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## **Investment Newsletter – December 2015**

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This newsletter starts with a discussion of recent events in the bond market with emphasis on implications for future returns. Next we take a look at Value versus Growth investing over the years and the interaction with investor psychology. We'll conclude with an update of performance for the Quantitative Investment strategy.

### **Bond Markets: Liquidity Risk Drives Panic Redemptions**

Corporate bonds are typically much harder to trade than stocks. Tighter regulations on banks since 2008 have reduced their ability to provide liquidity to institutional investors. As a result it can be very difficult to sell or buy large positions without significantly impacting the price. For most retail investors it doesn't make sense to hold bonds directly because they can get better liquidity and better diversification by buying into a fund that holds a portfolio of bonds.

There are 3 types of funds – open end mutual funds, exchange traded funds (ETFs), and closed end funds (CEFs). The law requires that mutual funds promise investors they can take their money out at the end of any day based on the net asset value (NAV) of the portfolio. ETFs and CEFs can be sold in the market anytime – although the market price may be either higher or lower than the NAV. In addition, in the case of ETFs, if the position is large enough, the shares can be redeemed or created in return for the underlying bonds. This feature is meant to keep market prices close to the NAV since large traders can arbitrage any price difference – assuming they can find the other side to buy or sell the underlying bonds. As discussed in the last two newsletters, CEFs can trade far away from NAV since there is no arbitrage mechanism to hold the prices close.

There has always been a mismatch between portfolio liquidity and fund share liquidity for mutual funds. This problem is compounded by the fact that less liquid bonds tend to provide higher returns for a given level of credit risk – thus providing an incentive for funds to hold more illiquid positions. As the banks have pulled away from market making in bonds, market liquidity has been declining. This raises the risk of "runs" on bond funds since it increases the chance that redemption requests may exceed the amount of holdings that a fund can easily sell. Therefore if a fund with a large percentage of illiquid bonds gets a lot of redemption requests, it may trigger other investors to try to get out while there are still some saleable holdings. The result would look much like a bank run from the depression.

For this reason, in September the SEC proposed new rules to prevent high concentrations of illiquid bonds in mutual funds. But these rules are not yet final.

In the meantime, Third Avenue Focused Credit Fund stopped cash redemptions from its \$788 million fund on December 9<sup>th</sup>. This fund held a lot of illiquid positions and was suffering a continuing stream of large redemptions – a run on the fund. The fund announced that it would redeem shares with shares in a liquidating trust – thereby postponing payouts for an indefinite period while they try to sell their positions. This event focused the market on the liquidity problem and triggered panic selling in the high yield market. Our Long Term Income portfolio dropped approximately 4% from December 10<sup>th</sup> to December 14<sup>th</sup> (2 trading days). Subsequently this loss was reversed by December 22<sup>nd</sup>. The portfolio is currently showing a 1.4% gain for the quarter as of December 23<sup>rd</sup>. In hindsight investors who sold during the panic only hurt themselves in their rush for the exit. Next we'll take the long view by examining the components of bond fund returns.

### **Bond Markets: Mark to Market Returns & Dividend Yield**

Bonds are promises to pay back principal plus interest over the term. In a well diversified portfolio of high yield bonds, some will default. This means that the actual yield after deducting credit losses will be less than the promised yield. Over the long run credit losses on a diversified portfolio are likely to be substantially less than the promised interest. We can think of such credit losses as a deduction from our yield so that on net we are getting back our original investment at maturity. Looking at the Long Term income portfolio results for a particular client over the first 11 months of 2015, I found that the dividend yield was at an annualized rate of 7.82% before fees. But the market value of positions dropped 12.53%. So we have a good return offset by a large "mark to market" loss which reflects what other investors would pay *if* we were selling.

Let's look forward now. The interest payments have not changed. Therefore the price drop has raised the current yield to approximately 8.2%. Here's the really counter-intuitive part: the mark to market decline in bond prices will give us higher returns if we are long term investors. At maturity, unless there is an unexpected large rise in defaults, we still get the same expected payoff even though the market marks down its value today. If bond prices stay low and yields stay high (as we hope they will), maturing bonds' principal will be reinvested into higher yielding replacements. We don't immediately benefit – we're still earning the original yield based on where we bought. But ultimately higher interest rates won't hurt us, they'll help us. (This is not true if you must sell in the short term to spend the money). Investors selling during the mid-December panic were either using a long term strategy when they really had a short term investment horizon or they didn't understand the market. It's important to have a strategy that fits your goals and time horizon and to think clearly about the consequences and implications of mark to market declines.

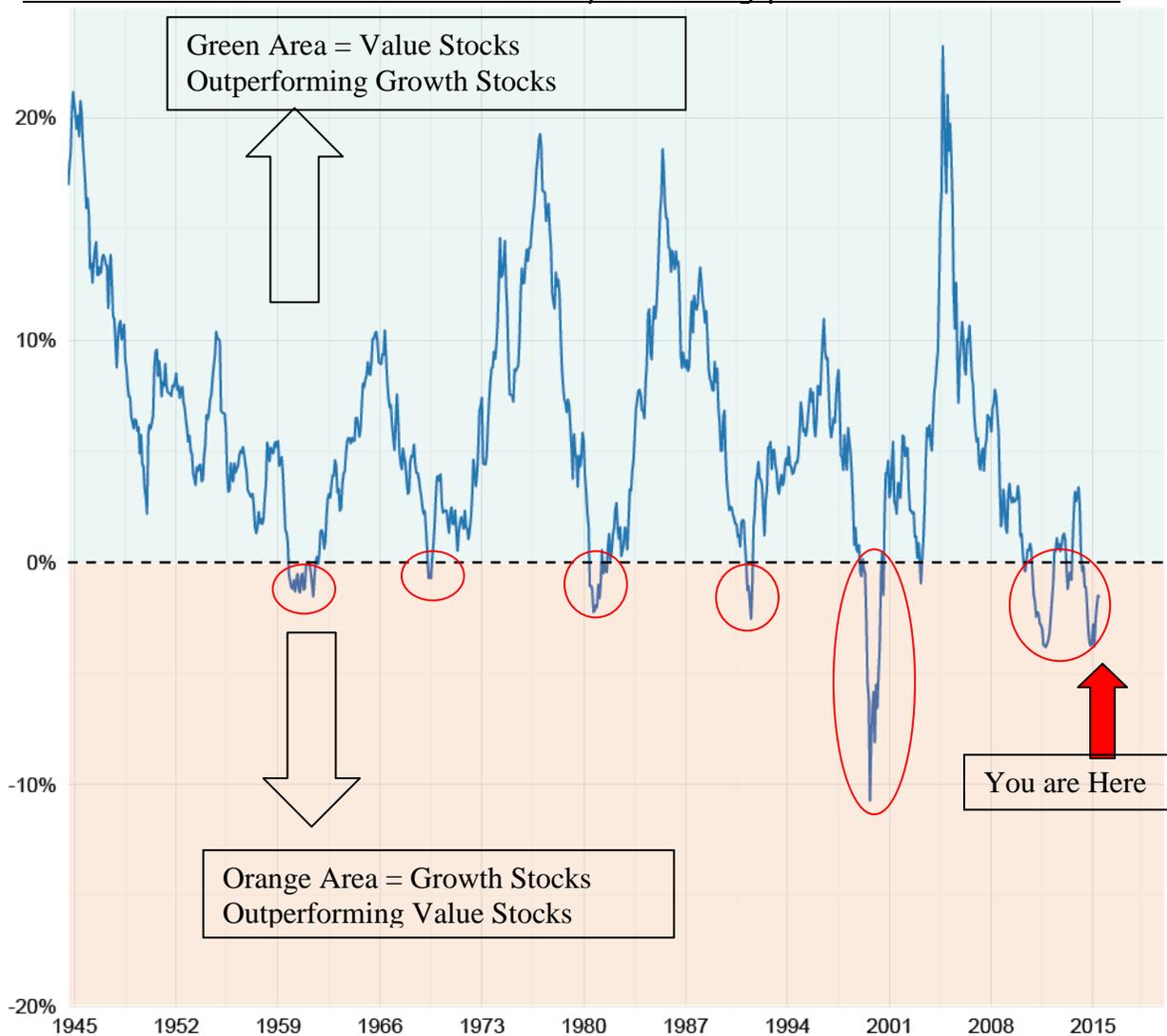
### **Value versus Growth – Investor Psychology and Switching Strategies**

At Berkeley Investment Advisors we follow a value investing strategy because it has worked well for us in the past and research shows that it outperforms growth strategies over the long term (we and our clients are long term

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investors). Of course, anything can happen in the short run and that's where the difficulty lies for a large number of investors – how to stick with your long term strategy when it feels so bad to under-perform in the short term. Investing successfully requires that our logical side wins out against our emotions. We need some ammunition. Our purpose here is to help investors maintain discipline by putting the situation into the proper context. The graph below uses data from Professor Kenneth French at Dartmouth. The 20% of cheapest stocks on the basis of the Price-to-Book Value ratio are chosen as the Value portfolio. The 20% of stocks with the highest Price-to-Book Value ratio are in the Growth portfolio. The erratic line tracks the returns to Value in excess of Growth over rolling 5 year periods. The red ovals show the 6 times since 1945 when the Growth stocks outperformed Value stocks over the prior 5 years.

Value versus Growth – annualized 5 year rolling performance difference



What we see in the graph is that Value stocks outperform Growth stocks during most 5 year periods. The Value portfolio outperformed Growth by about 5%

annually on average over the last 70 years. But occasionally Growth beats Value over 5 years. These are typically periods which appear as bubbles in retrospect. We are currently in just such a period. Only the late 1990's bubble produced a larger (temporary) advantage for Growth.

The next chart below uses the same data but separates the data into segments where each comparison line starts at the time point where the Growth portfolio's 5 year return first exceeded the Value portfolio return. The horizontal axis is the number of months since Growth's 5 year return first exceeded the Value portfolio return. So each line below starts at a red circle on the first chart and ends at the next red circle.

Cumulative Return of Value in excess of Growth for Six Cycles



Months since beginning of Cycle – When Growth first exceeded Value Return

This graph shows very strong returns for Value stocks just after the cycle turns back in their favor after a period where Growth out-performed.

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If you are curious to understand why these cycles occur I urge you to read the June 2014 newsletter which summarizes an academic paper titled "An Institutional Theory of Momentum and Reversal". This theory seems to fit the cycles we see in the market: investors react emotionally to short term market events and their investment flows impact returns - driving the cycle of Value and Growth returns.

The current cycle is very unusual in the length of time that Growth stocks have outperformed Value stocks. We cannot know for sure why the cycle is prolonged this time but I hypothesize that the Federal Reserve bank's policy of quantitative easing and long term zero interest rates have played a major role. These policies have encouraged speculation because of the psychological effects on investors - the belief that the Fed will come to the rescue whenever markets decline. This belief has reduced the caution that might otherwise restrain the run up in Growth stock valuations.

Another contributing factor may be the increasing attention traders pay to "Adjusted Earnings" and other similar measures of performance created by company managers to convince investors to ignore a significant portion of their costs (which they must still report under generally accepted accounting principles). These made-up measures create the illusion that companies are far more profitable than they actually are. These "earnings ignoring bad stuff" (as they are referred to by the Wall Street Journal) may be fooling some portion of the market into thinking stocks are cheap. Over the long run, however, returns to shareholders are driven by the underlying economics of the business - not the happy stories that managers tell to boost their stock options.

Whatever the cause of this unusually long cycle in favor of Growth stocks, history tells us that the probability is very high that the cycle will turn strongly in the favor of Value stocks and that this is more likely to occur sooner rather than later.

If you've followed my newsletter over the years, you understand the role of psychology in markets and investors' results. For example the March 2012 Newsletter provided a review of academic findings about investor behavioral errors, including giving too much weight to recent trends. These psychologically driven errors present real risks to successful execution of long run investing strategies and so therefore we should be alert to these biases so as to resist them. Here's a short reminder from the September 2009 newsletter about the impact on returns when investors react to recent trends in the market:

From 1984 through 1995, the average stock mutual fund posted a yearly return of 12.3% (versus 15.4% for the S&P), yet the average investor in a stock mutual fund earned 6.3%. That means that over these 12 years, the average mutual fund investor would have accumulated more than twice as much money by simply buying and holding the average mutual fund, and more than three times as much by buying and holding an S&P 500 index fund. {Cumulative returns: individuals = 108%, mutual funds = 302%, S&P = 458%} There is something in most people's nature which compels them to buy high and sell low.

*“Investing is not a game where the guy with the 160 IQ beats the guy with the 130 IQ...Once you have ordinary intelligence, what you need is the temperament to control the urges that get other people into trouble in investing.” – Warren Buffet*

In response to the graph of the Value versus Growth returns cycle, I was asked whether I try to switch between Growth and Value strategies to time the cycle and earn higher returns. Unfortunately we only know which one is performing better after the fact, which doesn't necessarily predict the future. If we were to switch strategies back and forth according to which has outperformed over the last 5 years, the most likely result would be that we would be switching just in time to miss the higher performance of the strategy we just exited. Switching strategies based on past returns will generally lead to performance worse than sticking with either strategy over the full cycle. This is exactly what the typical mutual fund investor seems to do – buying high after performance has been good and selling low after performance has been poor.

Given that we don't know which strategy will outperform in the short run, it makes sense to use the one with the better chance of outperforming in the long run – especially when we have a long run investing horizon. (Although my focus is value, I do occasionally buy growth stocks if I can justify their current price or if insider buying is convincing enough to overcome any disadvantage on price).

There may be some gains to be had by incorporating measures of momentum (which correlate with growth returns) into an overall strategy, but this would likely require a purely quantitative approach so as to eliminate emotional biases and logically combine value and momentum factors. Such a strategy would involve more downside risk than a pure Value strategy. The next section looks at test results for such a strategy.

### **Quantitative Investment Strategy Test Results**

Two years ago, we implemented a quantitative strategy on a test basis. The goal for this strategy is to outperform passive strategies across various market environments. This is not a risk managed strategy, so it would likely underperform our existing Long Term Value strategy in a down market. Assuming we allocate some portion of equity exposure to this strategy, it could serve to reduce the variation in our returns relative to the market in up-markets.

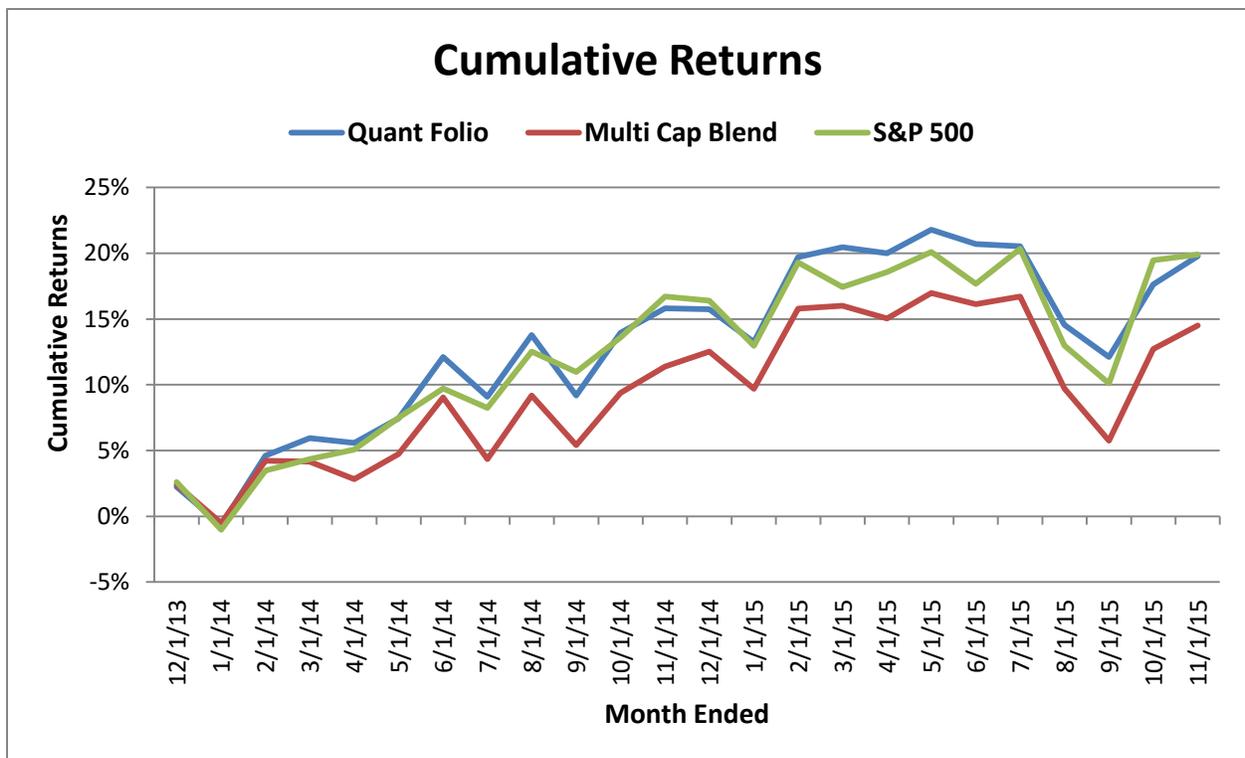
Because our goal with this strategy is to reduce volatility of our return variance versus the market, the portfolio is designed so that industry weightings are approximately in line with the overall market's industry weightings. We did not, however, put any constraint on the size of the companies chosen for the portfolio. Given that larger capitalization stocks are more efficiently priced in the market, we expected the portfolio to be weighted more towards small and mid-cap stocks. In fact the portfolio varied in composition widely from month to month, but on average it has been 38% large capitalization, 28% mid-cap, and 34% small capitalization.

Over the long run smaller capitalization companies tend to outperform larger companies in generating returns for investors. The last 2 years has been unusual in that this has been reversed: larger capitalization companies have done much

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better relative to smaller ones than we should expect going forward. Therefore, we would like to isolate this effect in evaluating the Quant Portfolio. This is important because we are really interested in how it would perform over the long run, not just in the late years of a bull market. If the strategy can outperform a blended benchmark with similar capitalization composition, that is likely to be a good indicator of long-run relative performance. The chart below plots the cumulative returns of the Quantitative Investment Strategy compared to the S&P 500 and a “Multi-Cap Blend” benchmark. The Multi-Cap Blend is a weighted average of large, medium, and small capitalization market indices<sup>1</sup> where the weights used match the capitalization of the Quantitative strategy month by month over the two years. The returns in this chart are from a “watch portfolio” rather than an actual account but they have been adjusted assuming a fee of 1.25% which would apply for accounts between \$500,000 and \$1 million.



The chart shows that the return (after fees) for the Quantitative Strategy lagged the annual return on the S&P 500 by 0.07% and it outperformed the Multi-Cap Blend benchmark by 2.4% annually. Its total return over the first two years was 19.8%. This is a very good result. The tracking error is within a small range and the strategy produced a nice spread over the comparable blended index return. This strategy is appropriate for retirement accounts especially at the early and mid stages of a bull market. By allocating some portion of our portfolio to the current methodology we can reduce overall tracking error and increase returns in bull markets.

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<sup>1</sup> Large was S&P 500, mid-cap was S&P Midcap 400, small was Russell 2000