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Heads I Win, Tails You Lose

Ruminations on Investment Philosophy

Summary

- Successful investing is often seen as the ability to consistently and accurately make predictions about the economy, markets and specific securities.
- In reality, success comes less from predicting the future with blinding accuracy and more from selecting securities and vehicles that perform well when an investment thesis proves correct and perform OK when the thesis proves wrong.
- From Glenmede's perspective, a disciplined approach to finding undervalued assets is the best way to construct a risk-controlled growth portfolio.
- Over the past 24 months, the nature of investment opportunities has changed dramatically.

Striving for an Asymmetric Outcome

Winning a bet with my father was never an easy proposition. At an early age, when I learned how to flip a coin, he wouldn't simply predict the future by picking either heads or tails like I wanted. Instead, he would propose that if the coin came up heads he won; and, to be fair, I lost if it landed on tails. In other contests, I ran into similar issues. Setting up any sort of wager with my father usually involved a protracted discussion about the terms of the bet. Where I wanted to match wits and predict outcomes, his inclination was to discuss different ways he could skew the odds in his favor. Not surprisingly, these games never seemed to go my way.

This anecdote serves as useful backdrop for a discussion about competing investment theories. For most of the financial world, as with my father, investing is the art of predicting the future. Consider how the press tends to characterize a successful investor as a demigod, likening that person to an oracle, capable of foreseeing the next opportunity or, conversely, capable of avoiding the next disaster.

However, when you compete against the market, where prices are set by very smart people around the globe, it is difficult to consistently win solely by making highly accurate predictions.

In reality, success comes less from predicting the future and more from selecting securities and vehicles that perform *well* when an investment thesis proves correct and perform *OK* when the thesis proves wrong. A "Heads I Win, Tails You Lose" model where the "you" = the market. Economists refer to this as setting up an asymmetric outcome.

Finding investments with asymmetric outcomes can be a difficult game to play; but it is one that becomes easier when players, through hard work and discipline, tilt the odds in their favor rather than attempt to develop a truly unique prediction about the future.

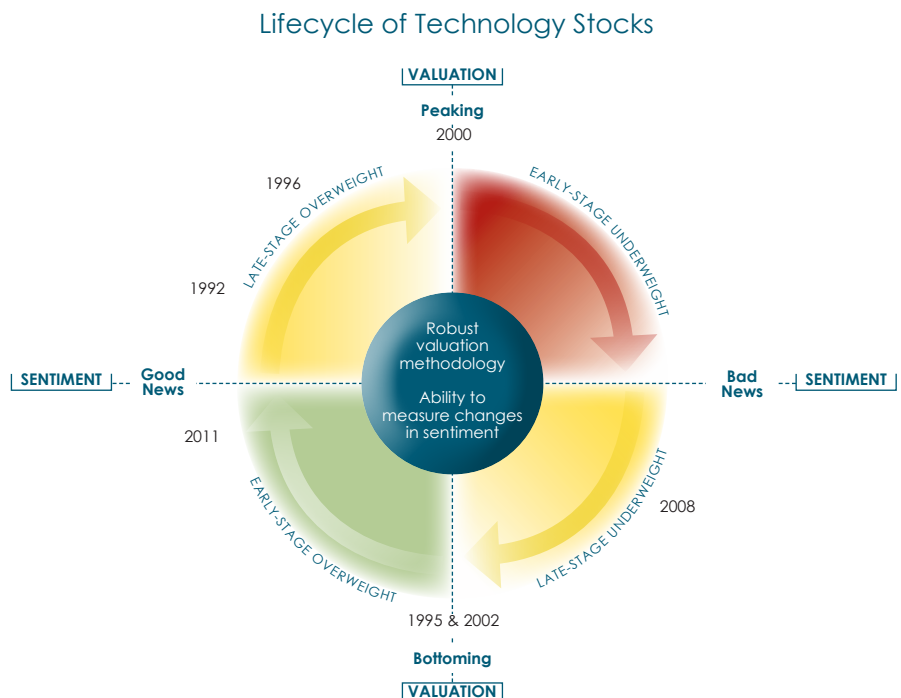
The Investment Discipline of Oscar Wilde

As an artist and bon vivant, Oscar Wilde was not always the most disciplined person. However, he did, in *Lady Windermere's Fan*, create what could be viewed as one of the most worthwhile maxims for investors — “A cynic is someone who knows the price of everything and the value of nothing.” If this is the definition of a cynic, then by deduction, I am an optimist; for in the world of investing, establishing the value of an investment is priceless. A truly undervalued asset has the potential for outsized returns and a lower-than-average possibility of experiencing price declines.

Undervalued assets are generally discounted due to fear, complexity, illiquidity or the absence of a long-term view of growth potential. At a certain point, the market begins to realize that its caution is misplaced and participants decide to re-engage, prompting prices to rise. As prices improve, creating good news around a security, the asset price is pushed up until it may become not only fairly valued, but overvalued. This is the ‘Heads I Win’ aspect of value investing. Downside protection is inherent as these investments have already experienced a fair amount of price depreciation. When bad news deflates the optimism built into market prices, good values have less room to fall.

The clock-like graphic below illustrates this cycle of changing valuations, news and/or sentiment. Let’s use technology stocks over the past 20 years as an example of how an investment moves circularly from inexpensive to expensive and back again.

In the early 1990s, technology stocks were actually undervalued relative to their long-term growth potential. The 1980s saw a boom-to-bust cycle as technology stocks rose with the advent of personal computers, and subsequently fell due to a surplus of capacity. Then, in the early 1990s, these stocks rose with the breakthrough of the Internet age, moving from low valuations (6:00 on the clock) to fair valuations (9:00 on the clock), to striking overvaluations by the end of the decade. Yet, from 2001 onward, the news for technology stocks could not have been worse. Prices fell dramatically as business models and earnings were closely scrutinized by investors, media and the investment community. By 2008, technology stocks were unloved and spurned. However, the industry has reshaped itself by consolidating and cutting costs, and currently, valuations are again attractive for a new set of reasons. As the global economy improves, these stocks have begun to rally.



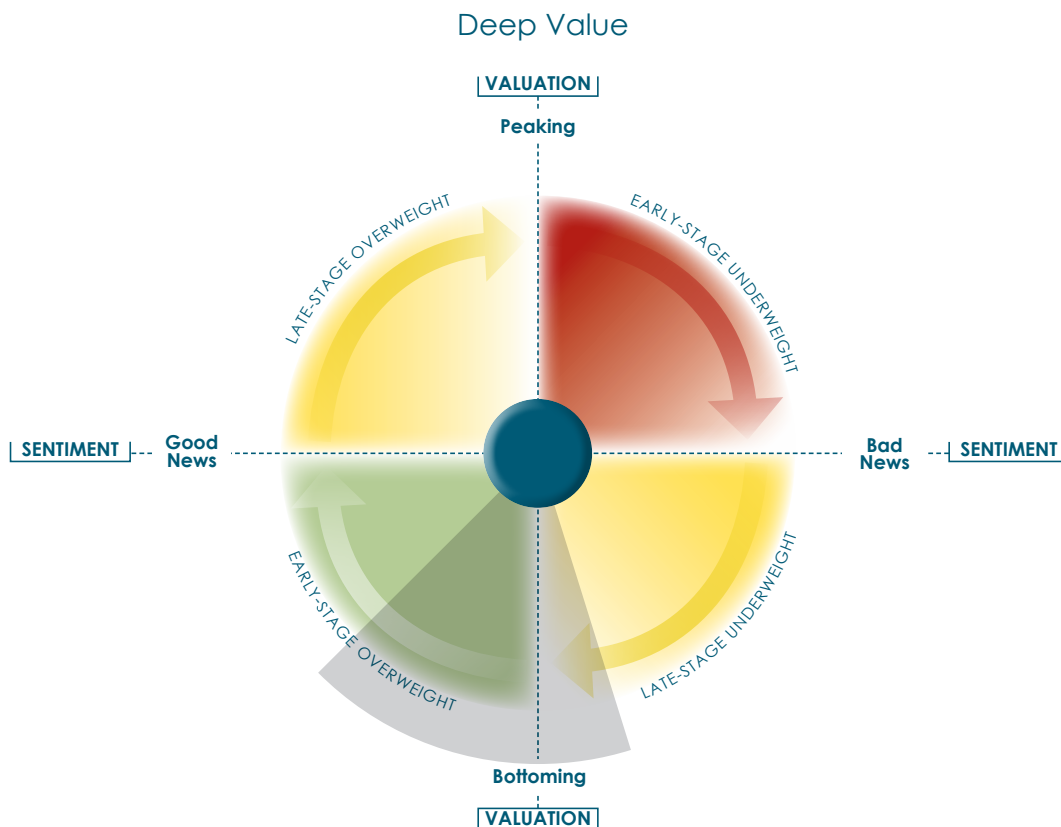
Three Types of Value

We seek to leverage value opportunities by either investing directly or by partnering with specialist managers who have demonstrated track records. Portfolios created with a value discipline and an emphasis on non-correlated assets and strategies are well positioned to earn superior returns with limited risk of loss.

The value opportunities we analyze generally fit into one of three categories: deep value, good value/good news or value hidden by complexity and illiquidity.

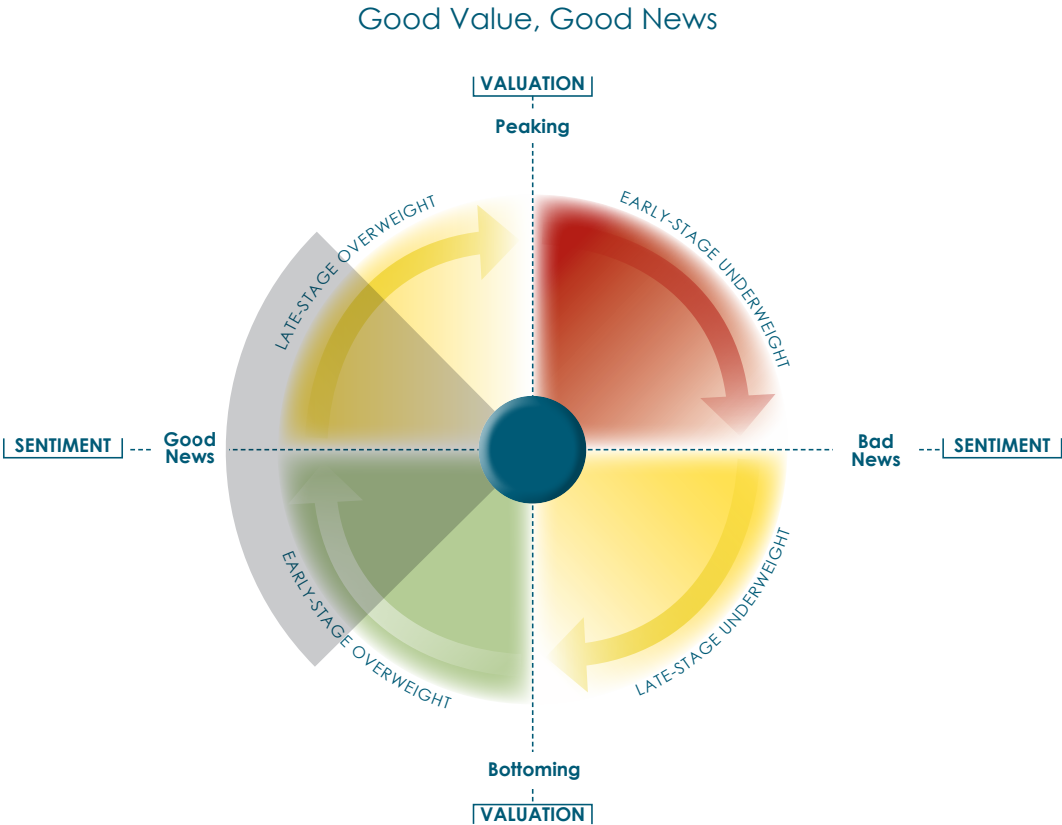
Deep Value (5:30 to 7:30 on the clock): Unloved and ignored assets and securities often tend to deliver the best values. When a security is adversely impacted by troubling news, market participants are apt to indiscriminately sell assets at prices well below reasonable levels. For those able to opportunistically benefit from these situations, courage and patience may be required in the face of dismal headline news. While the market may be delayed in recognizing its mistake, the returns can be tremendous.

Example: Following the 2008 sub-prime mortgage debacle, high-yield bonds were priced to earn yields of up to 15% and news of the economy was extremely discouraging. Yet, even if companies had incurred historically high default rates, high-yield bonds in aggregate represented a good value.



Good Value/Good News (8:00 to 10:30 on the clock): A second form of value investing comes when good news has begun to relieve some of the uncertainties associated with inexpensively priced assets and prices become more fairly valued. The payoff may be smaller since some of the value has already been realized, but thanks to the emergence of good news, returns can be more immediate.

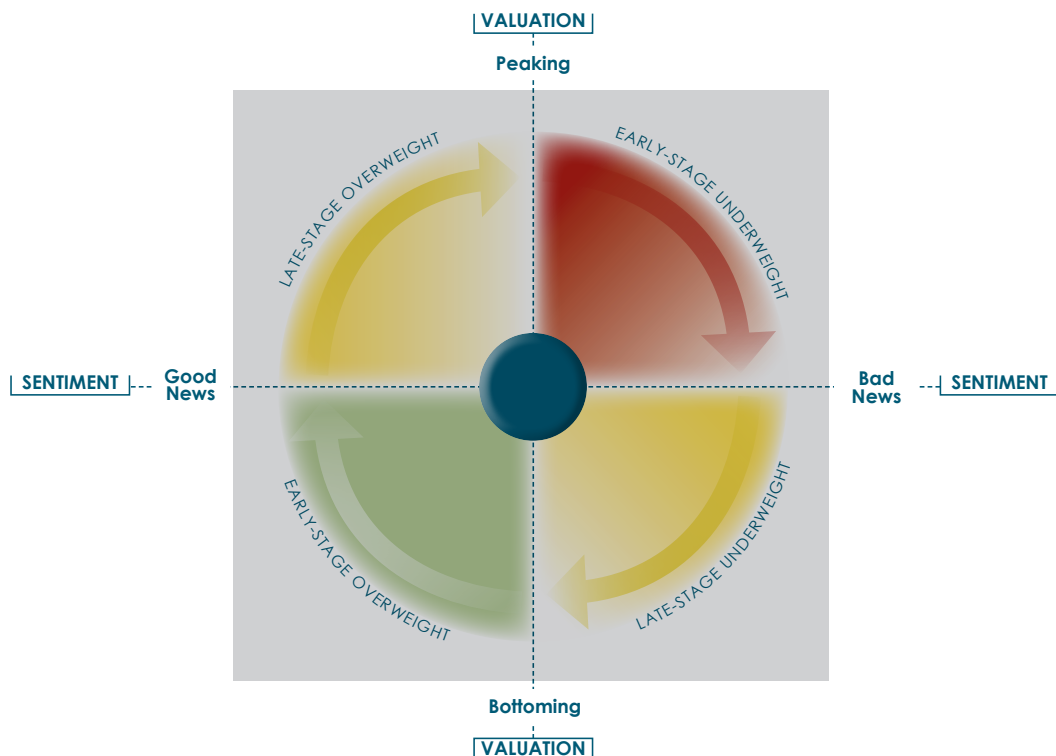
Example: American companies, such as 3M, Yum! and Emerson Electric, which prospered from emerging market growth over the last decade, have generally traded at fairly inexpensive valuation levels. These companies have also benefited from strong economic growth and, as a result, have produced returns in excess of U.S. indices over most of the past 10 years. Emerging market equities as an asset class would also qualify as a similar sort of investment.



Value Hidden by Complexity and Illiquidity (The clock is submerged beneath a grey mist that hinders visibility): Some asset markets are incredibly varied and complex, sometimes producing vastly mispriced valuations. Understanding the true value of a complex or illiquid asset requires specialized knowledge. Investors with this knowledge are more likely to uncover attractively priced securities that yield high return rates.

Example: Private equity investments are usually illiquid and are bought and held by long-term investors. After the market collapse of 2008 and early 2009, a number of these investors, pressed for cash, were forced to liquidate portfolio holdings at substantial discounts. For investors with the ability to acquire these assets at discounts that ranged from 30 to 80%, this situation presented a tremendous opportunity. Success, however, depended on having the ability to accurately value complex and opaque investments.

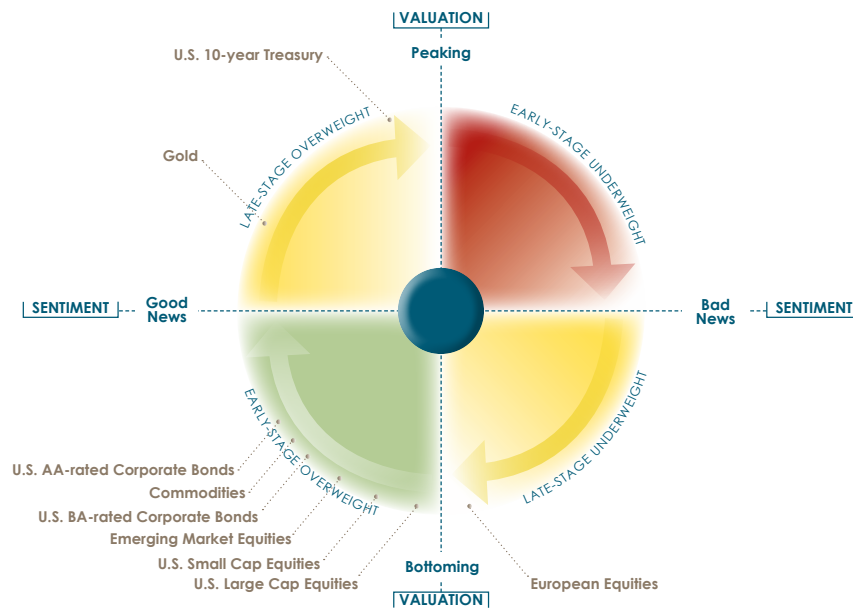
Value Hidden by Complexity and Illiquidity



Where Are We Now on The “Wheel of Fortune”?

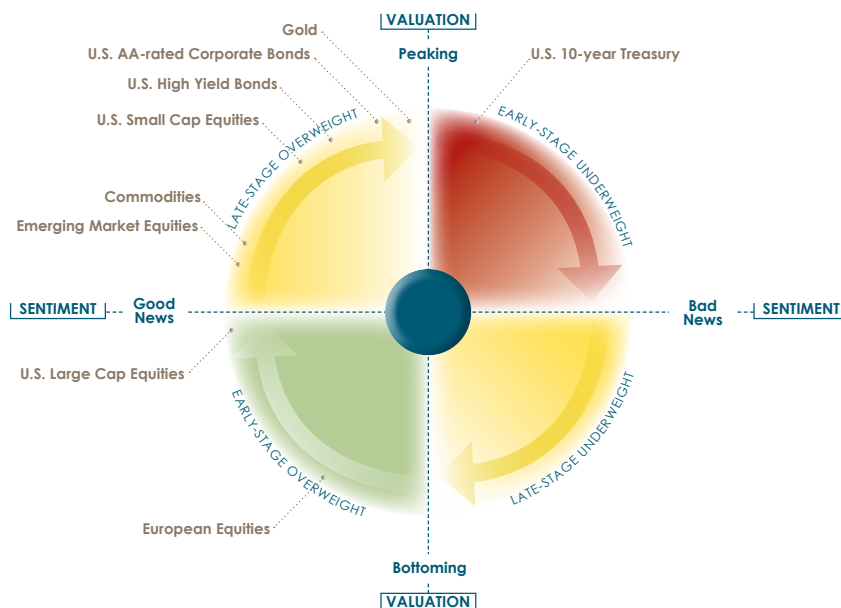
It is interesting to contrast the current environment with the depths of the downturn in March 2009, when there was very little good news. The consensus at that point in time was that investors were doomed. However, in hindsight, we know there was no shortage of undervalued assets. Most assets that were perceived as having any risk were trading at tremendous discounts. The assets that did register as fairly priced or overvalued were Treasury Bonds and gold.

Positioning of Assets as of March, 2009



Rolling the clock forward, the valuations of the different assets have shifted significantly, with the bulk now being priced at fair or overvalued levels. However, we expect that news of improving world economies should continue to positively impact the earnings and pricing of most equity assets. There are some assets, in particular U.S. quality growth companies and European equities, that currently appear undervalued. For the most part, this is a period when fairly or slightly overvalued assets will ride a wave of improving news until eventually tipping to the more overvalued category (i.e. the trend is your friend).

Positioning of Assets as of February, 2011



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