Portfolio Manager Commentary

"I will gladly pay you Tuesday for a hamburger today"

MOATX
CASTX

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MARKET COMMENTS

"Deviating too far from consensus leaves one feeling potentially ostracized from the group, with the risk that one may be terminated."

-- Robert Shiller

In October of 2013, Robert Shiller won the Nobel Prize in economics for his research on spotting market bubbles. Shiller, an economist and professor at Yale University who accurately predicted the housing bubble, is a pioneer of behavioral finance, or the understanding of how psychology causes us to act irrationally with our money. From 1990 to 2004, Shiller sat on the economic advisory panel of the Federal Reserve Bank of New York, an institution powerful enough to have prevented the housing bubble by raising interest rates. Despite Shiller's status as a highly regarded economist and his conviction that the situation was perilous, he found himself alone in his opinion: *"I felt the need to use restraint,"* Shiller said. *"The consensus in the group was that there was no bubble and no need to raise interest rates. To suggest otherwise was distinctly uncomfortable. I made my point very gently, and felt vulnerable expressing such quirky views."* Shiller summed up his experience: *"Deviating too far from consensus leaves one feeling potentially ostracized from the group, with the risk that one may be terminated."*

The word "groupthink" was first definitively used in a 1972[1] study showing how seasoned professionals working in their respective field of expertise tended to follow each other off a cliff toward bad decisions. The study concluded that it does not

[1] Janis, I. L. (1972). Victims of Groupthink: a Psychological Study of Foreign-Policy Decisions and Fiascoes. Boston: Houghton Mifflin

matter how much experience or education one has in a subject—most people are hardwired to follow the crowd. One of the ironies in investing is while almost everyone believes that they are a contrarian, almost no one actually behaves as a contrarian. One eventually learns that everyone is behaving in similar fashion. What people see as a contrarian view can actually be groupthink, as it is rare that someone can remain blissfully content when everyone else around them thinks they are crazy. Notably, the Fidelity Contrafund (Ticker: FCNTX), one of the largest equity mutual funds in the world, implies "contrarian" in its name. Yet the Fidelity website notes that as of February 28, 2014 the Fidelity Contrafund counts among its largest portfolio positions companies such as Google.com, Amazon.com, Priceline.com, and Salesforce.com. In our opinion, these are not contrarian positions.

In 1951, Solomon Asch, a social psychologist, brought together a group of students in a study[2] and asked them to solve a set of problems. These were simple problems with obvious answers, such as whether two lines were the same length. However, several of the students were actors hired by Asch and purposely gave the wrong answers in front of their peers. Asch repeated the study with varying numbers of actor-students calling out the wrong answers. As a result, just one in four consistently gave the right answer when their acting peers disagreed with them.

When everyone around gives an obviously wrong answer, we tend to second-guess ourselves for fear of embarrassment. Our natural desire to conform can undermine our rationality.

We recall the story of an investment professional that, as a student studying for his MBA, had an interview in early 2000 for a sell-side analyst job at a large Wall Street bank. The interviewer asked the candidate how he would value Amazon.com. The candidate answered frankly that he had no clue, because it was too difficult with far too many uncertainties. The interviewer looked at him as if he was stupid or did not want the job, or perhaps both. Sensing that his chances for a job were slipping away, the candidate gave the answer that the interviewer possibly wanted. He stated that it would be proper to plug current trends (population, penetration, growth rates, margins, etc.) into an Excel spreadsheet and assume that everything is going to keep growing at the same pace for the next ten years. (Naturally, company management will execute perfectly and therefore there is no need to factor any uncertainty into one's financial model.) Not surprisingly, the candidate did not get the job, but the experience provided valuable insight on how Wall Street operates with an implied conformity. One would think that we have learned from our collective experiences in the market crashes of 2000 and 2008, but groupthink is a powerful aphrodisiac.

"Keep calm and remain optimistic" continues to function as the prevailing market groupthink. Five years and counting, equity markets continue to push higher and reaffirm this collective confidence. The combination of higher stock prices and a rebounding housing market have boosted American household net worth to record levels, but this blissful state masks the market's underlying investment risks. Most notably, the Federal Reserve must eventually exit from its expansionary monetary policies, zero interest rates, and quantitative easing programs that they have used to engineer an economic recovery since the 2008 credit crisis. However, the size of the Federal Reserve's monetary intervention complicates the difficulty of any monetary exit. The United States currently operates with a $640 billion budget deficit, augmented by $1 trillion in central bank monetary liquidity, in order to create about $300 billion in annual economic growth.

Globally, the balance sheets of the world's major central banks have expanded from about $5 trillion to more than $18 trillion in the last five years, as central bank activity represent approximately 25% of economic output for many developed countries. As a result, we believe that zero interest rate and quantitative policies have materially increased investment risks. Low rates allow both

[2] Asch, S. E. (1951). Effects of group pressure upon the modification and distortion of judgment. In H. Guetzkow (ed.) Groups, Leadership and Men. Pittsburgh, PA: Carnegie Press.

companies and countries to maintain or increase their borrowing rather than reducing their debt levels. Low rates also encourage levels of debt and investment activity that would be unsustainable in any normalized interest rate environment. Investors are experiencing a false sense of comfort, as these misguided policies allow markets to continue operating as Wimpy from the cartoon Popeye did: ***"I will gladly pay you Tuesday for a hamburger today!"***

During World War II, the British Royal Air Force (RAF) undertook a plan of misdirection to allow a squadron of bombers to approach an exceptionally valuable target in Europe undetected. The target was heavily guarded and any hope for success in destroying it required more than the usual degree of surprise.[3] Although the British RAF had the means to jam the electronic detection of their aircraft along the route to the target, they feared that jamming the German radar signals would alert the Germans and reveal their actual intentions. Their solution was to train the German personnel responsible for detection to believe something that was not true. The RAF had a great advantage in undertaking the training: The intended trainees were operating equipment that was novel and far from reliable; and they had the task of interpreting signals without the help of direct observation, such as seeing the approaching bombers.

At sunrise on the first day, the RAF broadcast a jamming signal for just a fraction of minute. On the second day, it broadcast a jamming signal for a minute longer, also around sunrise. Thereafter, on each successive day, the RAF sent the jamming signal for a progressively longer period of time, but always starting just before sunrise. The training continued for nearly three months, and the German radar personnel interpreted the signals their equipment gave them in just the way the British expected. The Germans concluded that their equipment operated poorly in the atmospheric conditions present at sunrise and that the problem grew as the season progressed. That mistaken inference allowed the British to send a RAF squadron unnoticed far enough into Europe to succeed in destroying their intended target.

Just as the German radar defense grew comfortable with the radar anomaly at sunrise, we believe investors have grown complacent in a market levitating on a sea of central bank liquidity. Investors read about central banks conducting quantitative easing, money printing and corresponding government deficits, but they never see the tangible impact and they never feel it negatively affecting them directly—the situation has been going on for so long that it no longer generates any concern. Very few investors notice that the present situation regarding the economy and investment markets is beyond unusual. The situation is seriously abnormal yet all have grown comfortable with the current status quo.

We doubt many investors imagine that the current situation will continue indefinitely, but is there a way for it to end pleasantly? For most investors, the expectation that markets and economies can gracefully return to normal rests on confidence that the people in charge, especially at the Federal Reserve, know what they are doing. We believe this confidence is misplaced. If a group of intelligent people were in charge of designing a bridge, we would expect it to support a crossing truck. But if a group of intelligent academics are in charge of something that no one really knows how to control, we should account for some probability of failure at the very least. Economics is not a modern science that one can readily apply mathematics and massive computing power to achieve desired results.

Engineering, architecture, astronomy, and much of common science are linear domains. Complex domains encompass the social world, epidemics, and economics. While linear domains deliver mild variations without large shocks, complex domains deliver the opposite. We misunderstand complex systems because humans largely evolved in a linear domain—humans can predict the

[3] Jones, R. V. (1978). Most Secret War: British Scientific Intelligence 1939-1945, London: Hamish Hamilton.

movement of planets and stars, but not the economy and stock market. We instinctively know that it would be foolish to blame the collapse of a bridge on the last truck that crossed it, and even more foolish to predict which future truck might cause the bridge to collapse. However, economic policymakers see symptoms of a crisis but fail to understand the underlying cause of the crisis. As humans, we suffer from two mental biases: the illusion of control and the action bias, or the illusion that doing something is always better than doing nothing. These biases lead to the desire to impose man-made solutions but the fact remains that no central bank, not even the U.S. Federal Reserve, is powerful enough to dictate stability.

Complex systems, such as investment markets, that artificially suppress volatility may become extremely fragile and yet exhibit no visible risks. Although the stated intention of economic policymakers is to stabilize the system by limiting fluctuations, the result can sometimes be the very opposite. Artificially constrained systems become susceptible to a phenomena best described by Nassim Taleb, author and statistician, as "Black Swans"—that is, they become extremely vulnerable to large-scale events that lie far from the statistical norm and are largely unpredictable.[4] Such environments eventually experience massive implosions, catching everyone off-guard and undoing years of stability. Nassim Taleb postulates that the longer it takes for the blowup to occur, the worse the resulting harm. The good intentions of the economic policy makers inadvertently increase the risk within our investment markets.

The central bank of the United States, the Federal Reserve, actively advocates policies that minimize volatility—no more booms and busts in the economy. Unfortunately, these policies almost always produce undesirable outcomes. Former Federal Reserve Chairman Ben Bernanke, who was then a member of the Board of Governors of the Federal Reserve, declared the era of "the great moderation" in 2004.[5] During the 1990s, Federal Reserve Chairman Alan Greenspan wanted to dampen the economic cycle's booms and busts. Greenspan sought to control economic fluctuations with interest-rate reductions at the slightest sign of any downward tick in the economic data. Greenspan eventually adapted his economic policy to guarantee bank rescues, with implicit promises of a backstop—the now infamous "Greenspan put." Because politicians and policymakers believe it is better to do something rather than nothing, they feel compelled to heal the economy rather than wait and see if it heals on its own.

Nassim Taleb submits that we consider the life of a turkey before Thanksgiving. The turkey is fed for 1,000 days, and every day seems to confirm that the farmer cares for it—until the last day. When confidence is at peak, the "turkey problem" occurs because an overconfident belief in stability appears from the absence of volatility. The turkey problem for humans, and investors, is when we mistake one environment for another. We attribute the turkey problem to the reality that humans simultaneously inhabit two systems: the linear and the complex. We characterize the linear domain by its predictability and the low degree of interaction among its components, which allows the use of mathematical methods that generate reliable forecasts. In complex systems, there is an absence of visible causal links between the elements, hiding a high degree of interdependence and extremely low predictability. Translation--humans generally fail to see "tipping points" when they appear. Imagine someone who keeps adding sand to a sand pile without any visible consequence, until suddenly the entire pile crumbles. We instinctively know that it is silly to blame the collapse on the last grain of sand rather than the inherent instability of a structure, which is the pile of sand, but that is what investors consistently do with investment markets.

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[4] "The Black Swan of Cairo", Foreign Affairs, 90, 3 (2012) with Blyth, M

[5] Remarks by Governor Ben S. Bernanke at the meetings of the Eastern Economic Association, Washington, DC February 20, 2004

INVESTMENT PHILOSOPHY

"You never know what the American public is going to do, but you know they will do it all at once."

--Bill Seidman

After 15 years, punctuated by the dot.com crash and the 2008 credit crisis, individuals are actively trading stocks once again.[6] Brandon Garretson started trading stocks a few years ago as the market began to rally and now the 31-year-old chemical equipment salesman makes about two trades an hour through his electronic trading account. "I love it. You look over charts and come up with ideas for the next day. There's really not a better feeling," he said. In fact, Brandon is now considering quitting his job to trade full time. Unfortunately, Brandon is not alone. Average daily client trades at E*Trade Financial totaled about 160,000 in the fourth quarter of 2013, up 25% from a year earlier. The trend continued in January, even as stocks fell, with daily trades up 27% from a year earlier. Not only are investors trading more, but they also are borrowing more against their portfolios to increase their bets. In December, margin debt hit an all-time high of $444.93 billion, up 35% from a year earlier, according to the New York Stock Exchange.

Rhoda Allen is a 63-year-old retired IT professional who traded momentum-favorite stocks such as Nokia during the dot.com bubble but sadly lost more than half her money when the party ended in early 2000. But Rhoda is back, now actively trading as she tries to get a feel for market direction. She has made 40 stock trades in the first two months of this year. Rhoda wants to buy more stocks because *"stocks are the only piece of the American dream that's still working."* Then there is Stephen Prewitt, a 29-year-old disc jockey in Cleveland, who bought his very first stock in January. With the help of stock trading, Prewitt now says, *'I think I can have a decent retirement. If I do enough research and become a good trader, I think I can have a decent retirement when I'm 50 or 60."* Better yet is Chikoo Patel, a 22-year-old real-estate entrepreneur in Chicago who impulsively trades futures contracts on his phone at opportune moments. In fact, on a recent dinner date that was not going particularly well, Chikoo pulled out his phone to buy a futures contract while his date went to the bathroom. As Brandon Garretson concludes, *"You see somebody make a lot of money in a day and that shows you it's possible."*

Yes, it is possible to make a lot of money in one day, but highly unlikely and hardly sustainable. Perhaps two things explain this mentality: greed and fear of missing out. More than $14 trillion has been added to U.S. equity values since March 2009 and the Standard & Poor's 500 Index is now hitting record levels. As such, the human emotion of greed begins to takeover—or the willingness to pay a high price for something that may happen in the future and being afraid that one might be left behind. Investors are clearly comfortable returning to stocks—equity ETF inflows hit a record $185 billion[7] in 2013 as the S&P 500 jumped more than 30% for its best annual gain since 1997.

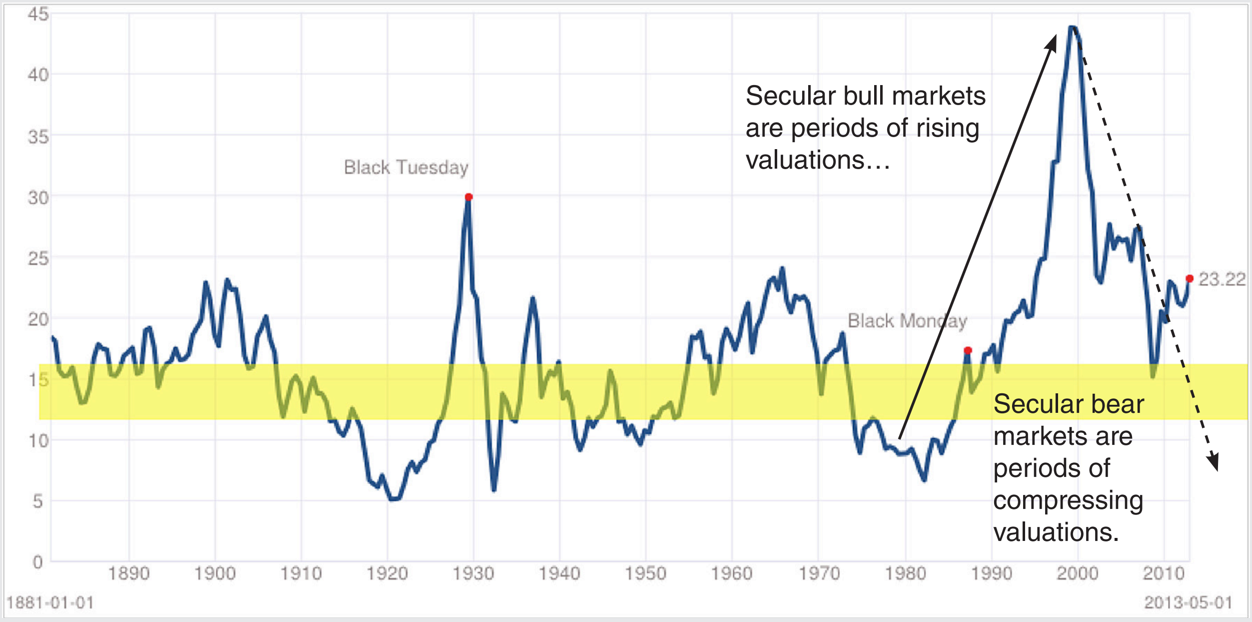
It would not surprise us if these equity inflows, or new active individual stock traders, found their way into Tesla (Ticker: TSLA), the electric car company. The company's stock recently closed above $250 amid wild rumors that the company may be an acquisition target for Apple, coupled with a Morgan Stanley analyst upgrade and increase in stock price target to $320 from $153. We would caution anyone from confusing "stock price target" with the concept of intrinsic value. The Morgan Stanley analyst likely employed the same valuation technique as the MBA student during his interview regarding Amazon back in 2000.

[6] Wall Street Journal, February 21, 2014
[7] http://www.nasdaq.com/article/2013-a-strong-year-for-etfs-cm321456

Tesla sold roughly 35,000 cars in 2013 and generated $2 billion in revenue. The market currently values Tesla's stock at 14 times revenue, compared with 0.4 for General Motors, the largest car manufacturer in the United States (valuation based on revenue as the company is not yet profitable). But Tesla is clearly a growth at any price story, and the Morgan Stanley analyst projects annual revenue growth rate of 25% for the next thirteen years, selling 1 million annually by 2027. Not to worry though, Tesla's stock has soared by almost 500% in the past 12 months.

Investors appear compelled to follow the market wherever it leads them. Right now the market is leading to a dangerous place, as starting valuation is crucial to overall investing results. For long-term investors not interested in trading, overpaying for stocks near the peak of bull markets is a reliable way to lose money. A secular, or long-term, bull market is best defined as a period of rising valuations, while bear markets are periods of compressing valuations. Near bull market peaks, investors become so optimistic that they pay silly valuations for stocks (Tesla, Google.com, Amazon.com, Priceline.com, and Salesforce.com, etc.). Valuation is the main reason for the inherent risk of a future bear market. Unfortunately, with its policies of zero interest rates and quantitative easing, the Federal Reserve has convinced investors to continue paying high valuations for stocks. We believe these policies can only pull future returns into the present rather than permanently elevate the value of stocks in our market. Rapid earnings growth, along with rising valuations, powered the great 1982-2000 bull market. The last gasp up to the 2000 peak was, in hindsight, the biggest stock market bubble in history…and history shows that bubbles are almost always corrected over long periods:

S&P 500 Price/Earnings (CAPE)



Valuations suggest that most people are fully invested today and we fail to see much evidence of caution. As a result, allocating any amount to cash hurts performance in the current market. However, following a value-based strategy requires an investor to be patient—a rare trait in human beings. Patience can be painful in euphoric markets, but we have no doubt that patience is the correct long term strategy. We would rather do the right thing over the long term rather than try and guess what will happen short term.

Despite the devastation of the credit crisis, valuations have actually risen in the last five years. Contrary to prevailing groupthink, the huge rally is not a reason to "get money to work", as we believe valuations are expensive and future returns are more likely to be negative for buyers of the S&P 500 today.

Kind regards,

Robert J. Mark
Portfolio Manager

The opinions expressed are those of the Fund's portfolio manager and are not a recommendation for the purchase or sale of any security.

*The following securities mentioned in this commentary were not holdings of the Fund as of 3/31/14: Fidelity Contrafund, Google, Inc., Amazon.com, Inc., Priceline Group, Inc., Salesforce.com, Inc., Tesla Motors, Inc., Apple, Inc., Morgan Stanley, E*Trade Financial Corp., Nokia Oyj ADR, General Motors Co.*

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