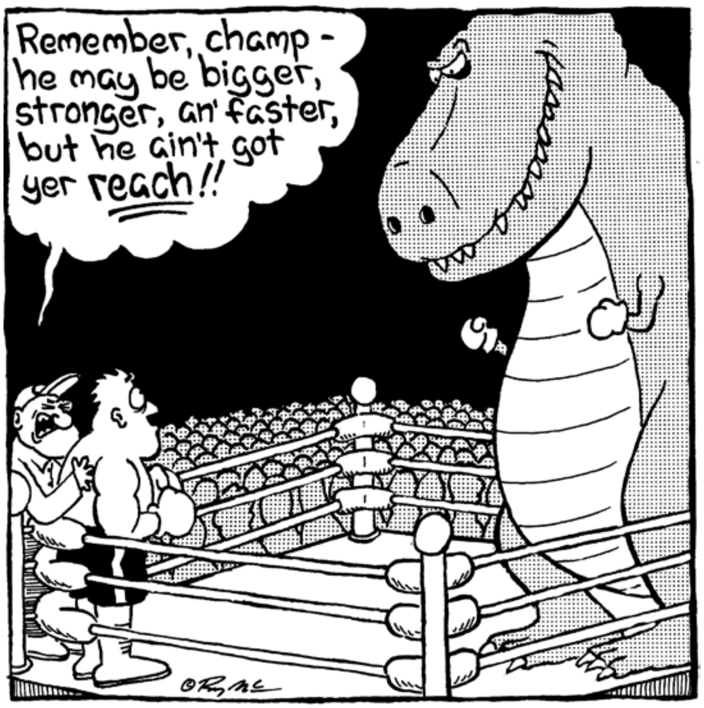
Who Wins – Stock Pickers or Portfolio Managers?

"Victorious warriors win first and then go to war, while defeated warriors go to war first then seek to win."

\- *Sun Tzu, The Art of War*



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Back in 1997 the boxer Mike Tyson was asked by a reporter whether he was worried about his opponent Evander Holyfield and his fight plan. He answered, "Everyone has a plan until they get punched in the mouth."

For me, Mike Tyson's expression rings close to home. Once upon a time, I fought competitively in Tae Kwon Do tournaments. In preparation for these competitions, I trained hard and sparred regularly with other young men at my skill level and weight class. When not training, I'd visualize my opponent in the ring – his actions, my response, and vice versa. Nevertheless, on more occasions than I'd like to admit, I've had the wind knocked out of me, or taken a swift round-house kick to the head. Most of the preparation and planning done up to that point usually went right out the window. My focus changed from winning to surviving the round.

Today, when I think about the above Mike Tyson quote, it is investors' risk exposure that comes to mind. The U.S. stock market has been on a tear higher for years now. Since the depths of the credit crisis, large market pullbacks and portfolio drawdowns have been few and far between. I sense a high degree of complacency. Will investors react to a market decline as a deer in the headlights would - frozen, passively betting on hope?

Very few assets out there are cheap. Global interest rates are low, credit spreads are tight, volatility indexes measuring both stock price and interest rate movements are depressed, while equity valuations as measured by the various price-to-earnings ratios are elevated.

Too often, investors and advisors focus solely on stock selection and neglect managing market risk. These are two very different things. When the good times are rolling (which is most of the time), stocks drift higher and the name of the game is to pick stocks that outperform the broad universe of companies. Managing market risk via an appropriate mix of stocks, bonds, commodities and currencies becomes an afterthought. Understanding the correlations between asset classes and how an investment portfolio will react to various movements and/or shocks is paramount. In the current environment, my fear is that many investors are on autopilot and ill prepared for that inevitable punch in the mouth.

Howard Marks, Co-Chairman of Oaktree Capital Management was recently interviewed on CNBC's Halftime Report. Mr. Marks is well known as an astute investor in the credit markets and for his informative quarterly memos. Although we have never met, I consider him a mentor, who has helped shape my philosophical view as it relates to financial markets and investment management. In the interview, Mr. Marks states two primary objectives an investment manager/advisor can achieve for their clients:

- Try to invest more in the things that will do well and less in the things that will do poorly.
- Know when to take more risk at the right time and less risk at the right time.

Although the above objectives seem obvious, in practice they are the very difficult to get right. The first statement is geared toward security selection (think stock picking) while the latter point speaks to asset allocation (think portfolio weightings of stocks, bonds, etc.), which empirically have a greater long-term effect on investment performance. At Pacificus we begin our analysis with a top-down macro approach to markets – seeking to increase risk when opportunities arise while cutting back risk when warning signals flash. From there we move to security selection, in which we attempt to accumulate cheap assets and either sell or avoid what we see as rich.

Managing an investment portfolio is not black or white. It rarely pays to be one hundred percent in or out of the market. Similar to popular philosophical questions debated throughout history, there is no right or wrong answer. There is no optimal solution. The proper response is one of degree and magnitude. With regard to knowing when to take more or less risk, both investor and manager would be wise to understand where prices and valuations lie today relative to history, and question if risk seeking attitudes have swung too far in the direction of panic or euphoria.

Sincerely,

Justin Kobe, CFA
Founder, Portfolio Manager & Advisor
