A Solid Foundation of Core Beliefs is Essential to Long-Term Investment Success

While we often write about aspects of our process we don't regularly shine light on our defining beliefs. These beliefs are the foundation supporting our investment process and approach. They are also an important source of our confidence in what we do and for that reason we're taking the opportunity to share them with you in this commentary. But first, we want to touch on an important conceptual theme.

Because we are living in a time where powerful macro forces are shifting, the historical frame of reference investors have built over much of the last 30 years may not offer a useful guidepost. Investors must have an effective investment approach that allows them to be both disciplined in sticking to a process and core investment values, while also being flexible enough to recognize relevant changes. When the most senior members of our firm first entered the investment business more than 30 years ago, interest rates were in the teens and investors didn't really believe the days of double-digit inflation were over. It turned out that interest rates were at the beginning of a 30-year decline. This was the single most important influence on financial market returns over the next three decades. Not only did it drive financial market returns, it contributed to growing debt levels as credit became more available and affordable.

But this long trend is over and from here it can't be repeated. Back then a lot was different. Baby boomers were young with some still just entering the workforce. Now they are beginning to retire. Japan was on its way to global economic domination—or so we thought. Now they struggle with deflation and 19 consecutive years of property price declines, and it is China that seems on its way to global economic domination. Globalization has taken hold to a much greater extent than back then. The Internet has driven fundamental changes in commerce. In the early 1980s PCs were showing up in offices for the first time and cell phones hadn't been invented. Now we each have more power in our phones than an entire office had back then. The United States and Soviet Union dominated geopolitics (sometimes that seems like the good old days). Tax rates were 70% on investment income and 50% on earned income. And stocks were selling at single-digit P/E ratios.

We believe our investment approach is particularly well suited for the challenges ahead as large portions of the global economy continue to face dangerously high deficits, debts, and aging populations at a time when China and other developing countries are rapidly gaining economic power. Our process is forward looking and that is a key. We believe we are highly disciplined in staying true to that process by being thorough and thoughtful in our analysis—never cutting corners. This too will be critical to our success in coming years.

Fundamental Beliefs: Our Foundation

- **We believe that investment fundamentals matter**—things like earnings levels and growth, debt levels, valuations, competitive advantage, inflation, interest rates, etc.
- But we believe **they matter over time, and most of the time, but *not all the time***. There can be periods where prices and fundamentals are out of whack as we saw in the dysfunctional markets of late 2008 and early 2009.
- Because fundamentals matter over time but not all the time ***we must be prepared to be patient and wait to be right***. Sometimes fundamentals suggest securities should be priced lower yet they go higher. Tech stocks in the late 1990s are a great example. But eventually the market got it and prices plunged (and we looked smarter when that happened). Sometimes securities can be priced at bargain levels yet they keep declining. Junk bonds in late 2008 were a great example, but eventually investors

realized that they were selling at prices far below their value. Their market surged in 2009 and we captured a lot of return when that happened.

- Because fundamentals matter most of the time, **we also must often avoid being tempted by the lure of bullishness or bearishness, i.e., greed and fear**. There are many times when compelling investments simply are not available and we must accept this and avoid being convinced otherwise, while knowing that eventually opportunities will come. But when we do get a fat pitch we should swing, and typically swing hard.
- **We believe that we increase our opportunities by being highly flexible and casting a wide net**. This requires a willingness to look around the world for opportunities, even in small niches (like short-term high-yield bonds, which we currently hold through flexible fixed-income funds).
- **We believe strongly in the value of being contrarian**, supported by our own independent thinking and common sense. When an investment is hugely popular it is probably overpriced (everyone has piled in and driven up the price) and when an investment is hated, relentless selling probably means the asset is a bargain. But any conclusions must be based on analysis of the fundamentals, not just on contrarian instincts. We regularly tap into the thinking of other smart investors and firms we respect but in the end we always rely on our own independent analysis and common sense.
- **We believe in our own common sense**. For example, sometimes the investment community exhibits herd-like behavior. While herding is not always wrong it is often psychologically easier to go with the crowd than to disagree with what is commonly accepted. In the extreme, independent thinking stops and group behavior becomes automatic. We see a lot of this in our industry. For example, not long ago a study suggested that REITs were great diversifiers with low correlation to other financial assets. This study was widely read and bought into by many financial advisors. However, we knew that the study was sponsored by the REIT industry, was based on a carefully selected time period, included few market cycles, and ignored the underlying REIT fundamentals that existed at the time of each cycle. It didn't make sense to us that REITs would always have a low correlation regardless of the fundamentals at the time. We sold our REITs years ago based on overvaluation, which we could assess with confidence, and ignored the possible correlation benefit, which we could not. This allowed us to avoid a crushing decline that began in 2007, and that ultimately turned out to be greater than the stock market— in other words, there was zero diversification benefit.
- **We must obsess about what could make us wrong** because it is too easy to fall back on past analysis, accept our assumptions, and find support for our views. This drives us to test and retest our thinking, to appoint a devil's advocate to take an opposing view, to regularly challenge our assumptions, and to stay humble.
- **We don't believe consistently accurate forecasting is something that can be counted on so we never bet on any one forecast**. We work to understand the range of potential outcomes so we can invest with an understanding of the opportunity and the risk.
- **We believe in honestly communicating our views and expectations**. It's common in our industry for advisors to want to tell a positive story. We believe our long-term credibility is dependent on telling it like it is, whether positive or not.
- **Finally, at the core of everything we do is intellectual honesty**. For us this concept means always searching for the truth; understanding what we can really know and what we can't, being realistic about our circle of competence, and being able to recognize when we are wrong and move on to fight another day.

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These beliefs have not changed over the last 24 years nor have the basics of our investment approach. Believing in our process is critical to avoid being tempted by investment fads and themes that may seem compelling in a given environment, but that are often backward looking and/or short lived. However, having a rock solid belief system and approach is not to say we are not flexible enough to evolve. We have enhanced our process over the years, in addition to gaining incredibly valuable experience and greatly deepening our team. Our asset class scenario analysis has vastly improved: in 1999 we implemented our neutral allocation/fat pitch approach, which helped us continue to add value from our tactical allocation decisions but in a more disciplined way; we've built much more detailed and robust models for most asset classes; we've expanded the number of asset classes we invest in when our research has convinced us that it makes sense to do so (in the last few years this, at times, included emerging-markets local-currency investments, commodity futures, and arbitrage strategies); we significantly deepened our requirements on manager due diligence, and more recently we implemented a formal devil's advocate element. There have been other forms of evolution but those have been the most significant.

Our scenario-based asset class analysis is particularly valuable today. Many investors tend to anchor to the recent past or to the cyclical patterns they've seen over their careers. However, this can be dangerous when there are powerful macro forces at play that can change those patterns. Our approach looks out five years. We don't try to predict what might happen over the next year— something that we might be able to do on occasion but not with the consistency needed to excel. Understanding the possible range of fundamental outcomes over five years gives us a framework for understanding the opportunity and risk in each asset class and acknowledges that we can't know for sure which will play out. We believe this is particularly important now and several of our scenarios are heavily influenced by the issues we have been writing about for many quarters.