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Defeat from the Jaws of Victory *continued from page 1*

The research also showed that growth investors fared even worse than value investors on account of market timing. If an investor choose to follow a growth strategy, despite the historical evidence that value beats growth, sticking with buy - and - hold was preferable to timing the market. The research results are summarized in Table 1.

Table 1. Buy & Hold vs. Market Timing

Fund Type	Buy & Hold Return	Market Timing Return	Difference
Value	9.4%	8.1%	1.3%
Growth	8.4%	5.2%	3.2%
S&P 500	9.0%	9.0%	NA

Source: Timing Poorly: A Guide to Generating Poor Returns While Investing in Successful Strategies by Hsu, Myers, and Whitby, July 2014

Note that value investing outperformed the S&P 500 as expected. Those returns were net of mutual fund management fee and any front-end charges. The average management fee was 1.3% and 23% of the 2,836 value funds in the study carried loads.

The research also answered a perplexing question that has troubled some thoughtful advisors. If historical data clearly demonstrates the superiority of value investing, why hasn't the value advantage been arbitraged away? In other words, why aren't all investors value investors? The siren song of market timing bears the blame. The temptation is just too great for most purported value investors. They snatch defeat from the jaws of victory. Given human frailties, any haruspex could have predicted that.

-Bill Miller, CFA

Under the Radar Screen

European Stocks Rally

European stock markets have been rallying strongly so far in 2015 despite sluggish economic conditions in the Eurozone. The German DAX-30, for example, is up about 25% in Euro terms and even Spain's IBEX 35 Index shows gains year to date above 15%. The European Central Bank's initiation of quantitative easing (money printing) earlier this year probably triggered the rush into equities. The Euro's exchange rate versus the dollar has concurrently been falling, down about 13% YTD. That reduced U.S. investors' returns to about 12% in the DAX and just 2% in the IBEX.

Bizarre Realm of Negative Interest Rates

Well over $ 1 trillion of European government debt now carries negative interest rate yields. That means investors pay governments to take their money. Switzerland recently sold 10 year bonds at a yield of -0.055%. Germany, the Netherlands, Sweden, and Denmark all have bonds yielding less than zero. This is unprecedented in financial history and a measure of how distorted global financial markets have become.

Hedge Fund Industry Stumbles (Again)

Hedge Fund Research, Inc. reported that its Fund Weighted Composite Index, a broad measure of the heterogeneous hedge fund universe, gained just 3.0% in 2014. The dispersion of returns was the narrowest since 2000 with the top decile of funds earning on average 27.4% while the bottom decile earned a negative 18.9%. That performance dispersion of 46.3% reflects the great variety of investment strategies, many including leverage, which prevail in the hedge fund industry.

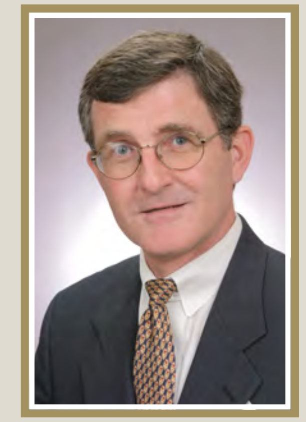
PATTON ALBERTSON & MILLER LLC

INSIGHT AND OUTLOOK

Spring 2015

A QUARTERLY MARKET COMMENTARY & NEWSLETTER PUBLISHED BY PATTON ALBERTSON & MILLER

Defeat from the Jaws of Victory



Bill Miller, CFA
Patton Albertson & Miller, LLC

Wall Street strategists have always devoted considerable effort in trying to divine changes in the Federal Reserve's monetary policy. Their efforts have become even more intense during the Greenspan-Bernanke-Yellen era. That's because the Fed's unprecedented interventions in the financial markets—creating over $3 trillion of money out of thin air, suppressing interest rates, actively talking up the stock market—have made it the dominant actor in the world's stock and bond markets. No wonder strategists parse every Fed press release seeking to glimpse its future actions.

Wall Street efforts remind us of mankind's age old quest to forecast the future, often by interpreting omens or using alleged paranormal powers. Cultures around the world have employed scores of methods over the centuries. The technical names of these methods often end in "mancy" from the ancient Greek word *manteia* (divination) or in "scopy" from the Greek word *skopein* (to look into, to behold). For example there is "chiromancy" (reading palms), "hepatoscopy" (divining with animal livers), and "tasseography" (reading tea leaves).

Hepatoscopy was a favorite forecasting tool in ancient Rome. It originated in the Etruscan religion and involved the interpretation of sheep entrails, especially the liver. A person trained in such divination was called a "haruspex" derived from the Latin word *haru* meaning entrails and the Latin verb root *spec* meaning to watch. The Roman historian Suetonious claimed that a haruspex named Spurinna warned Julius Caesar to beware the Ides of March. Sadly the arcane art of hepatoscopy died with the Roman Empire otherwise we might find entertainment comparing a haruspex's financial market forecast with those of Wall Street!

As our long time readers know we doubt anyone—including Wall Street strategists and Federal Reserve economists—can consistently forecast the financial markets or the economy. How many predicted interest rates would fall in 2014 despite the end of the Federal Reserve's money printing scheme? Who forecasted the collapse of oil prices? Our understanding of Austrian economics tells us that the complexity of the global economy and the myriad feedback loops and obscure interconnections put modern forecasting perhaps just one rung above the "mancies" and "scopies" of old.

Rather than forecasting, we see value in trying to assess the probabilities of risks and returns. At the macroeconomic level paying attention to financial history can be useful. History does not repeat but it does rhyme. Financial markets sometimes go to extremes and knowledge of such historical events can provide insights for today's markets. At the company level knowing a management's track record or the typical business cycle of its industry obviously has benefits.

Probability can be applied to investment strategies as well. We often have cited the voluminous academic research demonstrating that consistent value investing outperforms growth investing and the general market as represented by the S&P 500 over a complete market cycle. There is a reason some of the greatest investors - Ben Graham, Warren Buffett, David Dreman, Sir John Templeton—embraced value investing.

Value investing focuses on buying a stock only when the current price is below the estimated "intrinsic value" while growth investing focuses more on the forecasted growth in sales and earnings than on the price paid currently. We should note that value investing doesn't work every quarter or even every year. But over a complete market cycle, that is, from market trough to market trough, value usually prevails.

An example of a market cycle would be the cycle which began in March 2003, peaked in late 2007, and bottomed in March 2009. The complete cycle was six years. The bull market phase was about four and a half years, not too far from the long term average for bull markets. In measuring an investment strategy's success it is the complete cycle performance that counts.

It appears many value investors forget this. A recent research paper titled *Timing Poorly*: A Guide to Generating Poor Returns While Investing in Successful Strategies by Hsu, Myers, and Whitby revealed that many individual investors using value mutual funds underperformed the mutual funds themselves and the broader market as measured by the S&P 500. How could that happen? The paper's title supplies the clue—market timing. The authors found that many value investors, perhaps despite themselves, "chase performance". Even though they know value investing works, they lack the conviction to stay with it through the complete market cycle. This means they abandon it after a period of underperformance often near the peak of a bull market.

The classic case was in the late 1990's when value investing returns markedly lagged the S&P 500's which were rocketing upwards thanks to the technology and telecom mania. By 1999 many in the financial media were questioning whether value investors such as Buffett "got it." Surely the new internet era made stodgy value investing obsolete. Then the tech bubble burst in 2000 and value investors significantly outperformed from 2000 to 2003.

...Defeat continues on Page 4

Jimmy Patton
Patton Albertson & Miller, LLC

What Do You Mean by That?

In chapter 2 of his book *Words, Meanings and People*, Sanford Berman writes:

If you want to lessen misunderstandings you must realize that words are ambiguous; they can have many meanings. People too often wrongly assume that a word has only one meaning, their meaning. But words have many meanings, as any large dictionary will point out. Words are not only ambiguous, but people also respond to words differently. The following examples will illustrate how people respond to words.

"Any big men born around here?" a tourist asked in a condescending tone. "Nope," responded the native. "Best we can do is babies. Different in the city, I suppose."

As the (street car) conductor called out the various names of the streets, the country couple became more and more uneasy. The conductor called "Maple," then "Adams", and then "Rosewood." The country man grew very fidgety and, turning to his wife said, "Isn't it time we got off?" "Don't show your ignorance, Matthew," she said. "Wait until your name is called."

Perhaps nowhere are words more ambiguous and less understood than in the world of investment management. Wall Street is full of buzz words, esoteric acronyms, and words that belie their true meaning. Here are a few terms used on our quarterly statements that can sometimes be confusing.

Asset Class. A group of securities that have similar characteristics. The three traditional asset classes are Equities (stocks), Fixed Income (bonds) and Cash (money market instruments). At Patton Albertson & Miller we also use a 4th asset class called Alternatives which includes investments such as precious metals, commodities, and others that don't fit in the other 3 categories. All 4 asset classes have different levels of risk and return.

Asset Allocation. An investment strategy that allocates a portion of the portfolio to each of the asset classes (see above) to achieve a certain risk and return profile in keeping with your goals. For example, if your goals required your portfolio to produce an annual return of 7% then you would need to allocate most of your portfolio to stocks. If your required return was 2% then your portfolio could be allocated mostly to bonds.

Allocation Target. The percentage of the portfolio to be invested in each asset classes over time. A 60/30/10/0 allocation target means 60% of the portfolio is allocated to stocks, 30% to bonds, 10% to alternative assets and 0% to cash. These are long term targets and the actual percentage may be more or less than the target at any particular time.

Current Yield. The amount of annual income, expressed as a percentage of the current value that a particular investment produces. For example, if you have a stock with a current value of $100 that pays an annual dividend of $2.50 then the current yield of that investment is 2.5%. This is not the total return of the investment but merely the amount of annual income produced.

Index. An unmanaged portfolio of securities representing a particular market or a portion of the market. An index is useful as a performance benchmark to compare your securities. A blended index is a combination of two or more indexes with the purpose of creating a more meaningful and fair comparison to the entire portfolio.

Projected Annual Income. The amount of income a particular security, or group of securities will receive if held for a period of one year.

Rebalance. A portfolio management technique that involves buying and selling of securities so as to bring the asset mix back to its target allocation (see "Allocation Target" above).

Risk. The possibility of loss. The greater the amount of risk an investor is willing to assume then the greater the potential return and the greater the potential loss. Managing risk is one of the most important elements of portfolio management. Standard Deviation is one method of estimating risk. The higher the standard deviation, the higher the risk. Stocks with higher standard deviations have more variability of return.

Sectors. An area of the economy in which businesses share the same or a related product or service. We group equity holdings on our appraisal reports by sector. For example, all energy sector stocks are grouped together, all consumer staples stocks are grouped together, so forth and so on.

Total Return. The total return of an investment or portfolio of investments for a particular period of time. Total return includes income, capital gains, dividends and distributions. Total return is different from "Current Yield" which includes only income and dividends.

-Jimmy Patton

Castles, Moats, and Margins

According to Warren Buffet the ideal stock holding period is "Forever." In fact, he penned in his 1988 letter to shareholders that recent purchases in Federal Home Loan Mortgage "Freddie Mac" is expected to be held for a very long time. It is noteworthy then, how Warren Buffet had a change in opinion and sold shares in Freddie Mac. This was in the year 2000, a full 7 years before the housing crisis and the bursting of the credit bubble. What changed? Why sell a company whose initial prospects met the "Forever" requirements for investment?

One of Mr. Buffet's well known colloquialisms is that of an "Economic Moat." He looks for economic castles protected by unbreachable moats. The metaphor defines the castle as a business and the moat as the competitive advantage that a company has over other companies in the same industry. In general, the wider the moat, the larger the competitive advantage, and the greater the barriers against entry for competitors.

If companies were permitted unlimited opportunities for outsized profits, an investor would buy only those companies that met the criteria. In reality; it is excess profits that ultimately invite competition. As portfolio managers, we are tasked with identifying companies whose economic moats provide sufficient barriers to competition while also relying on their competitive advantage to protect profits in future periods. With the benefit of hindsight we can gain greater insight into the investing mind of successful investors like Warren Buffett.

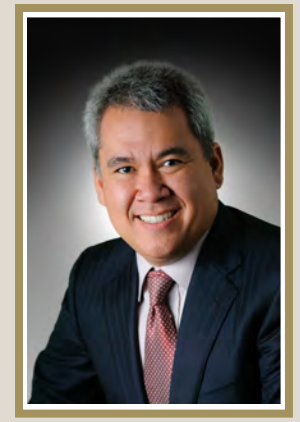
At its peak, the investment in Freddie Mac represented a 9% ownership valued at almost $4 billion dollars. It resulted in a return of 1200% on his original investment. Buffet views investments as allocation in businesses. He recognized that the implied backing of Freddie Mac by the federal government allowed the business to have a portion of their risk subsidized ultimately by the tax payers. It led him to conclude that the economic moat was not as broad as he initially believed. Furthermore; he realized that Freddie Mac was moving further and further away from their core business. In effect they were attempting to serve two masters, the federal government and Wall Street. It was this realization that led to the sale. Buffet testified to congress in 2008 regarding his sale of Freddie Mac by saying "if you see one cockroach, there's probably a lot." As the expression goes, the rest in history.

It is market competition that erodes excess profits. In fact, it is completely normal for a company's revenue growth and profit growth to naturally decay in the face of competition. Unless businesses continually innovate a natural equilibrium will result where products or services become commoditized. At this point an investor might conclude the business mature and demand a higher return of capital in the form of an increased dividend.

Charlie Munger, Vice Chairman of Berkshire Hathaway, who Buffet describes as his partner, provided his opinion on forecasting the markets by saying "People have always had this craving to have someone tell them the future. Long ago kings would hire people to read sheep guts. There's always been a market for people who pretend to know the future. Listening to today's forecasters is just as crazy as when the king hired the guy to look at sheep guts. It happens over and over."

How long should investors remain invested in a company? When should investors exit their investment and consider an alternative company to invest? Rather than attempting to predict the future, we instead can rely on empirical analysis of a business's economic data. It is within assessing these attributes that we can begin to measure and compare how companies measure against their peers and against the market as a whole. As value investors, we will always have an emphasis on purchasing business at a discount to its intrinsic value. That is a fundamental tenet of our investment process.

Recently, Patton Albertson & Miller has adopted a modification to our investment process that allows us to view a variety of companies through a common prism. We recognize that analyzing companies of different industries can yield very different results when viewed in isolation. However; when applying a common prism to different companies we can begin utilizing this shared lens to see how they compare; even though they may reside in unrelated economic sectors. Economic Margin is a cash flow based metric that measures the return a company earns compared to its cost of capital. The framework assesses the cost of capital, inflation, and cash flow to provide a more clearly focused view on management's ability to create shareholder value across a variety of industries, sectors, and countries.



Ricky Supan
Patton Albertson & Miller, LLC

Armed with this lens, we can screen companies and better answer the question as to how long investments should be held. Through back testing, history suggests that investments in companies might warrant a holding period of at least four years. Implicitly, this suggests that an investor might experience a portfolio turnover of 25% per year. Interestingly, this coincides with the idea that profits naturally decay as competition increases. In the absence of continued innovation, and given a sufficiently large economic moat, capital intensive industries such as railroads will enjoy significant barriers to entry and may warrant a longer holding periods. In comparison, the rate of innovation in technology may result in significantly lower barriers to entry, and by extension, a smaller economic moat.

Blackberry Limited, formerly known as Research in Motion Limited, was THE dominant smartphone maker in the early 2000s. Because of their robust platform for government and business, they enjoyed a 43% US market share in 2010. Unfortunately, they miscalculated the competitive landscape and failed to acknowledge legitimate offerings from Google and Apple. This failure to innovate and recognize the threat of competition resulted in a dramatic decline in market share. As of early 2015, Blackberry's market share has declined to 1.8%. Even though Research in Motion was one of the best performing stocks of the 2000s, when viewed within the context of Economic Margin, investors should have exited the name well before its ultimate decline. Utilizing tools such as the Economic Margin framework affords us the luxury of not reading tea leaves and instead depending on concrete information for which we can make rational investment decisions.

-Ricky Supan

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