

## INVESTMENT LETTER – FIRST QUARTER, 2014

### Follow the Money (Goldman Sachs Leaves the New York Stock Exchange?)

In the PR campaign book-launching coup of this century, Michael Lewis (*Liar's Poker*, *Moneyball*, etc.), *60 Minutes*, and Charlie Rose have confirmed long-held individual investors' worst suspicions; "the stock market is rigged." In a publicity tsunami which should keep Lewis's just-published book, *Flash Boys*, at the top of the best-seller list for the remainder of the year, we learn that *high frequency trading* (HFT) is not only prevalent, but accounts for upwards of 50% of combined US stock exchange daily trading volume. What's more, although obviously not ethical, and certainly serving no social or capital market purpose, HFT turns out *not* to be illegal. But then perception is everything, and whether moral atrophy or covert corrupt practice, the US capital market system has been again undermined in the view of those whose trust is essential to its continued viability.

As this saga unfolds, one assumption investors can be certain of is that when the media fixes on a story of this nature, the practice exposed has probably been underway for months, if not years and, of course, the regulators will be/have been the last to become aware of the problem. In fact, in today's "central planners know best" administered market environment, our regulators, with the best of intentions, may very well have laid the groundwork for the HFT debacle. The "new norm" in this highly regulated world is beware the unintended consequences.

Readers of these past letters might remember concerns of ours about HFT aired in a number of client communications. A while back it began to sound a bit Quixotic, so we stopped commenting about it.

Prime brokers, and today's version of day-traders (now millisecond traders), have been exploiting their high-speed, super-computer, fiber optic vs. copper advantage in a zero sum game that has "rewarded" them with billions of dollars in trading profits. This exposé is so embarrassing for the broker-dealer community that that virtuous paradigm of investment market decorum, Goldman Sachs, in a pique of altruistic behavior (think damage control) has announced its intention to resign from the New York Stock Exchange (NYSE)! Claude Rains, standing at the bar in Rick's Café Américain, comes to mind.

What has surfaced here is a classic Wall Street cycle in which the trading herd "... rushes into a business that is profitable for those with an edge—in this case millisecond computer connections and clever algorithms—but others catch up and the margins erode."\* What Goldman Sachs has decided is that the game is up, and no longer that profitable anyway, so let's align ourselves with the aggrieved. Possibly the right move for Goldman, but a cynic, remembering the Chinese adage "... what you cannot avoid, welcome," might question the motive. In the damage control manual this translates into "... if you have been outed, spin it and get on the PC side of the issue ahead of the pack.

\**Financial Times*, John Gapper, April 3, 2014

### **Investing for the Long Term (Gamble, Game, Clever Algorithm?)**

In the heat of the current revelations, it's hard to avoid the impression that risking personal capital in the global equity markets at times like this equates with James Bond placing bets at the tables in Monte Carlo. In the last analysis, any attempt to achieve a superior long-term REAL return, as well as a reasonable performance adjusted for the risk assumed, turns out to be an equation solving for a range of probabilistic outcomes—not an absolute result. The upshot of any attempt to translate past market patterns into projections, or financial market models, aimed at consistently beating the market in the future, to unbiased researchers at least, has been thoroughly discredited.

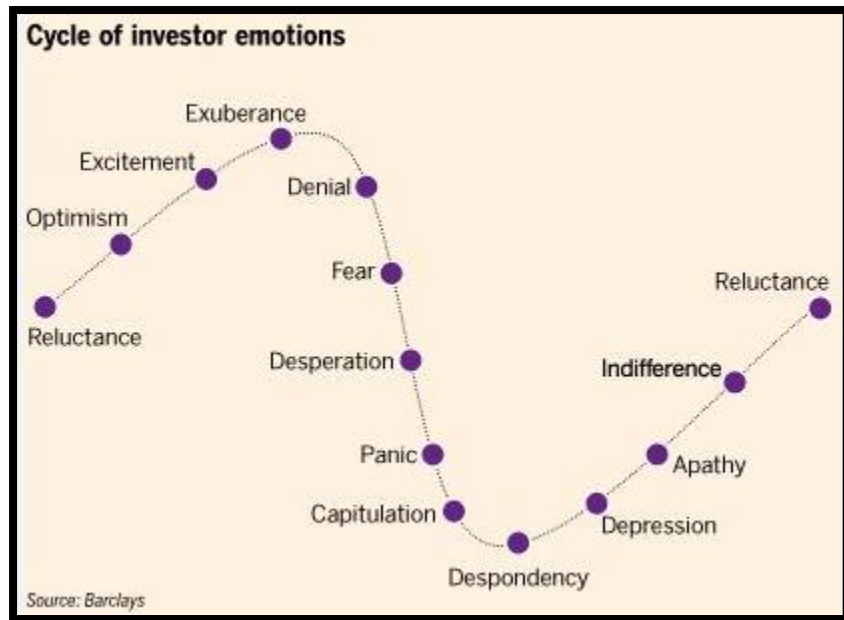
There *will be times* when one investment strategy trumps others, but as soon as publicly recognized, under the weight of massive investor cash flows, the anomaly is quickly arbitrated away, and the past-performance-chaser is left to scan the horizon for the next “hot hand.” It's an exercise rooted in the past, bound to disappoint, and (after expenses) destined to yield less-than-market returns.

In the late 1960's and early 1970's, when Big Data first became available to economists and professional investors,\*\* Nobel Laureate Paul Samuelson early on recognized that an objective study of the numbers weighed heavily against any one individual outperforming the equity markets over the long term. He became an early advocate of what became known as passive investing (i.e., owning broad samples of whatever segment of the equity market the investor wished to replicate). He also allowed that for isolated periods there would be a few exceptions to prove the rule (e.g., Peter Lynch, John Neff, Warren Buffett, etc.). But for the average investor attempting to identify these stock-picking mavens in advance, so as to enjoy the full ride of their future good fortune, it would prove to be difficult, if not impossible. Professor Samuelson's conclusion, shared by Jack Bogle of Vanguard and those at Dimensional Fund Advisors (DFA), was to accept what the market offers, and at the same time try to achieve comparable results while attempting to control the costs of trading, management and overall portfolio risk.

So regardless of the distractions of HFT, the passing of hot hands like Bill Gross of PIMCO, perhaps even eventually the aging talents of Warren Buffett, for individual investors the best course remains a globally diversified balanced portfolio structured to capture a reasonable total return on the combined capital at risk. Persistence, transparency, liquidity, as well as patience, in the longer term, distinguishes an *investor* from a speculator. Our conviction is that when it comes to funding adequate retirement resources, or family wealth for the next generation, it's better to be an investor than speculator.

\*\*Stocks, Bonds, Bills, & Inflation (Ibbotson & Sinquefeld)

**A Behavioral View—Six Years after “Despondency”**



Having passed “Reluctance” on the Investor Emotion Psychograph, and perhaps moving into “Optimism” in 2013, one senses 2014 could be a transition to “Excitement.” Already, the volume of Initial Public Offerings (IPOs) is building apace. For those still sitting on the sidelines with cash, or liquidity intended for stocks temporarily parked in higher-yielding bond funds, that empty feeling of reluctantly admitting the train has left the station is palpable. Whatever the current phase of the investor psychology curve it turns out we are in, or entering, history suggests that a six-year Bull market will begin to develop signs of its age at this stage. Even though the result was the generation of long-term capital gains, the portfolio rebalancing carried out at the end of last year, and earlier in January, was in part intended to anticipate the aging of this equity market cycle.

As always, we welcome your comments and questions.

Sincerely,

James L. Joslin  
Chairman, CEO & CCO