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NEWSLETTER

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NEWS OF PEABODY RIVER

In this issue, I am forgoing my usual essay on investment theory, and instead presenting a discussion of Peabody River Asset Management's investment performance through the end of 2010. This seems a good point in the firm's history to take stock of how we're doing, in the narrow sense of investing for a good return for our clients. In our next issue, I will resume my series of essays that explore the concepts that underlie the practicalities of investing, with an attempt to work out what the return on the stock market will be as we look far into the future, and what the risk associated with my forecast may be. That essay will provide concrete values to which I can anchor the succeeding essay, on why we invest at all and on investors' ability to tolerate risk.

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BRIEF REVIEW OF 2010

The U.S. stock market ended the year up 15.06% (measured by the S&P 500 with dividends reinvested). The U.S. bond market had a return of 6.54% (as measured by the Barclays Capital Aggregate Bond index), almost the same as in 2009. The stock market's return was a few percentage points higher than the average annual return, but pretty much in the middle of the range of experience, as you can see from the chart, below. The summary figure, as usual, masks quite a bit of variability within the year. There was a sharp fall in the stock market from April through the end of June, but there has been a nearly continuous rise since the start of September.

						2010	2009				
						2006	2001				
						2004	1999				
				2000	2007	1988	1997	2003	1997		
				1990	2005	1986	1993	1999	1995		
				1981	1994	1979	1992	1998	1991		
				1977	1993	1972	1988	1996	1989		
				1969	1992	1971	1985	1983	1985		
				1962	1987	1968	1982	1982	1980		
				1953	1984	1965	1978	1976	1975		
				1946	1978	1964	1977	1967	1955		
			2001	1940	1970	1959	1964	1963	1950		
			1973	1939	1960	1952	1963	1961	1945		
		2002	1966	1934	1958	1949	1955	1951	1938	1958	
	2008	1974	1957	1932	1948	1944	1934	1943	1936	1935	1954
1931	1937	1930	1941	1929	1947	1926	1927	1942	1927	1928	1933

-60 -50 -40 -30 -20 -10 0% 10 20 30 40 50 60 70

Returns %

Despite pundits' continuing forecasts of disaster in the bond market, the returns to bonds were actually somewhat above average. (Remember that when interest rates rise, mathematics requires that bond prices fall, resulting in a lower return; interests rates for U.S. bonds in aggregate did not rise over the year.)

The rest of the world's stock markets were up 11.15% (in dollar terms), but emerging markets' stocks were up 18.88% (also in dollar terms, as measured by the MSCI Emerging Markets Index). And this year's winner among the competing markets was the sector of the U.S. market that consists of the stocks of small companies; these were up 26.14% (as measured by the S&P 600 Index). This sector has a very good long-term record, and we always allocate a significant portion each client's stock portfolio to it, and especially to the sub-sector of small companies that have so-called "value" characteristics, which has an even better long-term record.

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NOTE: PEABODY RIVER'S INVESTMENT PERFORMANCE THROUGH 2010

I am often asked what the investment performance of Peabody River Asset Management has been. This is a fair question, but the answer doesn't come easily. There are usually several implicit assumptions behind that question, and both the calculation and the interpretation of the numbers that would ostensibly settle the matter are very tricky. I will attempt a cautious and provisional answer.

There was a time, decades ago, when many investors never thought even to ask a question like this, and worried only if their advisor's (or the market's) investment performance led to a loss of value. They would be satisfied as long as the dividends and interest payments rolled in, and they didn't notice if the *total* return, when price change as well as income was taken into account, was small or even negative. There are still some investors who think this way.

Since the 1960s, though, nearly all investors have learned, perhaps under the tutelage of Wall Street and the mutual fund companies, perhaps by from the financial press, to care about their advisor's performance relative to a benchmark. Most commonly, they want to know if the manager (of their account or of their mutual fund or funds) beat the S&P 500, a popular measuring rod for the stock market as a whole. (The venerable Dow Jones 30 Industrials index, although it still leads the news reports and generally gets the market's direction right, isn't a good benchmark for performance, because it is peculiarly constructed and, containing as it does only 30 stocks, isn't a fair representation of the stock market.)

The first of many problems with measuring against the S&P 500, though, is that it represents only stocks, not other asset classes, like bonds, which have performed and should be expected to perform very differently. Investment advisors invest in bonds to generate income and to control risk. No investment advisor invests in ordinary bonds with the intention of beating the return of the S&P 500 over the long term, because our usual expectation is that the total return on bonds (the income plus the change in price) will be less than the total return on stocks. That it hasn't turned out that way in much of the recent past is a reflection of the greater risk inherent in stocks, but it doesn't follow from this that the reasoning behind the expectation for bonds is wrong.

Consequently, it doesn't make sense to evaluate against the S&P 500 a portfolio that comprises both stocks and bonds. Because of the way Peabody River invests for its clients, by allocating the invested money among stocks and bonds (and other kinds of assets) in varying proportions for the purpose of mitigating risk, the S&P 500 is the wrong benchmark for our aggregate firm-wide performance. Our different accounts hold differing proportions of stocks and bonds.

But it might be reasonable to ask what our aggregate firm-wide performance has been for stocks only, over the roughly three and a half years that the firm has existed. Unfortunately, because of various technical problems that would be too tedious to describe here, our accounting system doesn't allow us to produce this number.[1] But I have another way of coming up with a performance number.

For each account that Peabody River manages, I have calculated, from the beginning of our management responsibility through December 31, 2010, the total return to just the stock holdings of the account, net of our management fee.[2] I have calculated the performance of the S&P 500 over the same span of time. I have annualized these numbers, so that they are in terms of total return per year. Then I have subtracted to find the difference. Finally, I have averaged the differences for all the accounts.[3]

And so, to answer the question about Peabody River's investment performance:, from June 30, 2007, to December 31, 2010, the average difference in annualized return performance between *all* the stocks in our accounts and the S&P 500 was -0.35%. That's a loss.

But wait! This is unfair to Peabody River, because one of the accounts in our care is unable to take advantage of our investment advice. This account (which happens to hold mostly stocks), comprises only stocks that were purchased decades ago. It is a taxable account, and if I were to sell the stocks,

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[1] I've spoken with the company that produces this software, and they've told me that they are working on a solution.
[2] Because the software allows me to do this for individual accounts, though not for the aggregate.
[3] I am also excluding cash. Standards of performance presentation require the allocation of some proportion of cash to a "breakout" account, like the stock portion we are evaluating here. Normally, Peabody River keeps cash allocations within an entire portfolio very small, so its drag on performance is negligible.

my estimate is that the client would immediately lose nearly 10% of the account's value to capital gains taxes. In short, I have hardly any room to maneuver in managing this account, and it very significantly underperformed the S&P 500 in the five and a half months it has been with us (though it still went up). This reflects, not our skill in managing stocks, but our judgment in taking account of taxes in managing the portfolio. So it is appropriate to exclude this account from the average.[4]

When I exclude this one account, then, **from June 30, 2007, to December 31, 2010, the average difference in annualized return performance between the stocks in our accounts and the S&P 500 was +1.93**%. In other words, on average, the stock-only portions of the accounts that Peabody River manages have added 1.93% per year to the return of the S&P 500 after payment of fees. That's very good.

Those readers who remember that Peabody River does not pick individual stocks, and that we believe in the benefits of broad diversification, may wonder how we can beat the S&P 500. The answer is simple: We don't try to replicate the S&P 500. We allocate among both international and domestic stocks, and we emphasize the stocks of small companies and so-called "value" stocks (stocks that by simple measures appear undervalued when compared with the rest of the market). The S&P 500, in contrast, is representative of only large U.S. companies. We believe that our stock allocations will continue, over the long term, to do better than the S&P500.

I must caution you about these numbers.

First, there is the traditional warning that past performance is not a guide to future performance. In our case, Peabody River Asset Management is a new firm and our record of three and a half years is very short, so there isn't much past performance to guide you. Moreover, if, as I am sure will happen sooner or later, the S&P 500 performs better than the foreign stock markets and better than the stocks of small companies, our figure for added return may well turn negative, especially if this happens just as we're adding new accounts and their results are averaged in. (Remember that in the methodology I just used, the length of time each account has been with us is irrelevant; we are not necessarily—indeed, we are hardly ever—looking at similar spans of time; and all the figures are annualized.)

All the same, I am confident (though I could be wrong) that by allocating among these different groups of stocks, including the stocks of large U.S. companies, we will, in the long run, produce a higher return than we would by putting all our clients' funds into an index fund tied to the S&P 500.

Second and third, there are two very minor qualifications to this performance report: Although the stocks are weighted by their proportions within the portfolios, the portfolios are given equal weight in the average, rather than being weighted by size. Although this is not best practice within the industry, it does provide a fair representation of the typical portfolio. Also, the performance number doesn't include master limited partnerships, which I consider to be a kind of stock, but our portfolio accounting system does not (nor do some other investment advisors).

[4] It is normal for an investment management firm to exclude from its gross performance figures any account that, like this one, does not reflect its investment judgment. Our profession's standards for reporting performance explicitly make provision for such exclusions.

Fourth, I never miss an opportunity to remind my readers that whenever you think of return, you must give due consideration to risk, and this suggests a last caution:

I did not present a figure for risk along with Peabody River's return increment for stocks. That's because it would have been much too difficult to compute a risk statistic that would correspond to the return figure. If I could find a practical way of computing some measure of the risk, I'd present it. You should be chary of anyone who boasts of good returns without presenting the concomitant investment risk. My guess—and it's only a guess—is that by one simple measure of risk, volatility, our stock holdings are a little more risky than the S&P 500. That's because, although we're more diversified than the S&P 500, which should lower risk, the stocks of small companies and so-called "value" stocks tend to be much riskier than the S&P 500, to a degree that on balance adds some risk to the stock portfolios.[5] But we are here considering only the stock holdings of our clients' portfolios, and as I've already said, Peabody River mitigates investment risk by blending in other asset classes. The risk of only a portion of the portfolio is a relatively minor concern, which is why, similarly, the risk of a single stock is of only small concern if it's part of a diversified portfolio that holds many stocks. What matters to the investor is the risk of his or her portfolio as a whole.

I will have more to say about asset class diversification, which is the use of multiple asset classes, like stocks, bonds, real estate, and commodities, in a future essay on portfolio construction, but because we're now considering Peabody River's investment performance, a word about our experience with asset class allocation would not be out of place.

One of our first accounts had its inception near the beginning of January 2008, when the market had declined a bit from its recent peak, but the financial crisis was still gestating and unborn. At the time, I determined that the time horizon of this client was very roughly five years, which is quite short. It therefore seemed prudent not to risk too much of the portfolio on stocks, and to control investment risk with a large measure of bonds. (Some professionals might think that with such a short time horizon, it would have been better just to save the money in the bank, but this client wanted to invest.) The client has recently cashed out the account, after just three years, so my estimate of the horizon, though short, wasn't short enough. Nonetheless, I returned more money than the client had invested, the account having earned an annualized total return of +1.18% after fees. If it had been invested entirely in the S&P 500 (and paid our management fee), it would have earned an annualized total return of -2.20%.

Now, to some extent, there was luck in this. The portfolio was down by 21% at the depth of the market's decline (after fees), which was much worse than I'd have hoped it would be in a crisis, but the S&P 500 was down 50% (with no fees) over the same span of time. All the same, the asset class allocation did mostly as I intended for these few years, which was to preserve the value of the account through times of trouble. This example demonstrates that, contrary to what many think, moderating investment risk does not necessarily result in a lower return. In a financial crisis, or even over a long stretch of declining market values, a portfolio properly designed to have less risk than the stock market will have a higher return. That's the whole point of moderating risk. Naturally,

[5] If I could do so easily, I'd calculate the monthly standard deviation of the stock portion of each of our accounts, annualize it, then find the ratio of annualized return to the annualized standard deviation of return. I'd do the same for the S&P 500 for the same span of time. I'd divide the ratio for the account by the ratio for the S&P 500, and average the ratios across accounts. An average greater than 1 would suggest that we're producing more return than the S&P 500 for a given level of volatility, and a number less than 1 would suggest the opposite.

though, if this account were to have stayed with us over the long term (yet we continued to manage it on the assumption that it might be cashed out soon), the likelihood, though not a certainty, is that it would have had a lower return than the stock market.

Let me return, finally, to the account that I excluded from my performance calculation, because it teaches an important lesson. If I were to sell all the stocks in that account and to buy the investments I prefer, the value of the account would, as I said before, likely decline by close to 10%. *But this decline would never show up in my performance report.* That's because the normal (and usually correct) way of reporting investment performance is unaffected by contributions and withdrawals. For example, if you first give me $100,000 to manage, and then, near the end of the year, you give me another $100,000 to manage, I shouldn't be credited with doubling the size of your account, nor should I be blamed for a 50% decline if, instead, you withdrew $50,000. If I were to cost my client 10% of the account in taxes, this might show up as a withdrawal from the account, or it might not even show up there, if the client were to pay his tax bill by writing a check on his existing bank balance. It would not affect Peabody River's performance number. Yet the tax cost matters, and I'd be responsible for it. Nearly all performance numbers that you see for an investment manager, mutual fund, or hedge fund do not reckon in the cost of taxes. They are overestimates of the returns that you would have earned on a taxable account.

So, although I am pleased with Peabody River Asset Management's investment performance so far, I warn that you should approach all performance numbers as a skeptic. I am not questioning the honesty of my investment peers; there are standards for the calculation and presentation of investment performance, and I am confident that published figures are nearly always correct. But they may not be as they seem. An investor has to learn to read performance reports critically and, if there's anyone to reply, ask questions.

The numbers I presented here for Peabody River took some effort to calculate. I intend to make another report in a year, but I cannot promise that, as Peabody River adds accounts, I will continue to have time for the effort needed to work out our stock performance.

Adam Jared Apt, CFA

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