business owner, not a market gambler, suits my temperament. I confess patience is not an ingrained virtue of mine, but it is something I have worked on over the decades.

Value investing is somehow thought to be old-fashioned, although it only dates to the 1930s. By comparison, momentum investing can be traced to the 17th Century, technical analysis to the late 1800s, and growth stock investing to the 1920s. The Quants have been with us since 1900. The only old-fashioned thing about value investing is the belief instant gratification is the result of luck, or, simply a statistical fluke.

> *"From the Bubble's peak through to the next cycle's top in 2007, value stocks were up about 40% plus dividends…growth stocks did not recover fully from their overvaluation."*

Value investing works for two main reasons. First, simple math. The great mathematician, Benoit Mandelbrot, aptly noted that it is, "…just common sense: A stock for which you overpay from the start is less likely to give you a profit." The opposite is also true.

There is also a value-investing 'fear' premium. Think of it as a long-term reward for taking a contrarian position. You are buying inexpensive things that others shun and avoiding what is popular. Hard to do unless you possess the correct temperament.

Strategy Investing and Mean Reversion

Time-honored strategies that have generated adequate returns over the decades include Value Investing, Trend Aggregation and Risk Arbitrage. None of these strategies consistently outperform, but if you give them time to work, all can be used in helping you to achieve a successful investing life. Employing different strategies as part of a long-term plan is called 'Strategy Investing.'

'Strategy investing' is a long-term, mean-reverting process. The idea is that those that are first shall be last and vice-versa. Another way of thinking about it—a .300 hitter should have a great second half of the season if he's hitting, say, .230 at the All-Star break. And, vice-versa. To value investors, mean-reversion is like compounding. It is yet another powerful tool in our box.

Mean-reverting means you should not chase performance, including 'strategy success.' Studies show a strategy's most recent five-year performance is negatively correlated with its subsequent five-year performance. A considerable period of underperformance is required to set the stage for future profitability. The opposite is also true. A period of underperformance sets the stage for outperformance.

The Case for Value Investing Right Now

Value investing has generated adequate returns during this eight-year bull market, but it has underperformed many benchmarks. Explanations are not relevant here. What is important are the reasons to think value-investing is on the verge of a multi-year outperformance cycle.

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In many ways, we are in a similar situation to the late 1990s during the Internet Bubble. An outsized amount of stock market gains in the Indexes have come from a disproportionately small group of large growth companies. The overall stock market is expensive by any historical measure.

On the other hand, many individual companies, particularly the ones shunned by Exchange Traded Funds (ETFs), continue to trade at reasonable valuation levels. Value stocks are historically cheap relative to the rest of the market, due to many years of underperformance.

> *"In many ways, we are in a similar situation to the late 1990s during the Internet Bubble."*

It is noteworthy that when the previous era ended, a powerful reversion-to-the-mean adjustment started. The result? From the Bubble's peak through to the next cycle's top in 2007, value stocks were up about 40% plus dividends.

This compares to a rise of 8% in the S&P 500. Notably, growth stocks did not recover fully from their overvaluation. Peak-to-peak, growth stocks would generate a negative return of -12% during the stretch.

Barrack Yard Investors, Llc.

Apart from our deep understanding of individual investor behavior, you should consider our focus on 'predictive' behaviors and factors, our practice of owning individual businesses, and our 'skin-in-the-game' approach.

'Predictive' Behaviors and Factors

'Predictive' behaviors and factors are time-tested actions and attributes shown to produce long-term outcomes. An example outside the investing realm is the idea that eating properly, along with daily exercise—*though no guarantee*—will lead to a healthier life, as opposed to a diet of junk food and persistent inactivity.

Investment success, like everything else in life, can be postponed or eluded by unknowable factors and events. *There are no guarantees*, but by focusing on 'predictive' factors, we can create probabilities in dealing with uncertainty, thereby improving our chances for success. As we add factors, we increase probabilities and further our odds of a desirable outcome.

Staying with the healthy-life metaphor, add a history of longevity, meaningful work, moderation in all things, a smoke-free environment and a happy social circle to the factors of proper diet and exercise, and the odds the person will indeed be healthy are increased.

'Predictive' factor investing works the same way. Not liquidating your stocks *after* a severe market decline, or viewing your holdings as pieces of operating businesses, or taking stock-market predictions with a grain-of-salt are examples. 'Predictive' factor investing can be used in implementing strategies such as paying attention to the

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Capital Cycle, or they can be the basis of an investment checklist in identifying suitable companies to own.

Without revealing too much of our secret sauce, we consider paying a fair price for a business that has consistently made money, earns high returns-on-investment capital (ROIC) versus its weighted average cost of capital (WACC), enjoys a modest debt profile, and has plenty of money-making reinvestment opportunities to be 'predictive' factors.

Owning Individual Businesses

Our focus on individual businesses runs to the heart of value investing. It allows us to avoid popular and overvalued assets, concentrating instead on companies that meet our yield requirements.

We believe the current mania for so-called passive strategies, as evidenced by the popularity of ETFs, will eventually disappoint participants. US stocks, in aggregate, are priced to deliver paltry long-term returns simply due to elevated valuation levels. ETFs reflect this reality.

For example, the NASDAQ 100 Index reports an earnings yield of 4.3%. This is low by historical standards and implies unattractive future returns.

Given the way index creators calculate valuations, however, the yield is overstated. Strip away financial alchemy, use a common-sense calculation, and the true earnings yield is an unappetizing 2.4%.

In addition to reflecting the way indexes report valuations, ETFs have an inherent flaw with many implications. It is related to an implicit promise of liquidity, and the assumption an ETF can be sold during the trading day at a price reflecting the value of each underlying component.

"This drives ETF manufacturers to subordinate all investment decisions to liquidity considerations [with] some weird implications."

In practice this means an ETF is only as good as its least liquid component.

This drives ETF manufacturers to subordinate all investment decisions to *liquidity considerations*. This is an anathema to our philosophy which considers *valuation to be the linchpin*. It also has some weird implications.

For instance, companies with heavy insider ownership (a 'predictive' success factor) are often excluded from ETFs because management-owned shares reduce the stock's liquidity. Many foreign country ETFs have minority exposure to business being done in that country. Again, liquidity is the culprit, resulting in portfolios of multinationals with limited domestic exposure.

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Then there are ETFs that purport to be 'Value' portfolios but are indiscernible from other strategies. One of the biggest, the iShares S&P 500 Value ETF, currently has valuation metrics not dissimilar to the actual S&P 500 Index, which itself is historically expensive.

In what can only be explained as yet another outcome of putting liquidity first, Value ETFs and Growth ETFs by the same manufacturer often hold many of the same companies!

"The potential return from owning "the market" at today's elevated levels, concentrated in expensive stocks, is just not worth the risk.

A herding effect has taken hold of ETFs, creating concentrated portfolios. Financials comprise 28% of the iShares Value ETF—not exactly consistent with the spirit of the "prudent man" rule regarding diversification.

Even the broad S&P 500 Index has concentrated risk, as a small number of companies generate an outsized amount of the returns. Just one example. In 2015, two percent of the Index's holdings (10 out of 500) generated more than 100% of its return that year.

I believe the potential return from owning "the market" at today's elevated levels, concentrated in expensive stocks, is just not worth the risk. A couple dozen good businesses with attractive yields is where my money is invested.

'Skin-in-the-game'

The phrase, 'skin-in-the-game' was coined by Warren Buffet. It simply means you have a personal stake in the outcome. It shows an alignment of interests. In evaluating a company in which we may invest, determining if the people who run the business have a meaningful ownership stake, and whether they committed their own money to acquire the stake, is a key consideration. It is a 'predictive factor.'

As portfolio manager at Barrack Yard Advisors, the same standard applies. I have over 90% of my financial assets invested in the same companies as my clients, along with the same fee structure. I eat my own cooking.

-Marty Leclerc

Winter 2017-2018

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