PERSPECTIVES

February 2014

Bernzott Capital Advisors

Is This Sustainable?

2013 was another good year for our investors. After returns in the mid-teens in 2012, the 2013 encore gave us returns not seen in a decade. One client observed that if the trend continues, we should expect 2014 returns in the forty percent range. Fortunately, that comment was made in jest. Still, the comment did bring up the question of how much longer prices can escalate.

A constant theme of *Perspectives* is our unwillingness to make predictions. There are so many things that can influence the markets over a short period of time that trying to pinpoint how much further prices will go up or when they will reach the peak is a guess that is bound to be wrong. And our admission that we don't know exactly where things are going to be in the next twelve months is actually an attribute of a prudent investor. Legendary investor Howard Marks made a presentation to the CFA Society of Los Angeles recently and he shared anecdotes that we would love to claim as our own, but the credit goes to Marks. Regarding the admission that one cannot predict the future he gave the example of a traveler who must drive to San Francisco. If the traveler realizes he doesn't know exactly how to get to San Francisco, how will he go about the trip? He will study maps, drive a little slower, check himself along the way and proceed with a bit more caution. However, the person who thinks he knows where he is going will proceed without a map, drive too fast and figure that he "will know it when he sees it." We know what happens to this kind of traveler. He goes off course, doesn't admit he is lost and by the time he figures out where he is, he is not even sure how to get back on track. So it is with investing. If one admits he cannot predict short-term fluctuations, then the intelligent investor will move more deliberately, he will do more research and he will use all the tools available to make the "trip" more assured of success. As Mark Twain said, "It ain't what you don't know that gets you in trouble. It's what you know for sure that just ain't so."

Marks shared another experience that helped him shape his defensive investing. In 1975, he read an article in *The Financial Analysts Journal* by Charles Ellis titled *The Loser's Game*. The article used a sports analogy to describe successful portfolio management. In tennis, there are essentially two types of players: 1) the elite player that wins matches by hitting winners; and 2) the rest of us who play a "loser's game." The non-professional tennis player plays the loser's game because the way the game is won by this player is by avoiding mistakes. This player will lose the match if he tries to hit nothing but winners all the time. He will lose because there are too many variables in his game to hit consistent winning shots. Similarly in investing, if you play to simply keep the ball in the court, despite the lack of any flash or panache, you have a greater chance of emerging as a winner.

How do we avoid (in tennis parlance) the "unforced error?" We own high-quality companies trading at a discount to our calculation of fair value. We want companies that have reasonable debt, high returns on capital and consistent cash flow. We look for experienced and skilled management to run the business and we prefer the management own a material quantity of stock alongside us. We avoid businesses with no track record of operational success, we stay away from emerging technologies and industries that are in their infancy. Certainly we may miss an IPO that triples in price, but we also avoid the new business that is competing in unchartered territory. Our method of investing is not going to allow us to avoid every stock that declines in value (WeightWatchers), but our style of keeping the ball in play as opposed to trying to hit only winners continues to provide very good performance for our clients while simultaneously mitigating risk. Marks ended his presentation with a few quotes, one of which we found particularly germane to Bernzott Capital Advisors: "Never forget the six-foot tall man who drowned crossing a river that was five feet deep on average." Even though the river crossing is easy right now with recent returns well into the double digits, the wise investor will be prepared for times where the going is not so easy. We certainly cannot see where the deep parts are, but we know they are coming. We don't expect it to be easy the whole time, but preparation and the admission that we cannot see into the future will help us get us across.

Unlike the proverbial river mentioned above, one thing we always look for is consistency. We stay true to our approach, we remove any emotion from the investment process and we understand that as equity prices increase, our comfort level decreases. We will not accept lower quality companies just because so many things have recently gone right. For many investors, the equity environment appears "nicer" as a result of rising prices. Consequently, the comfort level increases. On the other hand, we have a cash position as high as it has been in years. We are more likely to scream "Caution!" than we are to declare the coast is clear. We are not saying we are back in the Internet bubble days, but as an anecdote, the 23-year old CEO of a two-year old company with no revenue (Snapchat) rejected a $3 billion buyout offer. Additionally, Twitter's IPO price was $26 on opening day and closed at $44.90. Finally, through November, companies with weaker balance sheets rallied at a pace almost twice that of stronger companies. We don't think this is the time to go all in. While we don't believe the economic backdrop or the other market forces (i.e. real estate prices, sub-prime credit and risk-blind investing) are anything close to 2006-07, we are certainly paying attention to the relationship between price and value. We won't predict when we think the top has been reached, but our calculations of fair value are within screaming distance on many of our portfolio holdings. As we always do, we will invest with discipline and look for opportunities on both the buy and sell side.

Welcome Ryan Ross, CFA

Ryan joins our Investment Team as an analyst. He was previously an analyst at Madison Investment Advisors and American Century Investments. Ryan graduated magna cum laude with a BS in Business Administration from California State University, Northridge and has an MBA from the University of Michigan.

After a stint in the Midwest, Ryan is happy to be back in southern California, where he grew up. He will spend the majority of his time doing the bottom-up research that we consider important in driving good returns. These duties include financial statement analysis, fair value modeling, equity valuation and new stock discovery.

Ryan is our third recent hire as we opened a Santa Barbara office and increased research, portfolio management, and client service capabilities.