The following is an excerpt from our letter for the Second Quarter of 2010:

Under-Performance Is Inevitable

By under-performance, we do not mean losing money. Rather, we mean performance which may be positive or negative, but which trails some market benchmark.

On its face, an aversion to under-performance seems reasonable (who would want it?). But in investing, it is self-defeating: in order to have superior performance, periods of under-performance are inevitable. For instance, Warren Buffett reports under-performing his chosen benchmark in 7 of 45 years, more than 15% of the time. Yet his long-term record is almost certainly the best in history.

Davis Advisors (a value shop we respect) did a study covering the ten year period from July 1999 to June 2010. They examined a group of managers whose 10-year performance record ranked them in the top 25% of their peer group. Almost every one of them (97%) had under-performed the average for at least three consecutive years in that period. Almost half (41%) had *spent at least 3 consecutive years in the bottom 10%* of their peer group. Perhaps the most striking part of this study is not the conclusion, but how long the under-performance can last.

Why might long periods of under-performance be an inevitable part of a superior track record? While the conclusion is counter-intuitive, there are good, common sense reasons for it. For instance, one of the best ways to ensure long term out-performance is simply to avoid bubbles. But in doing so, a manager must forego participation in an extended period of rising prices, and his relative performance (and perhaps reputation) will suffer accordingly: one need only reach back to 2000 to find commentators debating whether Buffett had “lost his touch.” Those who participate in the bubble, however, suffer no such embarrassment: they accept large permanent losses of capital instead.

We have no idea when we may have to endure a protracted period of under-performance. But we each experienced some in the past, we’ve experienced brief periods since founding Capco, and it’s reasonable to think we will again. That hasn’t impeded the achievement of a superior long-term record, and we don’t believe it will in the future either. But capital preservation will always take priority over relative performance.

Charles Ellis, one of the great thinkers on investing, spoke in Tampa some years ago. In the course of an extended metaphor arguing that investors should choose their managers as if they were getting married, not going on a date, Ellis said:

> The best test of [an investment] relationship is, when performance happens to have appeared poor, for one, two, maybe three years, that you feel the real question is not: Should we fire [him]? But rather, should we add more money to his responsibility?

To be clear, we are not suggesting that investors should hire managers <u>because</u> they have under-performed, simply to be contrarian. Nor should they blindly accept poor performance without questioning it. The point here is that a period of under-performance, by itself, tells you nothing about likely long-term performance, even over multiple years. The investor must look deeper to interpret what any given performance (good or bad) actually means.

<u>Trying to Avoid Under-Performance is the Surest Way to Experience It</u>

The problem of "under-performance" is expensive – but not for the reasons you might think. The problem is not the under-performance itself. Rather, it is the tendency of investors to flee from it, and the industry's deliberate cultivation of that response.

It is not surprising that investors, as a class, are averse to under-performance. It <u>is</u> surprising that this aversion is greater than their aversion to losing money, or even being ripped off. For instance, numerous managers with good long-term records lost clients (or their jobs) when they temporarily under-performed in the 1990s by avoiding the then-inflating technology bubble. But funds that lose 50% when the market is also down 50% may see very little client flight. Even gross fiduciary breaches are more readily forgiven than under-performance: witness the relatively modest redemptions after the 2003 "late trading" scandal, when numerous well-known mutual fund families were caught, in essence, selling their client's returns to hedge funds.

So there is a strong disincentive for managers to under-perform, even for short periods. Is there an offsetting incentive to out-perform? The effect here is far smaller than one might think. There are mutual funds with superior long-term performance (and by long-term, we mean much longer than three years). Yet they hold only a tiny percentage of all mutual fund assets. Their brilliant records have not caused investors to come flocking.

The vast majority of assets in mutual funds are in large families of funds, built with expensive marketing and distribution (paid for by the fund investors), and producing inferior results. In the aggregate, these huge funds must perform about like the market. Over time, they therefore under-perform by the amount of their expenses. In any particular short run period, however, only a few will show significant under-performance. These few are easily offset by heavily marketing the ones with significant temporary out-performance.

Look at the next mutual fund ad you see. It will certainly not report the performance of all their funds (let alone the ones they closed or merged for poor performance). It will probably list a few funds with recent out-performance, and eye-popping one year records. Although many of the large fund families are decades old, the

funds they list will often be only a few years old. The following 2006 ad is typical: perhaps "growth investing" truly "never went out of style" at Janus, but this ad is pretty quiet about the "growth investing" funds it celebrated before the 2000 tech crash.

If long-term out-performance was truly what gathered assets, the investment landscape would look very different, and many of the gigantic mutual fund families might not even exist. As Keynes observed long ago, "worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally."

These lessons are not lost on investment managers, or the large financial institutions that employ most of them: losing money is acceptable, superior performance doesn't help much, but relative under-performance is a career-killer. Not surprisingly, the industry arranges itself to feed the marketing and distribution machine. So legions of managers widely diversify with weightings similar to the market, ensuring a high likelihood of tracking the market, while charging 10 to 20 times what an index fund would charge for similar results. Literally trillions of dollars are managed in this fashion. Among other things, this systematically ensures that when bubbles occur, large amounts of assets will be deployed into them.

The results are appalling. It has been repeatedly demonstrated that mutual fund investors systematically under-perform the average mutual fund over the long term <u>by more than</u> the amount of their expenses. This is an astonishing fact: investors actually go slower than the boats they are riding in. Many institutional investors, supposedly sophisticated, are among the worst offenders.

<u>If Under-Performance Isn't a Guide, How Should One Evaluate Performance?</u>

To assess what performance numbers mean, of course, one has must have performance numbers to work with. But on most brokerage account statements, that performance reporting is conspicuous by its absence. Individuals can in theory calculate this for themselves, but the math and record-keeping are fairly complex if money moves in or out of the account.[1]

Assuming one knows one's performance, a percentage return number by itself tells you relatively little. Negative performance could reflect the market's wild swings, or could reflect poor management. Flat performance could reflect poor management,

[1] For instance, the Beardstown Ladies, an investment club that wrote a bestselling book, discovered after publication that their remarkable reported returns were actually due to a calculation error, where new contributions were accidentally counted as investment returns.

excessive caution, or wise prudence. Very positive performance could reflect brilliant management, or reckless risk-taking.

It would be nice if there was a simple test or measure to distinguish among these different scenarios. But it is impossible to distill a single, precise measure from the myriad of real world risks. This hasn't stopped Wall Street from trying. Excessive reliance on the false precision of their risk calculations brought down (to name only the best known) Long Term Capital Management in 1998 and most of Wall Street in 2008. As Warren Buffett says, "it's better to be approximately right than precisely wrong."

So how can an investor be "approximately right" about the risks associated with a given set of returns – without having to know enough to do the manager's job? We suggest a few common sense questions:

- **Debt.** Nothing accelerates performance in good times like debt (or investments in leveraged companies). And nothing destroys capital faster in adversity. The reverse is true of cash.

- **Valuation.** Rising valuations can make performance look great. Yet high valuations are a major risk factor. And the better they make performance, the greater the risk. The reverse is true for low valuations.

- **One Trick Ponies.** A manager who is extremely focused on a single concept (like a tech fund in the late 1990s, housing in the mid-2000s, a Treasury fund in 2008, or a gold fund recently) can produce very large returns – for a while. It is often these funds you will see highlighted in magazine ads.

- **Rapid Trading.** There may be investors who can succeed with rapid-fire trading, but we don't know of them. At a bare minimum, high turnover reflects a strategy based on something other than fundamental analysis of the underlying investment.

- **Taxes.** Reported returns are pre-tax, but what the investor actually keeps is after-tax. The average mutual fund, turning its portfolio at well over 100% a year, is foregoing both tax deferral and a tax rate that may be 20 percentage points lower.

- **History.** Nothing is more telling than a manager's performance during past adversity. You find out who's swimming naked when the tide goes out.

- **Communication.** Is the communication consistent in good times and bad, or does the description of the strategy change when it performs poorly? Is the manager describing what he did – or what the market did? Is the manager himself chasing the performance of what has worked recently?

These things take a little thought, but they are not rocket science. The good news for investors is that while the industry is perversely arranged, there are investment managers and mutual funds that are exceptions. You may have to do a little research to find them, because you probably won't find them in any magazine advertisements.