RGA INVESTMENT ADVISORS, LLC

March 8, 2013

February 2013 Investment Commentary

"Own competently managed, competitively advantaged businesses at discounted prices."

– Burton Malkiel

The month of February saw little change across the board in the major stock indices—The Dow gained 1.35%, the S&P 500 added 1.28% and the Russell 2000 rose 1.00%. The most notable moves happened in Gold markets, with the precious metal shedding 5.11%. Perhaps the most interesting element of the gold decline is the timing—happening exactly one year after Warren Buffett took to the public printing presses to tell the world "Why stocks beat gold and bonds."(1) Buffett described gold as the type of asset where "Owners are not inspired by what the asset itself can produce -- it will remain lifeless forever -- but rather by the belief that others will desire it even more avidly in the future." What instead does Buffett invest in? He seeks out assets that generate an actual cash return. We are often asked our perspective on gold, and equally often, whether we are Bullish or Bearish on the stock market. We think this February is a good opportunity to take a roundabout path to answering both questions.

If an asset does not produce an actual return of cash, then that asset is valued purely on supply and demand; with the demand component based predominantly on human judgment. As we know, human judgment is prone to many heuristic biases. As such, it's impossible to conceptualize a fair market price for a non-cash generative asset without a little voodoo.

When there is an actual cash flow, we have functional tools at our disposal to gauge a prospective fair value. Many elements of valuation analysis are subjective rather than objective, and art rather than science; yet, when cash is indeed flowing, we can ascribe something that resembles a fair value for the asset. In order to accommodate the subjective elements, we subscribe to the doctrine that "it's better to be roughly right than precisely wrong" in using conservative numbers. This helps us err on the side of caution, but we also take what we believe to be an important next step in mitigating the risks of subjectivity: we focus deeply on the quality of business on all levels.

One of the key steps in Warren Buffett's own evolution as an investor was shifting his focus from the so-called "cigar butts" (stocks that are of poor business quality, yet are trading below liquidation value) to quality businesses. Much has been written about this shift, and many attribute this epiphany to Buffett's investment partner, Charlie Munger. Munger himself discredits this notion, though we ourselves credit both Mr. Buffett and Mr. Munger extensively for shaping our investment process and philosophy.

In a speech entitled "The Art of Stock Picking," (2) Munger spoke at length about how he selects investments without ever discussing any technical tools of the trade. To Munger, the key to outstanding long-term results lies in the pursuit of "worldly wisdom" and the amalgamation of "mental models." Mental models are a collection of the big ideas from throughout history and across the many academic disciplines. Robert Hagstrom has summed up this perspective in a book aptly titled *Investing: The Last Liberal Art*. The key for the Buffetts, Mungers and Hagstroms of the world is to take a balanced, well-rounded perspective in building your tools of the trade, with an insatiable hunger for more knowledge.

To that end, we have built ourselves an extensive checklist in order to determine whether a potential investment fits the necessary criterion of possessing a discounted price, competent management, and a competitive advantage in business. Our checklist consists of sections on valuation, the balance sheet, management, competitive dynamics and qualitative factors, growth, ownership, possible catalysts, risks and explicit questions on our own behavioral biases. We want all of our portfolio investments to adequately meet our rigorous demands in each of these relevant sections. There are many who try and declare one key to buying stocks ready to go up. We think this is alchemy. Instead, we think THE key to identifying investment opportunities lies in robust, well-rounded analysis that seeks out a balance of quality across a variety of metrics, both subjective and objective, qualitative and quantitative. Clearly such an analysis of gold is futile.

The noise in the Bull vs. Bear debate seemed to rise substantially during the month of February, with an abundance of calls echoing that "The Next Great Bull Market" or that "The Next Top is Here." We think both perspectives miss the point. In the short-run, the answer is always a coin toss, and in the long-run the market only goes one way. The key question in answering Bull vs. Bear in the short or long run is how exactly you define your timeframe.

In *Investing: The Last Liberal Art*, Hagstrom discussed the topic of "sideways markets." Hagstrom highlights that "On October 1, 1975, the Dow…stood at 784. Nearly seven years later, on August 6, 1982, the Dow closed at the exact 784." In other words, markets went nowhere for years. Meanwhile, during this time period, Berkshire Hathaway generated a 676% cumulative return. This is the great Warren Buffett at work, and is not a suggestion that we at RGAIA can come close to accomplishing similar performance metrics, yet it does prove a very important point. Prudent long-term investors need not identify the next Bull or Bear market to earn a good return; rather, they must focus on buying into high quality cash generative assets that will withstand the tests of time, competition and inflation. Each and every position in our core portfolio is designed to meet these objectives.

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In our 2012 Investment Outlook (3), we featured compound interest as the goal of investment management by highlighting what kind of annualized return a long-term investor in equities earns. We highlighted patience alone as one of the greatest sources of wealth generation, for it rigs the Bull vs. Bear debate greatly in favor of owning stocks. Today we want to highlight the compounding effects of adding together patience and a focus on quality in the abstract sense. This combination is a powerful long-term force to be reckoned with in any discipline and is at the heart of our mission in serving your needs and goals here at RGAIA.

Warm personal regards,

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