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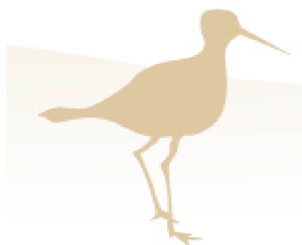
Sandpiper Capital

Gleanings



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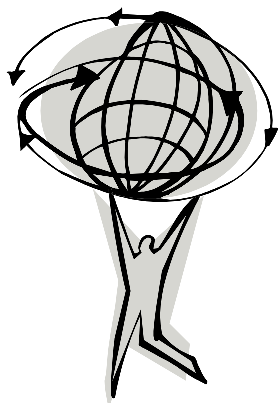


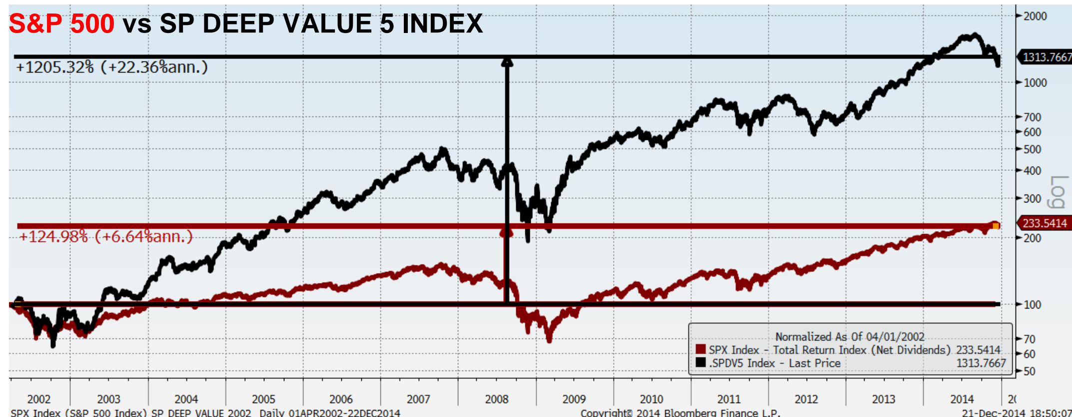
Good Times Coming…

It's funny the different reactions that investors have to the same circumstances. It is with appositive elation that I am watching the mini-bear market in bonds evolve, as fearful sellers anticipating the Federal Reserve's hike in rates this fall

Market Returns Annually and Ten Years Ending 06/30/2015

Index	2012	2013	2014	10 Yrs
S&P 500	15.9	32.4	13.7	7.7%
ML 1-5 yr Gov't/Corp	2.5	.3	1.5	3.4%
EAFE (Dev Fgn Mkts)	17.2	22.8	-4.9	4.4%
Emerging Markets	18.7	-2.5	-2.1	8.8%

interest. Sometimes that is a very clear delineation between your interests and the adviser's, such as insuring that your commission costs are kept to a minimum or that the portfolio manager doesn't receive benefits or remuneration as a result of directing your trades. Other times things are not so clear. For example, it is in your best interest to own a portfolio of securities that will give you the highest return per unit of risk possible. It is in the adviser's interest that you own a portfolio that performs in-line with the index. If the S&P 500 goes up 20% and your portfolio is not up, the manager stands to lose clients, even though the long run potential returns of a non-indexed portfolio are better. As a business practice, most advisers choose to invest in such a way that their portfolios will behave like the major market indices, (i.e., low tracking error). They own the same size companies, in the same industries, in the same proportion and then are somewhat doomed, because they have costs and the indices don't, to perform a little worse. As a business model, it's a pretty good idea. As an investment strategy, not so much. I would not want to rely on the performance of the market indices to make money. There are many objective reasons to believe that with corporate profit margins and stock valuations at record highs, market gains going forward will average in the low single digits while the month to month swings continue as wildly as they have, frustrating most investors. The average S&P 500 return for each ten year holding period since 12-31-1994 has been 5.1%/year. In the graph below, you can see the annual compound return for the S&P 500 index since 2001 has been 6.6%. The return to a non-diversified, pure value index consisting of the five best values in the S&P has been 22.4%. While focusing only on returns creates tracking error, it has its rewards.

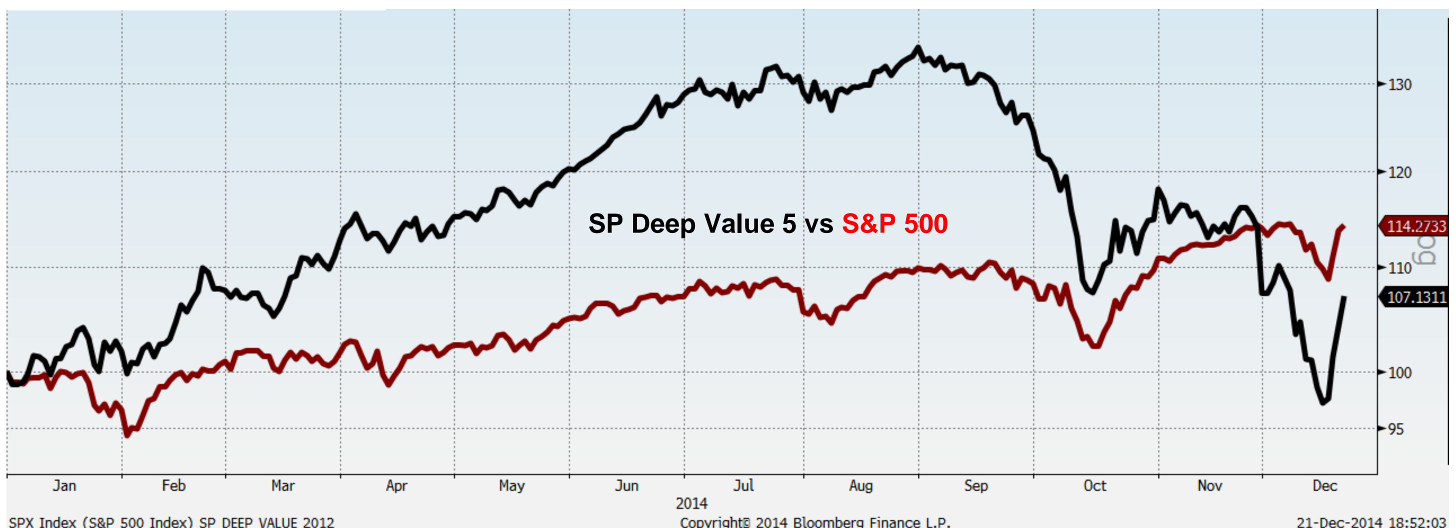


For one really good example of the *disadvantage* of tracking error, take a look at the table to the right for the 2012 returns to the S&P Benchmark (B) of 15.99% and then to the SP 5 Deep Value Portfolio (P) of -3.73%. When clients call and ask "Why are my stocks down when the market is up 16%?", it is a challenge to explain the benefit of a long term perspective. Similarly, look at the chart below. A deep value portfolio that was 30% ahead of the market mid-year has dropped to 7% behind. As a business model, erring on the side of maximizing long run returns at the cost of short term relative performance means that the adviser has a much greater responsibility to keep clients' focus on the long term. Making the positions the appropriate size for each client's risk tolerance is critical to that effort.

	Total Return (P)	Total Return (B)	+/-
12/31/2003	38.73	28.71	10.02
12/31/2004	54.86	10.89	43.97
12/31/2005	35.92	4.92	31.00
12/31/2006	36.50	15.81	20.69
12/31/2007	15.83	5.50	10.33
12/31/2008	-27.78	-36.99	9.22
12/31/2009	85.13	26.47	58.66
12/31/2010	19.04	15.06	3.97
12/31/2011	15.34	2.11	13.23
12/31/2012	**-3.73**	**15.99**	**-19.72**
12/31/2013	71.03	32.39	38.64

Best-Worst	Difference	Portfolio Perf	Bench Perf	Date
Best 1	58.66	85.13	26.47	12/31/2009
Best 2	43.97	54.86	10.89	12/31/2004
Best 3	38.64	71.03	32.39	12/31/2013
Worst 1	-19.72	-3.73	15.99	12/31/2012
Worst 2	3.97	19.04	15.06	12/31/2010
Worst 3	9.22	-27.78	-36.99	12/31/2008

Period Analysis	Winning	Losing
Number	10.00	1.00
Percentage	90.91	9.09
Avg Difference	23.97	-19.72



While the logic and the historic performance of investing in a portfolio of the five cheapest companies in the S&P is very compelling, we know from experience that diversifying investment models is the surest way to reduce risk. We do use the Sandpiper deep value screen to identify the best values but then we also look at each buy candidate very closely to make sure that the perceived risk that has made each stock so cheap isn't greater than we are willing to assume. That is, our actual portfolios don't track the SP Deep Value Index in that we don't want that much volatility. We will typically combine our selected deep value stocks with low volatility income stocks and/or index funds from our tactical fund allocation model. But with the powerful returns that these companies have historically offered, a little value goes a long way.

Tom Lukic