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INSIGHT & OUTLOOK

A QUARTERLY MARKET COMMENTARY & NEWSLETTER

PATTON
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FALL 2015

JUST JARGON

The word "jargon" comes from the Old French *jargoun* which meant a "warbling of birds." In English it retained that sense of "twittering" or "chattering" until the middle of the 17th century when it acquired its modern sense of "the specialized language of a trade, profession, or group."

The investment world teems with an abundance of jargon and we try to be careful when talking with clients not to overwhelm them with our "p/e ratios", "ROIs", and "standard deviations." Lately many clients have been hearing the financial media talk about "drawdowns." We thought it might be helpful to explain what that term means and how investment professionals apply the concept.

Drawdown

A drawdown simply measures the change in an investment (expressed either in absolute terms or as a percentage) from its peak value to its current value. The financial media likes to arbitrarily label drawdowns based on their magnitude. Pundits call a decline of more than 10% a "correction" and more than 20% a "bear market."

Drawdowns can gauge the riskiness of a security. Securities such as mining stocks or high yield bonds which historically experience large drawdowns carry more market risk than consumer discretionary stocks or U.S. Treasuries. We can see this in the S&P 500's sector returns this year. Through September 30th consumer discretionary stocks rose 2.9% (the only sector with positive gains for the year) while energy stocks collapsed 23.1%. The S&P 500 Index over the same period showed a drawdown of 5.3%.

The concept of drawdown has particular relevance when evaluating long term portfolio performance. It's really just a question of math. The following table shows various drawdowns and the required recovery to get back to even.

TABLE ONE

DRAWDOWN	REQUIRED TO RECOVER
-10%	+11.1%
-25%	+33.3
-50%	+100.0
-75%	+300.00

For example, if a portfolio declines 25% it must regain not 25%, but 33.3% to fully recover its losses. Unfortunately many investors suffered losses closer to 50% in the dot-com meltdown in 2001-2003 and in the 2008 financial panic. As Warren Buffett sagely observed, Rule #1 is "Don't lose money." While all investing incurs some risk of loss, value investors realize the critical importance of minimizing drawdowns. The mathematics of portfolio drawdowns is particularly interesting.

Consider two portfolios which start the year with $100,000. Portfolio A suffers a 35% drawdown and ends the year with $65,000. Portfolio B, managed more conservatively, endures only a 15% drawdown to $85,000. In the relative performance world of Wall Street, Portfolio B "outperformed" by 20 percentage points. We doubt the owner of Portfolio B would be particularly pleased however. In due course the market will rally. Let's assume it takes three years for Portfolio A to recover back to $100,000. How much could Portfolio B "underperform" over that time span and still match Portfolio A? See Table 2.

TABLE TWO - ($, 000'S)

	YEAR 1	YEAR 2	YEAR 3	YEAR 4
PORTFOLIO A	$65.0	$76.7	$88.30	$100.0
% CHANGE		18.0	15.1	13.3
PORTFOLIO B	$85.0	$90.0	$95.0	$100.0
% CHANGE		5.8	5.5	5.3
B'S UNDERPREFORMANCE		(12.2)	(9.6)	(8.0)

Because Portfolio B had a much lower initial drawdown during the bear market, it did not have to make the extraordinary returns of Portfolio A over the next 3 years. The year by year underperformance in the example was quite large, yet at the end of Year 4 Portfolio A and B were both back to $100,000.

In reality the owner of Portfolio A, having lost $35,000 from the peak, might have panicked and either exited the market entirely, or only participated partially in the stock recovery. On the other hand, the owner of Portfolio B, having incurred much lower relative losses, would have been psychologically better prepared to participate in a rally. Even with a portfolio of conservative blue chip stocks it is unlikely his portfolio would have performed as poorly as assumed. If it did just half as well each recovery year as Portfolio A, at the end of Year 4 Portfolio B would have reached $106,200.

For value investors the lesson is clear: Avoid large drawdowns! What counts is the long term compounding of investment returns over the full cycle (measured peak to peak), not Wall Street's obsession with the horserace of one year returns.

Bill Miller, CFA
Patton Albertson & Miller

DAF PRIMER

Donor Advised Funds, also known as DAF's, are relatively old (1960's) charitable giving vehicles that have grown in popularity recently. This is due mainly to their ease of use. To keep things simple, you can think of a DAF as a charitable checking account or even as a light version of a private foundation. You put money into the account and are able to direct the dispersal of those funds to charities. You may be asking, why don't I just write a check directly to the charity? Well, there are some benefits to a structured gift. Usually the motivation is either tax planning or legacy reasons; such as teaching the next generation the benefit of charitable giving. First, let's get into the weeds a bit on the structure of a DAF.

The DAF is established at a public charity. A bank or your financial advisor may also be able to help you open a DAF account. When the donor makes a contribution, he or she receives a charitable contribution based on the fair market value of the assets contributed. The contributed assets are held in an account where they are managed. This means the assets can grow tax-free but they must stay in the charitable stream.

The donor's contribution is irrevocable. The donor is not responsible for administration and compliance filings, unlike a private foundation. That burden is placed on the DAF administrator. In return, a donor gives up a level of control. The donor, or whichever party is named as authorized to initiate dispersals, can really only make recommendations for which qualified charities they wish to benefit. Their recommendations can be ignored; however, the vast majority of the time these recommendations are given the effect of an order. The administrators know that individuals will stop utilizing this vehicle if their charitable goals are not being accomplished so they generally follow donors' recommendations.

"THE ASSETS CAN GROW TAX-FREE BUT THEY MUST STAY IN THE CHARITABLE STREAM."

Now that we better understand the basic parts of a DAF, why do people structure their gifts in the first place? For tax purposes, they may want to move assets they intend for charitable purposes out of their portfolio. They can avoid being dinged annually on the taxes associated with the interest, dividends, and capital gains from those investments by earmarking them as charitable. We also frequently see individuals consider a structured gift when they have an unusually high income year (usually a bonus or the sale of a business) and need a current year tax deduction. A private foundation, charitable trust or DAF can help them accomplish their goals for tax purposes while allowing them to direct the assets in the future.

"DONORS CAN GET THE TAX BENEFIT NOW WITHOUT DISRUPTING THEIR ANNUAL GIVING."

In some cases, a DAF may be more beneficial because it is treated the same as a public charity. Regardless, the structure ensures that donors can get the tax benefit now without disrupting their annual giving. Legacy reasons are also a big driver of structured giving. Donors may wish to provide for an annual cause, such as a scholarship. They can also be used as a way to involve the next generation in philanthropy by letting the kids pick charitable organizations that are important to them.

Unfortunately, this is not an all-encompassing guide to the world of donor advised funds. We are happy to be a resource if you wish to learn more about the subject. Your attorney, CPA, or financial advisor may be able to provide you with advice. Community foundations can also be a great source of knowledge on the subject.

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MUNGER: MORE THAN A SIDEKICK

One of the great pleasures of the Berkshire Hathaway annual stockholders meeting in Omaha is the show put on by Warren Buffett and his long time investment colleague Charlie Munger. Sometimes the media tag Munger as "Buffett's sidekick", but we think that characterization vastly underestimates Munger's contributions. Buffett himself credits Munger with strongly influencing his investment philosophy.

Charlie Munger advocates the acquisition and use of what he calls "mental models." He says:

"You've got to have models in your head. And you've got to array your experience both vicarious and direct on this latticework of models."

By this Munger means that mental models, whether acquired through experience or through education, must be integrated into a latticework which is multi-disciplinary. Having just a few mental models will not be sufficient.

"It's like the old saying, To the man with only a hammer, every problem looks like a nail. But that's a perfectly disastrous way to think and a perfectly disastrous way to operate in the world. So you've got to have multiple models."

Munger realizes that models must come from multiple disciplines because no single discipline—mathematics, engineering, biology, economics, history, and so on—has a monopoly on wisdom. Investors in particular need a broad range of models if they ever hope to succeed in the financial arena. A key way to efficiently develop mental models is reading.

"In my whole life, I have known no wise people (over a broad subject matter area) who didn't read all the time—none, zero. You'd be amazed at how much Warren reads—and how much I read. My children laugh at me. They think I'm a book with a couple of legs sticking out."

Bill Miller, CFA
Patton Albertson & Miller

BUFFETT HIMSELF CREDITS MUNGER WITH STRONGLY INFLUENCING HIS INVESTMENT PHILOSOPHY.

In a speech he gave at the University of Southern California Business School in 1994, Munger listed the kinds of models and techniques which constituted the basic knowledge everybody needed to become a capable investor. He viewed the reliability of mental models as lying on a continuum from the hard sciences (such as mathematics and engineering) to the softer sciences (such as economics and psychology).

Here's a partial list:

Mathematical Models: Arithmetic and algebra, compound interest, elementary permutations and combinations. Munger said none of them were hard to learn, what was hard was using them routinely and consistently in everyday life. He said Warren Buffett automatically thinks in terms of decision trees and permutations and combinations.

Engineering Models: Critical mass, breakpoints, the necessity of redundance. Munger admires the use of cost/benefit analysis in engineering and sees its wide application to investing and everyday life.

Economic Models: Opportunity costs (choosing A versus B), the role of incentives in human action, the law of diminishing returns. Munger warns against the false exactitude which permeates many economic theories, especially at the macroeconomic level.

The global economic and financial systems are too complex, in his opinion, to be usefully distilled into precise equations. He likens the world economy to an ecosystem, not a machine. Like Buffett, Munger pays little attention to macroeconomic forecasts.

Psychology Models: Decision making under uncertainty, cognitive biases, perceptual errors. Munger is fascinated with all the ways people reason incorrectly (cognitive biases). He believes our brains evolved to take decision making shortcuts. These might have had great survival benefits thousands of years ago, but in modern life, particularly in investing, they often lead to suboptimal outcomes.

Munger insists that developing wisdom is a lifelong process. He seeks wisdom not only because it helps his investment performance but because it helps him live a more fulfilling life.

"Spend each day trying to be a little wiser than you were when you woke up. Day by day, and at the end of the day—if you live long enough—like most people, you will get out of life what you deserve."

Words worth pondering.