Winning Approach

By Jeff Otto, CFA

Every year, as the season turns to spring, college basketball fans rejoice as 68 teams compete in the NCAA tournament to win a National Championship. The tournament is a roller coaster ride for players, coaches and fans as a season's worth of work comes down to a single game. Either the team wins to advance or loses and the season is over. While there are upsets every year, by and large, the tournament is designed to give the best teams the easiest path to the title. In fact, the lowest seed to ever advance to the Final Four is the 11th seed and this has been achieved just four times, including last year with Loyola Chicago. The Villanova Wildcats, seeded No. 8 in 1985, were the lowest seed to ever win the tournament. Clearly, the odds are stacked in favor of teams seeded at the top of the bracket. It is also no coincidence that a relatively small number of basketball programs consistently earn these favorable seeds year in and year out. What similarities does a winning investment strategy have with these highly ranked basketball teams?

> *What similarities does a winning investment strategy have with these highly ranked basketball teams? Talent, Leadership and Execution.*

Talent, Leadership and Execution

This year the Duke University Blue Devils are the number one overall ranked team in the tournament. Incredibly, this is the 14th time they have been a number one seed. Lots of teams can catch lightning in a bottle and vault to a one seed for a year, but to have achieved this status 14 times requires something truly special. First, they build a team of talented athletes. Second, they have a tremendous teacher and leader in Coach Mike Krzyzewski. Finally, they are able to consistently execute their game plan on the court. While they may not win the championship every year, this combination of talent, leadership and execution has consistently placed them in a position to win.

The same logic applies when fundamentally analyzing businesses in which FCI looks to invest. Does the company have unique capabilities, such as innovative product development or superior services? Does the executive leadership, especially the CEO, have a sound business plan in place? Finally, does the company consistently execute on their plan and deliver positive results for shareholders? As an example, let's examine one of the largest companies in the world, Apple. The iPhone has now become essential to many people's everyday lives; they use it for communication, information and entertainment. They are led by a talented CEO, Tim Cook, who has expanded the app ecosystem as well as pushed into new areas such as health care and wearables. Their returns on capital have consistently exceeded a healthy 20%, and shareholders are being rewarded with increasing dividends and share repurchases by the company. It is not a surprise that Apple's stock, inclusive of dividends, has exceeded the return of the S&P 500 over each of the last one, three, five and ten year periods. An expanding product and services ecosystem, talented management team and strong financial returns all suggest this performance can continue going forward.

Know the Odds

Chances are you, or someone in your immediate circle, have filled out a tournament bracket, maybe even a few. While it may be extremely difficult to pick the national champion with precision every year, it is a pretty safe bet that at least one or two number one seeds make it to the Final Four. Conversely, picking a 16 seed to upset a top ranked seed is a risk not worth taking even though it happened for the first time ever last year to Virginia. Our philosophy on investing in stocks is that high quality companies, the proverbial one seeds, will prevail and prosper over low quality companies in the long term. We also believe that owning a diversified portfolio of quality stocks and bonds enhances the probability that long-term returns are positive while minimizing volatility. When managing portfolios, we have the ability to pick more than one "team" and we do not believe in taking "long shots" or unnecessary risk to achieve short-term returns.

As students of history, we also examine long-term market data to guide our investment decisions. There are two data points that are simple to understand, yet incredibly powerful. The first is that since 1950, corporate earnings have compounded at a 6% annualized growth rate. Some years may be better, as in 2018 on the back of corporate tax reform. Some years may be worse, most notably during economic recessions. Over long periods of time, this average earnings growth rate of 6%, combined with a roughly 3% dividend yield, is essentially equal to the long-term market return of 9%. The second data point is that over 80% of the time the economy is expanding, which means that about 80% of the time stock market returns are positive. With a long-term time horizon, those are very attractive odds.

Emotional Investing

One of the hardest parts of filling out a tournament bracket is picking upsets. It happens every year where a small school takes down a perennial powerhouse. The problem is that you have to know exactly which upset will occur in what game and in which round. This kind of guesswork is pretty similar to an investment strategy based on market timing, which rarely works out in your favor. The data actually shows one is better off being fully invested in a portfolio with a proper mix of stocks and bonds based on your goals and risk tolerance. Sound allocation is what truly protects a portfolio in periods of weakness and also allows one to fully participate in strong markets.

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Many investors panicked and sold stocks in December last year after the market declined close to 20%. Since then the market has almost fully recovered to the previous highs. Yet, if you "got out" of the market in December you are probably having a hard time "getting back in" the market now. This kind of emotional investing can have damaging effects to the long-term value of your assets. The reason is that, coming off the lows, markets typically experience large gains in just a handful of days. Removing the best performing day in each calendar year would have reduced portfolio values by 14% and 30% over five and ten year periods, respectively.

Long Term Success

As we have now passed the ten year anniversary of the current bull market, it is remarkable to think about how far we have come. There have been many ups and downs along the way, and surely more to come, but we believe the outlook is positive. We also realize that in today's world there is an ever increasing amount of noise that can cause even experienced investors to make short term mistakes. Our mission remains constant: create peace of mind for clients through disciplined adherence to a sound, long-term investment strategy while avoiding short term emotional decision making. This is our version of a winning approach to ensure long-term success.