August 12, 2015

# Ziggers and Zaggers

Prior to leaving on our recent vacation to Cape Cod, I wrote a draft of a letter about some of the interesting books I have read this summer. My plan was to finish that letter upon our return and share it with you. In particular, I planned to share some highlights from Richard Thaler's new book ***Misbehaving***. He is one of the best known experts on behavioral finance.

Due to the recent volatility we have been experiencing in the equity and commodity markets however, I have decided to place that letter on hold. Understandably some of our clients have expressed concern over continuing to hold positions in stocks and market segments that are heading "south" amidst unfavorable news reports. Presently these concerns center primarily around what appears to be deteriorating fundamentals in China, the energy and basic materials sectors, but also some other adverse political and economic headlines.

As we know, stock prices often move both up and down more than other measures like GDP growth or even individual corporate sales, earnings and dividends (the latter tends to be the least volatile). Particularly when the direction of the price change is negative (usually in the context of disappointing news) it is common for all of us to say, "Shouldn't I sell this investment now and wait for conditions to improve?" The premise being that we know the security's price is going to keep falling, so why not re-establish our position at a lower price? The problem is that it is very hard to know where the inflection points lie as prices often recover dramatically before the news improves. Moreover, it begs the question that if we ***know*** prices are going significantly lower (e.g. 20% or more) you need to ask, then why hasn't that already happened?

Throughout my career, I have found many clients who like buying stocks after they have fallen in price. Understandably far fewer of the clients I have advised are comfortable holding positions when stocks that they own are losing value - especially those declining more than stocks generally. This makes sense because none of us like playing the part of patsy. However my belief is that most of the time if you are investing for long-term results via appropriately diversified portfolios you will inevitably experience periods of time when portions of your portfolio feel quite uncomfortable. I hope this letter provides some context that can help you feel more comfortable and confident.

Perhaps you are familiar with Jim Rogers who is a well-known and colorful investor who has made many astute investments going back to the days when he worked for George Soros. Indeed he was a co-founder of the Quantum Fund and more recently he created the Rogers International Commodities Index (RICI). One notable thing he said: "Commodities tend to zig when the equity markets zag." In other words, when commodities are performing really well, equity markets often have difficulty due to inflation concerns and vice versa. As risk managers (which is our most important responsibility), we purposefully want to own ziggers and zaggers because we know it is impossible to consistently time into and out of stocks, market segments, or asset classes more generally.

I do <u>not</u> have a different than consensus view about the outlook for China's economic conditions than what we are all seeing in the Wall Street Journal and on CNBC, etc. It may well prove true that things are bad and going to get worse. If so, it may also prove true that share prices in China will fall appreciably more. The same may hold true for oil prices and energy stock prices. On the other hand, it may be that aggregate prices and valuations are already sufficiently low and that the recent sharp corrections will prove temporary and overdone. I do know that when we invest in companies and market segments that are less familiar (e.g. small caps versus "blue chips" or emerging markets versus the U.S. markets) it is far easier to be rattled when price changes are adverse to our desires. Over my career, I have observed that the folks who are forecasting continuation of the trend seem the most knowledgeable. This was true of the tech stock cheerleaders in early 2000 as well as the "gloom and doomers" in the first quarter of 2009. Warren Buffet and I, along with others who begged to differ, seemed like we just didn't get it.

In alignment with your interests, I want nothing more than for you and your family to have a great result with respect to your investment portfolios. I have no interest in placing your hard earned money into investments that I do not think have a good chance of performing well for you over the intermediate and long term. Therefore, I will not knowingly place your capital into investments that I think lack merit. Furthermore, I will never take what I consider imprudent risk by concentrating your wealth in just a few stocks, industries or regions. Rather I will take deliberate steps to help you protect and grow your capital.

As I have shared in prior letters and in our conversations with you, I believe success comes from prudent diversification. That said, I know that, despite our intentions, not all of the investments will perform well. I simply believe it is hard to figure out the timing and sequence - let alone definitively identify tomorrow's (and by that I mean the long-term's) winners and losers before the fact. Of course, hindsight is a different matter. Most importantly, I trust the true winners will have the greatest impact on long-term portfolio values.

With respect to China and the emerging market economies more broadly, I do want to share a couple of points. First, I do believe this is where we may well continue to see the greatest increases in long term GDP growth. However, we are not "all in": our allocation into EM equities averages to about *20% of the total <u>equity</u> portion* of our client portfolios.

Experience has taught me that the companies, industries, and countries that feel most comfortable to own often yield more modest results because the good news/outlook may already be "priced in" today's valuation. Of course along the way we want and expect some of our investments to perform well, at least on a relative basis. Accordingly, we will typically avoid the temptation to trim the winners. Conversely, we will also try to help you maintain exposure to other portions of your portfolio that are performing poorly when we have confidence that they can aid results in the future. In other words, we will adhere to our belief that we will all be well served to buy ziggers and zaggers deliberately and sell them reluctantly.

Warmest regards,

W. Richard Jones, CFA
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