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Robert Shiller and Eugene Fama have opposing views on human behavioral impact on market prices. Yet they were both awarded the Nobel Prize at the same time?

Efficient Market

When Eugene Fama was a student, he researched various stock market forecasting schemes for his professor and concluded that predicting (or forecasting) future prices doesn't work. Later on, as a professor at the University of Chicago, he continued his research until he determined that, in the short run, prices are unpredictable (hmm…).

His research brought him to the theory of Rational Expectations whereby he concluded that market prices are based on rational investors' forecasts. This theory further led to the Efficient Market Hypothesis (EMH), which stipulates that markets are efficient because investors have all the relevant information to determine market prices. Therefore, prices reflect rational future expectations; hence they also reflect the security's intrinsic value. Mr. Fama won the 2013 Nobel Prize in Economics for his work.

Behavior

Robert Shiller teaches Economics at Yale University and conducts research incorporating human behavior into economic models. He demonstrated that market prices are often influenced by our irrational behavior. Mr. Shiller used historical market prices to show that stock prices were more volatile than a rational expectation about the future would justify. Mr. Shiller also won the 2013 Nobel Prize in Economics.

Mr. Shiller has been a vocal proponent that sometimes irrational behavior by groups (or masses) of people sometimes result in asset bubbles. Bubbles, where prices of stocks, real estate, tulips, bonds, art, gold – anything really – get more out of touch with underlying economics (or supply and demand) than rational expectations would suggest.

While academics and much of the investing world applaud EMH, that "group think" failed miserably when it mattered the most: recognizing bubbles. Even after the global real estate, art and banking stocks bubble burst into the financial crisis of 2008, Mr. Fama claims he doesn't know what a bubble is.

The very foundation of Mr. Fama's theoretical work is based on the concept that human beings are rational. If Noble committee members believe humans are rational, than Mr. Fama deserves the prize. If not, without that "rational expectation" foundation, the whole EMH theory crumbles. Shame on the Nobel prize for this disservice to the investing public.

Random Walk

When I was studying finance at university, I took two courses which left a strong impression on me. The first one was on the stock market, relying heavily on a popular book on the subject, "A Random Walk On Wall Street" by Burton Malkiel. Mr. Malkiel is a disciple of the efficient market hypothesis. In his book he uses the example of how 3 monkeys throwing darts at stock listings in a newspaper on a wall would do better than individuals picking stocks (it even was tested in laboratories).

The stock market course was enlightening in its scientific (or statistical) approach. Yet its conclusions left a negative impression on me, as it lacked some elements of common sense. That impression made me say that I would never go into a business involving stock markets …

The second course was called "Organizational Behavior" which intuitively emphasized how business managers must take into account human behavioral traits to better run companies.

The behavioral management class borrowed from psychology and other social studies to better explain why some situations exist, even if they are irrational. It was a thoroughly enjoyable learning experience.

Little did I know that behavioral finance and efficient market hypothesis would prove so important in my professional life. EMH is the leading investment theory taught at a great majority of universities, used by most investors, packaged as index funds, sold as ETF's or other popular investment products. Yet it contains fatal flaws, including that human beings, as a group, behave in an unemotional, rational way.

In fact, every time a market bubble bursts, EMH loses some of its dubious credibility. EMH enthusiasts dismissed the Japanese stock market and real estate bubble of the Eighties (the Nikkei stock index is 60% below its peak in 1989, nearly 25 years later). They dismissed the NASDAQ stock bubble of 1998-2000 (the NASDAQ crashed in 2000). The global real estate and bank stock bubble of 2004-2007 was dismissed by the EMH crowd as "rational pricing" (real estate and bank stocks burst into the 2008 crisis). Behavioral finance was less common (academics didn't like to teach it), yet it has gradually grown in importance over the last three decades. Count me in that camp.

FIXED INCOME PORTFOLIOS

The 10-year U.S. Treasury bond yield peaked at 15.81% in 1981. Since then, interest rates have come gradually down over the years, bottoming out around 1.39% in 2012. A definitive turn seems to have occurred in May 2013 when the Federal Reserve made a surprise announcement that it might start to reduce the level of monetary support it had been steadily provided. To many, this means the 30-year-old bull market in bonds is dead.

It doesn't mean everybody should sell all their bonds, because that would depend on each financial situation or requirement. It does mean that the next few years could require particularly good investing acumen to make a reasonable inflation-adjusted return going forward.

CORE EQUITY PORTFOLIO COMPOSITE

Top contributors to performance

Several of the top contributors to our performance share a common characteristic. Investors and analysts often correctly analyze the most pressing issues companies face, but dismiss valuable opportunities, whose outcomes are not as clearly defined within short time frames. We have exploited those gaps to good profit in 2013.

1.) **Leap Wireless** was a very weak competitor of cellular phone giants like AT&T, Verizon, Sprint, and even T-Mobile. It was losing a lot of money. But in my eyes it had a proverbial ace hidden up its sleeve. Investors were rightly focused on Leap's continuing losses, so much so, that they dismissed the obvious: a large amount of a very coveted asset, wireless spectrum, worth many times Leap's stock price. As we consume more and more data on our cell phones, wireless companies need more and more capacity in airwaves, something called wireless spectrum. There had been many transactions whereby AT&T or Verizon had bought spectrum from others, so it was possible to calculate roughly how much Leap's unused spectrum was worth. We bought Leap's stock due to its depressed valuation relative to the intrinsic value hidden in its spectrum assets. And, much faster than I expected, AT&T bought Leap at almost 3 times our average cost.

2.) Internet file sharing and services like iTunes have virtually destroyed the music industry's hugely profitable reliance on compact disk sales. Artists now mainly rely on the impregnable fortress of live events or concerts for their income. **LiveNation** is by far the dominant player through its artist management, concert venue (stadiums) and ticket selling divisions. The growth in concerts has benefited LiveNation tremendously. TicketMaster has also been investing heavily in bringing its technology to the 21st century, and its potential effect on the bottom line is now becoming apparent. LiveNation rocked in 2013.

3.) **Valeant Pharmaceuticals** has been growing very fast for several years, mostly through acquisitions of other non-prescription drug companies (or products). In May of 2013 it acquired Bausch & Lomb at a high price, which turned out to be a low price.

How? Valeant has excellent management, pays great attention to sales and marketing, and applies a laser focus on reducing costs at acquired companies. Good strategy, low costs and revenue growth is a winning trifecta.

Top detractors from performance

Our top 3 detractors include a strategic decision on my part to hedge or protect our gains by taking a partial **short** position against the **S&P 500 Index**. In this case, being cautious cost us in losses that detracted from an already good year. Our second one was **GP Investments**, a Brazilian private equity (or leveraged buyout) company. It has made top quality investments in the past, but its current portfolio of mostly private companies has been hampered by a difficult Brazilian economy. It is a relatively new purchase for us (May 2013), and we expect to own it for a long time. Our third biggest detractor would have been **Sears Hometown and Outlets**. When taken as a group of spinoff companies though, the 3 Sears sisters (Sears Holdings, Sears Hometown and Outlets, and Sears Canada) were profitable overall for us. Therefore, the 3rd worst performer was **Dell Computers** whose overall business did not improve in a timely fashion (it ended up being taken private by its founder, Michael Dell).

Conclusion

One way to buy an asset (like a stock, a bond, or a business) at a discount to its intrinsic value is when a short term problem masks a longer term opportunity. At the beginning of last year, stocks were very cheap due to the continued focus of investors on macro-economic problems, compounded by political nonsense all around. What they were missing was that interest rates were low, companies were generating record cash flows, and buying back their own shares hungrily.

As we begin 2014, bonds are still subject to careful selection. And even if stock markets turn out to be a bit choppier in 2014, the outlook remains positive.

Thank you for your continued confidence.

Best wishes,

Karim Armand
President

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