

Exclusive Outlook

WEST COAST ASSET MANAGEMENT, INC.

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Is Investing an Art or a Science?

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Occasionally, someone asks whether we believe that investing is an art or a science. This presents a tricky situation, because the question suggests a desire for the definitive and a low tolerance for paradox. Thus, our answer of “Yes!” usually proves unsatisfactory and confounding.

WHAT IS THE REAL QUESTION?

The “yes” answer is mostly flippancy, but it’s close to the truth. People asking the question usually intend “art” and “science” to represent “intuition” and “knowledge.” They are really asking the following: Is there some sort of unified field theory that explains everything, such that if we only studied hard enough we could always make money; or does investing require high levels of sensitivity and intuition, at the level of some rarified natural talent, such that only a gifted few can prosper?

These really are terrible questions, but many in our industry persist in perpetuating the illusion that investing is indeed a science, so we feel the subject is worthy of further discussion. Let us begin by plainly stating that investing is not a science, although investors should behave like scientists in their methodology. Further, investing is not an art per se, but certain artistic sensibilities improve one’s chance of success. In fact, the traits common to great artists and great scientists - keen observation, active imagination, courage to experiment and openness to change - make great investors.

DIFFERENCE OF OBJECTIVE

Though we share traits with scientists, the point at which we must differentiate ourselves from our scientific counterparts lies in their objective: to achieve a consistently replicable finding.

Consider this further: Science depends on the replication of results. By quoting the words that appear on nearly every piece of literature issued by the investment community, “Past performance is no guarantee of future results,” we may dispense with the notion that investing is a science. To simplify in the form of a logical syllogism: science depends on replication of results; the only certainty in investing is an uncertain outcome; therefore, investing is not a science.

OBSESSION WITH METRICS DOES NOT MAKE A SCIENCE

Many brokers, analysts and other professionals believe investing is a science because they rely heavily on statistical analyses and tools like Monte Carlo simulators (a highly sophisticated spreadsheet that accounts for thousands of variables to predict the future value of a portfolio). Despite these obsessive forms of measurement and projection, they still must concede: Past performance is no guarantee of future results.

It’s silly to hear investors talk about trading “rules” they have discovered by sorting through historical data and hypothetical forecasts. We study charts and conduct extensive research, but we would never base an investment decision on technical analysis alone, much less some supposed immutable laws of investing.

MECHANICAL REPLACEMENTS FOR MANAGEMENT

There’s an old joke that you can always tell a Harvard man, but you can’t tell him much. No offense intended to our readers who claim Harvard as their alma mater, but this joke is a good metaphor for a type of arrogance that fuels elaborate investment decision mechanisms. Some people feel they must have a concrete answer for everything, and cannot bear ambiguity.

These people attempt to reduce investing to a science, and because they are in fact very intelligent people, laymen often believe them. Some preach market timing (the ability to buy low and sell high based on trend calculation); others preach the efficient market theory, which maintains that the market responds so quickly and perfectly to conditions that one can only achieve superior results through insider information or very good luck. Many install mechanical trading rules and stop/loss orders, e.g. automatically selling a stock if the value drops by a certain percent.

All have reams of data and powerful computer models to support their beliefs, which are of course presented as facts. Like mandatory sentencing laws and over-complicated sales incentive programs, these “scientific” approaches are designed to minimize management bias and human error, but they also serve to reduce individual accountability. And yet their biggest flaw remains: they rarely achieve their goals.

Neither of these approaches, on their own, make sense to us. We



believe in people and their good judgment - such is the premise of an open market. An investor must weigh all available information, determine whether a stock is a good buy or not, and then manage the investment. For example, if we buy a stock at 80 because we believe its intrinsic value is really 140, we do so knowing that that stock might drop to 30 before it goes up. If it does drop to 30, we buy more because it is an even better deal. Someone with an automatic sell rule would simply take the loss and miss the long-term gains.

In their effort to build a perfect investing machine, the academic-minded brokers and managers lose objectivity; they cannot distinguish between observation and interpretation. Much as college English students hunt for symbolism until they cannot follow the well-told narrative before them, mechanistic investors constantly try to force events to fit their models; they lose the ability to see things as they are. Ironic, since objective observation is the first step in the scientific method.

AS EINSTEIN WOULD SAY, "IT'S ALL RELATIVE"

We do not understand the theory of relativity, but then, Albert Einstein did not understand the income tax. We do understand that the stock market is a complex system, so like a painter making sense of a boating party or an astrophysicist making sense of dark matter, we look for patterns.

For example, we observe that in the short-term, the market responds to human emotions: reacting to news stories, pop culture fads and other ephemera. But in the long-term, the market rewards earnings. These observations can influence our actions in the short- and long-term.

We also accept that the stock market is a massive interconnection of causes and effects; it's all related. Not all of the connections are apparent, so we must use our imagination to predict how certain events might play out. Most of Wall Street is very focused on profit-to-earnings ratios (P/E) and future growth estimates. They rarely give debt and tangible assets enough consideration.

For example, a company with a P/E of 20 and no tangible asset value (value of real assets that can be sold, such as real estate and cash) is much riskier than a company with a P/E of 20 and net tangible assets worth 70 percent of the company's current share price, all other things being equal. The funny thing about this is that the company with real estate will probably have significantly understated earnings due to the depreciation of their real estate assets, so the P/E figure itself becomes less meaningful. Scientists applying formulas might miss this connection.

Everything must be taken in context, and with the context constantly shifting, it is impossible to have a "rule" for picking winning stocks. A low P/E means little until one takes everything else into consideration, such as the balance sheet, growth prospects, competitive advantage, management quality, etc. Everything is literally relative, because every ratio, statistic and metric is intricately tied to hundreds of other factors. Computer models may help us get a better view of the data, but the only computer that can accommodate the high level of ambiguity in the stock market is the human brain. Consider that Einstein, the quintessential scientist, said, "Imagination is more important than knowledge."

ARTISTS, SCIENTISTS AND BUSINESSPEOPLE

As the saying goes, "Data is not information, information is not knowledge, and knowledge is not wisdom." However much research one does, experience refines one's judgment beyond the mere weighing of facts. To improve our investment results, we behave like scientists and artists, using tools and traits refined over years of practice. But are we *practicing* an art or science?

Perhaps neither. Investing is Business, a noble discipline unto itself, with its own set of conventions and aesthetics. But if forced to choose between the two, we say business is clearly more art than science. Confronted with a pitchman's latest scientific formula for guaranteed market success, we remember that attempts to reduce art to a science are like Dr. Frankenstein's attempt to create life through mechanical rather than human means: doomed to only create monsters.

SEEING IS BELIEVING

Cockroaches take a bite out of Krispy Kreme's share price

Krispy Kreme's announcements of restated earnings for 2004, miscalculated lease-related expenses, investigations into insider trading with executive's families, and finally the resignation of CEO Scott Livengood are just the latest in a string of negative forthcoming that have investors speculating about the value of the company. It is what we consider to be a prime example of the cockroach theory - profiled in our October 2001 Exclusive Outlook.

Shareholders should have been alarmed as soon as the first allegation of improper accounting at Krispy Kreme was uncovered. For those who weren't, their share price is down approximately 75 percent from when the first cockroach appeared in 2004.

Cockroaches are things that make investors raise an eyebrow, such as aggressive accounting practices, SEC investigations, growing inventory, lawsuits or anything that shows a compromise in ethics. Casting a bright light on companies with an exposed cockroach will set other cockroaches scurrying, and the stock price will follow suit.

We pay attention to what is happening with the companies we own, and if the price of what we believe to be an under-valued stock drops even further, we usually buy more. On the other hand, if news comes out that displays compromised ethics, we expect more trouble to come and usually cut our losses immediately. Patience is good, naivety is bad - It's better to sell at a marginal loss than to hold out for a major one.

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Annuities: Betting Against The House?

Clients and prospective clients often inquire about annuities. Annuities are an insurance product sold as an investment product, and are touted for their security and tax deferred returns. But annuities are not necessarily secure or competitive, and while they may suit the needs of some people, they rarely make sense for the wealthy or those who intend to be wealthy by the time they retire.

On the surface, annuities seem fairly simple: you give money to a company and they invest it for you. Either immediately or after a predetermined period of time, they start paying your money back. A "fixed" annuity pays a specific incremental amount (e.g., \$10,000 a month for 36 months), whereas a "variable" annuity bases the incremental amount on investment success (e.g., the total investment value after 10 years, divided by 36 - to be paid over three years). Variable annuities have the potential to outperform fixed annuities, but carry the risks of any stock investment.

EASY TO MISUNDERSTAND

Either immediate or deferred annuities can be designed to pay out for the life of the investor or for a set period of time. Simple on the surface, annuity contracts sometimes run up to thirty pages, and can be hard to understand because of complicated fees, payment schedules and "surrender" penalties for early withdrawal.

The most misunderstood aspect of annuities, however, is the performance. People believe advertising claims and often tell us, "I can get a guaranteed return of 6 percent or more from an annuity." **Investors need to understand that an annuity's promised return rate is not always a return ON principal; it may include the return OF principal.** At the risk of oversimplifying, if you invest \$10,000 and receive payments of \$1,000 a year for 10 years, the ad claims would be fulfilled with a technical 10 percent return. In reality, the return was a zero percent increase on your principle.

While annuities sometimes make sense for low- to middle-income people who have trouble saving money, or who have spending problems and need external controls on cash flow, there are four main reasons we discourage high income people from investing in annuities:

1. Tax disadvantages
2. Performance disadvantages
3. Inflexibility
4. Insurer reliability

INCOME VERSUS CAPITAL GAINS

Annuities are often promoted as a tax benefit because they can be used to defer taxes (much like an IRA account). Taxes on the annuity's growth are not due until money is withdrawn. Thus, people can use annuities to spread their tax liability over time. Unfortunately, this method of tax deferral shares another feature in common with IRAs: The withdrawals are taxed as income, not capital gains.

For anyone in the highest tax brackets, maturation of an annuity creates a big liability, because the income tax rate is much higher than the capital gains tax rate. For people in the lowest tax bracket, the point is moot; but for those building long-term income sources, annuities may increase the tax burden.

To make matters worse, if your total net worth exceeds one million dollars at the time of your death, the annuity tax burden grows. First, your estate will pay income tax on the gains from your annuity; then the total annuity amount will be included in the calculation of your estate taxes. In effect, choosing an annuity double-taxes your heirs.

"A THOUSAND COMPROMISES DON'T ADD UP TO A WIN"*

The overall performance of annuities is a subject of considerable debate. First of all, annuities carry additional fees because they have to pay annuity sales commissions, fund the insurance component, and pay the standard costs of investing (trade commissions, management, maintenance fees, etc.). Fixed annuities offer the chance to lock in interest rates; but with interest rates near historical lows, that doesn't sound too appealing right now.

Not only do fees drag the performance of variable annuity investments, the investing philosophy of the carrier tends to favor security over high performance. This only makes sense; these are insurance companies, and moderating risk is their *raison d'être*. But this often leads to portfolios that are little more than glorified - and expensive - index funds.

LOSS OF CONTROL

Loss of liquidity and vulnerability to creditors represent two more limitations of annuities. Tax-deferred annuities are subject to a 10 percent federal penalty if withdrawals are made before age 59 1/2. Most annuities also have a surrender charge, which is a penalty for any withdrawals beyond the contractual amount.

Wealthy investors therefore limit their ability to move money where it serves them best. This not only impacts performance, but it increases vulnerability to creditors. While it is true that creditors cannot get to the money while it is in the annuity, they can certainly find it and wait for it. Upon payout, they can use a variety of methods to collect the money.

SECURE COMPARED TO WHAT?

Often touted as "100% guaranteed," annuities are only as good as the company issuing them. Usually, that's very good, but insurance companies can go bankrupt too, causing lengthy delays and likely losses for annuity holders. Frankly, no financial instrument is "100% guaranteed." When buying an annuity that pays for the rest of your life, it would be nice to think that the company will live at least as long as you do!

THE MARKETING OF ANNUITIES

Annuities are very attractive because of their promises of guaranteed income, and for some people this promise trumps all others. But for high-income individuals, there is no substitute for personalized portfolio management that offers flexibility, tax-efficiency and high performance. For those who still desire annuities, reputable firms like Fidelity and Vanguard offer a full range of no load products and tend to charge reasonable fees with no surrender charge.

We called annuities an insurance product, and it's important to consider that source. As Chartered Financial Consultant Andre Weisbrod has written, "Remember, with the classic immediate annuity, you get interest plus a return of principal. When you die, the insurance company confiscates the remaining principal. Believe me, they have calculated these annuities so that most people will die before the payments exceed the total return for the insurance company."

In other words, when you bet against the insurance company's actuaries, it's like walking into a casino and betting against the house. And when you bet against the house, you usually lose. ▲

**From the song "Something Good," by Aimee Mann*

