TRENDS & TAIL RISKS

a Capital Wealth Advisors publication

Investing is a Team Sport

By LEWIS JOHNSON - Co-Chief Investment Officer | August 9, 2017

"The stock market is designed to transfer money from the active to the patient."
- Warren Buffett

"We have met the enemy and he is us."
- Walt Kelly's Pogo

"The most important investment ability is an emotional discipline."
- William Bernstein

"If you fail to plan, you are planning to fail."
- Benjamin Franklin

"I may say that this is the greatest factor: the way in which the expedition is equipped, the way in which every difficulty is foreseen, and precautions taken for meeting or avoiding it. Victory awaits him who has everything in order, luck, people call it. Defeat is certain for him who has neglected to take the necessary precautions in time, this is called bad luck."
- Roald Amundsen

"If you aren't willing to own a stock for ten years, don't even think about owning it for ten minutes. Put together a portfolio of companies whose aggregate earnings march upward over the years, and so also will the portfolio's market value."
- Warren Buffett

CHIEF CONCLUSION:

One needs to look no further than the track record of the greatest investor of our time, Warren Buffet, to understand that even the most successful long-term investment strategy will experience periods of underperformance. The best results happen over time when we combine the ownership of the right securities with the patience to hold them, all driven by meeting the goals for which the portfolio was constructed. Successful investing is a team sport – and places great demands on managers, advisors, and clients too.

Imagine my pleasant surprise the other day when examining an inbound portfolio I found a long-held position in Warren Buffett's Berkshire Hathaway. You don't see many of those.

Although this client's investment in Berkshire began as only a small position decades ago, it had grown over the years into many millions of dollars, dominating the portfolio's value. Mr. Buffett's 2016 shareholder letter outlined his cumulative performance since 1965 of 1,972,595% or **155 times greater than** the S&P 500's total return. You might think that such incredible outperformance made Berkshire an easy stock to hold for the long run – but there you would be wrong.

For one out of every three years - seventeen of the last fifty one years - Berkshire underperformed the market. Some periods of underperformance stretched on for years and resulted in cumulative underperformance of as much as 50%! If there is only one enduring truth in the market it would surely be that periods of underperformance are inevitable; even for the most gifted investors. The portfolio I examined had won because the client did two things right: he owned the right investment – *and held onto it patiently, literally for decades.*

Investing is a Team Sport

There are so many challenges to successful investing that it demands a joint effort between us and our clients. It's not enough to own the right investments, *they must be owned patiently.* That is why we believe that investing requires the right team. So many things conspire to keep investors from earning the returns that they should; often it takes all our efforts to stay the course.

The evidence demonstrating this point is quite clear. For example, a 2016 study by Dalbar Inc., a financial industry research firm, demonstrates that over a thirty year period, investor's own behavior conspired against their returns, creating underperformance of 30% in equities and an even more ruinous 90% in fixed income. What drove this catastrophic failure? The primary culprit was impatience.

Critical factors that contributed to this were performance chasing at market tops and giving up at the bottom after periods of underperformance – basically understandable and typical emotional responses. These reactions are our greatest investing enemies. Think of the many investors who now look back at the Berkshire Hathaway that they prematurely sold. It wasn't enough that they had once owned it. They needed the patience to hold onto it too. Somehow this particular client mentioned earlier had found the patience to endure and as a result earned millions for it.

For manufacturers of investment products, such as mutual funds obsessing over their benchmarks, this horrible result for individual clients is somebody else's problem. All they care about is their benchmark. But for real clients this underperformance is a tragedy that can be avoided – if clients and their advisors come together as a team.

This is the reason that financial advisory exists. At our firm we provide clients with both research and advisory services for one low fee. Our focus is the best outcome for clients, not slavish devotion to short term benchmarks. This means attempting to deliver the returns our clients need to meet their plan's goals while taking the least amount of risk possible. Less risk means less chance of failure but it also sometimes comes with a price of some underperformance.

Our Process for Creating a Winning Team

The first step of our process is to understand our clients' financial goals. What expenses must the portfolio meet for living expenses, charitable giving, and generations to come? Once we understand these needs, we attempt to match these return goals with a portfolio that takes the least amount of risk possible while still meeting these goals.

We do this by creating a custom portfolio that meets each client's needs while balancing risk and reward. This requires much more thought than simply slapping together a "happy face" portfolio that shines in upcycles yet turns inevitably into a disastrous "frowny face" portfolio when skies darken and the cycle turns down. Those portfolios are easy to spot. We see many such portfolios among our inbound clients, sadly most often after they have failed. These portfolios were built as fragile flowers blooming in an upcycle but tend to fail in a downcycle.

We believe a defensive portfolio durable enough to avoid becoming a future "frowny face" portfolio is going to lag an overvalued, white-hot market blowing off into the peak of the cycle. It is highly likely to happen. This is the world that we live in.

This message is not thrilling enough to make the headlines at CNBC, but that is not our business. We are not in the headline business but rather in the bottom line business. Our bottom line business is by design unremarkable, and frankly – boring. And that is exactly as it should be.

Our emphasis is on controlling risk first with every investment that we make and then limiting the downside through asset allocation. Returns are something that investors enjoy only after they have successfully navigated the risks in the market. And from our perspective, there are a lot of risks in the current market.

It's our promise to you that we will use the tools at our disposal to promote the best long-term outcome for our clients. But we learn from Mr. Buffett and from Dalbar that we can't achieve that goal alone. If our team is going to win, it will only be through partnering with our clients, so that together we close the gap between what investment results are and what they could be.

In Conclusion

Our investment process begins with planning and custom design of a portfolio that attempts to achieve each client's goals while taking the least amount of risk possible. Day by day we manage this portfolio, communicating what we are doing and why. Slowly, very slowly, the short run turns into the long run. This process reaches a happy conclusion only after many years of our joint effort, at the point when we arrive together at our desired destination. Seeing that outcome fulfilled is the best part of this job and is what gets each one of us at our firm out of bed in the morning. We have worked hard to create a high quality analytical and customer service team, but without you, our star player, we can't hope to win.

Questions? Comments? Criticism? Email Lewis Johnson at lewis@cwafgi.com, or reach him at 239.434.7434.

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