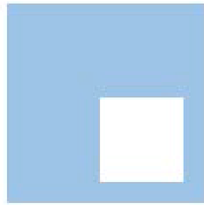

ATR Advisors

ABSOLUTE TOTAL RETURN
THIRD QUARTER 2013 COMMENTARY

By: Shawn Blau, PhD

FIVE YEARS AFTER THE FINANCIAL CRISIS

The 3rd quarter of 2013 marked the 5th anniversary of the most climactic moment of the Global Financial Crisis. Back on September 15, 2008, at 1:45 AM, early on that Monday morning, Lehman Brothers filed for Chapter 11 bankruptcy protection. It represented the largest bankruptcy filing in US history. Because of the interconnected nature of modern finance, the Lehman bankruptcy created a financial chain reaction, which led to a financial collapse around the world – the worst since the Great Depression of the 1930's. We are still feeling its effects five years later.

Having reached this five year anniversary, it helps to look back, and see how far we've come. In general, financial assets have recovered well – although it has been a rocky ride for most! The S&P 500 went from 1251.70 on the Friday before the Lehman bankruptcy, all the way down to 676.53 on March 9, 2009 – a stunning loss of 54% for the SP 500 Index. But, due to unprecedented action by governments and central banks around the world, the market turned around in March of 2009. And on September 18, 2013, the S&P reached a new high of 1725.52. For the ATR strategy, our own clients have prospered during the past five years.

Why has our ATR strategy been able to protect the wealth of our clients so well? I think it is because we focus on a different aspect of corporate finance than most of our competitors do. Most of our competitors focus on quarterly earnings, and try to identify firms that can grow those quarterly earnings rapidly. However, in the Great Recession this focus on earnings proved self-defeating. After Lehman's collapse, earnings fell through the floor, and took years to recover.

Our focus was – and is – different. We focus on what companies actually do with the cash they have under their control. CEO's of publicly traded companies control a vast amount of cash (trillions of dollars), and they have enormous personal discretion on what they choose to do with it.

In general, company CEO's have five different ways of deploying the capital they control:

1) Investing in existing operations;
2) Acquiring other businesses;
3) Paying down debt;
4) Paying dividends and or other cash distributions to shareholders;
5) Repurchasing their own stock.

We have found that in general, those companies that demonstrate a long-term commitment to options #4 and #5 above, do better by their shareholders over the long run than other firms do. And, in general, this "shareholder friendly" management is eventually reflected in the share price of their stocks.

So we have worked for the past decade on identifying and monitoring firms that can reliably deploy their cash in regular cash distributions to shareholders, and in steady reductions in the number of their outstanding shares via consistent repurchases of their own stock. This means that no matter what happens to the market in general, our clients will still get their stock dividends, their partnership cash distributions, and an increase in their ownership of their companies via stock buybacks. This is a comforting position to be in.

This rigorous focus on what companies actually DO with the money they control, has allowed our clients to weather the worst financial storms, and to steadily grow their wealth.

<u>How we monitor our own internal progress</u>

Since our strategy is designed to be an "absolute return" strategy, which seeks to preserve and increase wealth even when the stock market goes down, several very astute clients have asked us how we monitor our own progress, internally.

Well, we focus on trying to achieve yearly increases in what we call "Investor's Growth" for every single position in our portfolio. In general, for every stock we own we define "Investor's Growth" of that stock as:

1) One year's change in the book value of the stock owned by the investor; plus
2) One year's total of cash returned by the stock to that investor.

We have found, that over the long-term if we succeed in growing each position's intrinsic "Investor Growth", eventually the market will recognize that intrinsic growth, and stock prices will catch up.

Thus, even if a particular stock were to pay a very high percentage of cash back to the investor, that still wouldn't be of long-term value, if they put that investor's book-value at risk. So we look for increases both in dividends/distributions, and also in the net asset value of the stock itself.

A very good example, is our recent experience with residential mortgage-REIT's that invest in US Agency mortgage-backed securities. Although they continued to pay very high dividends, we learned that they were doing this at the cost of not hedging their portfolios sufficiently against

rises in interest rates. As a result, we had to cut back this sector substantially, and replace it with better total-return investments.

How Warren Buffett monitors performance

Fortunately, the question of performance was addressed by the world's greatest investor, Warren Buffett, in his most recent 2012 Letter to Shareholders. I quote:

"For the ninth time in 48 years, Berkshire percentage increase in book value was less than the S&P's percentage gain (a calculation that includes dividends as well as price appreciation). ...

To date, we've never had a five-year period of underperformance, having managed 43 times to surpass the S&P over such a stretch....

It's our job to increase intrinsic business value – for which we use book value as a significantly understated proxy – at a faster rate than the market gains of the S&P. If we do so, Berkshire's share price, though unpredictable from year to year, will itself outpace the S&P over time. If we fail, however, our management will bring no value to our investors..." (Berkshire Hathaway, Inc. 2012 Shareholder Letter, Page 3)

We endorse Warren Buffett's methodology completely. We use the exact same approach in assessing the performance of our own ATR strategy.

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