PATTON ALBERTSON & MILLER LLC

INSIGHT AND OUTLOOK

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Riddle Me This

Our old friend Mr. Q dropped by recently and I posed this riddle to him: "What do the following three definitions have in common aside from their common reference to articles of clothing?"

raglan- a loose garment with slanted shoulders seams and sleeves extending in one piece to the neckline

cardigan- a sweater or knitted jacket opening down the front

balaclava- a woolen hood covering most of the head and neck worn in cold climates

Mr. Q thought for a moment and replied "They define words which were all introduced into the English language as a result of the Crimean War, the 19th century conflict pitting the Russian Empire against the odd alliance of Great Britain, France, Sardinia, and the Ottoman Empire. Fitzroy James Henry Somerset, 1st Baron Raglan and James Thomas Brudenell, 7th Earl of Cardigan gave their titled names to the first two articles. Both were prominent generals in the war. The small town of Balaclava in the Crimea, famous site of Alfred, Lord Tennyson's *The Charge of the Light Brigade*, gave its name to the third article."

Mr. Q is obviously quite smart and well read, so I drew him into a discussion about the Crimea, Ukraine, and possible consequences. Here are some of the highlights:

PAM—So, what are the financial implications of Vladimir Putin's annexation of the Crimea?

MR. Q—In the case of Russia, Putin's action frightened a lot of foreigners out of the Russian stock market which is down 15% year-to-date. Russian bonds also took a bad beating with 10 year yields rising from 7.7% to 9.0%. The flight of capital out of Russia naturally put enormous pressure on the rouble which has fallen over 7% since January 1. When you realize that foreigners controlled an estimated 70% of Russia's stock market and held 20% of Russia's sovereign debt at year end, the investment climate for Russia has gotten very chilly. But that doesn't bother Putin, at least in the short run, because his domestic approval rating has soared above 70%. He's tapped into Russia's strong nationalistic pride.

PAM—What about longer term though, won't Western sanctions hurt?

Mr. Q—Western sanctions targeted individual Russians (members of the "oligarchy") which some American pundits thought was frivolous and weak. But given Russia's highly concentrated wealth, the sanctions will have meaningful negative consequences. In particular, Russian corporations face formidable hurdles accessing new Western capital or rolling over their existing debt. Remember Russia's corporate debt is around $650 billion of which $150 billion matures in 2014.

PAM—That's a big problem for the Russians but also their creditors, right?

Mr. Q—Bingo! You can guess who the major creditors are—the overextended, under capitalized banks of Western Europe. You know, the ones who made those brilliant loans to Greece, Spain, Portugal, and a few others. Our own Big Four (Bank of America, Citigroup, JP Morgan Chase, and Wells Fargo) have about $24 billion exposed to Putin's Russia. So sanctions are a two-edged sword.

PAM—We hear a lot about Western Europe's energy dependence on Russia. Will Putin play that card?

Mr. Q—By merely having the card he has leverage. Did you know that Sweden, Finland, the Baltic States, and Bulgaria get 100% of their natural gas from Russia? Poland, Slovakia, the Czech Republic, Austria, Slovenia, and Greece get over 50% of their natural gas from Russia. Mighty Germany relies on Russia for 35% of its gas. So Putin has a very big lever to pull provided he's willing to endure the economic fallout for a while. Russia has $495 billion of foreign exchange reserves so it's not clear who would blink first in an energy standoff. Russia could cut gas sales for several months

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and draw down its foreign exchange reserves to pay for essential imports, but it couldn't do so indefinitely. On the other hand, what is the appetite of Western Europeans to suffer energy dislocations, even for a short period of time? Who wants to shiver for Crimea?

PAM—How do you see this Crimean crisis playing out?

Mr. Q—I worry that the chance of serious miscalculation is growing. There are hotheads on both sides and lingering historical insecurities (especially on Putin's side) which could inhibit a de-escalation of tensions. Russian paranoia has Napoleon, the Kaiser, and Hitler to thank. Putin acted because he feared Ukraine was drifting into the West's sphere of influence. His nightmare was Ukraine in NATO and no base for Russia's Black Sea fleet. That probably never would have happened, but some Russians thought NATO would never invite the Baltic States in either.

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Listening To Our Shots

In the January, 2009 issue of *Golf Digest Magazine*, Johnny Miller shared his "10 Rules for Sticking Your Irons" (for those not familiar with golf lingo, sticking your irons means hitting shots that are nearly perfect). Rule number three on his list was "Listen to your shots." He explained that as a kid, he would practice in the winter by hitting practice shots into a canvas tarp in the basement of his house. Naturally, he couldn't see the flight of the ball (the best source of feedback to a golfer) so the only reliable feedback was how the shot felt, and how it sounded. Thin shots, balls struck on the toe, and shots hit fat had distinctive sounds. Even today, Johnny Miller says he can tell from the TV booth whether a shot is mis-hit, or well-struck by listening to the sound of the club striking the ball.

Like hitting golf balls in the basement, delivering service to our clients does not always afford us a view of the entire flight of the ball. We aren't afforded the opportunity to follow our clients home and hear their thoughts about how we are doing in meeting their needs. Like Johnny Miller, we have to develop a keen sense of hearing to determine whether we are delivering not just good, but excellent service.

Last fall we invited all of our clients to participate in a survey that would help us "listen to our shots" and tell us if we were "sticking our irons." Before I go any further, let me promise we won't be one of those companies that constantly sends out surveys. Our intention is to do a written survey every other year, and to ask for oral feedback at every client meeting. We have a true desire to become better; we want to be known as a firm that "sticks its irons." We want to thank all of you who participated in our survey and we will honor your time and effort by listening and making changes to our service based on what you tell us.

The feedback you provided told us that 87% of our clients are satisfied with the overall relationship they have with Patton, Albertson & Miller. The survey data also told us the specific drivers of client satisfaction. Our clients place very high importance on:

- ➢ Peace of mind;
- ➢ Limiting the negative impact of down markets on their investment portfolio;
- ➢ Feeling their advisor understands their financial needs and concerns;
- ➢ Their needs being the first and only consideration in our recommendations;
- ➢ Being confident in the skills of their advisor;
- ➢ Receiving value above and beyond investment performance;
- ➢ The long term (6 years +) performance of their investment portfolio.

In addition to telling us these factors were important, the data also told us how we were doing in meeting these satisfaction drivers. The feedback told us very clearly that the area representing our biggest opportunity for improvement was in long term investment performance. We took this feedback very seriously and did a broad review of our investment philosophy, our investment process, and our investment personnel. This comprehensive review led us to some conclusions and to some changes:

- ✔ We affirmed our belief in, and commitment to, our value style philosophy. Empirical studies show that, over time, value investing out-performs all other styles. Our value process is based on time tested investment principles, not the momentum of the market. We continue to believe our disciplined, value approach is most capable of delivering the peace of mind and limiting the negative impact of down markets that our clients told us was important.
- ✔ We have made changes in our investment process by making a significant investment in new research tools. These tools enable us to develop new investment ideas quicker than we were able to do in the past. As we communicated in last quarter's commentary, we have added Bloomberg and AFG to our investment research process. These tools are already paying off and I have never been more confident in our investment process.
- ✔ This feedback also caused us to review our investment management personnel and we made changes in this area as well. Over the past two years we have added two superior Senior Portfolio Managers and many of our clients have had the opportunity to get to know Keith Jaworski, or Ricky Supan. The leadership and critical thinking they are bringing to our investment management team is very refreshing. I am pleased to announce that Keith Jaworski has been named our new Director of Research.

For more information on the backgrounds of both Keith and Ricky please visit https://www.pattonalbertsonmiller.com and click on "About Us", "People", "Investment Services Team"

Our investment management team has been re-invigorated and I am confident that our next client survey will tell us that we are meeting the expectations of our clients.

Again, I want to thank those of you who took the time to complete our survey and I invite all of you to call me directly with your feedback. You can reach me at (866) 606-5554. We don't "stick every iron shot we make" but your feedback helps us listen to our shots and make improvements to our service.

Jimmy Patton

Riddle *continued from page 1*

PAM—The geopolitical future is annoyingly unpredictable isn't it?

Mr. Q—Yes it is but so is the financial future.

PAM—We're well aware of that which is why we pay so much attention to risks in the markets whether they be stock valuations, credit spreads, or asset allocations. We will continue to steer clear of big American and European banks since they appear quite vulnerable if this political crisis leads to another banking crisis. We suspect there could be a flight of capital to U.S. markets if economic weakness spreads in Europe. That could boost domestic stocks, at least in the short run. This is a time to keep options open and to remain flexible.

Mr. Q—As always.

Bill Miller, CFA

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From The Archives

Back in the fall of 2006 we wrote an article titled *Remember the Somme!* which compared investing to certain aspects of war. We used the British cavalry charge into High Woods in 1916 as a lesson on investing wisely. We have extracted portions of that article and added some updates and additional commentary. Some things about war and investing are timeless. We think this extract from the archives will reinforce that.

Investing has often been compared to war so there are lessons to be learned about assessing the terrain and adopting tactics to conform with the current reality.

Assessing the Investment Terrain

We believe the great bull market which began in August 1982 ended with the technology bubble in 2000. Its 18 year length was comparable to the post war bull market from 1949 to 1966 and twice the length of the famous 1920's bull market which ended with the Crash of 1929. If history is a guide, it might be many years before the 2000 highs are exceeded meaningfully. [*It took until 2007 for the S&P 500 and Dow Jones Industrial Average to exceed their 2000 highs. The NASDAQ 14 years later remains below its 2000 high.*] Remember that the Dow Jones Industrial Average first broke 1000 in February 1966. It traded in that area again in 1968, 1972, 1976, and 1980. Each time it did Wall Street believed a great new bull market was about to begin. The market dashed those hopes repeatedly for 16 years. In fact, if we take into account the high inflation of the 1970's, the Dow did not exceed the 1966 highs until 1995, 29 years later! Similarly, in terms of purchasing power the 1929 highs required 30 years before they were decisively exceeded. Now we have often told clients that history never repeats exactly, but it does rhyme. We think the odds favor at least a few more years of meandering market action before we see a strong new bull market. [*We didn't foresee the crash in 2008 which reset the dial again.]*

Chart 1 shows the long term price history of the DJIA. The long secular bull markets and the intervening periods of limited price gains stand out clearly. Note that even those intervening periods were punctuated with cyclical bull markets which lasted several quarters to a few years. The stock market had many attractive times during the 1930's, 1940's and 1970's in which to make money. How many investors know that the Dow's greatest annual performance came during the depths of the Great Depression in 1933 when it soared over 66%?

Of course the stock market provided the most consistent returns during the multi-year bull markets of the 1920's, 1950's, and 1990's. Because "A rising tide lifts all boats" most investors found a way to make good profits regardless of their investment philosophy. During such times professional money managers often struggle to outperform amateur investors, and adherents of stock indexing argue against paying for active investment management because professional do not perform meaningfully better than the unmanaged indices such as the S&P 500.

If index funds had existed in 1966, some academics undoubtedly would have urged investors to forego active management in favor of indexing. But like the French after World War I, adapting what had worked in the recent past would have failed investors because the investment terrain had changed. For the 16 years from 1966 and 1982 an investor indexed to the S & P 500 would have seen total price appreciation of only 6%. [*For the 14 years from 2000 to 2013 the S&P 500 had total price appreciation of just 25.8%, or an annualized 1.7%. Even with dividends included the total annualized return was only 3.6%.*]

We think the next few years will prove equally challenging to the tactics of indexing, at least in terms of broad market indices such as the S&P 500, NASDAQ 100, or the Russell 2000. There might be a place for more focused indices such as sector funds. [*Of course the ensuing years saw the global financial crisis and the worst stock market (2008) since the Great Depression.*]

Strategy versus Tactics

At Patton Albertson & Miller strategy remains unchanged regardless of the investment terrain. We strive to buy stocks of financially strong businesses at significant discounts from their "intrinsic value". In general we estimate intrinsic value based on the sustainable cash flow we think a company can generate in the future. We insist on buying at a discount in order to have some "margin of safety" in case we are incorrect in our assessment of a company's intrinsic value.

Investing is a matter of weighing probabilities and the one thing we can be sure of is that sometimes we will be wrong. So a margin of safety is important to the overall success of our investment strategy. Our approach is often referred to as "value investing" because it takes into account not only a company's fundamental business value but also the price we pay to acquire an interest in that business.

Our tactics are driven by our analysis of the investment terrain. We don't think broad diversification (sometimes referred to as "closet indexing") will provide satisfactory returns. More so than during great bull markets, selectivity, patience, and a willingness to

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overweight certain economic sectors will be critical to investment success.

Sector Returns

The following table [*Updated from the original.*] illustrates how important sector selection can be. It shows the best and worst performing sectors comprising the S&P 500. It also shows the return of the index itself.

Table 1.
Selected Sector Total Returns of the S&P 500 Index

	2007	2008	2009	2010	2011	2012	2013
Best Sector	**Energy**	**Staples**	**Technology**	**Cons. Dis.**	**Utilities**	**Financials**	**Cons. Dis.**
Return	34.4%	-15.4%	61.7%	27.8%	20.0%	26.3%	41.0%
Worst Sector	**Financials**	**Materials**	**Telecomm**	**Health Care**	**Financials**	**Utilities**	**Telecomm**
Return	-18.6%	-45.7%	8.9%	2.9%	-17.0%	-2.9%	6.5%
S&P 500	**5.5%**	**-37.0%**	**26.5%**	**15.1%**	**2.1%**	**16.0%**	**32.4%**

Source: Invesco,, iShares

[*Note that the difference between the best and worse sectors is often over 25%. For example, during the Euro crisis in 2011 utilities were up 20.0% while financials fell 17.0%. In 2012 the situation reversed with financials up 26.3% while utilities lost 2.9%.]*

How do we decide which sectors to overweight or underweight? Actually our investment process often helps direct us to undervalued sectors. That is how we backed into our Energy sector overweighting in late 2003. [*The same process helped us avoid Financials in 2007-2008 to the great benefit of our clients.*] At the same time, our demand for a sufficient "margin of safety" made us avoid technology stocks because they had rocketed off their crash lows and no longer offered an attractive risk/return tradeoff. Interestingly in 2004 Technology was the worst performing sector.

In addition to the help we get from our "bottom up" investment process, we spend considerable time trying to understand the domestic and world economy, foreign currency trends, geopolitical developments and a whole host of other factors which could impact our clients' investments. Investing is still much more an art than a science—otherwise computers, not people, would be managing investment portfolios. [*Although many people are becoming concerned about computers' role in high frequency trading*.]

Conclusions

In war and investing the ability to "read the terrain" is crucial for knowing what tactics to employ. The British cavalry at the Somme showed the extreme cost of using inappropriate tactics. We are constantly surveying the investment terrain to make sure we avoid the equivalent of High Woods or the Maginot Line as we do battle in the investment world.