decides not to invest in are equal decisions to those decisions to invest. We never bought the first dot.com stock. We never invested in hedge funds. We did not allocate away from U.S. stocks in 2008-2010 to bonds and non-U.S. markets. These were very productive decisions.

HOW TODAY IS DIFFERENT FROM JUST 10-15 YEARS AGO

Before noting how WIC has adapted, and how we continue to improve, it is interesting to briefly mention a few commonalities to the earliest days of the firm. From the very beginning in 1979, we have spent a lot of our time (i) reading academic research for clues on how to improve our methodology, (ii) working with our company valuation models to make the decision-making process more logical and rational (and less emotional), (iii) reading company financial statements and research and evaluating companies' financial strength, and (iv) writing client letters and memos to educate our clients and provide them counsel. These disciplined practices have become deeply engrained in our culture.

Like any firm that continues to thrive after 40 years, WIC has adapted and improved along the way. Certainly, technology has dramatically changed how we analyze companies and make decisions. We have improved our Fixed Income Strategy and developed additional equity strategies to provide broader portfolio diversification – our Small Cap Value Strategy and our Managed Volatility and Income Strategy. The following are a few conceptual adaptations we have made to improve risk/reward outcomes:

A better balance of art and science; less reliance on valuation models. In the early years, we had excessive confidence in mathematical models and in Excel spreadsheets (SuperCalc and Lotus preceded Excel). We naively believed we could almost reduce the investment decision down to calculations and metrics. We have gradually evolved to a much better balance of art, instinct, and experienced gut, all of which now play an important role with a continued large measure of math.

A more triangulated approach to valuation measurement. We have always believed in the academic teachings of intrinsic value and discounted cash flow modeling. And, from the early days we have followed a *value philosophy*. During the first 25 years of our history, we adhered to a low price-to-earnings and low price-to-book stock selection process. While we continue to favor a value-oriented methodology (which at times can be contrarian), we are far less dogmatic than we used to be. We now evaluate a broader distribution of potential outcomes and consider a wider range of valuation estimates.

A better blend of valuation rules and company quality/durability. Brett Slattery has convinced us that a company's quality and durability, and return on invested capital history and capability, should be given heavy weight in our company evaluation and decision-making process. Jay Kilroy has pushed for less emphasis on strict valuation cut-offs. Bob Willis now pays more attention to balance sheet strength than valuation. These adaptations, along with robust debate and ongoing research, are strengthening our processes.

Gradualism. Last year when we evaluated the outcome of every stock we have owned over the last 20 years, we saw a thread we hated to see – impatience. It appears we probably could have had better outcomes if we simply had been more patient with:

- The initial decision to buy a company
- The time we took to establish a full ownership position
- The pace at which we sold a fully valued stock in which we had a solid profit
- The pace at which we sold a poorly performing stock in which we had a large loss

For these four decisions, we now are more patient, more gradual in making and executing these decisions. We strongly believe (i) this gradualism, (ii) giving more weight to a company's quality and return on capital history and potential, (iii) being less rigid with valuation, and (iv) requiring a stronger, more adaptive balance sheet, will result in better outcomes.

PSYCHOLOGY AND BEHAVIORAL LEAKAGE

Our interest in cognitive science, and how we have added psychology-based protocols to our fundamental framework of thinking, and to our portfolio decision-making processes, are probably the most unique and important changes we have made over the last 40 years. Ever since we read about the 2002 Nobel Prize in Economic Sciences awarded to Daniel Kahneman for his research on the psychology of judgment and decision-making, we have been fascinated with how cognitive and behavioral science should be an integral part of our work.[1]

Twenty years of being serious students of psychology has led us to believe that *behavioral leakage* is the primary reason investors realize sub-optimal returns. Behavioral leakage is chronic, persistent, and insidious. Research has shown it is not uncommon for 25-30% of the market's returns (e.g., the S&P 500 return) to be lost to this leakage.

Investors of all backgrounds, education, and sophistication often realize 25-30% less than what they "should have" realized due to this leakage. What is *behavioral leakage*?

Behavioral leakage is the difference between a market's or benchmark's *theoretical* return and what an investor actually earns or realizes. WIC's whitepaper *The Investment Highway* documents this leakage.[2] For example, if a mutual fund's 10-year return was 9.00%, but the average *investor's return* in the fund was 6.00%, that 3 percentage point difference equals a 33% behavioral leakage. The leakage is *behavioral* because the lost return is often due to the investor's extrapolation, over-reaction, fear, and/or impatience.

[1] Vernon Smith and Amos Tversky were part of this research and recognition. Daniel Kahneman's book *Thinking Fast and Slow* captures much of his research.
[2] This whitepaper was written in October of 2018 and is available upon request.

Likewise, if the 10-year *theoretical* return for a S&P 500 index fund return was 6.00%, but the average actual investor's return was 4.00%, the 2 percentage point difference is the 33% behavioral leakage. WIC's whitepaper explains this in detail and includes Vanguard, Morningstar, and academic research to support its findings.

Because this leakage is significant, widespread, and chronic, minimizing this leakage is a common thread that runs throughout WIC. It is essentially a market timing issue; an excessive changing of strategies issue; an over-reaction to temporary trends issue; a seeing patterns that don't exist issue; an emotional versus rational decision-making heuristics issue; and an impatience issue. The more one sticks with a productive strategy for decades and thereby allows the strategy to accomplish what it is designed to do, and it is capable of, the less the behavioral leakage. Of course, it is unknowable in advance if the chosen strategy will be productive; and if it should be given decades of patience. No one has that crystal ball. That is what risk is all about – unknowable outcomes.

OUR RESPONSIBILITY: MANAGE UNKNOWABLE OUTCOMES AND RELATED BEHAVIORAL LEAKAGE

No firm can predict outcomes. No firm can eliminate risk. But it is WIC's responsibility to study risk; think about risk; evaluate a wide distribution of potential outcomes (good and bad); and understand risk-reward trade-offs and probabilities. Risk and psychology and the emotions of decision-making (yours and ours) are inextricably connected. We deeply believe managing the inherent risks of the markets, of owning securities, of applying our decision-making processes, and of reaching your goals cannot be effectively done without an understanding and application of cognitive science and behavioral economics. As described in WIC's *The Investment Highway*, behavioral leakage is too powerful and persistent to ignore.

The shareholders of Willis Investment Counsel are always here to answer your questions, discuss your concerns, and review your portfolio with you. We understand your portfolio and its holdings very well because each of us has substantial amounts invested alongside you in the same WIC strategies. It should be no other way.

For more commentary, we invite you to visit our website at www.wicinvest.com.

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