KLCM Kitzinger, Lautmann Capital Management, Inc.

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Time Arbitrage

Arbitrage involves taking advantage of disparate pricing on similar assets by buying one asset and selling the other. Later when the price discrepancy is lessened or resolved, the trades are reversed. Investing may be viewed as a type of time arbitrage where investors buy a portfolio of securities and later have the option to sell the components of that portfolio with the benefit of time and the magic of compound interest. In true arbitrage, the investor is hedged and risk is theoretically constrained. While there is no simultaneous hedge in the concept of time arbitrage, **the last 140 years of equity history fully support the concept of constrained risk and attractive returns over longer periods of time.**

Most investors equate risk with volatility; a bumpy ride implies high risk. By that definition, stocks are very risky. Over the 140 years, from 1871 to 2011, stocks had negative returns in 38% of the months and in 29% of the years. There is no doubt that stock prices are visibly whipped around by changing investor sentiment in the short-term. But buying any asset with a 30 or 365 day horizon is more akin to speculating than investing. An investment is made looking broadly at the quality of the asset being purchased, the growth characteristics of the business and end markets, the capabilities of the management team and the valuation of the asset. Those factors can only play out over time, with help from growth in the global economy.

Over longer periods of time, earnings growth and the valuation paid will have more influence on equity returns than investor sentiment. As Benjamin Graham stated, “In the short run, the market is a voting machine but in the long run, it is a weighing machine.” Since the economy and corporate earnings grow over time, with higher highs and higher lows through economic cycles, so too do share prices. Thus, **equity investors with at least a five year horizon, an appropriate asset allocation and reasonable withdrawal rate should be able to successfully navigate adversity.** This has been demonstrated time and time again; most recently from the depths of 2008-2009.

The real risk in investing is not the volatility of marketable assets unless one is forced to sell on a bad day. The real risks for investors are the permanent loss of capital or the loss of purchasing power. Permanent impairment of capital may occur when an investor dramatically overpays for an asset or when an investor gives up in a period of adversity. Though individual stock mistakes will happen, **a focus on value** mitigates the risk of permanent loss of capital for a portfolio of stocks and a comfortable asset allocation helps investors ride through bear markets without capitulating.

The loss of purchasing power occurs when investment returns do not keep up with inflation. Commodities are a good example of an asset class that has not kept up with inflation over long periods of time. However, **stocks have posted a 6.9% real rate of return (after inflation) over 140 years and have a lower probability of losing out to inflation than bonds.** So while stocks are volatile in the short-term, they provide the best chance of growing capital among marketable asset classes in the long-term. In effect, **equity investors can trade time, short-term volatility and patience for a high probability of superior real returns on their capital.**

Warren Buffett in his 2013 Berkshire Hathaway Letter to Shareholders summed up how investors should view the erratic short-term behavior of the stock market.

It should be an enormous advantage for investors in stocks to have those wildly fluctuating

Two Plaza East ·330 E. Kilbourn Ave. · Suite 1180 · Milwaukee, WI 53202 · 414-765-1234 · klcm@klcminc.com

valuations placed on their holdings – and for some investors, it is. After all, if a moody fellow with a farm bordering my property yelled out a price every day to me at which he would either buy my farm or sell me his – and those prices varied widely over short periods of time depending on his mental state – how in the world could I be other than benefited by his erratic behavior? If his daily shout-out was ridiculously low, and I had some spare cash, I would buy his farm. If the number he yelled was absurdly high, I could either sell to him or just go on farming.

Owners of stocks, however, too often let the capricious and irrational behavior of their fellow owners cause them to behave irrationally as well. Because there is so much chatter about markets, the economy, interest rates, price behavior of stocks, etc., some investors believe it is important to listen to pundits – and, worse yet, important to consider acting upon their comments.

Those people who can sit quietly for decades when they own a farm or apartment house too often become frenetic when they are exposed to a stream of stock quotations and accompanying commentators delivering an implied message of "Don't just sit there – do something." For these investors, liquidity is transformed from the unqualified benefit it should be to a curse.

A "flash crash" or some other extreme market fluctuation can't hurt an investor any more than an erratic and mouthy neighbor can hurt my farm investment. Indeed, tumbling markets can be helpful to the true investor if he has cash available when prices get far out of line with values. A climate of fear is your friend when investing; a euphoric world is your enemy.

Investors with the staying power to own equities through rough markets for five years using income, cash and, if necessary, selling some bonds, can reap superior absolute and real returns through the vast majority of cycles. Staying power also requires the temperament to make it through down-cycles. As they say, one should reduce equities down to the level of comfortable sleep well before adversity strikes. We hope that individualized asset allocations, open communication and our style of equity management have helped each client to reach that level.

We have accumulated a fair amount of cash in equity portfolios as the market has become more fully valued. In addition, we have entered a period of disequilibrium fueled by diverging economic growth and central bank policies around the world. Economic weakness in Europe and Japan is leading their central banks to print money (quantitative easing - QE) just as the US is concluding its QE and preparing to raise short-term rates. **The resulting strengthening of the dollar is rearranging global capital flows, commodity prices and valuations across financial markets.** Unfortunately, the stronger dollar and weakening emerging market economies will make growing corporate earnings more challenging. Fortunately, US consumers are poised to benefit from lower costs for commodities such as gasoline, lower prices on imported goods and a solid jobs market. So, while the US economy is growing at a reasonable rate, new winners and losers will emerge from this environment and the markets may have more sorting out to do.

We look forward to utilizing cash should this digestion period extend. We hope that the "erratic neighbor" offers us the opportunity to buy growing enterprises at valuations that offer worthwhile long-term return potential and more restrained near-term downside. **When the entry price is right, the future benefits of time arbitrage become more visible and the short-term bumps less relevant.**