WILLIS INVESTMENT COUNSEL
Principled Investing

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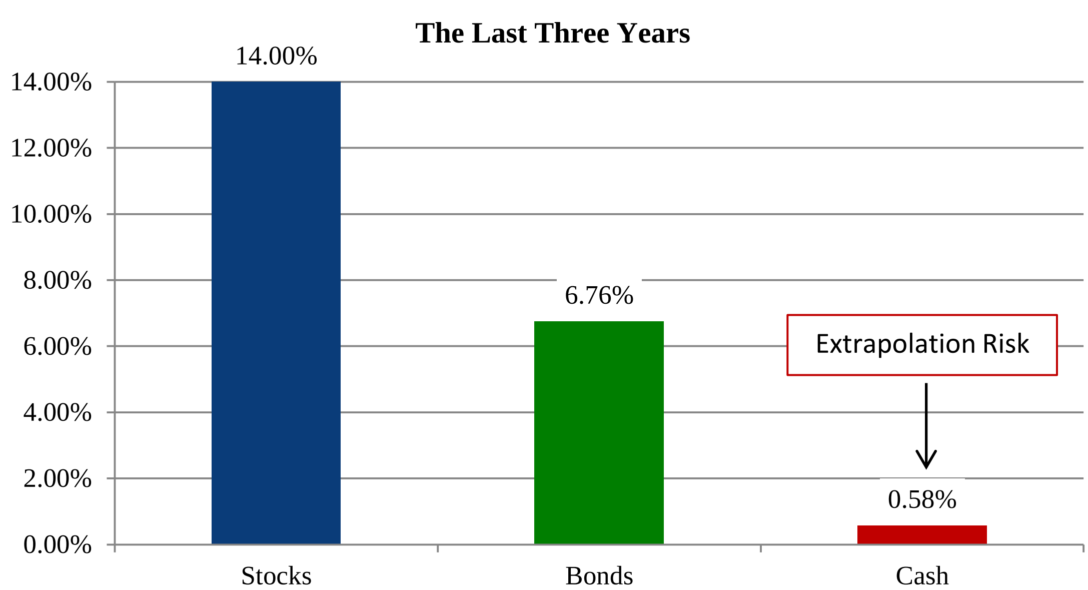
A THREE-YEAR INVESTMENT RETROSPECTIVE: SURPRISINGLY GOOD

Extrapolation – to predict by projecting past experience or known data.
(Source: The Merriam-Webster Dictionary)

Many investors have fallen prey to extrapolation risk over the last three years. Because the substantial returns since the severe market decline in 2008 illustrate important principles, this commentary purposefully focuses on the last three years of market performance. We examine what the market provided investors after the severe market decline in 2008 when the S&P 500 declined 37%. More specifically, we compare the market returns that materialized during this time to widely-held expectations that returns would be negative, given the then current economic and market environment.

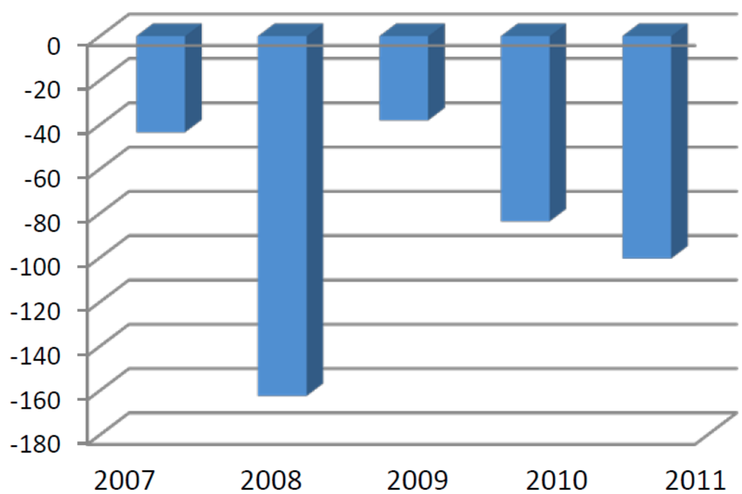
With so many economic headwinds – seemingly intractable problems in Europe, gridlock in Congress, and market volatility, just to list a few – it may come as a surprise that the broad stock market has generated an annualized rate of return of 14% over the last three years. That 14% average annual return (a cumulative gain of 49%) was much greater than the broad bond market return of 6.76%. The average bank CD yield (six month CD) for this period was only 0.58%. These three-year outcomes are graphed as follows:



Human nature is incredibly powerful and influences all of us more than we realize – and more than we would like to believe. The last three years of market performance provide a powerful example of the *behavioral mistakes* in investment thinking that frequently occur. We believe behavioral mistakes are the primary reason investors, including professional portfolio managers, often fail to capture the returns the markets offer. Successful investing is often counter-intuitive and requires one to patiently wait years – and not necessarily just a few years – for a portfolio to bear fruit. Unfortunately for investors, as well as for many professional portfolio managers, patience and the ability to look beyond the current environment are often beyond reach.

Because human nature caused many investors to believe the 2007-2009 bear market would continue (extrapolation of recent trends is a powerful human nature force), and because many investors were unwilling to think and act in a contrarian manner (people are more comfortable staying with the crowd or consensus), they were unable to invest, or remain invested, over the last three years. Therefore, they were unable to capture the exceptional returns the market provided during 2009-2011. With the sting of 2007-2008 still prominent, and a strong preference for return *of* capital versus return *on* capital, many investors across the country chose to bail out of stocks or otherwise shun them. The graph below shows the exodus from stock mutual funds from 2007-2011, a good barometer of investor sentiment. For any given year, it is unusual for more money to be withdrawn from stock mutual funds than added (a net withdrawal). Two straight years of net withdrawals are unprecedented.

Net Withdrawals from U.S. Mutual Funds (in billions)



Source: TrimTabs Investment Research, Inc.

This graph suggests that investors have been overwhelmed with the constant barrage of negatives and have fled stock mutual funds for five years running, and in so doing missed the recovery.

There are two primary reasons our clients participated in the strong returns of the last three years. First, it is axiomatic that one cannot participate in a market's returns unless capital is invested. Therefore, we worked hard to educate and convince our clients that the probability of a substantial recovery from 2007-2008 was more than sufficient to compensate for market uncertainties. We knew we had to keep our clients from joining the masses that were bailing out (see the above graph). Our counsel was effective, and our clients "sat still in the boat."

Second, we did not allow the litany of very real issues and concerns to dominate our decision-making. The policy trends in Washington, macro-economic headwinds, debt and deficit issues, geo-political developments, etc. were the subject of many of our investment committee meetings. The issues were, and remain, real and worrisome. But we made sure those issues were *part* of the analysis, not *the* analysis. To balance the analysis, we considered economic and market history, the operating and financial strength of the companies we owned and were evaluating, and relative valuation and risk/reward. We also drew on decades of experience. Perhaps most importantly, we knew the market's pricing of companies was emotional and irrational and did not reflect the true or intrinsic value of the companies in which we were investing. At the risk of over-simplifying, the following considerations kept us invested over the last three years and prevented us from bailing out and re-allocating our clients' portfolios to cash and bonds:

- Market and economic history suggested recovery was likely
- The balance sheets of the companies in which we were invested were strong
- The fundamental profitability of the companies in which we were invested was sound
- The valuation metrics suggested the return potential far out-weighed the risks
- Psychology – knowing the more the crowd is fearful, the greater the opportunity.

For most of our clients, we are using a combination of the following strategies:

- **Cash reserves** utilizing investment grade corporate bonds with maturities ranging from 1 to 3 years ($20 million minimum)
- **Bonds** utilizing investment grade corporate issues with maturities generally ranging from 3 to 10 years, and utilizing tax-free bonds when appropriate
- **Managed Volatility and Income Strategy** utilizing blue chip stocks with above average dividend yields and covered call options providing a relatively defensive means to invest in multi-national companies
- **Core equities** utilizing the strategy we have employed for 33 years, which focuses primarily on large-cap and mid-cap value stocks that we believe are under-valued
- **Small and mid-cap value** strategy that focuses on under-followed, somewhat under-the-radar companies that have significant upside potential along with greater volatility
- **Balanced portfolios of stocks and bonds** that blend the above strategies.

As we begin 2012, we are spending a great deal of time analyzing (i) inflation and currency risks, (ii) potential impact of slowing growth in China, (iii) correlation risks inside each strategy, (iv) bond duration and yield positioning in what could be another year of low yields, and (v) sharper tools to reduce the timing risk of initiating new equity positions too early. Otherwise, we will keep plugging away on our investment decision-making process. Our portfolio management success ultimately comes down to making good investment decisions and maintaining patience. As long as we can consistently make solid decisions *and* apply the patience that is necessary to see those decisions through, we fully expect that we will continue to have good long-term outcomes.

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