



VIEW FROM THE GRAND...

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Is Fundamental Analysis and Long-Term Investing Dead?

The Efficient Market Theory argues that it is impossible to outperform the market. Being bottom-up fundamental investors, we obviously disagree, but we will need to leave that argument for another letter. For many, it has become conventional wisdom that anyone can add beta (general market risk) to an investment portfolio, but adding alpha (return earned from unique insight) is more difficult. Therefore, many investors have come to the conclusion that trying to manage their exposure to beta is the only logical way to control risk and increase investment returns. Why spend long hours researching a company's business model, learning how it is positioned relative to its competitors, analyzing the quality of its financial condition, the expertise of the management team, and many other important factors, if none of this matters?

This methodology used to beat the market is sometimes referred to as tactical asset allocation. Tactical asset allocation is an old concept used by many investment practitioners and sounds very professional. However, the way in which this strategy is being implemented, it is actually something very different. Many of us greybeards know this strategy as the long discredited investment approach called market timing. This time rather than trading in individual stocks, investors are trying to time the market using various Exchange Traded Funds (ETF's).

ETF's come in many different forms. They can represent a broad market index, an economic sector, or an industry group. They can be leveraged or unleveraged. Some are even structured to go up when the market goes down. The possibilities are limitless and we are certain Wall Street will continue to develop new ETF's to satisfy almost any potential use an investor can imagine. Conceptually, the goal is taking out of the equation the specific company risk that has confounded so many investors. It's like owning a mutual fund. You get exposure to a large diversified portfolio of stocks, but in this case your cost is lower and you have the ability to trade in and out of most ETF's very quickly and inexpensively. An advantage of this strategy is that you are decreasing the number of decisions you need to make. It can be as simple as, is the market going to go up or down? If you want to get more sophisticated you can add specific bets on how one sector or industry will perform relative to another or even one country versus another. And, if that is not enough, you can choose to add fixed income, commodities, as well as currency options. We understand the appeal, it sounds great. Less work and earn higher returns, who can argue with that outcome?

While this all sounds great we see a couple of problems. First, just because an investor can make changes to their investment portfolio cheaper and faster does not mean that it will increase investment returns. For example, equity mutual funds have seen trading costs fall dramatically over the years and as a result increased turnover has been encouraged. In the 1960's the average mutual

fund had turnover of approximately 17%, in the 1970's it grew to a little under 50% and today it averages a little over 100%. In spite of or maybe because of the increased turnover most funds underperform their benchmarks!

Second, no matter what you call it market timing is dangerous. Many studies over the years have shown that not being invested in the market for just a few days over long periods of time can substantially decrease investment returns. The obvious counter argument is that if you are smart enough to miss a few bad days your returns would be incredible. Additionally, many argue that you need to be proactive to protect your portfolio against a black swan or negative market event. This is a particularly appealing argument considering the investment environment we have all experienced over the last decade. The problem is that all of the research shows that most investors make these decisions at the wrong time. Individual investors inevitably buy high and sell low. You will probably not be surprised to learn that institutional investors have shown equally poor results. The reality is that to earn higher returns you need to take risk and there is no way to eliminate that risk without a corresponding cost. No one has consistently been able to time the market. Therefore, as much as some want to deny it, the only way to protect investors is by having a portfolio that balances risk and return.

These facts do not stop many investors from trying and this new investment strategy is having a significant impact on the financial markets. It is a significant contributor to the increased volatility we have been experiencing. Too many investors are trying to move in and out of the ETF's quickly to outsmart the market and capture outsized gains quickly. This has made our job as long-term investors more difficult. It undermines investor confidence and causes some investors to fear that the market is rigged. Someone must be manipulating the market in the background. How else can you explain the market moving so dramatically on a day-to-day basis? We understand this sentiment but don't believe it is true. Wall Street is often dominated by themes and emotions that move markets over short intervals of time, but during longer periods successful operating results and profitability will be rewarded.

This lack of attention to fundamentals makes the market less efficient not more. With so many investors concentrating on macroeconomic analysis, inefficiencies take longer to correct and work through the system. This is both good and bad. As a consequence of the increased volatility, we are seeing more extreme data points where clients can look at their advisor and conclude that they are either really smart or really dumb over the past month, quarter, or year. The reality is probably somewhere in between.

We are not so arrogant as to claim we know the only successful way to invest. We have often said there are many ways to make money and we have not changed our view. However, we believe the key to successful investing has not changed and the hard work involved in knowing what you own cannot be avoided. The devil is always in the details and the details matter.

"Any intelligent fool can make things bigger, more complex, and more violent. It takes a touch of genius - and a lot of courage - to move in the opposite direction." -Albert Einstein