October 2013

Dear Clients and Friends:

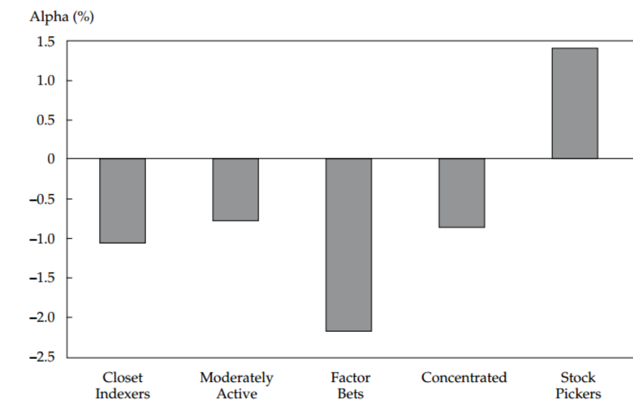
As I write this on Wednesday, October 16th an agreement has been reached in Washington DC to reopen the federal government and raise the debt ceiling. While I realize that many of you disagree with the events in Washington, it is good to have some assurances that the US will not run the risk of default. Coincidentally, I was in DC last week and as you can see, I had my finger on the pulse on what was going on. I'm not saying yours truly lit a fire under our elected officials, I am just saying it is quite a coincidence.

In recent weeks there has been other big news besides what has been happening in DC. Of course I am talking about the finale of the AMC series Breaking Bad. Some of you may be fans of the show. I had never watched an episode, but all the hoopla surrounding the finale persuaded me to watch the series. I have become quite obsessed and I am currently in the middle of the 3rd season on Netflix. Without giving anything away, the story is about Walter White, a husband, father and high school chemistry teacher who gets diagnosed with terminal cancer. Facing mounting medical bills and his family's future, Walter decides to do the most logical thing………cook meth.

Ok, time for the parallel; like Walter White, investors have had to accept a new diagnosis and success will require a response. I am not suggesting as extreme a response as Walter White's or methamphetamines as an investment strategy, but we prefer money managers that have the ability to adapt.

The reason for my trip to DC was to attend Roumell Asset Management's Annual Investor Meeting. You may or may not have money with Roumell, but I will be using him as an example in this letter. Roumell is an active money manager. A trend that has emerged over the past 10+ years moves in the opposite direction of Roumell--index investing. As you know, index investing is using funds or ETFs that passively track a particular index such as the S&P 500. There is nothing wrong with index investing. In fact, studies show that **less than 1/3 of actively** managed mutual funds out perform their index. It begs the question of why would we invest in actively managed funds if they are just going to lag the "lower fee" index.

First of all, those historical studies may be a bit flawed at what they consider "actively managed". More recent studies show that roughly 1/3 of all mutual funds are just closet indexers. Closet Indexers stay invested very close to the benchmark index while claiming to be "active" charging active manager fees. This closet indexing category has a very poor record of beating the benchmark. In contrast "stock pickers" have historically added "alpha" or excess return over the benchmark. "Stock Pickers" are managers that have more concentrated portfolios and actively adapt and seek opportunities. Stock pickers take meaningful positions in a relatively limited number of securities that they know very well. As you can see in the chart, over this study period, "stock pickers" are the only style of equity investing that has added any meaningful performance worth paying for over an index.



> *"You can understand why many succumb to the pressure to hug the index, so to speak. But we believe if you go down that road of trying to make sure you'll never do much worse than the index, you're almost insuring you'll never do well enough to justify your compensation as an active manager" Bill Nygren-Harris Associates*

Roumell Asset Management is a "stock picker" similar to a number of other managers we use in client portfolios. At the conference in DC, 2 CEOs of companies Roumell invests in spoke. Together they comprised over 10% of Roumell's current portfolio. In fact, his top 10 holdings make up nearly 40% of his portfolio. To me, that truly fits the mold of a stock picker. He is constantly doing research to identify opportunities and find companies to invest in that at least give him a chance to beat the market. When he doesn't see opportunities, he gladly holds cash. In fact he has 40% in cash now. That is one thing that an Index or Closet Indexer will definitely not do. I view my job is to find managers that adapt like Walter White and implement them into a portfolio for my clients. In this "new normal" environment I want managers that can be nimble. It was easy to invest in the 1980s and 1990s. During those times it was a joke that you could throw a dart at the Wall Street Journal stock quote page and that stock would go up. Now we have had to adapt.

Walter White lived a pretty basic, normal life in suburbia teaching chemistry. His life changed and he adapted. I can't say it was the best decision for Walter, but he did adapt. Will the "closet indexers" who charge fees like they are active managers adapt and start working to add the value they charge for? I hope not, since their existence creates opportunities for those managers we seek with a proven ability to adapt. Of course, there is no guarantee, but based on history our odds are better with these managers.