Institutional Imperative

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Curb Your Emotions:
A Go-Anywhere Investment Policy Statement

Investment policy statements are important for all investors. A good defense against being overcome by your emotions, which are virtually guaranteed to be sorely tested during any market cycle, is to have some prearranged investment rules in place.

With this in mind, I set out to create an investment policy statement for the equity portion of an investor's portfolio using the best go-anywhere value mutual funds I could find. I used absolute value funds, meaning these funds' managers will own bonds or cash if they think opportunities are better in those asset classes. Therefore, these are not pure equity funds, despite their occupying the equity or longer duration portion of a portfolio.

As the equity portion of an investor's allocation, this portfolio is intended to occupy an investor's long-term assets not required for spending for at least five years, and preferably 7-10 years. It is also intended to complement a bond portion that is generally shorter-term and higher quality than the main bond index, the BarCap US Aggregate Index. The operating assumption is that your bond money is your safe, short-duration money, and the go-anywhere funds, with their exposure to equities and higher yielding bonds, properly purchased, will provide the more robust performance and inflation protection over time. Each investor will have to decide how much of his or her assets to maintain in each portion.

The go-anywhere approach is one possible way of constructing an equity or long-duration portfolio, and it may not suit everyone. However, I think arrangements like it have been given short shrift in recent decades by analysts, consultants, advisors, and institutions because of the ascendancy of modern portfolio theory, which places a greater importance on maintaining strict, prearranged asset class exposure than on underlying asset class valuation. In other words, the funds recommended in this policy statement are not absolute in an asset class sense precisely because they are absolute in a valuation sense.

Much of this statement relies on Steve Romick's recently published investment policy statement for his fund, FPA Crescent (FPACX), which is among the recommended funds in this statement. However, nobody should take my recommended portfolio as being endorsed by Romick, with whom I have not discussed this at all. Successful investing can take other forms than the one Romick outlines, and his remarks don't even encompass all forms of value investing. Investor activism, to take one example, is absent in his statement, though at least one of the recommended funds in this statement practices that form of investing.

Nevertheless, thoughtful investors everywhere must come to terms with Romick's remarks about the definition of risk, his attention to absolute valuation, and his willingness to consider (at least mildly) macroeconomic factors among other things, and decide whether this approach is appropriate for them.

Besides reliance on Romick's statement, my advocacy of this position rests on the great analyst and teacher of Warren Buffett, Benjamin Graham, who made two main arguments in his book, *The Intelligent Investor,* about asset allocation. Graham said that most investors ("defensive" investors, he called them) should maintain static 50%/50% stock/bond allocations at all times, only performing rebalancing or allocation maintenance along the way. However, he also argued that a smaller cohort of investors ("enterprising" investors, he called them), who paid great attention to security valuation, could move to as high as 75% equity exposure and to as low as 25% equity exposure, as their understanding of valuation dictated.

Implicit in this policy statement is the argument that the finest enterprising investors in the Graham mold can provide superior returns with lower risk however understood (volatility or permanent capital impairment) – a feat the efficient market hypothesis and the modern portfolio theory that derives from it assert is impossible to achieve consistently, if at all. Publishing this statement is an effort to encourage analysts, consultants, advisors, and pension fund managers to suspend, if even only for a moment, what they learned in business school, and take Graham seriously.

Equity Investment Policy Statement

<u>*Goal*</u>

We will seek to achieve equity-like returns with less risk than the stock market. We understand risk mostly as permanent capital impairment.

<u>*Principles*</u>

Absolute Value

We will seek out and deploy capital with managers who buy what they perceive as genuine or absolute bargains rather than relative bargains versus other securities. This doesn't mean these managers can provide performance or return guarantees from year to year, but it means they will choose not to invest, or to invest less, when they think securities are expensive, and to invest, or to invest more, when they think securities are cheap.

"Absolute value" does not mean managing to achieve a prearranged annualized return number or even to match or exceed an inflation number; it does not mean "absolute return." Instead, absolute value means being concerned with the absolute value of a security and, consequently, refusing to be fully invested when it appears that securities are generally expensive.

Absolute value managers tend to be 'tactical," but not in the sense of trying to anticipate short-term market performance and zig-zagging quickly. Instead, they are "tactical" in the sense that their investments are dictated by their understanding of the underlying long-term absolute business value relative to security prices. Even when these managers are correct, the markets can take time to correct to proper prices in order to vindicate the managers.

Absolute value managers are motivated by price and their understanding of underlying longer-term business value rather than by an anticipation of shorter-term market movements that may or may not have anything to do with underlying business value. As Ben Graham would say, they want to "use" the market's volatility to purchase cheap securities and sell expensive ones, rather than be "instructed" by the market about what a security price should be.

To the extent that they appear "tactical," their moves or trades are dictated by the fact that they view themselves as buying the value of underlying businesses, based on assets and/or earnings power, at what they think are cheap prices – or refusing to buy businesses that they think are overpriced.

Not only are absolute value managers not "tactical" in the usual sense of that word, but they tend not to be concerned with the broader markets in the typical way. Absolute value managers react to or are concerned with broader market movements only because those movements may cause securities to be offered at attractive prices or bid up to unattractive prices relative to underlying long-term business value. As Warren Buffett has written about value managers in general, no matter how much they may seem to differ in style, they are always "mentally buying the business." And of course, since they want to buy the business at a good price, an element of timing is involved – but only as it provides the opportunity to exploit a discrepancy between price and value.

Go-Anywhere Mandate

Absolute value investors tend to be go-anywhere managers, which means they look for securities that are cheap in absolute terms anywhere in a company's capital structure. In other words, they buy both stocks and bonds, depending on where they see the best opportunities. They are content to be owners or lenders, depending on where the opportunities present themselves. In fact, many absolute value investors exhibit great talent on the bond side, where the cash flows are more secure. Generally, absolute value investors want very large – equity-like -- yields to assume bond risk because of the inherent interest-rate and inflation risk in fixed-rate securities. The object, after all, is equity-like returns with minimal risk of permanent capital impairment.

Some absolute value investors are so talented and adroit on the bond side that they know how to navigate the bankruptcy process and effectively exchange distressed debt, purchased before or after a bankruptcy filing, for equity in a restructured company.

Of course, absolute value managers also move up and down the market cap scale in equities, buying large-caps or small-caps depending on where bargains present themselves.

Finally, some go-anywhere managers can short or bet against securities. They can do so traditionally by selling a borrowed security before repurchasing it at a lower price at a later date, or they can use put options. They can also short either individual securities or asset classes.

Risk

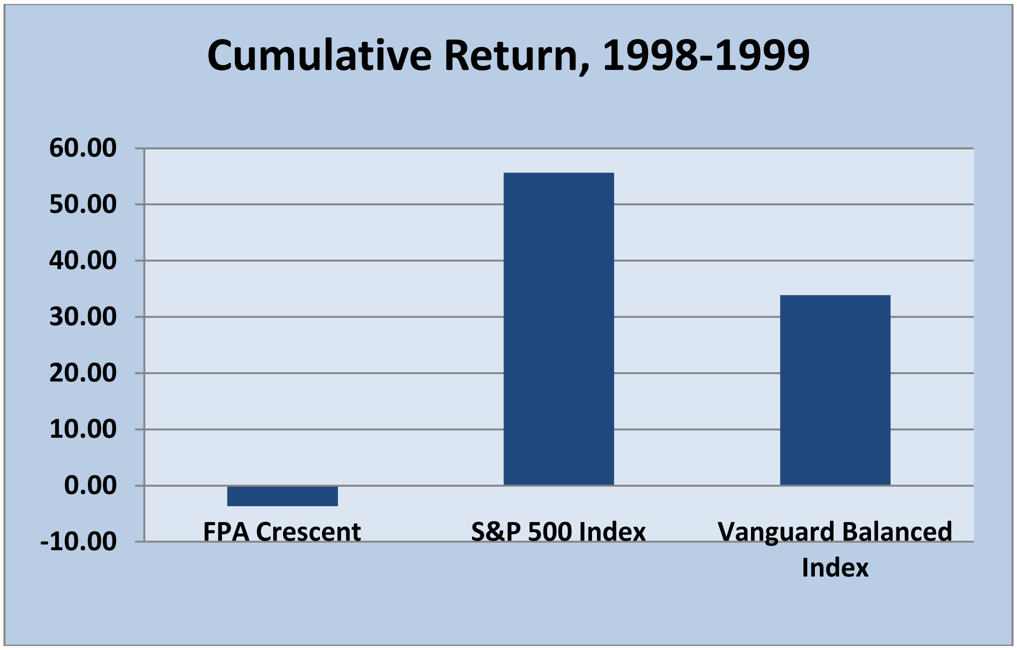
Volatility matters, but risk is ultimately the permanent, not temporary or quotational, loss or impairment of capital. Absolute value managers will tend to have less volatile performance, but they don't manage for that. Low volatility tends to be a byproduct of the process, just like residual cash in the portfolio is at various times. Absolute value managers care much more about permanent loss of capital, and are willing to look silly at times when the market is roaring in order to meet that goal of capital protection. Absolute value managers "look down" before they "look up;" they ask how much they can lose before they ask how much they can gain.

The major risk that absolute value investors run is underperforming a roaring market, and that's a relative risk. They don't put capital at risk of permanent impairment as much as they risk missing opportunities due to caution. Absolute value managers cling tightly to Warren Buffett's remark that investing is like "baseball without called strikes." They like to wait for the "fat pitch," even if it means letting some decent-but-not-great pitches go by. Opportunity cost is real, but outright permanent loss is worse.

Setting Expectations

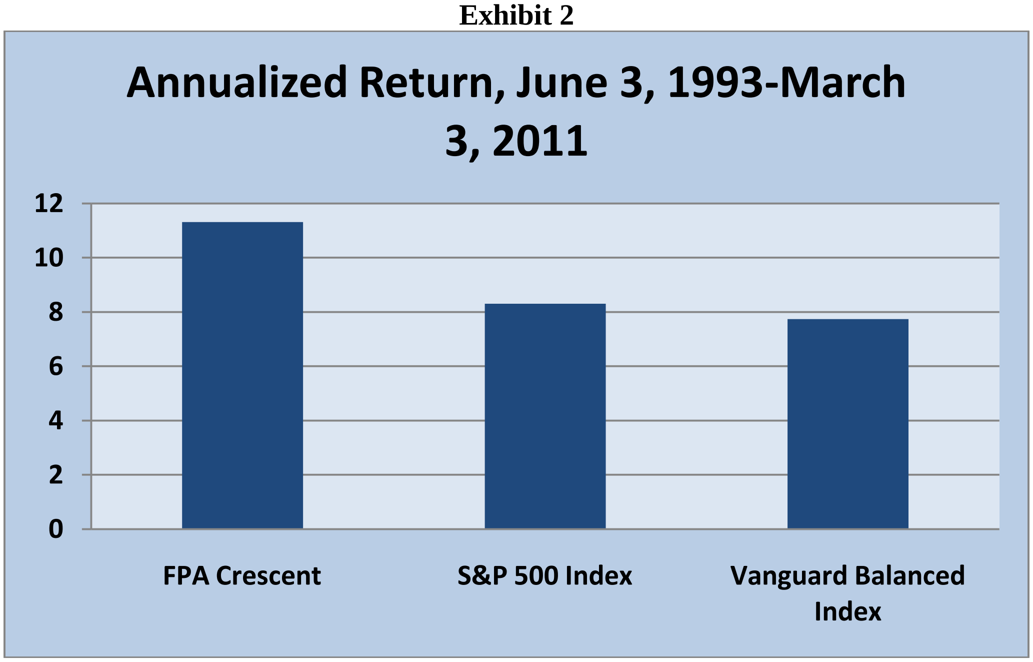
These cautious tendencies produce unique return characteristics. The following three slides indicate the kind of performance one is likely to receive from an absolute value fund. First, Exhibit 1 shows how FPA Crescent performed in the roaring market of 1998-1999. Crescent managed to lose 4% over that period, while the S&P 500 Index surged 55%. The Vanguard Balanced Index Fund, which maintains a 60%/40% split between stocks and bonds rose more than 30% over that time.

Exhibit 1



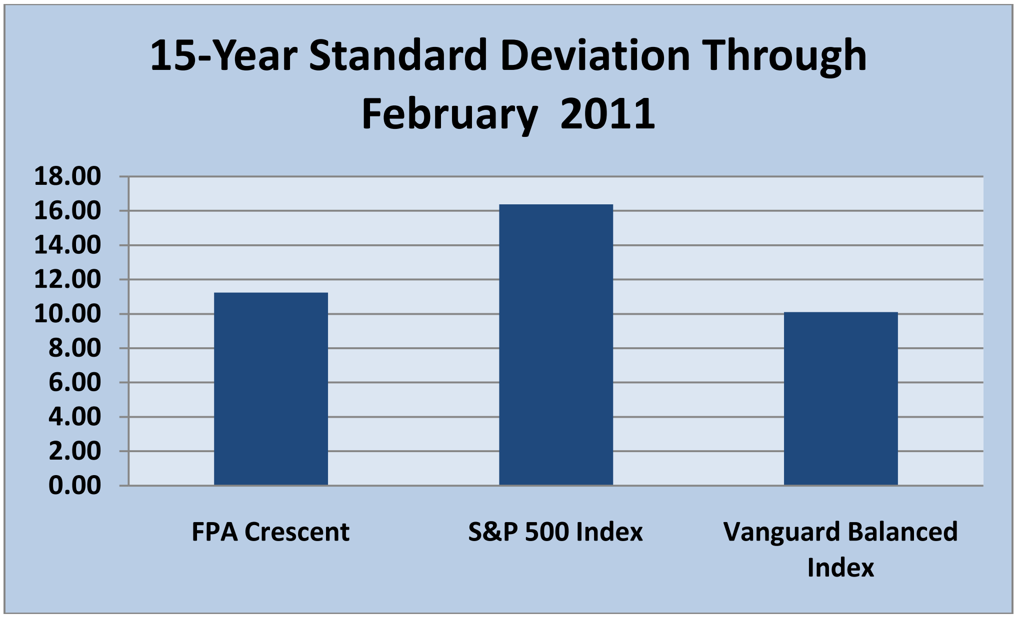
As miserable as FPA Crescent looked during the roaring market of 1998-1999, its long-term performance and volatility characteristics are excellent. Exhibit 2 shows the fund's annualized returns from its June 3, 1993 inception through March 3, 2011. Crescent produced an 11.3% annualized return for this 17.75-year period versus an 8.3% annualized return for the S&P 500 Index and a 7.7% return for the Vanguard Balanced Index Fund.

Exhibit 2



In addition to strong absolute performance, Exhibit 3 shows that Crescent achieved its performance with lower volatility than the S&P 500 Index and only slightly more volatility than the Vanguard Balanced Index Fund.

Exhibit 3



Taken together, the three exhibits show that Crescent has behaved like a balanced fund while producing returns superior to those of a pure equity index for nearly two decades. Crescent has achieved this result not simply with strong stock selection, but also by not being fully invested in stocks when Romick thinks they're expensive.

For example, Crescent currently holds around 40% of its assets in cash and bonds. Moreover, Romick has some short positions, including some real estate investment trusts (REITs). The risk an investor assumed for this performance was lagging a roaring market in the late 1990s, when prices, in retrospect, had become divorced from any meaningful measure of underlying value.

Investors should expect similar performance from value-based go-anywhere in the future. If prices soar beyond reasonable measures of value, these funds will trail meaningfully, though it may be a while before the S&P 500 Index trades at more than 40 times its underlying components' cyclically-adjusted (10-year average) earnings as it did in 1999.Conversely, if the market declines, go-anywhere funds will likely do better than their fully-invested peers, and will have cash to make purchases at cheaper prices. Over a full market cycle, enduring fewer bad years and/or less intense bad years should make up for lagging strong years. Remember: if you lose 50%, you must achieve a 100% return to get back to even. Tactical managers operate under the assumption that if they don't lose the 50% (or some big number) in the first place, the upside tends to take care of itself.

Benchmarking

A portfolio of funds similar to and including FPA Crescent should be benchmarked to both a balanced (stock + bond) index and a pure stock index. The latter comparison should matter over the longer haul. The goal of the go-anywhere approach, after all, is to provide equity-like returns. Over a full market cycle or more, a portfolio of go-anywhere funds should exceed the return of the S&P 500 Index and/or the MSCI AC World Index, which represents most the world's total stock market.

A list of Absolute Value Funds

Besides FPA Crescent, there are other mutual funds – though not very many – that retail investors could tap to gain access to an absolute value strategy. Three or four of them could constitute one's entire equity or long duration portfolio, depending on how much diversification one seeks. An investor may want to equal weight these funds, and rebalance among them on occasion. In addition to Crescent, possibilities in the mutual fund world include those on the following list:

Fund/Strategy	**Comment**
IVA Worldwide	Closed as of Feb. 18, 2011
First Eagle Worldwide	Younger, but capable management
Mutual Discovery	Manager turnover at this venerable value shop hasn't spoiled the funds
PIMCO Pathfinder	Ex-Mutual Series hands, Anne Gudefin and Charles Lahr, have the support of a first-class bond shop.
Fairholme	Bruce Berkowitz has delivered the goods for a long time, though financials may provide a rocky ride.
PIMCO All Asset, All Authority	Rob Arnott uses PIMCO's bond and portable alpha funds to express his valuation calls.
Doubleline Multi-Asset Growth	One of the best bond managers in the business, Jeffrey Gundlach, has just opened a go-anywhere fund.
Wintergreen	Ex-Mutual Series hand, David Winters, has been more dedicated to straight equity at this fund.
Evermore Global Value	Ex-Mutual Series hand, David Marcus, pursues activist strategies more than exploiting general asset class valuation.
Third Ave. Value	Marty Whitman stumbled with bond insurers and real estate during the financial crisis, but his long-term record is solid.
Yacktman	Eschewing cash currently for highly profitable consumer name-brand firms

Conclusion

A portfolio of three or four go-anywhere value funds can constitute all or part of a larger allocation’s equity or long-duration piece. These funds are likely to underperform a roaring market, but hold relatively steady in plunging markets. They are also likely to equal or outperform major equity indexes for extended periods, while maintaining sometimes significantly less than 100% equity exposure.

You can outperform the market over the longer haul, but it necessitates forgetting a lot of modern portfolio theory and static (valuation-agnostic) allocation practices. It also necessitates the willingness to appear incorrect or out of step with the market when it’s roaring over a painfully long (say, 2-3 year) period. In other words, if you’re a retail investor, it necessitates looking foolish at dinner parties on occasion, and if you’re an institutional investor, it necessitates the ability to take career risk or buck the institutional imperative.

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