NOESIS
Capital Management

A Global Perspective Focused on You

October 15, 2012

Dear Client:

As we enter the final quarter of 2012, we acknowledge that there is an elevated level of uncertainty ahead of us. Just to name a few issues: the presidential election and "fiscal cliff" in the U.S., a leadership transition in China, geopolitical uncertainty in the Middle East and East Asia, questionable solvency in Southern Europe and a weakening economy in the Eurozone. Despite this, stock markets worldwide have continued to rise, leading to an increasingly unstable situation. In an August 11 *New York Times* interview, Vanguard founder John Bogle warns of this development:

> "It's urgent that people wake up," he says. Why? This is the worst time for investors that he has ever seen – and after more than 60 years in the business, that's saying a lot.

As we have commented in recent quarters, we continue to believe stock markets look much more attractive than bond markets. With further quantitative easing sponsored by the Fed, European Central Bank, and Bank of Japan, many investors can no longer afford to accept low interest rates and have switched their attention to buying into dividend-paying stocks. Among the worldwide markets, the U.S. stock market still seems like a safe harbor and the preferred choice of global investors. Interestingly, hedge funds have been underperforming the S&P 500 so far this year and fund managers are rushing to buy stocks. This recent run has caused risk levels to rise due to higher stock valuations.

That being said, high cash levels in portfolios worldwide and relatively healthy corporate balance sheets may soften any blow to stock prices. At Noesis, we continue to make our investment decisions based on company fundamentals and valuation, instead of timing markets, as we believe they are the primary drivers of long-term investment success.

**<u>The Most Important Thing</u>**

During this quarter, I read *The Most Important Thing – Uncommon Sense for the Thoughtful Investor* by Howard Marks. This turned out to be one of the best investment books I have ever read. I strongly recommend it to all serious investors and believe we should discuss some of his key points here, as the investment philosophy and thought process at Noesis is similar to his in many aspects. Warren Buffett said it best: "When I see memos from Howard Marks in my mail, they're the first thing I open and read. I always learn something, and that goes double for his book."

Howard Marks is the Chairman and co-founder of Oaktree Capital Management, an investment firm with $80 billion in assets under management. According to Mr. Marks, his foundation was built through two great business schools: nuts-and-bolts fundamental analysis at Wharton School and a theoretical, quantitative education at the University of Chicago, the birthplace of the efficient market hypothesis. Armed with such a unique background, he focuses his research on inefficient markets, value investing, risk management and a bottom-up approach.

In this book, Marks presents all “the most important things” regarding investing he has said to his clients and prospects over the years.

**Understanding Market Efficiency (and Its Limitations)**

Marks states that, “Because investors work hard to evaluate every new piece of information, asset prices immediately reflect the consensus view of the information’s significance. I do not, however, believe the consensus view is necessarily correct.”

He then gives the example of Yahoo!, which traded at $237 in January 2000 and $11 in April 2001. “Anyone who argues that the market was right both times has his or her head in the clouds; it has to have been wrong on at least one of those occasions,” he argues. His point is that market efficiency applies only to certain markets, certain asset classes, and to a certain degree during a certain period.

Marks also questioned the legitimacy of most celebrated investors, as they are rated relative to each other and most of them have no true long-term records to be considered statistically significant. “The fact that the Warren Buffetts of this world attract as much attention as they do is an indication that consistent outperformers are exceptional,” he writes.

Keeping these limitations in mind, he prefers investing in inefficient markets to analyzing economies or stock markets.

**Value**

There are two principal schools of investing, Marks says: value and growth. “Value investors buy stocks out of conviction that the current value is high relative to the current price,” Marks explains, and “growth investors buy stocks because they believe the value will grow fast enough in the future to produce substantial appreciation.” However, he clarifies, “there is no bright-line distinction between value and growth; both require dealing with the future. It’s all a matter of degree.” Marks’s approach is to focus on value, believing that consistency trumps drama.

Value investing has the potential to consistently produce favorable results, he says, but he also admits that it isn’t easy: First, “it depends on an accurate estimate of value.” Second, you have to “hold it firmly.” “You’ll often find that you’ve bought in the midst of a decline that continues,” Marks writes. “If you liked it at 60, you should like it more at 50…and much more at 40 and 30. But it’s not that easy. No one’s comfortable with losses…”

The bottom line, he writes, is that “an investment approach based on solid value is the most dependable. In contrast, counting on others to give you a profit regardless of value – relying on a bubble – is probably the least.” His point, allow me to repeat, is that factors other than value are hard to depend on and thus we should focus on valuation.

**Risk**

Marks stresses the concept of risk-adjusted return: "Return alone – and especially return over short periods of time – says very little about the quality of investment decisions. Return has to be evaluated relative to the amount of risk taken to achieve it."

Importantly, he disputes that "bearing higher risk produces higher returns." He writes, "The market has to set things up to look like that'll be the case; if it didn't, people wouldn't make risky investments. But it can't always work that way…because if riskier investments could be counted on to produce higher returns, they wouldn't be riskier. Whereas the theorist thinks return and risk are two separate things, albeit correlated, the value investor thinks of high risk and low prospective return as nothing but two sides of the same coin, both stemming primarily from high prices." Again, his view of risk mainly stems from prices.

**Awareness of the Pendulum**

Marks claims that investment markets follow a pendulum-like swing between:

- Euphoria and depression
- Celebrating positive developments and obsessing over negatives
- Overpriced and underpriced
- Greed and fear
- Optimistic and pessimistic
- Risk tolerance and risk aversion

He stresses that "The oscillation is one of the most dependable features of the investment world…But just like the oscillation of cycles, we never know:

- How far the pendulum will swing in its arc
- What might cause the swing to stop and turn back
- When this reversal will occur
- How far it will then swing in the opposite direction."

**Contrarianism**

Like Warren Buffett, Marks says the key to ultimate success lies in doing the opposite. He explains that market movements are driven by the actions of "the crowd," "the herd" or "most people." Bull markets occur as more people want to buy than sell. Eventually, a top occurs when the last potential buyer enters. At that point, bullishness can go no further and the market is as high as it can go. As soon as anyone switches from buyer to seller, it will start to go down. As you can see, the extremes are created by the crowd/the herd/most people and they are all proven wrong over time.

"Therefore, the key to investment success has to lie in doing the opposite: in diverging from the crowd. Those who recognize the errors that others make can profit enormously through contrarianism."

However, the problems associated with being a contrarian are:

- "Much of the time there aren't great market excesses to bet against."
- "Markets can be over- or underpriced and stay that way – or become more so – for years." That can be extremely painful.

- From time to time, “contrarianism itself can appear to have become too popular, and thus contrarianism can be mistaken for herd behavior.”

Therefore, we cannot react just because we want to be the opposite of what the crowd is doing. We have to know why the crowd is wrong.

**Patient Opportunism**

Unfortunately, there aren’t always great things to do between extremes. Marks suggests a few possibilities:

- Invest as if it’s untrue – It doesn’t make sense.
- Invest anyway – trying for acceptable relative returns under the circumstances.
- Invest anyway – ignoring short-run and focusing on the long run. This makes some sense, as long as clients are happy.
- Hold cash – it’s tough to meet client’s expectation.
- Concentrate investments in “special niches and special people” – It makes sense but difficult to do.

The fact is that there is no easy answer. Marks suggest that patient opportunism – waiting for bargains – is often the best strategy.

**Knowing What You Don’t Know**

Marks is firmly convinced that

- It’s hard to know what the macro future holds
- Few people possess superior knowledge of these matters that can regularly be turned into an investing advantage.

On the contrary, he believes that the more we concentrate on micro issues such as corporate fundamentals, the more it’s possible to gain a knowledge advantage.

As always, we are grateful for the trust you have placed in us as well as the opportunity to serve you.

We are getting settled into our new home office in Boca Raton and believe this move will further improve our productivity and the level of service we provide to each of you. We would welcome your visit—just give us a call to schedule a time to stop by.

Best Regards,

Joseph Lai, CFA
Chief Investment Officer

*Our most recent Form ADV, Part II is available upon request*