July 2016

The Price You Pay

"You make up your mind, you choose the chance you take
You ride to where the highway ends and the desert breaks
Out on to an open road you ride until the day
You learn to sleep at night with the price you pay"

- Bruce Springsteen, "The Price You Pay"

One of life's great conundrums, whether in the pursuit of happiness or alpha, is that near-term suffering is practically a prerequisite for a successful outcome. What is true for Mount Everest climbers, Ironman triathletes and diaper-changing parents also holds true for investors: fulfillment comes from following an uncomfortable and often indirect path rather than chasing a series of happy moments.[1] Only with steadfast conviction in their respective ethos can a climber, triathlete, parent or investor persevere through the valleys and stay on the winning course.

Mar Vista's path to happiness, at least in the investment realm, fixates on one pursuit: to provide long-term value for our investors by adhering to our set of guiding principles. If an active manager is unable to create economic value by producing risk-adjusted returns exceeding the opportunity cost of investor capital (i.e., the returns of passive benchmarks), the outlook for the business is not favorable.

The typical direct investment path – a myopic focus on near-term relative returns, risk-agnostic appreciation and high batting averages – routinely leads to disappointing long-term results. Conversely, an investor pursuing the indirect path typically suffers from the loneliness of being a contrarian, extended periods of underperformance, higher tracking error, poor batting averages and sitting on their hands during euphoric stock runs - all in the name of generating alpha. The experience can lead to mental distress but, as Berkshire Hathaway's vice chairman Charlie Munger has said, "Investing is not supposed to be easy. Anyone who finds it easy is stupid."

Mar Vista's unwavering process is guided by four simple principles:

- Stock prices follow intrinsic value over the long-term
- Intrinsic value is created when returns exceed the cost of capital employed
- Sustaining excess returns requires durable competitive advantages
- Capital preservation is equally important as appreciation

Note that our "indirect" approach to creating value ignores what style is in vogue or which sectors could outperform over short periods. Instead, we focus on barriers to entry, capital intensity, reinvestment opportunities, price relative to intrinsic value, as well as the probability and magnitude of permanent capital loss. The inevitable short-term anguish derived from owner-oriented thinking should, in the fullness of time, provide more capital at the end of our investors' time horizon while also dampening the magnitude of drawdowns.

[1] The concept of "indirect paths" to investing success was first brought to our attention five years ago by Lattice Strategies' Q2 2011 letter "The Indirect Path to Growing Capital" and their reference to the thought-provoking book *Obliquity*, by John Kay. We have replicated and updated certain of the publicly available S&P 500 historical data that Lattice Strategies also presented in their erudite and eloquent letter. Mar Vista owes a debt of gratitude to their team for the thoughtful research.

It is a mathematical truism that superior down capture in negative periods provides more capital for compounding in the ensuing positive periods. Using S&P 500® Index monthly total return data for the last thirty years, the chart below demonstrates the expansive value created by preserving capital in the down periods even with subpar returns in the positive periods. Each column shows the ending amount of capital with $100,000 invested in the S&P 500® Index over thirty and ten years with various combinations of monthly up and down capture.

Ending Capital with $100,000 invested in S&P 500 versus Monthly Up/Down capture series

		10% Mthly Up/Down Spread			20% Mthly Up/Down Spread			30% Mthly Up/Down Spread		
	S&P 500	100/90	90/80	80/70	100/80	90/70	80/60	100/70	90/60	80/50
30 Years (Jul '86-Jun '16)	$1,660,084	$2,728,834	$2,121,708	$1,637,532	$4,468,438	$3,461,281	$ 2,661,678	$ 7,289,673	$ 5,626,052	$ 4,310,947
Beta	1.00	0.95	0.85	0.75	0.90	0.80	0.70	0.84	0.74	0.65
10 Years (Jul '06-Jun '16)	$204,649	$243,983	$229,302	$214,981	$290,487	$272,649	$255,293	$345,401	$323,774	$302,782
Beta	1.00	0.94	0.84	0.74	0.89	0.79	0.69	0.83	0.73	0.63
Maximum 5Yr Drawdown [2]	-29%	-21%	-18%	-15%	-12%	-9%	-5%	-2%	2%	5%
1987-2005 Calendar Batting Avg[3]		100%	48%	34%	100%	69%	48%	100%	79%	52%

[2] The maximum capital decline over any 5 year period during the last 30 years.

[3] The percentage of calendar years that the monthly up/down series outperformed the S&P 500

We would highlight the following:

- The impact that a small 10% spread has on capital growth and risk is remarkable. Capturing 90% of the upside in positive months and 80% of its downside in negative months produced almost 30% more capital ($2.12m vs. $1.66m for the S&P 500) with 15% less volatility over the last thirty years.
- Over a shorter ten year period, a 90/70 spread enjoyed one-third more capital ($272k vs. $205k) and 20% less volatility (beta = .79).
- Better down capture lowers the risk of material capital losses should investors need their capital in the midst of a bear market. Over any five-year holding period during the last thirty years, the maximum drawdown for a 90/70 spread was -9% compared to -29% for the S&P 500.
- Batting averages are not the drivers of alpha-generation. An 80/60 spread had a poor 48% calendar year batting average since 1987 but ended up with 60% more capital ($2.66m vs. $1.66m for the S&P 500) with 31% less risk over the last thirty years.

Below is a comparison of the outcomes for a more conservative 90/70 manager to that of an aggressive 130/130 manager:

	90/70	130/130
30 Years (Jul '86-Jun '16)	$3,461,281	$ 3,336,228
Beta	0.80	1.30
10 Years (Jul '06-Jun '16)	$272,649	$241,898
Beta	0.79	1.29
Maximum 5Yr Drawdown	-9%	-40%
1987-2005 Calendar Batting Avg	69%	79%

While the more aggressive manager enjoys outperforming the vast majority of the months and only suffers in the infrequent down months, their investors lose over the long run. The conservative manager provides more capital at the end of both ten and thirty year holding periods with materially less volatility (beta = 0.79 vs. 1.29) and a meaningfully lower maximum drawdown (9% vs. 40%).

With that scenario, we are reminded of the following excerpt from Seth Klarman's legendary book *Margin of Safety*:

> *"An investor who earns 16% annual returns over a decade, for example, will, perhaps surprisingly, end up with more money than an investor who earns 20% a year for nine years and then loses 15% the tenth year. There is an understandable, albeit uneconomic, appeal to the latter pattern of returns, however. The second investor will*

outperform the former nine years out of ten, gaining considerable psychic income from this apparently superior performance. If both investors are money management professionals, the latter may also have a happier clientele (90% of the time, they will be doing better) and thus a more successful company. This may help to explain why risk avoidance is not the primary focus of most institutional investors."

Mar Vista's Commitment to Our Investors

Though there are never guarantees in investing results, the Mar Vista team remains committed to the foundations of our success:

- Focus on the process, not the outcomes
- Emphasize capital protection as much as upside potential
- Think like rational business analysts first, not traders of individual stocks
- Identify good capital allocators that think and act like *Outsiders*
- Exploit the manic-depressive nature of Wall Street
- Take concentrated positions when the expected returns relative to the risks are favorable
- Expand our circle of competence and latticework of mental models
- Align our economic incentives with our investors

As always, we appreciate the trust you have instilled in us as stewards of your capital. Our role as fiduciary is paramount to everything we do and open communication about how we are managing your capital is an important part of that responsibility.

Please let us know of any questions, comments or concerns you have. We look forward to the opportunity to discuss our investment philosophy and thoughts with you through these updates, conference calls and personal meetings. You can reach us by phone at 310.917.2800, via email at info@marvistainvestments.com or visit our website at www.marvistainvestments.com.

All the best,
The Mar Vista Investment Team