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3rd Quarter 2013 Investment Review

Investment Thoughts

"The fact that people will be full of greed, fear or folly is predictable. The sequence is not."

Warren Buffett, Chairman, Berkshire Hathaway

"We like to stay sane while others go crazy. That's a competitive advantage."

Charlie Munger, Vice-Chairman, Berkshire Hathaway

What do ***Performance Enhancing Drugs***, ***Five Finger Discounts***, ***Beanie Babies*** and ***Detroit*** have in common? Irrational behavior. It's all around us, and the investment world isn't immune. We see numerous situations that beg the question: "***What were they thinking"?***

We write frequently about the behavioral aspects of investing. We think it's ultra-important to investment success. Our philosophy stresses rational behavior, which separates us from less-disciplined competitors. As Charlie Munger says "***that's a competitive advantage***". Far from being controlled ***by*** the market, we call the shots. We select high quality merchandise and determine the appropriate price to pay. If our price isn't available, we wait.

In our view investing is similar to a manufacturing business. First gather raw materials—information. Next process the materials—intensive study and analysis. Finally create the finished product—investment valuations and ultimately decisions. Benjamin Graham, Warren Buffett's mentor, wrote that "***Investing is most intelligent when it is most businesslike***". Graham meant that investors need a system that minimizes if not eliminates human irrationality from the investment process. Society is full of irrational behavior, and we find that investors can be subject to the same influences. Let's look at some examples.

The world of sports offers a large field (sorry) of opportunities to evaluate irrational behavior. Whether it's drug-enhanced multi-millionaire athletes, budget-busting billionaire owners hell-bent on bringing home a championship regardless of cost, or cities coughing up mega taxpayer dollars to finance stadiums, the sports world doesn't always behave rationally.

Given their prestigious positions and high salaries, it's hard to understand why athletes cheat. Or municipal officials agree to taxpayer-financed stadiums with poor economics. And team owners who lose money every year due to astronomical player salaries. I'd suggest it's a combination of ego, arrogance and disregard for the long-term consequences. Call it poor risk assessment.

But irrational behavior is not limited to sports. We have many examples in the celebrity world. Such as celebrity shoplifters. Why would Lindsay Lohan, Britney Spears or Winona Ryder steal anything? They're obviously not short of cash. Britney got caught stealing a $2 lighter. Temporary insanity? Arrogance? Poor risk assessment? No risk assessment?

While athletes and entertainers can be a bit mercurial, level-headed business types are considered more rational. Right? Not always. Remember Beanie Babies? Those cute stuffed animals debuted in 1993 and turned founder Ty Warner into a billionaire in 6 short years. No, Beanie Babies aren't irrational, but poor ol' Ty has made some poor choices since stacking up his billion dollars. He pleaded guilty to tax evasion this month. Ty failed to report income on $24.4 million in earnings on assets held at a Swiss bank. Said Ty: "I apologize for my conduct. I made a mistake. I'm fully responsible." His reward? The 69 year old faces up to 5 years at Club Fed along with $53.6 million in penalties.

This stuff astounds me. Here's a guy who hit the jackpot selling stuffed toys, became a billionaire in his early 50's and could live a life of complete leisure. Instead, he'll likely be washing dishes or manning the prison library at an age when most of us are collecting Social Security. ***What was he thinking***? A big case of "oops, I didn't evaluate the risks too well."

No cursory review of irrational behavior would be complete without addressing our political system. Political life is chock-full of behavioral misdeeds. Detroit filed for bankruptcy in July. Its former mayor, Kwame Kilpatrick, was recently sentenced to 28 years in prison for systematically milking the system. Is there a connection between his actions and the city's bankruptcy? It didn't help. "I really messed up", a tearful Kilpatrick told the judge.

Finally, let's look at the investment management industry. There's plenty of bad behavior here. Newspapers are full of stories about insider trading, penny stock scams and Ponzi schemes, all designed to line one's pockets with cash. If these people are willing to risk their careers and freedom for financial gain, what risks will they have their clients assume?

What do these situations have in common? First, in many cases, ***greed*** is in the driver's seat. Second, I would suggest there wasn't much ***risk assessment***. While in many cases it might be a very low probability of being caught, the consequences of getting nailed can be severe. In the insurance world this risk is called "Low Frequency, High Severity", like a hurricane that hits New York City. Not very likely, but it hurts when it hits. In my world this is called "Are you nuts?" Why successful people would risk what they have to get a bit more, which ***in many cases isn't even needed***, seems irrational. In hindsight, most people would agree.

So, almost every walk of life contains irrational behavior. To think that investment decisions are somehow immune from irrational thinking is laughable. Investors are just as susceptible to misjudgments as athletes, entertainers, businesspeople and politicians. It's a reminder that ***people don't always make correct assessments of the risks*** (jail, fines, public humiliation) ***along with the rewards*** (money, celebrity, sports championships) ***in life and investing***. People buy stocks near market tops, and sell stocks at market bottoms. Or buy based on tips, without sufficient research. Or day-trade thinking it's the road to fast, easy riches. In a zero-sum world where winners largely offset losers, the irrationality of some investors keeps us in business. Fortunately for our clients this should be the case as long as markets exist. Or until Google conquers driverless cars and targets "driverless", presumably rational markets. Until then, we're pretty sure we have a job. So much for the Efficient Market Hypothesis nonsense I learned from my Finance Professors in business school.

Economic Conditions

Not much has changed in the economy since last quarter, with the Federal Reserve continuing to stuff its balance sheet with bonds. Eventually the economy will be required to stand on its own two feet. That looks to be next year at the earliest.

The U.S. has been described as the best house in a bad neighborhood, and that's not an inaccurate description. Our economy continues its sluggish growth and low inflation. Housing markets continue to recover, car sales are still strong, manufacturing competitiveness is improving and domestic energy independence is closer at hand.

Emerging foreign markets became submerging markets this year, with many former highflyers such as China, Brazil, Russia, India, etc. experiencing reduced growth and declining stock markets. There's probably opportunity in some of these markets, but we have no intention of finding out. We stick to what we know best. Think Peoria, not Prague.

Europe, despite some flickers of life, will be in the sick bay for years. Greece is working on its 3rd or 4th bailout. I've lost track. Europe needs to pray that Germany doesn't get sick.

The immediate concern is the continuing calamity known as Washington, D.C. where budget stalemates and 11th hour near-misses hover over investor mindsets. We don't know what the Beltway folks will do, but we keep our fingers crossed that compromise is reached. As we write this, there are flickers of life in the idea of compromise, but D.C. could blow it.

Investment Conditions

We had a productive third quarter, but our current gains reduce the potential for future gains. ***Equities generally look fairly valued.*** We see signs of excessive optimism in Initial Public Offerings (IPOs), Biotechnology, Social Media and Internet companies. Smaller companies also appear to be generously valued. Overall investor sentiment is more positive than it's been in years. Remember, ***when others are greedy, we need to be fearful.***

While stock valuations are higher, somewhat surprisingly many investors continue to embrace the "safe trade", owning essentials such as consumer staples, healthcare and utilities. We value safety as well, but only at attractive prices. The crowd appeal of these stocks has pushed up their valuations, and we are not participating.

Our largest common stock exposure continues to be unloved financial companies of all stripes, including commercial banks (Bank of New York Mellon, Wells Fargo), investment banks (Leucadia/Jefferies, Goldman Sachs) and insurance (AIG, Fairfax Financial, White

Mountains). What they have in common are strong business franchises, capable managers and attractive valuations. Commercial banking has become a scale business, and if you're not large, you're competitively disadvantaged due to significant technology and regulatory costs. In insurance and investment banking, our companies focus on markets where expertise is valued and competition less intense.

We also continue to have notable positions in energy and housing, which along with financial companies are essential to modern economies. Financial companies are the economic equivalent of the human circulatory system, and energy is the blood (forgive the crude metaphor, and pun). Further, everyone needs a place to sleep. We like ***essential businesses***, in areas that Google and Amazon aren't targeting in their quest to control the world.

Beyond stocks, bonds look a bit more attractive, as the recent rise in interest rates has increased available yields. We are finding a few opportunities in municipal and corporate bonds, but not much in convertibles. As rates continue their upward trajectory over the next few years, bonds should become more attractive. But right now, it's still slim pickings. So, we need to be patient.

We remain confident in our investment philosophy and process. We're not immune to temporary fluctuations, but are comfortable that we can handle whatever markets throw at us over the next 3 to 5 years.

We encourage comments, questions and suggestions. As always, your loyalty and patience remains our secret weapon.

Sincerely,

John Heldman, CFA
October 16, 2013

"Many shall be restored that are now fallen and many shall fall that are now in honor." Horace

"Always do right. This will gratify some people, and astonish the rest." Mark Twain