Not Blowing Out The Lights Each Year Never Leaves You In Darkness: An Investment Surprise

Saturday's With Jim

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Dear Friends,

Howard Marks, Chair of Oak Tree Capital, a distressed bond investor, is famous for writing quarterly letters to clients dating back to the late 1980's. His third quarter 1990 letter contains what we need to know to achieve outstanding long-term (decades) performance[i]. In his words:

> ". . . in order to strive for performance which is far different from the norm and better, you must do things which expose you to the possibility of being far different from the norm and worse. …bold steps taken in pursuit of great performance can just as easily be wrong as right.
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> "As an alternative, I would like to cite the approach of a major mid-West pension plan whose director I spoke with last month. The return on the plan's equities over the last fourteen years, under the direction of this man and his predecessors, has been way ahead of the S&P 500. He shared with me what he considered the key:
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>> 'We have never had a year below the 47th percentile over that period or, until 1990, above the 27th percentile. As a result, we are in the fourth percentile for the fourteen year period as a whole.'
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> "I feel strongly that attempting to achieve a superior long term record by stringing together a run of top-decile years is unlikely to succeed. Rather, striving to do a little better than average every year -- and through discipline to have highly superior relative results in bad times -- is:
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>> - less likely to produce extreme volatility,
>> - less likely to produce huge losses which can't be recouped and, most importantly,
>> - more likely to work (given the fact that all of us are only human)."

What does all of this mean?

Remember Vanguard Dividend Appreciation Fund (VIG), which outperformed the S&P 500 Index from 2007-2016 but lagged it in seven of those ten years? We suspect that the Midwest pension plan that Howard Marks mentioned followed much the same investment pattern as did VIG – to keep a quality focus that massively protects in severely down markets, which come every five to ten years, and at other times stay ahead of the pack while perhaps not achieving index-beating results.

The Math

How can that Midwest pension fund's annual results never be better than 73 out of 100 or worse than 53 out of 100 of their peers and STILL rank above 96% of them after 14 years? The key lies in falling much less than peers in severely down times, while being well into the top third in good times. The plan's strategy surely was a lot like ours – lose less and there's not so much pressure to gain more.

So what?

Evaluating your account performance over one, two or even three years gives you very little helpful information IF the performance you are evaluating is always in the top half of peers and often near the top quarter. Remember that volatility is a drag on performance. This means that blowing out the lights on the upside one year is likely leading to no lights in the dark and down years.

Thank you for investing with us.

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[i] Special thanks to Ben Carlson of *A Wealth Of Common Sense*, who apprised me of the Howard Marks article quoted above in his blog of March 6, 2018, "Short-Term Outperformance vs. Long-Term Outperformance".

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