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Driving Towards Greater Returns

Two roads diverged in a wood, and I—
I took the one less traveled by,
And that has made all the difference.

--Robert Frost, *The Road Not Taken*

Map and navigation apps have changed the way we experience driving and managing traffic. Not long ago everyone stored a map or two in their car glove box. Thanks to the proliferation of devices with GPS and social map applications (such as Waze and Google Maps), paper maps are a relic of the past. Historically, we had little way to gauge how long a trip should take with precision. We could examine anticipated mileage and assume some kind of average speed. Typically, we would say something like "it's about an hour trip" for anything that took over 45 minutes and under an hour fifteen. Today we know exactly which trips should take an hour, and we can even choose the best course based on current traffic patterns. Whether or not maps and direction apps fascinate you (as they do for some of us here), they provide interesting insights into how people operate and serve as a fun metaphor for unrelated but pertinent investment insights.

Let's say we have a goal of completing a one hour trip in 30 minutes with the secondary goal that we want effectively a 0% chance of finishing the trip in more than one hour. Assume that we can pick any route in the United States that can be measured by inserting a starting point and ending point into Google Maps where the estimated time with no traffic is exactly one hour. In effect, we would have to drive twice as fast as the implied trip-speed predicted by Google Maps, while assuming the risks associated with speeding, ranging from getting pulled over by an officer (which costs a lot of time and money) to a car accident (as higher speeds result in an increased risk of accident). Two separate one hour trips can vary quite significantly by geography, terrain, and road formation. One option may be an open road highway, with a consistent speed for the entire length, while another might be through a crowded urban artery with lots of merges, turns and varying speeds. As such, we have considerable flexibility in what kind of one hour trip we would choose. How would we try to accomplish our primary and secondary goals simultaneously?

Montana is a great place for exceptionally fast driving with some of the fairest (Ie. weakest punishment) for speeders. Montana is known as the Big Sky state because of its huge mountains and expansive horizon. Driving in this environment often feels as if there is nothing but blue sky ahead. Even while cruising at 85mph, it feels as if you're barely moving with a tapestry of mountain peaks fixed to the horizon though slowly growing or shrinking depending on your perspective. The state is a great place to drive fast and it would be a good candidate to avoid falling short of the one hour estimated time; however, it would be very challenging to find a good location to make a trip in half the estimated time. This is so because the speed limit in much of the state is sufficiently high enough that only a handful of cars can even reach speeds double that of the speed limit. Even with one of those few special cars that could go fast enough, it would be very challenging.

Montana's speed limits put the place right at the boundary of what is safely possible to accomplish speed-wise in the typical car today. To cut a one hour drive in half, we need to find somewhere we are 'assumed' to go much slower than we are actually capable of moving through. Some roads in heavily trafficked, urban areas have slow speed limits that are designed to accommodate the heavy merges and volume of cars that travel those areas, despite the road's capacity to potentially accommodate much faster speeds. We know of a few such roads in and around New York City with 25 mile per hour speed limits, where cars theoretically could drive upwards of 70 miles per hour for long stretches. Yet major slowdowns are all too common on these roads. Even at off times, you just never know when there will be a traffic jam, a lane closure, or simply too many cars on the road to move fast.

Ideally we would be able to find some relatively straight, open road with at least two lanes headed in our direction and a speed limit between 25 and 30 miles per hour, such that we could travel double the speed limit without testing the safety boundaries of our vehicle. Two lanes would be essential, for in a one lane road, it would only take one slow car at some point in the trip to make the one hour journey in thirty minutes an impossibility.

Driving double the speed limit in Montana is not too different from investing in some of the growth stocks in today's market. The fast growers are priced to grow exceptionally fast and as such, there is little opportunity over the long-run to get a return better than that which is implied by the market's expectations. These stocks are effectively suggesting there is nothing but blue sky straight ahead -- the slightest storm cloud could seriously impair value.

This game we outlined was crafted to be similar to investing. Think of the expected time as beta, and the quest for exceeding it as alpha. Further, think of the demand that we do not fall short of beta as a form of risk management—an insistence that our vehicles at least give us what is there to be taken. We aim to find these ideal conditions within our investment framework by focusing on value and effectively managing risk. These are principles we discuss in greater depth in our Investment Strategy Overview.[1] To us, intrinsic value is not defined by a single price, but rather a range of possible outcomes that correspond to a business' true worth from the owner's perspective. To this end, we conduct extensive fundamental analysis in order to fully understand what the market is implying about a company with regard to its cash flow yield, growth, and cost of capital over time and the business' competitive position in its industry. After we have gained adequate comfort within our assessment of a given security's value, we test and retest any assumptions underlying our quantitative and qualitative analysis as time marches on. This approach enables us to contextualize a business over a long horizon and enables us to operate with a very long-term focus while the market harps on what will happen one or two quarters out in a given stock. We aim to stay out of the fast-lane in Montana despite how nice the scenery can be – we know better than to push our vehicles beyond the boundaries of their constructs, especially with the knowledge that a quick storm cloud can quickly turn a perfect ride into a disaster.

The heavily trafficked roads in urban areas are not too different from the indexation philosophy taking over the investment world today. Everybody's doing it! When all are doing the same thing, (think of the Cross Bronx Expressway, which is anything but express) it doesn't take much for an otherwise simple drive to devolve into a traffic mess. One car jamming the breaks too quickly can ripple into a slowdown for miles, or worse yet, a domino-like multi-car accident. With so many people piling into index strategies, we worry that if a few big players start to leave the act can ripple into a much larger flight from indexation.

To that end, we think it is best to take road that is "the one less traveled" and focus on areas that the market today is overlooking – the less congested, back-road opportunities. We can focus on areas we know the market does not favor today, as suggested by our multi-year interest in Europe or our appreciation for stocks that do not fit neatly into the cookie-cutter labels the market assigns. In our August 2014 investment commentary we discuss indexation in contrast to our 'actively-passive strategy.'[2] It is worth considering contrarianism (again) in this context:

> "A market truism that persists over time is how when everyone does something (aka when something becomes conventional wisdom) it is exactly the time to do the opposite. The corollary is that when everyone ignores something is the time to be doing that very thing. The rise of indexing itself is one of the bigger factors creating opportunity in today's investment landscape. This does not mean that the non-indexer

[1] http://www.rgaia.com/investment_strategy/

[2] http://www.rgaia.com/august-2014-investment-commentary-indexation-creates-opportunity/

can beat indices in each and every timeframe, whether large or small, but it does mean that over the long-run non-indexers can put themselves in position to both earn the cost of capital of the asset class (essentially the average long-term return of the indices) and gain exposure to factors which with prudent analysis can lead to increased upside."

Thank you for your trust and confidence, and for selecting us to be your advisor of choice. Please call us directly to discuss this commentary in more detail – we are always happy to address any specific questions you may have. You can reach Jason or Elliot directly at 516-665-1945. Alternatively, we've included our direct dial numbers with our names, below.

Warm personal regards,

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