The First (and Last?) Competitive Advantage

"Capitalism is a pretty brutal place."

- Charlie Munger

Everyone is looking for a competitive advantage, especially in investing. With all the smart people battling for an edge, are there any competitive advantages left to exploit?

Warren Buffett once quipped, "As they say in poker, 'If you've been in the game 30 minutes and you don't know who the patsy is, you're the patsy.'" Which is just a humorous way of saying you need to know where your advantage lies, or else you should consider not playing.

What are some possible investment competitive advantages?

Perhaps access to special information? This used to be a real problem in financial markets. Insiders would get information early and use it to their material advantage, front-running other investors. It's debatable if it's still an issue today. In 2000, the SEC released regulations that required companies to disclose information to all investors at the same time, leveling the playing field. People risk going to jail when they preferentially disclose information. It may still occur, but at no where near the previous levels.

Special information can come in other forms. Hedge funds pay extreme sums for access to data sets which they believe will give them an edge. As an example, satellite images of parking lots can theoretically be used to guess at retail numbers. Parked cars = store traffic = sales, so the hypothesis goes. This kind of research has been around forever, often called "channel checks" or "scuttlebutt." We suppose it's a lot sexier when it's done from outer space. Charlie Munger didn't need to use a U2 spy plane to realize that people liked See's Candy and it was a special business worthy of buying.

What about "Big Data"? The recent explosion has meant a geometric growth in data creation. Supposedly, more data has been captured in the last 2 years than in the entire previous history of the human race. A veritable flood, ever-expanding. It's unclear if we humans really have a handle on how to turn all of these data into quality, useful information. Complex systems, like markets, are notoriously difficult to untangle. All the data in the world are meaningless if you can't draw the arrow of causality in the right direction. There's an incredible amount of noise, and often-loose or changing correlations. All these data are even potentially dangerous if the user arrives at a false level of precision. Most of the world shouldn't be measured out to the thousandths decimal place. We remain currently skeptical of infant Big Data.

How about a superior investment process as an edge? As much as every investor thinks their "proprietary" system is unique and special, there are only so many ways to skin this cat. A multi-trillion dollar industry's lifeblood is making "buy low and sell high" more complicated than it has to be.

You can figure out what kind of investor you are by answering some simple questions.

Do you like to buy things when they're going up? Do you prefer to buy things on sale? Do you like high quality or really cheap? Do you hang your hat on the numbers or the narrative? Do you need action or can you watch grass grow? How much leverage or cash are you comfortable with? Every thoughtful investor has their blend of answers to questions like these that constitutes a "system."

We're no different. If we're successful, it's because we'll have used investment checklists and procedures to avoid the obvious unforced errors that carry high penalties. We've also spent a semi-ridiculous amount of time thinking about the above questions in order to match up our "system" with our own psychological wiring, dispositions, biases, and blindspots. *Know thyself* remains useful advice. It's also why we aren't a suitable manager for every investor.

So what's the one competitive advantage everyone is overlooking?

Before we reveal our answer, an observation. Many academics have declared there are no actual advantages available and recommended indexing. Opt out and just "be the market." People must have listened. In the last three calendar years, investors sank an astounding $823 billion into Vanguard funds, which specialize in indexing strategies. Maybe not the worst idea in the world given the high-cost generic mutual funds these investors were likely fleeing, but we can't help but think of the Buffett quote, "What the wise do in the beginning, the fool does in the end." Vanguard now has $4.2 *trillion* in assets; talk about a crowded trade. It's fun to just "be the market" when it's going up. It'll be interesting to see what happens when this bull market peters out and indexers' resolves are tested by bad news and crashing prices. There's a whiff of false modesty to this indexing revolution. *Pride cometh before the fall.*

Now for the big reveal.

We posit that one of the last unexploited competitive advantages is actually one of the originals: health and vitality.

Health?! Can the answer be that basic? We believe so.

In early 2015, we spent 4 days at a Tony Robbins event. Tony gets a bad rap from his early infomercial days. Yes, he can be overly self-promotional, but he might also be the world's greatest practical psychologist and peak performance coach. We were impressed with our experience and remain fans.

There was also an unexpected outcome from the event. At 57 years old, Tony pours himself into the audience for multiple 15-hour, high-activity days on stage. It's a sight to behold and we we were envious of that raw, unflagging energy. We've always been health conscious self-experimenters, but we embarked on a quest to unravel what it would take to achieve Tony's unique level. We believe we've found it.

In our pursuit of this physical energy, we found something even better for an investor: extreme mental clarity. We'll argue that there are more epiphanies to be had when you're in the right physical state. The mind-body connection is dynamically real and underappreciated.

Your mental state can dramatically affect your decision making. All of the big decisions we make are measuring and balancing risk vs. reward. Depending on your mood and physical state, the chemistry of your brain (serotonin, dopamine, oxytocin, endorphins) can change drastically. These chemical building blocks act as lenses through which you process incoming information and make decisions. When they're out of whack, you may become more risk averse or reckless, depending on the imbalance. Both are potentially lethal to sound decision making.

What investors have you heard profess to seek peak physical health in order to improve their investment acumen? We haven't either, but we consciously avoid making any important investment decisions unless we're in a peak state. The dots simply don't connect like they do when we're at our best.

Studies show exercise, sleep, sunlight and diet directly impact serotonin levels, which also correlate with creativity. When you're feeling great, the ideas flow and combine to make magic.

"All life is an experiment. The more experiments you make the better." – Ralph Waldo Emerson

We're hesitant to offer any prescriptions— everyone is different. What you arrive at is unique to you, so don't be afraid to experiment. We will say we happen to enjoy the benefits of fasting protocols, but to each their own.

We will give you one hint at a not-to-do:

"Three things ruin people: drugs, liquor, and leverage."
– Charlie Munger

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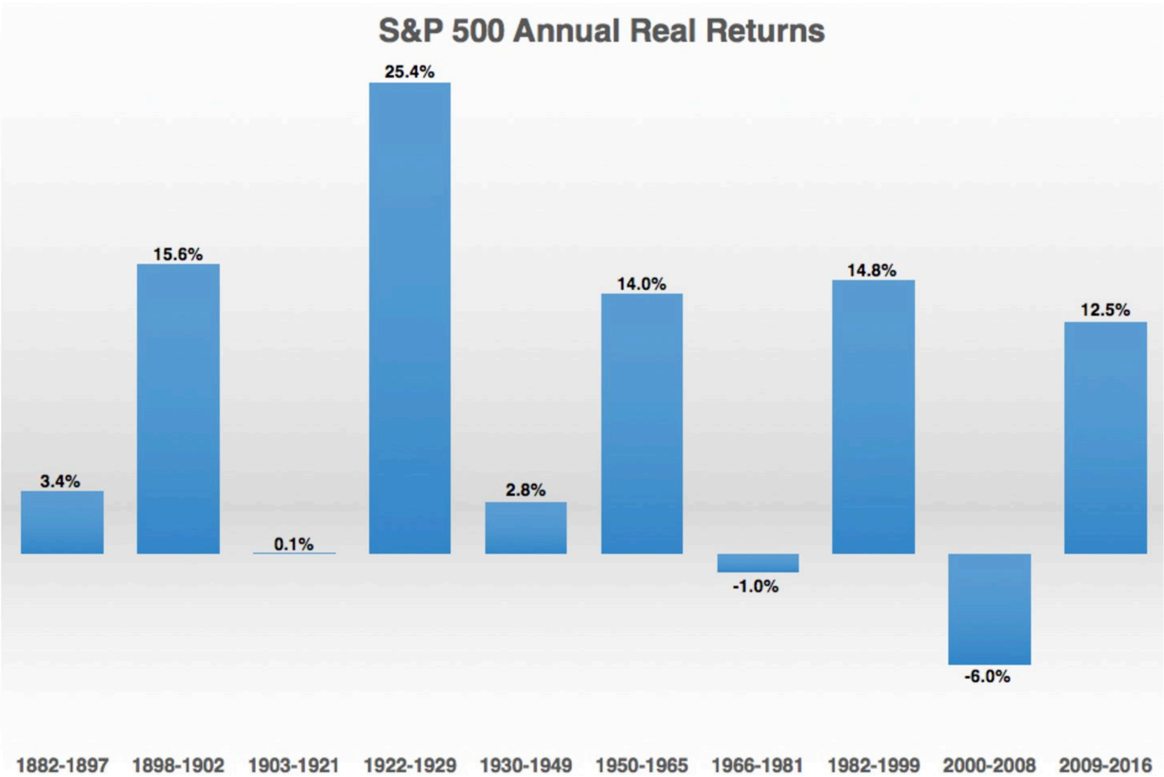
There's one other investment competitive advantage, which we'll discuss in the next quarterly letter. But here's a graphical hint below. Feel free to email us if you have a guess. Maybe we'll send a prize to the first person who gets it right. :)



Quick Market Update

The markets remain grossly overpriced.

According to Ned Davis Research, the S&P 500 index would need to decline to 1665.72 to be get to "fair value" (the median historical valuation). That's a drop of -29.5%. To get to "undervalued," it would have to drop by -51.1%. We're not saying that's going to happen tomorrow, but in statistics you have to spend some time "below the mean" on occasion.

Starting Median P/E Ratio & 10-Year Returns

Starting Date	Starting Median P/E	10-Year Annualized Return
12/31/1989	13.9	15.28%
12/31/2000	20.6	-0.48%
12/31/2001	23.5	0.92%
12/31/2002	18.8	4.94%
2/28/2003	16.9	6.06%
12/31/2003	21.2	2.17%
12/31/2004	20.3	5.54%
12/31/2005	19.0	5.24%
12/31/2008	12.5	13.21% *
2/28/2009	11.0	16.69% *
1/31/2017	24.2	???

* Less than 10 years (through December 2015)
Source: CMG Investment Research, Ned Davis Research, Worldscope

What's the concrete takeaway? Save more money! Based on these expensive starting prices, returns will not be great over the next decade. You'll need to save a lot more than most are projecting, if you are going to meet your future goals. Some of the expenses won't even be yours. State and local pensions are estimated to carry a $6 *trillion* unfunded liability, which you (we) will be on the hook for. Nevermind the $165,000 US Federal debt *per taxpayer* already on the scoreboard. As John D. Rockefeller said, "Save when you can and not when you have to."

Quick Housekeeping Item

Part of being a registered investment advisor with the State of California means providing compliance updates and disclosures annually. Here's where we keep the most up-to-date documents for our clients: https://www.dropbox.com/sh/sp5mqetpcwrjc1b/AABxGZXC6vKI-AFosZam6xita?dl=0

As always, we're thankful to have such great partners in this wealth creation journey.
Jake & Lonnie

Performance since Jan 2008*

FSI (after all fees)	+87.7%
S&P 500 (w/ dividends)	+96.9%

* Based on auditable track record of our flagship The 5505 Fund formerly named RCM Partners Fund.

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