January 30, 2013

THE GREATEST RISK HAS BEEN EXCESSIVE PESSIMISM

Not the financial crisis, not Europe, not the fiscal cliff, but extrapolation and pessimism

SURPRISING TO MANY, BUT THE LAST TEN YEARS HAVE BEEN WORTHWHILE

Over the last ten years, investing in companies has been a worthwhile endeavor. For those investors who remained shareholders of good quality, reasonably valued companies throughout the last…

- ten calendar years,
- nine years,
- eight years,
- seven years,
- six years,
- five years
- four years
- three years,
- the last two calendar years, or
- throughout 2012…

…it was a profitable journey.[1] I listed each of the last ten-year-time periods to emphasize the fact owning companies provided a positive return that was meaningfully greater than T-bills, money market funds and bank CDs.[2] The stock market provided a positive return every year during the last ten years, except for 2008. This profitable experience was only realized by those who remained shareholders throughout the inherent and unavoidable bad years. Therefore, this profitable and worthwhile period eluded many, probably most, investors.[3] Why?

[1] The S&P 500 and Wilshire 5000 provided positive returns for every rolling calendar year period ended 12/31/12.

[2] For every one of these periods, the broad market provided an annualized return at least 1.00% greater than T-Bills; for the full ten year period the market provided an average annualized return that exceeded T-bills by an average of ~ five percentage points and that exceeded a broad treasury and corporate bond index by ~ two percentage points. One could argue that although the last ten years were profitable, and over long periods of time such excess returns versus defensive cash returns compound into substantial additional capital, the risk in terms of volatility over the last ten years was not sufficiently rewarded/compensated. The volatility risk caused many to harmfully bail-out.

[3] I am making a point here and certainly do not know what *every* investor did or did not do during the last ten years. But we do know from data published by Dalbar and Vanguard that actual investor returns are far less than the markets' returns because of fear, chronic market-timing mistakes, and the harmful practice of chasing performance.

Many investors failed to benefit from this profitable period of investing because of excessive pessimism rooted in "bad behavior". Herein, "bad behavior" connects to the term – *behavior* – that psychologists use. We believe the *behavior* of investors knows no experience, intelligence, or investment sophistication boundaries. The natural human behavior of investors of all stripes chronically interferes with effective investment decision-making and therefore with capital preservation and growth. After laying some groundwork, I will connect behavior to several specific areas that cause the greatest harm and how WIC seeks to avoid such harmful behavior. *Pessimism* and *over-weighting recent events* and trends is at the top of the bad behavior list.

HUMAN NATURE AND BEHAVIOR ARE MORE INFLUENTIAL THAN THE ECONOMY

More than polices promulgated by Washington, the economy, the fiscal-cliff, Mid-East never-ending strife, Federal Reserve policy, China's growth trajectory, currency devaluation, inflation, or price/earnings multiples, human behavior has been a primary driver of the decisions made by investors over the last five years -- often a harmful driver of decision-making. For over 100 years, human behavior has been a subject of great interest for psychologists.[4] In college, we learned about "Pavlov's dog" and conditioned responses.[5] That research was done in the early 1900s. Around thirty years ago, some psychology and finance professors began comparing notes and collaborating on how investors make decisions. This morphed into what is now known as *behavioral finance* or *behavioral economics* -- the study of how investors behave and make decisions about their portfolios, and why so many investors (individuals and institutions) fail. This research led to a Nobel Prize in 1985.[6] Much of the decision-making that harmed investors over the last 5-10 years was driven by the behavioral biases that were the subject of this Nobel Prize research; and these biases are deeply engrained in our brains' hard-wiring. Most investors do not come anywhere close to realizing the markets' return and the reason is primarily *behavioral*.[7]

It is extraordinarily difficult for the human mind not to extrapolate recent trends into the future. Painful, sudden, dramatic events especially get seared into our memories and cause us to assume the future will look a lot like that painful past. That memory, that extrapolation assumption becomes the foundation of our decision-making. For investors, memory is often a powerful and harmful influence (it was definitely so over the last 5-10 years).

Behavioral psychologists have long known that the human mind has a powerful need to explain what is going on around us, and to explain it quickly. Therefore, we frequently see patterns that don't exist or accept explanations that are not rational. Regarding explanations, forecasts, and our conclusions, we usually don't take the time to carefully and critically examine if (i) there is a statistically significant correlation or cause-and-effect to justify the concern or conclusion, (ii) the "explanation" is fact or opinion, (iii) there is valid data underneath the assertion, (iv) the pundit or forecaster has a reliable, valid long-term successful track record or is just throwing out opinions, (v) there is another equally compelling viewpoint, etc.[8] This explains why many investors latched on to the dire assessments, and overly-pessimistic forecasts, of the media and market strategists (e.g., they were looking for plausible explanations of dramatic events) and decided to go into foxhole-mode and stay there; thereby limiting their portfolio's recovery.

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[4] Ivan Pavlov, John Watson, Edward Thorndike and B.F. Skinner pioneered behavioral psychology in the early 1900s.
[5] Ivan Pavlov, 1849-1936, was awarded a Nobel Prize for his psychology/behavioral research in 1904.
[6] Daniel Kahneman and Amos Tversky were recognized with the 2002 Nobel Prize for this behavioral research.
[7] Vanguard and Dalbar studies suggest *actual investor returns* are significantly less than mutual fund and market returns.
[8] *The Signal and the Noise; Why so Many Predictions Fail*, Nate Silver, 2012

Adding to misinformation and drama, marketing consultants exploit how our minds quickly and uncritically respond to catch phrases and certain numbers (e.g., 50% off sale). After all, the media is a marketing enterprise that has no peer in the art of persuasion and getting our attention. Headlines are designed to "grab us by the throat" with drama, suddenness, fear, and hyperbole. Combine the way our minds work and how we often emotionally leap to decisions with (i) what we instinctively respond to (and over-respond to), (ii) the flood of information that bombards us all day as we constantly check our smartphones and emails, and (iii) the almost impossible task of taking the time to read beyond the headline, and it is no wonder that so many are influenced (if not "controlled") by the media. Especially about that which we are not expert in, the media essentially tells us what is important and what we should most focus on. The media "controls" much of what we hear and read; therefore the media "controls" much of what takes root in our minds. Because the media needs readership and viewership and website hits, it effectively uses marketing psychologists to influence our thinking and consumer decisions – and this includes financial decisions. The media and most market/investment "experts" insist in an unrelenting manner that the following is what is most important with investing:

- **Headline news -** especially the world and economic trouble-spots, e.g., the fiscal cliff
- **Forecasts –** the economy, debt ceilings and fiscal cliffs**,** European Union, the dollar, China's slowdown, and of course, the stock market's direction in 2013
- **Playing the game -** what horses to bet on, when to change horses, and winning the horse race vs. the quarterly and annual benchmarks given to us by the industry and the media

THE GAME

Headline news and forecasts. When you think about the amount of ink that is dedicated to news and forecasts by the financial press and investment advisors/strategists, it becomes clear they believe news and forecasts are critical ingredients to sophisticated investment analysis and decision-making. We are led to believe that portfolios must be frequently adjusted in response to trouble spots around the globe, to Washington's anticipated policies, to forecasts of political, economic, and market outcomes. WIC believes many investors pay too little attention to the efficacy of such forecasts and predictions. Years ago, we became convinced by creditable research that basing investment decisions on economic, political, and market forecasts increases portfolio risk. While we certainly read a wide range of opinions, including forecasts, we use it in a contextual manner, not as a decision-driver.[9]

The tendency of investors to rely on news and forecasts likely played a large role in their poor investment performance over the last 5-10 years. Partly because it is considered more sophisticated to do, it is hard for many not to be swept up in the pessimism and negativism that dominates the news. Decades ago the Austrian economist Joseph Schumpeter took note of this human nature tendency, "Pessimistic visions about almost anything usually strike the public as more erudite than optimistic ones". We believe many investors eschew the promise of mean-reversion and self-correcting forces that characterize our economy and markets: companies adjust and recalibrate, consumers adjust, entrepreneurs innovate, inventors invent, countries adjust and figure things out, etc. All those corrective adjustments have been occurring resulting in a profitable journey over the last 5-10 years. But for many investors, behavior trumped rational thought making the journey most unpleasant.

[9] For example, see footnote 8 on prior page and Federal Reserve studies on accuracy of their economic forecasts.

Playing the Game. Charles Ellis recently wrote a seminal paper that was published in the *Financial Analysts Journal* examining the chronic underperformance of institutional portfolios.[10] He discusses the roles played by investment committees (the client), consultants (gatekeepers who select, monitor, and fire investment management firms), and investment management firms (like WIC). He concludes they all are responsible for portfolio performance that usually is less than the performance of the broad market. Some of the underperformance is about the behavioral issues noted above, some is about chasing "hot performing" managers or sectors or strategies, some is about the high cost of excessively switching managers and/or strategies, and some is attributed to lack of patience. While all those factors no doubt contribute to underperformance, we believe another significant reason is how portfolio management has almost become *a game.*

By *a game*, we refer to the way portfolio management has dissolved into a scorecard. The conversation and analysis often seem to be little more than whether or not the portfolio's return beat the market. If the portfolio beat the market, the manager is deemed skilled and useful; if not, the manager is often deemed unskilled, not adding value. Far too often, the evaluation gives little consideration to the objective of the funds, the portfolio's purpose, the risk associated with the returns generated, the client's temperament, and whether or not a better outcome would have necessarily occurred with a different structure.[11] Instead, it is all about the score – thus *the game*. And the score is measured in very short time periods (usually 3 – 5 years) that promote excessive and costly switching of strategies and managers and feeds the bad behavior of chasing performance. None of this discussion is an attempt by WIC to avoid measurement and accountability. Rather, we want to measure in a way that enhances risk management, and therefore risk-adjusted returns.

Measurement and Accountability. *A general management principle is that which is not measured is not effectively managed*; no measurement, no accountability; the path to improvement is via measurement. We agree with that principle and our quarterly reports always include market returns for comparison. Here is the paradox – the obsessive focus on the S&P 500 may be contributing to the large scale failure to perform. We know two things: (1) for decades the dominant focus of consultants, investment committees, the media, investment advisors, clients and investment management firms has been beating the S&P, and (2) the vast majority of investors – individuals and institutions – have failed to consistently beat the S&P. [12] That should at least cause us to ask "is such a singular focus on beating the S&P really effective?" We believe excessively focusing on the S&P is not effective for at least two reasons:

1. It fails to consider the risk part of the equation. Returns versus the S&P (or any other benchmark) usually only address raw returns and ignore the risk the portfolio was exposed to in order to get that return. Return and risk cannot be decoupled.

2. It fails to consider the *bad behavior* it encourages: impatience, chasing performance, excessively changing strategies, and the resultant game-mindset that develops.

[10] Charles D. Ellis, The Mystery of Underperformance, *Financial Analyst Journal*, July/August 2012

[11] The assumption the alternative outcome would necessarily have been better is invalid. It is always assumed that the "alternative" portfolio would have remained fully invested 365 days per year for the entire 3-5 year evaluation period and the client would have had the required discipline to stay invested in order for the S&P 500 outcome to be superior; or that a change in course, strategy or manager would have generated a better outcome. The alternative course that might have occurred is entirely different from knowing what course actually occurred and therefore what outcome actually occurred. Because the alternative outcomes are unknowable, one cannot conclude the alternative portfolio return would have been better or worse.

[12] There are hundreds of indices to measure every slice of the market and depending on the strategy indices other than the S&P 500 are used. But the S&P 500 is dominant. The historical data clearly show most firms and clients fail to match, let alone, beat the market.

HOW WIC MEASURES SUCCESS

So, how does WIC hold itself accountable and measure success? Based on 34 years of working with clients and observing client behavior (the full spectrum of fear and greed and decision paralysis), and based on decades of studying why poor investment outcomes are not uncommon, we best serve our clients by:

- Educating and counseling them to remain invested over decades; patience is key
- Helping them resist *bad behavior* which leads to greater risk and poor returns
- Demonstrating we are serious about risk management
- Better protecting their capital in most down markets
- Generating competitive risk-adjusted, long-term returns

More specifically, Willis Investment Counsel defines and measures success as protectors and managers of our clients' capital, and as a firm, in these terms (objectives we strive for):

- Risk management – less percentage decline in most down markets[13]
- Risk management – clients remain steadfastly invested more than 3-5 years
- Competitive returns – risk-adjusted returns greater than market indices over ten years [14]
- Client retention – our clients remain clients for decades; a solid indication of success
- Firm reputation – we want to be known for straight-talk, integrity, excellent research, and superior results for our clients[15]

This letter has been a long one and we hope you made it to the end! Please let us know what is on your mind and come to us with any questions.

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

Disclaimers: *The views expressed represent the opinion of Willis Investment Counsel's research and portfolio management team. The views are not intended as a forecast or guarantee of future results. This material is for informational purposes only. It does not constitute investment advice and is not intended as an endorsement of any specific investment or strategy. Past performance is not predictive of future results, which may vary. Investing is subject to risks and uncertainties; future returns are not guaranteed, and loss of principal may occur.*

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

Contact Information

WILLIS INVESTMENT COUNSEL
Principled Investing

710 Green Street
Gainesville, GA 30501
P: 770.718.0706 | F: 770.718.0805

[13] We are realists, we do not expect to perform better in all down markets, but we do expect to perform better in most.
[14] The Sharpe Ratio combines returns with volatility: (annual portfolio return – Tbill return) / standard deviation of returns
[15] Occurs if clients remain invested for many years due to effective counsel earning competitive risk-adjusted returns.