CORDA

TOGETHER WE'RE INVESTED

Understanding Permanent Loss of Capital

Almost every American investor has seen the film, "It's a Wonderful Life." The film stars James Stewart as George Bailey, a man who has given up on his dreams in order to help others and whose imminent suicide on Christmas Eve brings about the intervention of his guardian angel, Clarence Odbody, played by Henry Travers. Clarence shows George all the lives he has touched and how different life in his community of Bedford Falls would be had he never been born. The key here for us today is the valuable economics lesson offered as George tried to calm his panicked customers during a bank run in 1929. His competitor, Mr. Potter, offered to buy the savings and loan shares at fifty cents on the dollar, and many of Bailey's customers were ready to sell. But George got their attention; "Don't you see what is happening here," he implored. "Potter's not selling, he's buying!" George's savings and loan had real assets – the homes of his customers – and Potter wanted to buy them on sale. Potter understood the difference between permanent loss of capital and temporary loss of capital.

We've grown accustomed to a rising stock market for the past four years; we have forgotten that volatility should be treated as a friend and not a foe. Permanent losses can occur two ways. First, a company can go bankrupt. This is akin to the dreadful Enron collapse, or in some similar yet scary way, what is happening to Volkswagen right now. Things can change suddenly, without warning (Volkswagen), or a little more slowly over time (Enron), but a dramatic loss of capital or complete bankruptcy is possible when you own a business. The second more dangerous form of permanent loss with severe damage to your asset base can occur when viewing a paper loss, succumbing to the emotional pressures and selling at the depths of the market. You can avoid the first scenario by being diversified across many businesses - if malfeasance or other corporate tragedy happens to strike one from out of nowhere (today VW and its emission problems, or earlier this year – think privately held Blue Bell ice cream). Owning a diversified portfolio can minimize the sudden impact of that something out of the blue. However, fear and greed will always manifest itself in the stock market, and if you let your emotions get the better of you, selling a security just because the price is down will surely negate any possible chance for success.

In investing, stocks can go up many times the value of your initial investment and cover a handful of 20-40% losing stock holdings. Allowing the math of common stock investing to be your ally is good permanent loss prevention.

Since we are looking to the past to help us navigate the final months of 2015, we are reminded of the impressive performance of Peter Lynch's Fidelity Magellan Fund during his tenure. From 1977 – 1990, the famous fund manager guided the Magellan fund to 29% average annual returns. Despite such an outstanding rate of return, according to a study of its shareholders over that time period, Fidelity found that the average investor in the fund actually lost money! During periods of poor performance, investors would run for the doors (sell low) and return after periods of good performance (buy high). This behavior plays itself out in the capital markets time and time again.

Did you know since 1980, the average annual calendar year drawdown in the S&P 500 is -14%? The problem today is that investors haven't had one since the summer of 2011, over four years ago. What is possibly even more difficult for investors to come to grips with, is that the 38% decline in year 2008 was seven years ago... for some it feels like only yesterday. What we call the recency effect has a big influence on investor behavior these days. Everyone fears the worst case scenario. Would you believe it if I reminded you that in 2010 the market had a 16% decline during the year and still finished up 13%? In 2011, the market corrected 19% and finished unchanged.

In an effort to overcome the tendencies to be out of sync with the market, we are guided by a few primary tenets.

1. We buy businesses. We do not own slips of paper, but fractional ownership interest in an actual business, with an underlying value that does not depend on its share price. In most cases, if the income streams continue year in and year out, (and in most cases grow over time), capitalism would be a failure if the value of that business did not increase over time.

2. You should engage the market only to the extent that it serves your interests. (Please refer to our blog posts on our website under the setting "Insights" to learn more). The market will provide you with prices; your job is to decide whether it is to your advantage to act on them.

3. Intrinsic value is key. Price is what you pay, value is what you get. If you understand the underlying value of a business, you can invest with a margin of safety or seek to buy at a sufficient discount. Right now, the market is favoring businesses such as Amazon, Facebook, Netflix, and others, and allowing household brand businesses to languish, such as P&G, J&J, Chevron, Merck, and United Technologies to name a few. Attitudes will change, as they often do on Wall Street, and at some point, the enduring businesses with stable cash flows, balance sheets, dividends, and long term potential, will thrive. Utilizing all three tenets of value investing will help you stay disciplined and instill a confidence to manage through these times when it is so typically elusive for most investors to win the day.

We appreciate your patience and leave you with this...some of the businesses in your portfolio are trading at over ten year low valuations. There are some prices and dividend yields that we have not seen in a very long time. We are invested right alongside of you and plan to reap the rewards – a la George Bailey, in the years ahead.

Sincerely,

Bonner Barnes

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