The Last Competitive Advantage?

"The stock market is a device for transferring money from the impatient to the patient."

- Warren Buffett

Last letter, we explored different competitive advantages. We hinted there was one we didn't address, leaving it as a teaser and soliciting your guesses. Several people emailed us with the right answer, reflecting the high quality of our readership. A few congratulatory boxes of See's Candy were even shipped out as reward.

Here's the big competitive advantage reveal, summed up in one word.

Patience.

Sounds too obvious, but we'll explain why although it seems simple, it's anything but easy in practice.

To start, we can't say it better than one of our investing heroes, Joel Greenblatt, did in a recent Forbes interview:

> **"Right now patience is in short supply. You used to get a quarterly statement and throw it in the garbage; now you can check your stock price thirty times a minute. Time horizons are shortening, and the payoff for patience is getting better."**

The Whole Story in One Chart

This is an amazingly telling chart of the headwinds our value style of investing has faced and the patience that is required to be a great investor.

Let's unpack some of the big takeaways. To help explain, each point of the graph shows you how value vs. growth compared looking back over the previous 10 year period.

FARNAM STREET Investments
FARNAM STREET INVESTMENTS
1847 Iron Point Rd, Suite 180 Folsom, CA 95630
916.542.2008
www.farnam-street.com

Mean Reversion Would Seem to Favor Value

Russell 2000® Value Less Russell 2000® Growth 10-Year Annualized Rolling Returns

Source: Furey Research Partners, LLC and Russell®, 12/31/1978 to 3/31/2017, annualized return over rolling 10-year periods
Growth and value investing each have their own unique risks and potential for rewards, and may not be suitable for all investors. A growth investing strategy typically carries a higher risk of loss and a higher potential for reward than a value investing strategy. A growth investing strategy emphasizes capital appreciation; a value investing strategy emphasizes investments in companies believed to be undervalued.

Past performance does not guarantee future results.

Calendar Year Annual Returns (%)

	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Russell 2000® Growth Index	20.37	20.17	-17.41	51.19	7.77	13.37	-2.43	31.04	11.26	12.95	1.23	43.09	-22.43	-9.23	-30.26
Russell 2000® Value Index	29.47	12.43	-21.77	41.70	29.14	23.77	-1.54	25.75	21.37	31.78	-6.45	-1.49	22.83	14.02	-11.43

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	YTD 2017*
Russell 2000® Growth Index	48.54	14.31	4.15	13.35	7.05	-38.54	34.47	29.09	-2.91	14.59	43.29	5.62	-1.38	11.32	5.35
Russell 2000® Value Index	46.03	22.25	4.71	23.48	-9.78	-28.92	20.58	24.50	-5.50	18.05	34.50	4.22	-7.47	31.74	-0.13

*Not annualized, as of 3/31/2017

Source: Copyright 2017 FactSet Research Systems Inc., FactSet Fundamentals. All rights reserved; and Russell®

Standard Deviation: is a measure of volatility of returns and is computed as the square root of the average squared deviation of the returns from the mean value of the return.
Russell 2000® Growth Index measures the performance of those Russell 2000® companies with higher price-to-book ratios and higher forecasted growth characteristics.
Russell 2000® Value Index measures the performance of those Russell 2000® companies with lower price-to-book ratios and lower forecasted growth characteristics.
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Past performance does not guarantee future results.

For a concrete example, let's start with the good. Take the high point of the chart in 2009. It shows that from 1999-2009, value outperformed growth by 10.99% annualized. That sums to +184% total outperformance. Wow, that's the stuff of legends! With that kind of tailwind, it shouldn't be a surprise that 1999 was a great time to start a value track record. It also shouldn't be a big surprise that there are an outsized number of value investing gurus with 1999 start dates. A little luck at the beginning never hurt anyone, right?

Now onto the bad. The latest data point shows that from 2006-2016, the roles were reversed and value has been a laggard. Growth outperformed our value style by 2% per year annualized over the previous 10 years. That compounds to about a 22% total lag over a decade for value.

Even strong swimmers can only fight the tide so much.

Why do we remain unshakably optimistic?

If you knew nothing else, just look at how little time the plot spends below 0%. Value simply does better than growth most of the time.

If you believe in statistics and mean reversion, _the future is unbelievably bright._

Let's recall what we learned in our introductory statistics class about normal distributions to dive deeper into our analysis.

If we were to pick any one year at random, we'd expect value to have outperformed growth by 4% per year over that previous 10 year period. Value, as a strategy, is generally a pretty good default bet.

It gets better.

There are roughly 10,000 days represented on a chart spanning 1988-2016. We can say that if we picked any single day at random, 68% of the time (6,800 days!) the result we'd expect would be value outperforming between 0.64% and 7.54% per year. That projects out to between 6.6% and 106.8% total expected outperformance. Very nice.

Sixteen hundred of 10,000 days would be truly magical. We'd expect to crush it and do even better than 7.54% annualized outperformance.

That also leaves the remaining 1,600 dismal days where we'd expect to underperform.

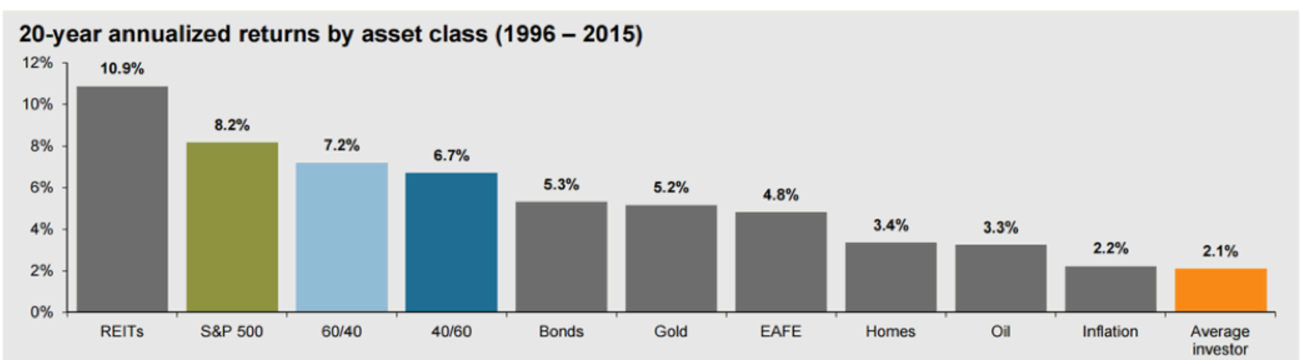
We'll happily take those odds over an investment career. Even if it means we're forced to underperform 16% of the time. It's an obviously great trade off.
It just so happens we're mired in one of those 16% bad stretches right now.

Which is exactly why patience is so important.

Taking One For the Team

Talking about being a patient investor is easy. Sadly, the results show over and over again that most people simply can't do it. Fear of missing out is very real, and the dangers of an expensive market only seem blindingly obvious in the rearview mirror.

One 20-year study from JP Morgan found that the average investor underperforms pretty much every asset class due to performance-chasing and lack of patience.



Source: J.P. Morgan Asset Management; (Top) Barclays, FactSet, Standard & Poor's; (Bottom) Dalbar Inc.
Indexes used are as follows: REITS: NAREIT Equity REIT Index, EAFE: MSCI EAFE, Oil: WTI Index, Bonds: Barclays U.S. Aggregate Index, Homes: median sale price of existing single-family homes, Gold: USD/troy oz, Inflation: CPI. 60/40: A balanced portfolio with 60% invested in S&P 500 Index and 40% invested in high quality U.S. fixed income, represented by the Barclays U.S. Aggregate Index. The portfolio is rebalanced annually. Average asset allocation investor return is based on an analysis by Dalbar Inc., which utilizes the net of aggregate mutual fund sales, redemptions and exchanges each month as a measure of investor behavior. Returns are annualized (and total return where applicable) and represent the 20-year period ending 12/31/15 to match Dalbar's most recent analysis.
Guide to the Markets – U.S. Data are as of March 31, 2017.

J.P.Morgan Asset Management

There's more. TD Ameritrade has an interesting index that **tracks "average investor" sentiment**. It's based on meta-data from trades in their 7.2 million retail investor accounts. Lured in by advancing prices and record low volatility, this index has recently been making new highs. These new peaks indicate a strong level of bullishness from retail investors. There are more enthusiastic buyers than sellers right now.

Unfortunately, history shows "mom and pop" investors have historically been sucked in just as the market tops and the trouble starts. Think 1999 and 2007. This isn't the crowd to take your investment cues from.

Suffice it to say, waiting patiently is hard. So what's a thoughtful advisor to do for a group of people they truly care about?

To bolster the FSI Family's collective patience, we've stepped up with a novel solution for our clients.

We've elected to forgo our management fees on the *excess cash* in our clients' accounts. Due to our conservative approach, most clients are currently around 50% invested in attractive businesses and 50% in cash, depending on when they joined and their age.

In plain English, that means Jake and Lonnie have personally volunteered to cut their own paychecks in half to take one for the team.

Our goal is to lower the cost of patience by moving some of the burden from our clients' backs and placing it firmly on our own. We want to see as many of our clients make it through this difficult "16% stretch" and enjoy the inevitable reversion to the mean.

We have faith that we'll do extremely well on the other side and we'll all be rewarded for our patience.

And yes, despite the pay cut, we'll still be having the FSI Annual Bash, complete with BBQ just like previous years. :)

Save the date of October 7th on your calendars. Evite with full details to follow.

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

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