

StaufferWilliams Asset Management, LLC

Investment Commentary January, 2012

Happy New Year!

2012 begins with an introduction of StaufferWilliams Asset Management, LLC. In February, Jonathan Williams will officially join with Curt Stauffer full-time to form an entirely new Central Pennsylvania asset management company. This company will merge the professional passion of two portfolio managers, who combined have decades of experience developing investment processes and strategies, researching securities and managing portfolios for a broad array of individual and institutional clients.

The investment process which will drive StaufferWilliams Asset Management will be one defined by complementary and collaborative team work. Every client will immediately benefit from the dynamic created by this partnership. The New Year represents an evolution for our respective clients, from a past characterized by a relationship that was defined by trust and confidence in one person, to a relationship defined by the durability and strength of a true partnership built upon experience, proven results and shared passion. We are consumed with the promise of this new partnership and what 2012 and beyond will hold, but we do have to reflect on 2011, and what it can teach us as investment professionals.

2011 showed investors that most stock market participants are in denial. They really want to believe that they are fundamental long-term investors, when deep down they can't resist the urge to think like market timing traders. They don't want to be market timers, but that is just the way they are wired and as much as they try to think long-term, they can't help hanging on every news story which might move the market, as if tomorrow's market direction will make or break them as an investor. For the average investor, who is either investing for retirement or is investing in retirement, his or her investment time horizon is typically between 15 and 50 years. However, because of extreme market volatility and the financial media, that typical investor spends most of his or her time thinking about what their equity investments are going to be worth tomorrow, instead of what those investments will be worth five or ten years from now.

The investing world is not lacking in well publicized and often quoted luminaries of investment wisdom. The world's most successful equity investor, Warren Buffett, has famously said that to be successful investing in stocks, one has to "be fearful when others are greedy, and be greedy when others are fearful." That seems simple enough in concept, but it is virtually impossible for most investors because of their deeply repressed wiring which compels decision making which is the opposite. Reflect on Mr. Buffett's words and you will realize that what he is saying only makes sense if those following his advice are the small minority of investors. If the majority of investors could execute that very straight-forward investment strategy, those very opportunities which helped him amass his multi-billion dollar fortune would not have been present.

Another stock market made billionaire, Shelby Davis, the founder of the Davis Funds, is quoted as saying, “a down market lets you buy more shares in great companies at favorable prices. If you know what you are doing, you’ll make most of your money from those periods. You just won’t realize it until much later.” Mr. Davis is simply stating Warren Buffett’s axiom a different way.

One of the most successful investors of the last 20 years was David S. Swensen who managed the Yale Endowment from 1985 until 2009. In Swensen’s book, Unconventional Success, he reminded his readers of John Maynard Keynes’ quote that “Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally”. Swensen follows his reference to Keynes with the following statement, “sharing a common outcome with large numbers of fellow citizens creates a mutually reinforcing social bond. Unfortunately, the comfortable rarely produces success.” Swensen is reminding his readers that in the business of investing, following the crowd or conventional wisdom usually leads to failure.

The aforementioned references to Buffet, Davis and Swensen were used to illustrate the common contrarian DNA which each of these incredibly successful investors possesses. There are not thousands of examples of investors as successful as the three mentioned. We believe that the reason for this is that having the conviction and emotional discipline to execute the basic tenants of successful investing is uncommon.

Are we saying that we have the formula for investing success all figured out? It sounds relatively simple, but having the ability to swim against conventional wisdom is not what it seems. Having the ability to see value in unpopular stocks is not as simple as buying last year’s worst performing stocks. The distinction is that concept of value. Not all poorly performing stocks have unappreciated value, many are merely “value traps”. Not all growth companies trading at steep discounts to their historical valuations are cheap. Value traps are stocks which have experienced poor performance relative to their peers and are now selling at multiples much lower than they have been historically, but deservedly so. In most cases of value traps, management of these companies has made decisions, which instead of creating shareholder value have destroyed shareholder value. The ability to discern the difference between management teams creating shareholder value and those destroying value is important to being able to avoid value traps. The ability to identify and avoid value traps requires process and discipline. It is in this area, in particular, where our focus on a relatively small number of companies and our use of the “economic margin” concept allows us to identify opportunities where management is creating shareholder value, not destroying it.

That brings me to the subject of security selection, otherwise known as stock picking. Academic studies abound which tell us that stock picking plays a relatively insignificant role in long-term investment results. Most people take those academic studies at face value. We find an inherent conflict between this notion that security selection plays an insignificant role in investment results and the success of investors such as Buffett, Davis and Swensen. Swensen, in his book Unconventional Success, addresses security selection and sheds significant light on this apparent conflict. Swensen states, “security selection plays a minor role in investment returns, because investors tend to hold broadly diversified portfolios that correlate reasonably strongly with the overall market. The high degree of association between investor security holdings and the market reduces the importance of security-specific influences, causing portfolio returns to mirror market returns.” Swensen’s explanation is describing a self-imposed infliction which is becoming an epidemic in the financial services industry and that is “closet indexing”. Louis Lowenstein, in his book, The investor’s dilemma: how mutual funds are betraying your trust and what..., he references the “sheep index” which is the result of a study that concluded “that three fourths of institutions display conformist behavior behavioral patterns, or a positive sheep value.”

A very recent study from Yale University took a look at “closet indexing” among purportedly active managers. This study was the subject of an article in [Financial News](#) on December 17, 2011. In this article by Ben Wright, titled “Yale study reveals scale of closet indexing” , Martijn Cremers, one of the Yale professors who conducted the research, was quoted as saying, “All managers used to be active in 1980, now it’s only 20% at most. It paints a very sad picture for the industry.”

The newly created StaufferWilliams Asset Management Company takes great pride in being fundamentally centered active managers of private client and institutional investment portfolios. Through our combined portfolio management experience and our unquenchable appetite for knowledge about what drives value creation in an investment portfolio, we are passionate, but rarely completely satisfied with the results that we generate for our clients. 2011 was one of those years when time tested strategies and courage of conviction did not guarantee success. This past year, many time-tested successful investors, as evidenced by the under-performance of Buffett’s Berkshire Hathaway and Davis’ flagship fund, performed poorly relative to the S&P 500. After such a year, it is more important than ever to reflect on what could have been done differently, while still remaining loyal to those long-term investing tenants which we hold sacred. We are in the process of that important reflection and will share our conclusions with you over the next several months.

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