

LOOKING IN THE MIRROR

“MANAGING TO PERFORM IN ALL MARKET ENVIRONMENTS”

At the time of Perennial’s inception, we stated our philosophy, written above, to emphasize our flexible investment style’s ability to execute in all economic and investment climates. This philosophy has been instrumental in our success and it has been the reason we have been able to earn our clients excellent returns.

The Perennial Equity Portfolio has earned more than 160% since inception in 2006 compared with less than 20% for the S&P 500 Total Return Index. These positive returns were not earned by assuming extra risk. They were made possible because we have not had a year of negative returns, even when others were experiencing huge losses in 2008.

These past years have been thrilling for those of us at Perennial but we are concerned as we now look to the future. It appears that the need for investment flexibility will be even more important if investors want to hold on to their hard earned gains and preserve their capital.

Let’s deconstruct our philosophy statement as a guideline for how equity portfolios will need to be managed in order to earn premium returns in the coming years.

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MANAGING

During the very long bull market in the US that began in 1982, investment managers looked very smart because the ever-rising markets made anyone who bought anything look smart. In 2008 those same investment managers looked foolish because the correction took all stocks down, no matter how good the companies were. What changed?

In our experience most investment managers are very smart. They can take apart a financial statement with ease and they can understand what makes complex businesses work. They digest immense volumes of data and their excellent memories enable them to recall this data effortlessly. However, managing a portfolio in these difficult times requires that investment professionals need to consider more than just the financial prospects for an individual company. Investors will be required to evaluate the external environment prior to determining appropriate company valuations. If you have ever seen the video on YouTube, [Count the Number of Passes](#), you will understand this point clearly. At Perennial, we look to get perspective by reviewing previous markets when the economy and markets were more like what we are now experiencing.



During the twenty year bull market, ignoring economics and market trends became de rigeur. Analysts concluded that markets only went up so one should never be un-invested. Focusing on choosing the best companies was all that was required.

Managing therefore became simpler as there were fewer issues to be concerned with. This was an excellent strategy at the time but if you accept that we have entered the next stage of an investment cycle, investors will need to add an extra dimension to their process.

Perennial's solution to this portfolio management challenge has been to design a process that has four components:

1. Is there value in being invested and if not how do we protect the portfolio and earn income?
2. If there is value, where can it be found? Which assets, sectors, and sub-industries represent the best value and will they perform well in the current economic environment?
3. How can the portfolio be designed to balance the desire to earn excellent returns and protect the portfolio from unforeseen shocks?
4. Which companies have the characteristics to perform well in the expected environment?

This strategy is not new; it takes the portfolio management process back to how things were done in the nineteen sixties and seventies.

PERFORM

Investors describe themselves as having very different performance objectives. At one extreme some say they don't care about returns, they just don't want to lose their principal. At the other extreme, others do not even mention the possibility of loss as they want to maximize returns. The vast majority of investors depict themselves somewhere in the middle. In our experience, even those that say they are not concerned about risk, only say that because they do not expect to lose money. When returns fall dramatically they get as upset as or more than the others.

Our view is that all investors' objectives are similar; they want high returns and fewer losses. This is easy to say but not so easy to accomplish. Understanding some of the math of investing can help investors come to terms with their objectives. An investor whose portfolio grew by 50% in year 1 and went down by 40% in year 2 will have lost 10% of his/her money. For every \$100 initially contributed, \$90 would remain. Maybe this was exciting but it definitely was not a good investment plan.

Another investor that made 4% in year 1 and 6% in year 2 would have \$110.25 for every \$100 contributed. Multiply this by 20 years and the differences are spectacular.



How should people view returns? What matters is what the portfolio is worth, when it is needed, and what you had to live through to get there. Obviously if one could earn 20% per year and not experience losses this would be preferred over either scenario described previously. However, the impact of large losses should not be lost on investors as they plan their investment strategy.

Hefty losses are devastating and are very difficult to recover from. Investors received this lesson in 2008 and they are still reeling from the after-effects despite a 100% subsequent gain in the equity markets. There is little comfort in knowing you lost 32% of your money even when the index is down 38%. While losses cannot always be avoided in investment markets, the tragic results caused by large losses necessitates that investors question the need to earn the highest return for their portfolios at all times. A team that only plays offence may be exciting to watch, but it rarely wins.

Performance should be measured by how much you have at the end combined with how much anxiety it caused getting you there.

MARKET ENVIRONMENTS

As we endure the heat of summer it is a good time to discuss the environment. This year we have experienced an unusual spring where rain and cloud were the norm and the beautiful spring weather we come to expect passed us by completely. It happens, and as good Canadians we accept living with unusual weather. Somewhere in our closets we have the appropriate clothing.

Many businesses that depend on the weather have had a very difficult spring. Clothing retailers had to put spring clothing on sale early to reduce inventories and to make sure they have sufficient cash to pay for their summer purchases. Restaurants that expect sales on their patios had to reduce their overhead to deal with lower revenue. If either of these groups ignored the weather and assumed it was always average, it would not be long before they were out of business.

Historical analysis tells us what to expect from spring. We can calculate the average temperature, average rainfall, and when spring begins and ends. The patterns emerge year after year and while we know that they are never exactly the same, we understand what to expect. The Farmer's Almanac uses this data to predict the weather. That does not mean they can predict weather accurately but if they can improve the odds marginally it can be very valuable.

Stock markets also have cycles and when one looks back on the stock market's performance over history, the cycles clearly pop out. It is difficult to predict market cycles but we would have to be naive to assume one can ignore them completely. It might be analogous to walking outside in winter without a coat. Or it might be similar to retailers ignoring the weather.



At Perennial we have referred to where we are in the investment cycle numerous times over the past six years. We have been decidedly negative for the majority of that period as we believe that the bull market that began in 1982 is over. During the last three years we have watched as governments around the world had to pump more and more electricity into the “Frankenstein” economy to keep it dancing. This cannot provide much comfort as we look to the future.

Despite this overall negative stance we have helped our investors earn excellent returns. We have been able to do this because we were willing to stand back and view what was happening in the world with the perspective of how this was similar or different to previous markets and how these assets were valued in relation to how other asset were valued. This helped us avoid the worst and accept the opportunities the market provided. An investor that can put this all together reasonably well will be able to succeed in difficult markets.

Final Thoughts:

When you look in the mirror do you see someone with a strategy designed to take advantage of the opportunities that will be present over the next few years? Looking to the future will enable you to have a more logical strategy than reacting to each new day’s good and bad news.

Maximizing the upside is an excellent strategy in bull markets. Protecting capital is better in a bear market. Stretching to maximize returns can be disastrous in either scenario if you are wrong. Balancing risk and return remains the key.

Enjoy the summer and make sure your portfolio is positioned for the upcoming stormy weather.

