Avenue
Investment Management

47 Colborne Street, Suite 300
Toronto, Ontario, Canada M5E 1P8
T 416.482.2004 • 888.482.2007 F 416.482.0007
www.avenueinvestment.com

A Case Study on Reliability

We use these case studies to discuss big picture aspects of Avenue's investment strategy. This quarter we would like to lay out another argument for why we go on about the importance of reliable, consistent and predictable investments. Here we will distinguish why Avenue's approach is different from the two mainstream investment strategies of our time, broadly defined as those who index and those who attempt to beat the index.

Investing in a market index like the TSX will guarantee that you capture the market return that the index is replicating along with the average market level of risk. Most Index funds have low fees. However, it is still up to the individual to stick with their plan and hold their Indexes long term. Many investors will invariably succumb to buying high and selling low.

The argument against indexing was stated most clearly by Larry Fink, the CEO of BlackRock, "As the largest index player in the world, we have to own companies, even if we hate 'em." The reality of the stock market is that often bad or risky businesses and people do well for a time. By buying the index you are implicitly saying that you cannot be bothered to sort out what is good and what is bad. Then by definition, the return you get will be that which the market gives you. At times this might be positive. However, at other times, like the period 1996 to 2008, there was a 12 year stretch where returns were negative. If this happened to coincide with your golden years of retirement, well, that was just bad timing!

If you are not investing in the index you will still likely be familiar with the phrase, "did your professional money manager beat the index?" Active money management has become the common term for this type of strategy compared to indexing, which is referred to as passive management. Whether the active strategy is value, or growth or momentum investing, the goal remains the same. The active manager's role is to beat the return of their chosen index over time. But herein lies the contradiction.

To get a better return than the index, the active manager, by definition, has to take on more risk. All financial theory is based on this core belief. Why would you take on more risk if you were not going to get paid for it? But the problem is that as you take on more risk, reliable returns drop significantly. Some investors will have a better return than the index, but many will have a much worse return.

The July 2014 edition of the Financial Analyst Journal published a report showing that out of 2,846 of the largest funds in the US, only 195 were managed by the same person after a 10 year period. Or, a little less than 7% kept their jobs after 10 years. The average tenure for a money manager is 3.5 years. These are fairly shocking statistics but they indicate that beating the index is very difficult, and taking on higher levels of risk usually ends poorly. We can illustrate how this might happen with a more concrete example. Inevitably the money manager will speculate by buying a bad business or management team with the hope that they will be in for a pop and

Paul Harris, CFA
Partner
pharris@avenueinvestment.com

Paul Gardner, CFA
Partner
pgardner@avenueinvestment.com

Bill Harris, CFA
Partner
bharris@avenueinvestment.com

then out of it before it goes down again. Continually guessing like this year after year is very hard to do consistently.

At Avenue we have digested all this and asked ourselves the question: Can we avoid many of these pitfalls? We know that the broad market indexes have compounded at roughly 7.5-8% over the last 100 years. We also can calculate and therefore know the historical risk or volatility of investing in the stock market. So instead of indexing or beating the index, we try to capture the historic rate of return which is somewhere around 8%, but do it with less risk or volatility than the market index. Less risk should result in our returns being more predictable. We believe this is an achievable goal.

We always look for reliable, consistent and predictable companies or income streams. As well, we occasionally find a tangible asset which is mispriced. Another way of describing this part of Avenue's investment strategy is to win by not losing. With reliable investments our downside is much better protected because actual cash income and hard asset value can only go down so much when markets are turbulent. Much of what most stock market investors do is chase stocks that are ascribing value to potential sales or growth. We prefer to leave that kind of investing

Avenue Investment Management
Getting there together

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