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Recently I spoke at the Value Investing Conference at the Darden Graduate School of Business Administration at the University of Virginia. The subject was whether or not the current ongoing implosion of financial engineering in the investment management world would lead to a return to classic value investing. I thought you might find this topical.

I have every confidence that the major tenets of value investing, many of which I touch on in this speech, will successfully see our clients and ourselves through this historic financial dislocation, as they have for the last 36 years. I believe also that many institutional and private investors who ventured into complexity and leverage in the management of their assets in recent years will return to classical long-term portfolio management. Value investing is different from speculation and leverage. Value investing has everything to do with the financial reality of companies, their cash flows and their quality.

—Donald Wilkinson

Will the Collapse of the Shadow Banking System Give Value Investing a Second Wind?

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It's an honor to speak at the First Annual Value Investing Conference at Darden, a conference that I feel certain will take a leading role in the future of portfolio management.

Tonight I am going to talk to you about *ideas having consequences* and whether the dramatic reversal of fortune that occurred in structured/engineered/leveraged finance will lead to a renaissance of value investing. Modern portfolio theories have led to the destruction of more capital in 2007 and 2008 than all the bank failures and corporate frauds in the post-World War II period. As yet, I am unaware of much discussion of the root causes of this disaster. As a champion of value investing, I have strong views and hope to start such a discussion.

Wouldn't you think that with the global financial crisis of the last 18 months and the obvious disregard for risk that took place in the industry, it would be a logical moment for value investing to come into its own? Yes, but only if logic prevails.

Let's look at history leading up to recent dramatic events. The bursting of the bubble in the *Shadow Banking System* has taken with it much of the intellectual underpinnings of modern financial engineering and has led to what I believe will be over \$2 trillion in losses in write-offs alone. The rapid collapse of the independent investment banking industry, commercial banks, mortgage banks and hedge funds, and the toxic effect of CDO's, CDS's and other financial instruments has pushed the global economy into the worst recession in 60 years and the first synchronized global recession since the world became flat. It has led furthermore to unimagined involvement by government in the financial industry.

How did this mess happen and what does it have to do with investment portfolio theory? Great popular movements *always* begin with ideas, and most ideas are nurtured in an academic/intellectual environment – ideas that find their way into commercial and civic affairs. Think Jefferson. Think Marx or Adam Smith or Art Laffer. Ideas matter, especially if later at some point Mother Nature finds they have inherent weakness. Let me take you through my version of MPT history and how these ideas overshadowed the concepts of classic value investing and have been institutionalized for four decades.

At first I thought I might title this address "Extraordinary Popular Delusions and the Madness of Crowds." Charles MacKay wrote the seminal work on manias published in 1841. This should be

must-reading for students of finance because MacKay catalogs the great financial manias such as: “The Mississippi Scheme,” “The South Sea Bubble,” “The Tulip Mania in Holland,” and were he alive, he would write the next chapter, called the mania in “The Shadow Banking System.”

The *Shadow Banking System* encompasses that group of investment firms and structures that adopted the business model of banks. That is, they borrowed short and lent long. Unlike commercial banks though, because they were not regulated, they were not required to set aside reserves for emergencies. At its peak, this system built up liabilities of trillions of dollars. This year the entire system of short-term funding experienced a “run on the bank” putting at risk any institution or fund highly leveraged.

This did not happen overnight. In my view, the SBS has been a conceit built on 50 years of portfolio theory, which led steadily down a path away from value investing towards increasingly complex, highly leveraged, quantitative structures, structures which under stress failed investors and a lot of other people. Don’t ask those folks about risk controls – they had the most sophisticated ever. They were just asking the wrong questions.

Well, how did we get to this sorry state? I think it’s clear. The investment management field began its journey down the slippery slope with a remarkably simple idea. That idea was that a stock’s volatility is a measure of its risk. And to use Alice Schroeder’s image, from there it has been a snowball rolling down a long hill of wet snow.

That seductive, but I believe fatally flawed, premise that volatility equates to risk, grew in complexity over the years until in this decade in its most updated version the idea had evolved to a point where a number of hedge funds sold investors on the concept that they could structure a highly-leveraged portfolio with such exquisite risk-management techniques that they would only show positive monthly returns but have low volatility. Thus, “volatility is risk” turned into “we can produce a high return with low risk,” or more simply said, “yes, there is such a thing as a free lunch.” The boldness of this message was awesome because it turned upside down the concept of risk and return. In our firm we used to scratch our heads as to how this was possible. Now we know it wasn’t. A number of hedge funds managed this way never had a down month until they closed their doors recently – essentially wiped out.

The birth of financial engineering came earlier than you might think. Harry Markowitz wrote a paper in 1952, “Portfolio Selection,” which made the case that rather than focus on individual securities in constructing portfolios, one should build a portfolio focusing on the overall risk-reward characteristics of the securities owned. His emphasis was on portfolio construction, not the merits of individual holdings. The emphasis was on quantitative characteristics of a stock’s price movement, not its fundamentals. In 1990, Professor Markowitz won a Nobel Prize for his work on portfolio theory.

In the interest of time, I have to skip forward and not dwell on each step, but needless to say over the intervening five decades modern portfolio theory and financial engineering gained ascendancy, resulting in an evolution in thought and practices, which led to new financial products and created a multi-trillion dollar industry.

The random walk theory, efficient markets, index funds, sector funds, style boxes, tracking error, alternative investments and derivative products were created and facilitated the institutionalization of the investment management business. Each step of the way pushed investment managers further from specific fundamental analysis and encouraged reliance on quantitative measures of risk in portfolio construction. Of course concepts of diversification and correlation were all part of the conceit. And it may surprise you that even the earliest academic papers encouraged the use of leverage in portfolios to effect the most efficient Capital Market Line or Efficient Frontier. Debt was seen early on as a positive force for better portfolio performance.

Now many years later the cumulative effect of this intellectual construction of how markets work and how portfolios should be constructed is crashing. Systemic risks have been exacerbated by the very ideas that were purported to grant immunity and to be uncorrelated. Nor have complexity and opaqueness served investors well in crisis. Markets for some financial securities that were recently created and often highly rated are now frozen and when sold, securities are often sold at cents on the dollar.

This past Monday, Professor Markowitz was quoted in *The Wall Street Journal*. He said that financial engineers had violated the first principle of his portfolio theory, "Diversifying sufficiently away uncorrelated risks can reduce portfolio risk toward zero." Then he added, "But financial engineers should know that's not true of a portfolio of correlated risks." However here Professor Markowitz should surely know by now that most recently all markets *have been correlated*. There was no place to hide. There is simply no asset or sector diversification that is possible that will protect assets in a global market in crisis. I have watched this evolve for years now. The Heisenberg effect has been at work at an exponential rate as each new financial strategy has been pursued. Heisenberg noted that if something is observed, the observation itself creates change. In the world of finance over each of the last decades, previously uncorrelated markets and assets, such as international investing or commodities, became correlated, as global markets opened up and financial engineering grew. As soon as an asset was identified as being uncorrelated, then in the next cycle it became correlated. Diversification was lost.

In my memory, the failure of LTCM in 1998 was the first great warning of this correlation crisis, as almost all markets for a time then became correlated to one. The watchword became, to market practitioners like ourselves, that in times of crisis all assets have a correlation of one. Don't fool yourself. That is exactly what has been happening in 2007 and 2008.

Throughout this period there has been in the investment industry a core group of value investors, many you have heard today at this conference. These investors have pursued their interests, possibly breaking all of the currently popular quantitative rules, i.e., they may have emphasized individual stock selection – they diversified but with moderation and avoided excessive leverage, knowing that it has always been destructive in finance unless used carefully.

Which brings us to the question before the house this evening: Will this systemic failure in the *Shadow Banking System* and the more obvious flaws in its intellectual foundation now give value investing a second wind?

Before answering, let me take one last detour and emphasize why I think value investing is a more enduring investment management model. In my career, I have been really just an analyst of companies, industries and events, with a dose of international money and banking as a background. Therefore my observations are more pragmatic than theoretical.

As a student of finance I have been lucky, my career has paralleled the progress of MPT. I have watched it grow from its infancy. In the 1960's, I was lucky enough to know wonderful advocates of quantitative investing like Jack Traynor, Bill Sharpe, Dick Brealey and Dean LeBaron. However from my earliest familiarity, I have always been struck by how unstable the core ideas were about volatility. Knowing a stock's volatility never seemed important to me in the process of investing. It really never has helped me in calculating a future return, nor have I ever looked back and attributed success or failure to volatility. Possibly it was my education at Darden, my own proclivities or my experience with stocks, but I have always had a deep skepticism about statistical series, especially in investment management. Instead, all those essential elements that make up an investment, like people, regulation, pricing, the underlying fundamentals of supply and demand, and opportunity, always caught my imagination. I thoroughly believe value investing not only allows for change but best equips you as analysts to capitalize on it.

First and foremost, value investing *is* about financial values. Yet I submit it is also, when practiced at its best, about human values. Most of these values are related to human nature, the foibles and strengths we all possess. Value investing must forever be connected to Graham & Dodd, but in my own experience, while financials have to make sense and must meet high standards, of equal importance is the character and maturity of the people in whom you invest. I don't mean to set an unrealistic standard, but if you invest in people who have a proven record of achievement and who treat their shareholders fairly, your odds of achieving your investment goals go up sharply.

In our firm, we think of value investing as also being about integrity. Integrity informs the makeup of great companies: how they sell their products; how they structure their balance sheets; how they compensate themselves; how they communicate to shareholders and more recently how they relate to the environment.

An understanding of this human nature component of investing is actually the genius and in my view the chief characteristic of Warren Buffet's success. No one has ever written as consistently and so well about human nature in investing as he does in his annual commentaries. Over the years these reports have been the closest comparison in contemporary work to Ben Franklin's almanac. Think about how Buffett highlights the qualities of the men and women who lead his companies. The annual reports always brim over with straightforward Midwestern-American wisdom. He gets right to the heart of the matter. He reduces complex issues of today to an example everyone can understand. I suspect he does this for himself first.

My experience has been that most great investors can usually boil down the reasons for making an investment to a paragraph or a short statement. Buffet stands head and shoulders above everyone in this regard. For example and quite topically to this evening's subject, it was Buffet who after

experiencing the reality of managing the General Reinsurance portfolio of derivative securities, first described them as “weapons of mass destruction.” Ask the poor shareholders of AIG who maintained their positions if they now understand what he meant?

This emphasis on the human element highlights the great differences between the two schools of value investing and modern portfolio theory. Value investors know that other than when they are simply buying extraordinarily cheap assets at a discount, management truly matters. It is the risk-control above all others. If you want a high margin of safety when investing then simply find good people. They will deal with risk for you.

And what about performance? Can you, as a value investor, really outperform efficient markets? I won't dwell on this for too long but just to say that there are simply enough long-term public records of value investors who have produced superior returns compared to the market to make this a moot issue. “Yes” is the answer.

Our firm has been one of those outperformers.* The way we explain this is to say that if you own an indexed or a closet indexed portfolio you simply will earn market returns. But if you build a portfolio of excellent financial machines generating above-average returns on capital and producing free cash flow; and these companies have some form of natural moat around their business; when they are led by managements you admire and trust and are proud to be in business with, those who have footprints showing they respect shareholders; and furthermore if you do not overly diversify; then it is hard over time not to get a superior return. We have been doing just that for 35 years, not without some very tough years and demanding moments.

So let's finally get to the point. Do I think that the crisis and downsizing in financial engineering, leveraged finance and the whole *Shadow Banking System* is going to give value investing a second wind? *Not necessarily.*

Don't count on it. There is an enormous entrenched operating and marketing infrastructure supporting even the damaged *Shadow Banking System*. Nor will its intellectual base cede ground easily. I expect these two parallel universes will most likely co-exist for a long time. Certainly the current hard times of credit contraction have financial engineering on the ropes for the moment, but I sense that there are so many talented people involved that the industry is more like a Schwarzenegger “Terminator” movie. No matter how many times you try to destroy it, it just keeps coming back.

Value investing may be too easy to talk about and too hard to do. Value investing just isn't edgy enough for some investors. It seems pedestrian or boring and maybe old-fashioned. Of course, it is enormously satisfying and a proven way to build wealth. There certainly is no mystery in the language surrounding the field, although it does require a fair amount of discipline, patience and independence from the investment pack to be effective. The latter is particularly hard on people, for being in the warm center of the herd is more comfortable for most participants in investment markets. Not that this is a bad thing for value investors. It's really best for investment firms like my own if the larger institutional investment management business sticks with its infatuation with

quantitative management. This will almost insure that we and other value investors have an open field ahead in searching for opportunity. Personally, I like that.

Looking ahead, I anticipate a number of historic changes in the world of finance in the next five years. Any investor or investment firm is going to have to possess great flexibility to adapt to changing circumstances. The driving forces behind the global economy may shift sharply. Currencies will realign again. Different asset classes may surprise you by their performance both negatively and positively. We expect a number of six-sigma events or shall I just say *surprises*. For value investors, I think of this probably unstable environment as rich with opportunity. For financial engineers it may be continuing hell. I urge you here tonight to think of the years ahead as a golden opportunity for value investing and for you. Thank you.

** Wilkinson O'Grady's Global Equity Composite compound annual 10-year rate of return (net of fees) as of October 31, 2008 was 8.2% vs. the MSCI World Index return of 0.8% and the S&P 500 Index return of 0.4%. Additional performance details can be found in the Investment Performance section of our website: www.wilkinsonogrady.com or by contacting David C. Johnson, Jr. at: (212) 644-5252.*