The Zen Strategist

Issue 1, February 2017

Investing While Sitting Still

Welcome to the inaugural issue of the Zen Strategist.

My name is Eric Winig, and I have spent the past decade and a half advising large institutional and private investors on portfolio construction, manager selection, and, really, anything else to meet their investment goals. During that time I developed an investment strategy I call "Investing While Sitting Still," and this letter is my attempt to pass the system on to you.

IWSS is, basically, Zen methodology applied to investing. Much as many people, particularly in the industrialized Western world, spend a large percentage of their time "chasing after wind," the majority of the investment world seems obsessed with activity, from brokers churning client accounts, to consultants recommending incessant changes to portfolios, to high-frequency traders locating their servers right next to the stock exchange to get their trades executed a tiny fraction of a second before everyone else's.

This is insane.

Even worse, all this craziness has taken the *idea* of investing further and further away from its original intent; instead of a *means* to provide financial security, investing has morphed into an *end* in itself that seems designed mainly to enrich those doing the advising and trading.

I must warn you that IWSS will almost certainly seem strange at first. Many of my old clients found it confusing, and some simply couldn't abide it. Used as they were to their advisor recommending a variety of changes to their portfolio every quarter (or even more often), they struggled to come to grips with meetings where I recommended doing…nothing.

Yet for those able to approach this with an open mind, willing to risk looking "different" from others, or simply looking for an alternative to the frenzied nature of modern investing (and life!), IWSS has, I believe, a lot to offer.

Again, it is not for everyone. Don't expect "hot" stock picks or speculative gambles, and understand that, difficult as it may seem, the best thing to do is quite often to…sit still.

Zen and the Market

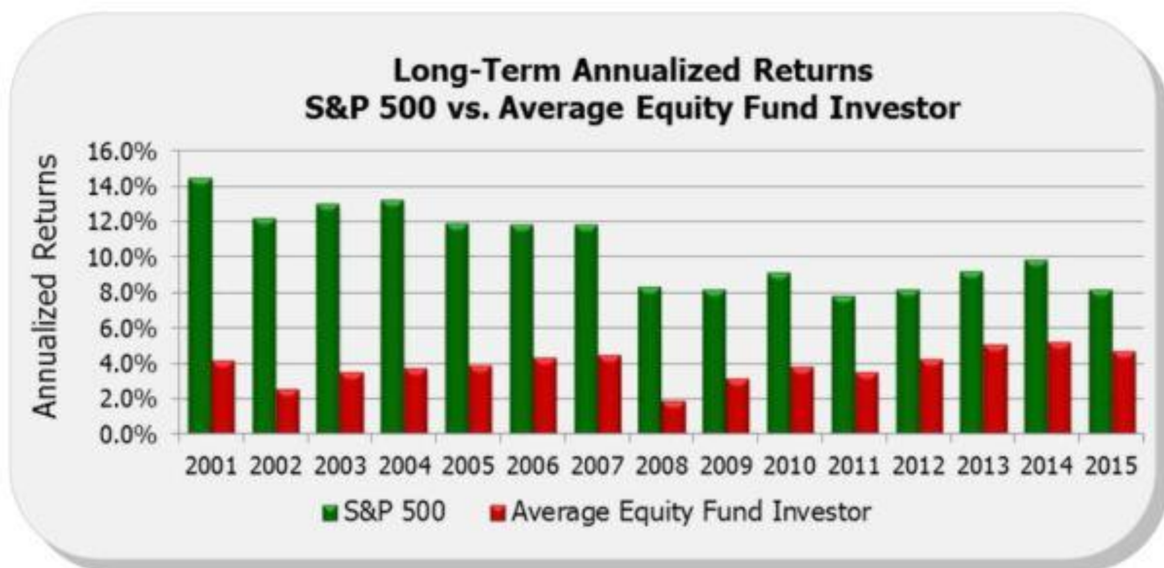
Zen, according to the website Zen-Buddhism, "is the experience of living from moment to moment, in the here and now." Investing, on the other hand, involves buying something today that will (hopefully!) be worth more tomorrow. Or, in the somewhat stilted language of Investopedia: investing is "the act of

committing money or capital to an endeavor with the expectation of obtaining an additional income or profit.”

In other words, Zen is about the present, while investing is about the future. What can one possibly have to do with the other?

As it turns out, quite a bit. In fact, I would argue the primary reason for most investors' underperformance—whether compared to the market or their own goals—is a *lack* of Zen. Most humans have a built-in fear of inertia, which causes them not only to act far more often than is necessary, but healthy.

According to research firm Dalbar, which has been studying investor behavior for nearly a quarter-century, the average mutual fund investor has earned 4.67% a year over the past two decades[1], which doesn't sound too bad…until you compare it to the 8.19% annual return for the S&P 500. This is particularly shocking when you consider that *everyone* involved in this endeavor—from investors to analysts to portfolio managers—is, in theory at least, trying to *beat* the market.



* *The original analyses began in 1984, so 2001 represents an 18 year analysis and 2002 represents a 19 year analysis. Starting in 2003, the long-term analysis covers a 20-year timeframe.*

But wait…it gets worse. If we assume our “average” investor had $100,000 at the beginning of 1996, he would now have $249,000. Not bad, but, due to the power of compounding, far below the $483,000 for the index. Or think of it this way: assuming an even distribution of returns (obviously not the case, but bear with me) the index was worth more after year 12…than the average investor's fund after year 20.

There are, of course, several reasons for this. Active managers charge higher fees than index funds, and tend to lag the market during strong bull markets such as we have experienced since 2009. But the

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[1] As of year-end 2015; 2016 data are not yet available.

biggest reason for the gap is the fact that most investors simply cannot help themselves from buying high and selling low. Much as we like to view ourselves as rational, thoughtful, profit-maximizing machines, we are more like the proverbial dog peacefully sniffing the yard until…SQUIRREL!!!

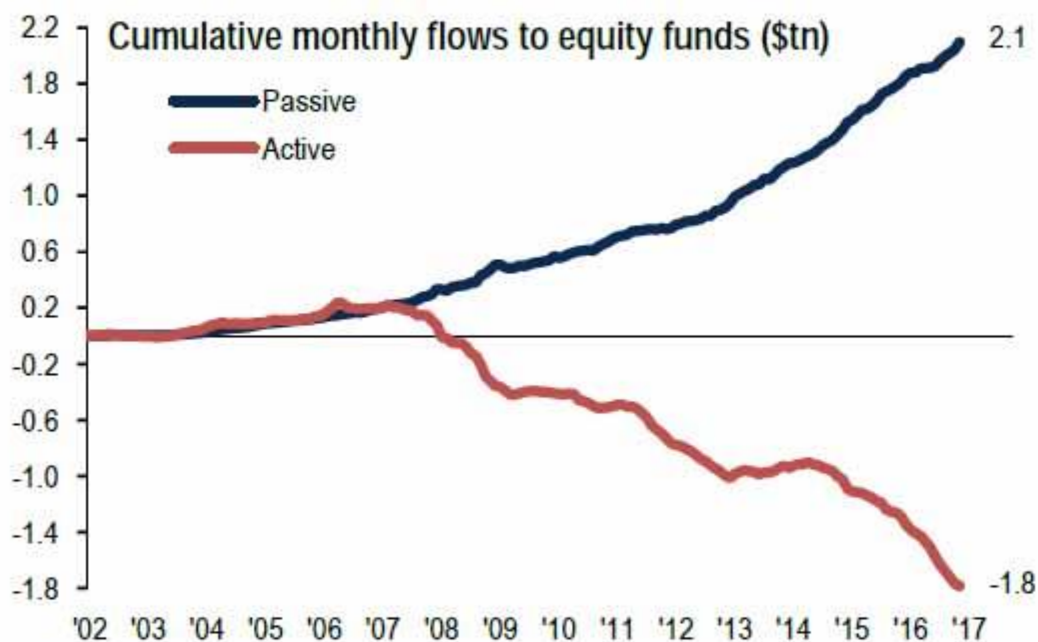
This has been especially true over the past couple of decades due to the violent swings in markets, which have made it even more difficult to take a hands-off approach. Few are those who could stay out of the late-90s bubble, buy in at the 2003 Iraq War bottom, sell during the 2006-07 real estate boom, and buy during the depths of the 2008-09 bust. Ironically (or perhaps not), platitudes such as “keep your head while all about you are losing theirs” or “buy when there’s blood in the streets,” or even Warren Buffett’s famous “be greedy when others are fearful, and fearful when others are greedy” tend to be little help when such scenarios actually arise.

So what can we do?

The crux of the matter is a disconnect between our “rational” brain—the person we think we are—and our so-called Reptilian brain—the person we *actually* are. As eloquently explained by Jonathan Haidt—drawing on Daniel Kahneman’s seminal book *Thinking: Fast and Slow*—the situation is analogous to a rider (the rational brain) on the back of an elephant (the reptilian brain). The rider *feels* in control, and most of the time can steer the elephant in one direction or another. But in periods of stress the elephant takes off running…and there’s not much we can do.

This all sounds pretty hopeless! Still, before we throw in the towel, let’s consider some potential workarounds.

One obvious approach is to invest passively (i.e. in an index fund). This is certainly the “in” thing to do, as evidenced by the massive amounts of money fleeing actively-managed funds for indexes. According to BofA Merrill Lynch, investors have pulled roughly $2 trillion from active funds over the past decade, with a similar amount going into passive funds. (More on this later.)



However, even those who choose to index must make decisions—small-cap or large, developed markets or emerging, what about sector funds, etc. And of course owning an index fund doesn't solve the original problem; many indexers sold near the bottom in 2008-09, only to buy back in at higher levels.

Another method is to set up rules designed to prevent you from doing stupid things. You could, for example, only look at your brokerage statements every quarter (or even every year). Or commit to buying more stocks if the index falls some predetermined amount. Or impose a "waiting period" on any decision to see if it still seems wise a week/month/year later.

As you are likely thinking at this point (or if not…you should be!), all these strategies have a fatal flaw. Just as there are no atheists in foxholes, there are few long-term investors during a sustained market downdraft…and even fewer sellers in a bubble. So anything you commit to doing today, while the elephant is calm, is likely to go right out the window during the next stampede.

I witnessed this over and over during my advisory career. Indeed, one of the dirty little secrets of the investment world is that large investors—widely viewed as more intelligent, more thoughtful, and dare I say more "rational" than smaller individual investors—consistently make the *exact same mistakes* as the rest of us.

I, of course, am no different. While I am naturally predisposed to be a contrarian—e.g. when everyone is bullish it makes me want to be bearish—this in no way lessens the hold emotions have over me. The only difference is I work hard to stay *actively* aware of this tendency, taking steps to mitigate it by seeking out those with different opinions, imposing mandatory waiting periods before implementing investment ideas, and forcing myself to argue the exact opposite position to the one I hold.

And, of course, *doing less*.

Finally, I have developed a simple system, described below, to make sure any investment meets some basic metrics that, while not ensuring success, significantly lessen the possibility of failure.

Institution of Higher Learning?

Allow me to illustrate the perils of too much activity with an anecdote (one of many!) from my prior life.

As I mentioned, one of the "secrets" of the institutional investment business is that "sophisticated" investors make the same mistakes as everyone else. One of my favorite examples involves a liberal arts college with whom I began working in mid-2009, after their endowment fell more than 50% during the 2008-09 collapse.

Everything about this story is classic. Let's start with the reason they were looking for a new advisor—basically, because their existing advisor had put them into very aggressive investments during the 2003-07 run-up, then advised them to sell during the late 08-early 09 carnage. While not entirely typical for institutions during this period—many were frozen with indecision and/or had illiquid investments they couldn't sell even if they wanted to, while a relative few behaved admirably, adding thoughtfully to risk—this was far from a unique story.

And much as individuals generally view successful investments as personal triumphs, but blame their broker when things go south, institutional clients are far more likely to fire their advisor when markets turn down. In fact, the problem is arguably worse with institutions, which have an amazingly strong element of CYA. I'll explore this more in future letters, but suffice to say that the makeup of most investment committees—generally short-term appointments of busy, "important" people—often lends itself to action for the sake of "doing something."

At the time I had a well-deserved reputation for caution, having viewed the 03-07 bull market as an "echo bubble" caused by extraordinarily loose monetary policy in the wake of the tech collapse, and likely to end in similar, if not worse, fashion. Thus, my company asked me to pitch the account, and the client chose me to advise them—from more than 20 finalists—largely, I believe, because I preached safety and *protecting* capital.

Moreover, when, after winning the account, I asked the investment committee point blank whether they were more concerned about missing a strong market rally or suffering through another downdraft, they unanimously voted for the latter.

Was this a fair question? Perhaps not, as it was the middle of 2009 and the elephant was still in charge. While it now seems obvious this was the buying opportunity of a lifetime, at the time it was far from clear. I recently heard Seth Klarman, founder of Baupost Capital—one of the largest and most successful hedge funds in the world, and also one of the most cautious—state that when his fund started buying assets in early 2009 they had no idea whether they were cheap (a la 1987) or expensive (a la 1929).

Still, my reason for asking was to establish a level of buy-in for the committee. Since none of us knew what would happen, it was important—or so I believed—to make sure we were all singing from the same hymnal.

But the best-laid plans…

Five years later, I attended a contentious meeting at their bucolic campus. The committee—nearly 20 individuals, all graduates of the college and most very successful in local business—was boiling over. How come we were lagging the market so badly? Why were they among the worst performers in their "peer group" (colleges in the area with similar-sized endowments)? Most importantly, how could the professionally-managed endowment be trailing their *personal* portfolios?

The crime for which I was held to account? Their portfolio, which we had purposely invested very cautiously in accord with their wishes (and, you may recall, the reason they hired me in the first place) had returned an average of 10% a year since I started working with them, below the average for their peers (about 12%) and well below the S&P 500 (nearly 19%).

However, that 10% return had been achieved with a very defensive portfolio, including a lower percentage of stocks than peers, more in bonds, and a good-sized slug of commodities, gold mining stocks, and cash. Given their spending rate of about 5% a year, the endowment portfolio had funded spending, provided healthy growth on top of it, and done it all with a very conservative risk profile that protected against downside risk. In other words, we had not only done exactly what they asked for…but been extremely successful doing it!

Nevertheless, the committee voted to fire me and hire someone else (ironically someone within my firm); their first request (in mid-2014) was to buy the non-US EAFE index, which had rallied strongly off its 2012 bottom, just in time to see it lose more than 20% of its value. They also sold a gold equities fund that had suffered consistent losses…shortly before it posted a triple-digit gain.

(I was told, verbatim, after their decision: "The client was complimentary of your work but thought that your philosophical approach was much different from what they want or need now.")

The point, of course, is not to pick on this institution, but rather to illustrate the pernicious effect of acting based on emotion. Let's review their decisions:

1. Fire their old advisor for being too aggressive heading into the global financial crisis.
2. Hire me based on my cautiousness, then instruct me to protect downside risk even at the expense of giving up additional upside.
3. Fire me for being too cautious and hire someone more aggressive.

4. Liquidate losing investments at the point of maximum pain, and buy winning investments at the point of maximum optimism.

One final note: the committee informed the new advisor that he would be evaluated on a quarterly basis, with any sustained underperformance considered cause for dismissal. Even my 14-year-old son could tell you the result of that…

Winning By Not Losing

OK, enough chatter.

My first recommendation is a fund with an outstanding long-term track record, proven stock-picking ability, and a curiously under-the-radar profile. Recent underperformance, meanwhile, has some investors heading for the exits. (Hmm…that sounds familiar…)

Further, it is of course an *active* fund, and as noted above, such strategies are wildly out of favor. In fact, both the Wall Street Journal and Bloomberg have recently run stories on the “death” of active investing. Color me skeptical. If form holds, such stories are more likely to have marked the bottom for active managers.

A bit of background. Since its 1993 inception, this fund has had a mere three losing years: 2008 (-20.6%), 2015 (-2.1%), and…1999 (-6.3%).

Wait…1999?! Not 2000, 2001, or 2002, when the S&P 500 fell 9.1%, 11.9%, and 22.1%? Nope. In fact, the fund returned 3.6%, 36.1% (not a misprint), and 3.7% for those three years. Unfortunately, most early investors missed out on those returns, as (stop me if you’ve heard this before) the fund suffered redemptions of nearly 90% of its assets from 1998-2000 as investors flocked to tech stocks.

The fund’s profile soared in the wake of the global financial crisis, as not only were its 2008 losses about half those for the S&P 500, but performance over the next couple of years roughly tracked the market despite the fund holding a large slug of cash. Put another way, the fund was able to sidestep a good portion of the 2008-09 decline through holding cash, then managed to keep pace with the recovery through superior stock picking.

Indeed, one of my favorite stats for this fund is the performance of its stock holdings relative to the market; i.e. net of cash, which is currently about 35% of assets. Thus, while overall performance after the crisis was in line with the market, returns net of cash were substantially better.

	2016	2015	2014	2013	2012	2011	2010	2009	2008	2007
FPACX long equity	15.19%	-1.04%	13.67%	39.62%	17.69%	6.25%	22.30%	38.39%	-38.27%	11.47%
MSCI ACWI	7.86%	-2.36%	4.16%	22.80%	16.13%	-7.35%	12.67%	34.63%	-42.19%	11.66%
S&P 500	11.96%	1.38%	13.69%	32.39%	16.00%	2.11%	15.06%	26.46%	-37.00%	5.49%

Well, fine, but what about that cash? Should we really be paying management fees (a little over 1% a year) on that? This is an excellent question, and one that comes up often in the institutional world,

particularly when those holding cash are hedge funds charging fees of 2% (on assets) and 20% (of profits).

The answer is…it depends.

While a large cash holding is at the very least a yellow flag, it depends on the manager's history and rationale. In our manager's case he has a proven record of sidestepping crises and putting cash to work *when appropriate*. Or as he put it in a 2011 Barron's interview (when the fund was riding high): "Our job is to protect capital first and get a return second."

More broadly, this brings us full circle from our original question about overcoming behavioral biases. While not a panacea, one way to counter our worst instincts is to find someone we trust, and outsource decisions to them. This fund manager likes to say that while he doesn't recommend you invest all your money with his fund, he and his team manage the portfolio as if you do.

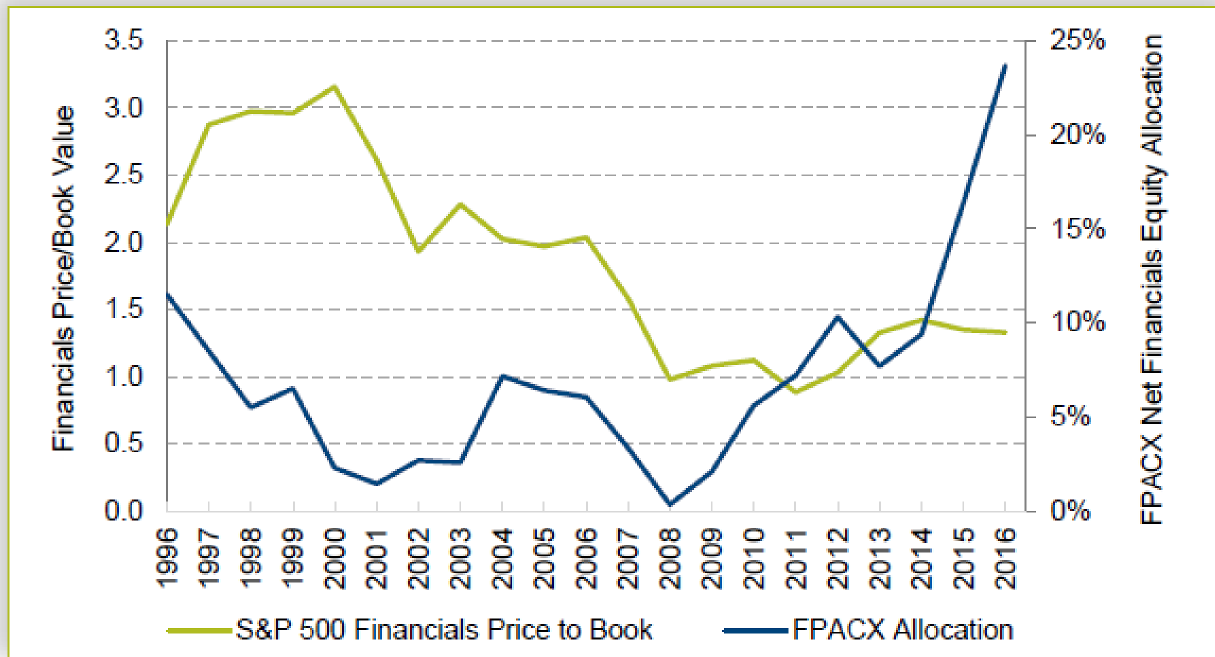
The manager is Steve Romick, and his fund is FPA Crescent (FPACX).

I assume some of you are familiar with him, but for those who are not, he is one of the fastest talkers you will ever meet, as if his mouth can't keep up with his thoughts. He is also remarkably personable and has the classic laid-back California attitude. He's about as far from "Wall Street" as you can get.

(Worth noting: while Romick gets most of the press, the fund is no longer a one-man show. As Romick himself points out, his partners and co-portfolio managers, Brian Selmo and Mark Landecker, have been instrumental in the fund's success in recent years.)

The fund's portfolio is refreshingly eclectic, and changes depending on the opportunity set. For example, big holdings in the late 90s were small-caps and value stocks, while in 2011 they poured money into large-cap tech names like Cisco and Microsoft. Currently they have nearly a quarter of the fund in financials—Romick says the fund has long "had an on/off affair with lenders"—with 10%+ holdings in tech and industrials, and are looking closely at healthcare stocks. They have also owned farmland and office buildings, and are more than willing to invest across the capital structure (e.g. buying corporate debt rather than stock).

S&P 500 Bank Industry Price/Book vs FPA Crescent Allocation to Financials



As to when that cash hoard will be put to work, they're still waiting for a fat(ter) pitch. As Romick put it in his latest shareholder letter: "The reason we haven't found more to do is a function of price, not diligence."

Interestingly, Romick might be better known had he chosen to join a different firm, but at FPA he spent a long time in the shadow of Bob Rodriguez—an outspoken critic of the Federal Reserve and government overreach in general—who put up an eye-rubbing annualized return of 15% during the 25 years he ran the firm's flagship fund called, simply, FPA Capital. Rodriguez stepped down from running the fund in 2009, but had been acting as a consultant until his retirement last year.

In my opinion Romick is a more-than-worthy successor to his legacy, and the timing is right to commit capital to FPA Crescent.

Let's see how this investment stacks up with my system, which I term SIT: Safety, Investment edge, and Transparency. Pretty self-explanatory—screening for these three metrics does not, of course, guarantee anything in terms of returns, but it does tend to weed out most problematic investments, thus allowing us to (ahem) *do less*.

Safety: High marks, both for the willingness to hold cash and eclectic value approach.

Investment edge: Proven over 20+ years. This team can pick stocks.

Transparency: Excellent, not just because it is a mutual fund and discloses holdings every quarter, but also for Romick's detailed and informative quarterly letters.

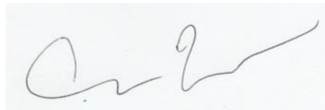
In Closing

Investing while sitting still is not for everyone. It requires patience, a willingness to go against the grain, and the ability to endure being "wrong," sometimes for long stretches of time. (As one of my ex-colleagues used to say, "Every good investment has to suck for at least a year.")

But the rewards can be immense, not just in terms of financial returns, but from a lifestyle perspective. Put it this way: I'd rather spend my time attending the annual FPA Investor Day (last year's was in Santa Monica) than poring over last year's "winners and losers" to see who to hire and fire…until doing it all again next year.

Thanks for reading, and here's to doing less!

Until next month…



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