



## *Portfolio Manager Commentary*

### IS IT A DUCK OR IS IT A RABBIT?

**MOATX  
CASTX**

April 6, 2016

#### FIRST QUARTER LETTER

---

#### MARKET COMMENTS

---

*“All of humanity’s problems stem from man’s inability to sit quietly in a room alone.”*

—Blaise Pascal

When the dermatologist saw the spots on the back of the patient’s hand, he grew suspicious and removed a small piece of the skin. A pathologist confirmed that the skin sample was a basal cell carcinoma, the most common malignant skin tumor. Although basal cell carcinoma carries a low metastatic potential, this tumor can cause significant disfigurement by invading surrounding tissues. Because the patient was himself a physician, he knew this form of cancer often did not spread. However, as a precaution the physician removed the carcinoma and the patient decided to see a well-known specialist.

Unfortunately, the well-respected specialist found a lump in the patient’s right armpit, or axilla. As the patient did not know how long the lump had been there, the specialist suggested removing the lump and the patient agreed. While recovering from the surgery, the patient realized that his entire chest was wrapped in bandages. The specialist arrived and sadly explained that his axilla was full of cancerous tissue and the procedure included removing his pectoralis minor, the thin, triangular muscle located in the upper part of the chest. The specialist concluded that in his professional opinion, the patient did not have long to live. The patient, Archie Cochrane<sup>1</sup>, left the hospital in 1956 and went home to face his pending death.

Philip Tetlock described Archie’s story in his book *Superforecasting, The Art and Science of Prediction*. Many will not immediately recognize the name of Archie Cochrane, but his impact on our lives today is enormous. He was instrumental in

---

<sup>1</sup> Archibald L. Cochrane and Max Blythe, *One Man’s Medicine: An Autobiography of Professor Archie Cochrane* (London: British Medical Journal, 1989).



modernizing medical procedures by stressing the importance of using evidence from randomized controlled testing, which provided far more reliable information than other sources of evidence<sup>2</sup> - something we simply accept today as common sense. Given Archie Cochrane's background, the surprising reality was that Archie did not in fact have terminal cancer. The specialist suggested surgery before receiving the pathologist's report and was wrong. Archie never thought to question the surgeon's opinion and the surgeon never doubted his own judgement. Even Archie couldn't temper his natural instinct, as it's human nature to make decisions based on first assumptions and then typically remain slow to change our minds.

Like Archie's misguided trust in his doctors, the faith politicians and investors place in the wisdom of central bankers is also misplaced. Politicians hope that monetary policy can support the economy while they struggle with growing budget deficits, and investors jump into equities as soon as they believe central bankers are even thinking of easing monetary policy. However, it's important to remember that central bankers are fallible. When asked about the possibility of a housing bubble in July 2005, former Federal Reserve Chairman Ben Bernanke replied "*Well, I guess I don't buy your premise. We've never had a decline in house prices on a nationwide basis.*" Knowing how the housing bubble actually unfolded should give one pause when listening to central bankers talk today. And, yet, when asked if central banks would be able to exit their current policy, the former head of the Bank of England responded, "*I have absolutely no doubt that when the time comes for us to reduce the size of our balance sheet that we'll find that a whole lot easier than we did when expanding it.*" Absolutely no doubt, just as the surgeon had no doubt that Archie Cochrane's axilla was full of cancerous tissue.

Strong conviction based on one's initial judgement is a coping mechanism humans developed in order to react quickly to potential danger or opportunity. Nineteen hundred years ago Galen of Pergamon, a prominent Greek physician, surgeon and philosopher, advised the emperors ruling the Roman Empire. Many historians consider Galen the most accomplished of all medical researchers of antiquity. He influenced the development of various scientific disciplines, including anatomy, physiology, pathology, pharmacology, and neurology<sup>3</sup>. Not unlike the specialist who treated Archie Cochrane, or today's central bankers, Galen was also a man untroubled by self-doubt regardless of the evidence before him as demonstrated by his infamous quote: "*All who drink of this treatment recover in a short time, except those whom it does not help, who all die. It is obvious, therefore, that it fails only in incurable cases.*"

Most people intuitively understand risk in the short term. When crossing the street, one would obviously speed up to avoid an oncoming car that suddenly comes around the corner. Humans are wired to survive: it is a basic instinct that takes command almost instantly, enabling our brains to resolve ambiguity quickly so that we can take decisive action in the face of a threat. The impulse to resolve ambiguity appears in many ways and in many contexts, even when danger is not present.

Look at the picture to the right. Some see the profile of a young woman with long hair, a nice dress, and a bonnet. Others see the image of an old woman with a wart on her large nose. Some actually see both of the images simultaneously. Our brains instantly decide what image one sees, based on the first glance. For some people the initial glance oriented on the vertical profile on the left-hand side and they perceived the image of the young woman—the brain interpreted



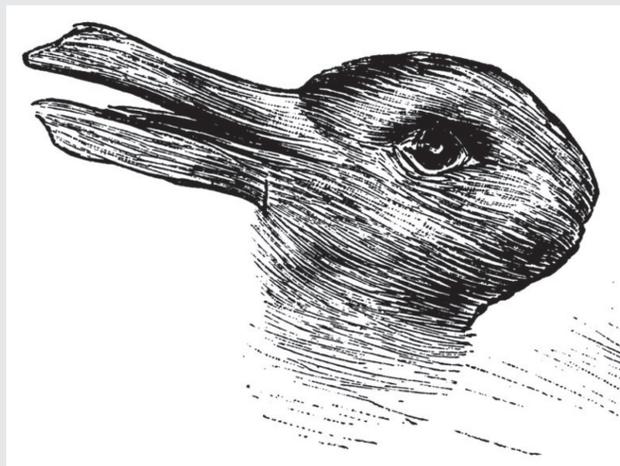
<sup>2</sup> <http://community-archiv.cochrane.org/about-us/evidence-based-health-care>

<sup>3</sup> <https://en.wikipedia.org/wiki/Galen>



every line in the picture according to the mental image that one had already formed, even though each line can be interpreted in two different ways. By contrast, if one's first glance fell on the central dark horizontal line that emphasizes the mouth and chin, your brain quickly formed an image of the older woman.

Now look at the picture on the right. There are two animals in this drawing. The optical illusion is an image of a duck or a rabbit depending on how one interprets the image. Depending on whether one sees a duck or a rabbit first and how fast one sees the other indicates how fast our brains work. The drawing first appeared in a German magazine around 1892 but was made famous by U.S. psychologist Joseph Jastrow in 1899. Jastrow used the illusion to make the point that we 'see' with our brains as well as our eyes. When testing children at different times of the year, the results change. During Easter, children are more likely to see a rabbit first. In October, seeing a duck first is more common.



Regardless of one's interpretation of these pictures, our brains quickly decide what the pictures are and fill in the missing pieces, as our brains naturally resolve uncertainty from conflicting information. Every input of information can be interpreted differently according to one's perspective and this certainly applies to how we, as individuals, invest. If one operates with a risk-averse mental framework, then one may interpret a further fall in stocks as additional confirmation of their bearish bias. Of course, the individual who maintains a positive framework may interpret the same event as another buying opportunity.

U.S. stocks ended the first quarter of 2016 slightly positive, but investor sentiment took a wild ride over the last three months. Investors started the year in a panic over the impact on banks from negative interest rates. Stocks, commodities, the Chinese currency, and corporate and emerging market debt sharply sold off as each new data point reaffirmed our human instinct of flight in order to survive. And then "*once more unto the breach, dear friends, once more*"<sup>4</sup> another round of soothing words emanated from the world's central bankers; and the electronic investing herd quickly turned. Investors' brains suddenly perceived opportunity and once again decided the moment had arrived to buy the most beaten-down assets and stocks with the shakiest fundamentals. The pessimism of the year's first six weeks morphed into an outright buying panic that propelled U.S. stocks back to levels just shy of record highs. We would note the lack of any significant change in the economy or corporate fundamentals supporting this rebound rally.

While some investors view this market picture as the equivalent of the young woman with long hair and a nice dress, we mostly see an old woman with a wart on her large nose. The mispricing of assets across world markets has reached disturbing proportions. Even after the first quarter's strong rebound, most market analysts see further gains, believing that the selloffs of last August and early 2016 represent healthy corrections. We disagree and contend that the rise in stock markets remains underpinned by debt, financial engineering and central bank liquidity. The overvaluation of financial assets, coupled with significant leverage in a low-growth economic environment, are the exact conditions where one should exercise investment caution. Unfortunately, excessive risk taking remains the order of the day for those who still find central bankers infallible.

<sup>4</sup> William Shakespeare, Henry V, Act III, Scene I



Strangely enough, our very own brains present a challenge when thoughtfully investing. We evolved to excel at resolving uncertainty in the face of an immediate threat, but remain less equipped to navigate the long term intelligently, including when investing. When logic and reason conflict with our instincts, our instincts typically prevail—investors often trade too frequently and, typically, at the wrong time. One way our brains resolve conflicting information is to seek out safety in numbers. In the animal kingdom, herding helps to ensure an animal’s survival. Just as a zebra will try to stay with the herd in order to minimize its individual vulnerability to predators, investors feel safer and more confident investing alongside equally optimistic investors in a rising market....and selling when everyone around us is taking the same course of action.

Even institutional fund managers fall victim to the herd mentality. In a study titled *Thy Neighbor’s Portfolio*<sup>5</sup>, researchers found that professional mutual fund managers were more likely to buy or sell a particular stock if other managers in the same city were also buying or selling that security. Unfortunately, the comfort managers receive from this electronic herd can prove costly for investors. The surge in buying activity and the resulting bullish sentiment is self-reinforcing, causing markets to react even faster. This cycle leads to overvaluation and the inevitable crash when sentiment reverses. Booms and busts are characteristic of all financial markets, regardless of size, location, or even the era in which they exist.

The study’s researchers concluded that investors spread information and ideas about stocks to one another through word-of-mouth communication, as people who speak regularly with one another tend to think similarly. The study examined the holdings and trades of mutual fund managers, based on the assumption that fund managers who work in the same city are more likely to come into direct contact with one another. A fund manager working for a fund family, which is located in Boston, may decide whether or not to buy shares of a particular company’s stock in a given quarter. The researchers found that this decision will be more heavily influenced by the decisions of fund managers working at another Boston-based fund family, than by the decisions of fund managers located in other cities.

Valeant Pharmaceuticals (NYSE: VRX) is an interesting example of this herding mentality, as this pharmaceutical royalty company became a Wall Street favorite. Billionaire investor Bill Ackman greatly over weighted his Pershing Square Holdings hedge fund with VRX shares at an average entry price of \$192, ultimately building a stake of 21.5 million shares, not including another nine million call options that he later added to average down his cost. John Paulson, famous for making billions in profits by shorting the housing market in 2007, held thirteen million shares of VRX. The Sequoia Fund, the only mutual fund that Warren Buffett recommended to his investors when he closed his original Buffett Partnership in 1969, owned thirty-five million shares of Valeant Pharmaceuticals. In fact, an analysis of 13-F regulatory filings with the SEC show that 88% of Valeant’s outstanding shares were held by hedge funds, mutual funds, and other institutional investors—most of them located in New York City.

Valeant is in the pharmaceutical sector, where the business model typically requires companies to allocate roughly 30% of their revenue towards research and development (“R&D”) in order to maintain a future pipeline of drugs. By contrast, Valeant Pharmaceuticals CEO Michael Pearson convinced Wall Street that it was better to disregard R&D. Valeant would borrow money in order to buy existing drug companies, eliminate their entire research staff, sharply increase drug prices, and sell the drugs through specialty pharmacy channels. Wall Street loved it—from 2008 to 2015, VRX shares rose from \$7 to \$260.

The company’s glow began to dim late last year. In September 2015, both the New York Times and the Wall Street Journal printed articles on Valeant’s “price-gouging on life-saving drugs.” In 2015, Valeant raised drug prices 66%, five times more than its

<sup>5</sup> Harrison Hong, Jeffrey Kubik and Jeremy Stein, *The Journal of Finance*, Vol. LX, No. 6, December 2005



closest industry peer. This behavior attracted the attention of the U.S. House Committee on Oversight and Government Reform, which requested that CEO Pearson testify on the company's pricing tactics. In October, a well-known short-seller presented evidence of "channel stuffing" – sending excess product to certain affiliated specialty pharmacies and counting it as sales. In February 2016, the company announced that it may have to restate prior-year financial statements due to accounting improprieties, and that the U.S. Securities and Exchange Commission (SEC) just launched a full investigation. Most recently, the company reduced its earnings guidance for 2016 although the company had just released the previous guidance only three months ago. VRX shares now trade around \$27, a 90% drop in the company's share price.

The electronic herd that chased Valeant Pharmaceuticals higher did not just confine its enthusiasm to the company's equity. As a darling of Wall Street, Valeant was able to issue over \$31 billion in debt to facilitate its acquisition spree. Another potential concern according to Jim Grant, editor of *Grant's Interest Rate Observer*, Valeant is the most widely held credit in structured investment products known as collateralized loan obligations, or "CLOs." CLOs were the main vehicle Wall Street used to package and repackage mortgage debt during the 2008 credit crisis. Although history may not exactly repeat itself, we find it fascinating that Wall Street is rebuilding its securitization business with Valeant bonds as a major component of today's CLOs. Human biases often prevent individuals from making fully rational financial decisions in the face of uncertainty. When asked by researchers to choose between a certain loss and a gamble, in which they could either lose more money or break even, people tend to choose to double down on the investment—that is, they gamble to avoid the prospect of any losses, a behavior known as "loss aversion." By acquiring nine million call options on top of his existing position in order to average down his cost should Valeant rebound in price, Bill Ackman at Pershing Square, one of today's most accomplished investors, exhibits classic loss aversion behavior. This much is clear: human behavior frequently prevents investors (even famous institutional investors) from always thinking "rationally" which can cause them to hold "suboptimal" portfolios at times.

Of course, the time to consider decisions for extreme market scenarios is when one is building out their investment strategy, not in the middle of a market crisis or at the moment a concentrated high-risk, high-reward portfolio craters. A disciplined process for managing risk in relation to a clear set of goals will enable the investor to use human instinct to their advantage, rather than fall victim to their inherent weaknesses.

---

## INVESTMENT PHILOSOPHY

---

All investors instinctively understand that if they want to be wealthy, they must not lose money. Or, more succinctly stated, investors must not lose big money. Any investor who allocates their savings to the stock or bond market is assuming a certain level of risk. Academics will argue that trying to time the market is a lost cause—and that the best one can do is simply place their savings into an index fund. Because the market is efficient, academics argue that it is impossible for the average investor to beat the market because it is impossible for most people to beat the average result. This is correct—at some point it is a mathematical certainty that not everyone can outperform the market.

Although, just because something is "true", on average, across a population does not mean it must be true for everyone. For example, one could argue that, on average, everyone who marries will end up with a marginally attractive spouse of normal intelligence. Therefore, one should probably stop wasting their time trying to find a beautiful and intelligent person to marry<sup>6</sup>. In theory, that might be good advice but we seriously doubt anyone actually implements that strategy.

---

<sup>6</sup> Unknown exact source of quote but we attribute to Tim Price, a London money manager

# CASTLE FOCUS FUND



PM Commentary :: Q1 2016

Investor Class: MOATX Class C: CASTX

Fidelity Investments conducted a study on the performance of its flagship Magellan mutual fund during the tenure of its famous manager Peter Lynch. Peter Lynch ran the Fidelity Magellan fund from 1977 through 1990 and delivered an incredible 29% average annual return during his tenure. To comprehend that level of performance, if one invested \$1,000 for a period of thirteen years and compounded that capital at 29% per year and added no additional capital, the account would grow to over \$27,000. Despite Lynch's remarkable performance while running the fund, Fidelity found that the average investor actually lost money during his thirteen year tenure. According to Fidelity Investments, investors ran for the doors during periods of poor performance and rushed back in after periods of success.

Once again, our very own brains hindered our ability to navigate the long term intelligently, particularly when investing. A human's highly-evolved ability to resolve uncertainty, in the face of an immediate threat, pressed the average investor to sell the Fidelity Magellan fund at the exact wrong time, just as our evolution conditioned us to seize opportunity and buy the fund at market peaks. When logic and reason conflict with our instincts, our instincts typically prevail.

A quote from investment legend Benjamin Graham, the father of 'value' investing, makes the point clearly: "*The investor's chief problem – and even his worst enemy – is likely to be himself.*" As Graham also said "*...it isn't about beating others at their game. It's about controlling yourself at your own game.*" Clearly the average investor in the Magellan Fund did not even trust Peter Lynch, arguably one of the most successful investors of all time. The average Magellan Fund investor during Lynch's tenure should have heeded the Frenchman Blaise Pascal's cautionary advice and sat quietly in a room alone.

With kind regards,

Robert J. Mark  
Portfolio Manager



# CASTLE FOCUS FUND



PM Commentary :: Q1 2016

Investor Class: MOATX Class C: CASTX

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

*As of March 31, 2016 the Fund does not own any shares of Valeant Pharmaceuticals.*

*The Fund's investment objectives, risks, charges and expenses must be considered carefully before investing. The prospectus contains this and other important information about the Fund, and it may be obtained by calling 1-877-743-7820, or visiting [www.castleim.com](http://www.castleim.com). Read it carefully before investing.*

*Performance data quoted represents past performance; past performance does not guarantee future results. The investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance of the fund may be lower or higher than the performance quoted. Performance data current to the most recent month end may be obtained by calling 1-877-743-7820.*

*The risks associated with the Fund, detailed in the Prospectus, include the risks of investing in small and medium sized companies and foreign securities which may result in additional risks such as the possibility of greater price volatility and reduced liquidity, different financial and accounting standards, fluctuations in currency exchange rates, and political, diplomatic and economic conditions as well as regulatory requirements in foreign countries. There also may be risks associated with the Fund's investments in exchange traded funds, real estate investment trusts ("REITs"), significant investment in a specific sector, and nondiversification. Technology companies held in the Fund are subject to rapid industry changes and the risk of obsolescence. The Fund is non-diversified, meaning it may concentrate its assets in fewer individual holdings than a diversified fund. Therefore, the Fund is more exposed to individual stock volatility than a diversified fund. Distributed by Rafferty Capital Markets, LLC-Garden City, NY 11530.*