



# CUBIC ASSET MANAGEMENT, LLC

## 2014 2<sup>nd</sup> Quarter Stock Market Commentary

### HERD ON THE STREET

“As a group, lemmings may have a rotten image, but  
no individual lemming has ever received bad press”  
- Warren Buffett

In late 1938 Harvard Freshman Lothrop Withington Jr. was contemplating a run for class president. His campaign managers (drinking buddies?) suggested he needed a gimmick to generate some publicity. A decade earlier Withington had been on a family vacation where he saw someone swallow a live goldfish and decided this was just the thing to boost his presidential aspirations. The event received vast coverage from the local media in Boston and soon college students throughout the country were trying to top his feat. Within weeks, young men were sucking down five, ten, twenty and even thirty fish at a sitting.

After several months, though, adults began feeling that this ridiculous fad was not really all that funny. Many towns passed ordinances making it illegal and a Massachusetts State Senator, continuing a long history of banning anything that might be fun, presented a bill which attempted to protect the fish from “cruel and wanton consumption.” Universities threatened to suspend or expel participants for “conduct unbecoming a student” and the U.S. Public Health service warned that eating live goldfish could result in the swallower contracting anemia through tapeworms living in the fish. Finally a professor at UCLA concluded that an adult male could safely consume up to 150 fish, but warned against exceeding that amount.

Goldfish swallowing is only one of thousands of fads that have swept the country. Some, like the posting of “selfies,” are fairly benign. Others, like car surfing, not so much. (Car surfing is riding balanced on a moving vehicle driven by another person which has so far resulted in over 60 deaths.) But all fads seem to be propelled by our need to be part of the crowd.

This tendency to cluster is ubiquitous in the animal kingdom. After all, birds of a feather flock together. Fish swim in schools, and wildebeests form herds. Even some types of amoeba (*Dictyostelium discoideum*) aggregate into clusters when times get tough. It seems a bit counterintuitive. After all, a single starling is difficult for a predator to spot, while a synchronized group of thousands of birds can be seen from miles away. Elephants in a herd face much more competition for food than a lone grazer.

But apparently these costs are outweighed by several important benefits. For one, groups can be much more vigilant in looking out for predators, since there are many pairs of eyes looking in many directions. A large group can be much more effective at locating food than a single animal. And it is undoubtedly easier for group members to find a mate, a powerful evolutionary imperative. The instinct to move in groups is so prevalent in the animal kingdom that we have a separate word for groups of hundreds of different species - a pod of whales, a crash of rhinos, a murder of crows or a pandemonium of parrots.

One organism whose group behavior has been extensively studied is *Drosophila*, the fruit fly. It was long known that fruit flies in a darkened room which has a dim light at one end will tend to flock together around the light, and it was thought that this behavior, known as phototaxis, was a way to efficiently locate a mate, a matter of great urgency to a species whose life span is roughly ten days. But it turns out that fruit fly behavior is much more complicated than originally thought.

In a wonderful book called *Time, Love, Memory: A Great Biologist & His Quest for the Origins of Behavior* by Pulitzer Prize winning author Jonathan Weiner, the author tells the story of pioneering molecular biologist Seymour Benzer. Benzer (1921-2007) earned a PhD in solid-state physics, but soon turned his attention to the burgeoning field of genetics, where he is credited with developing several techniques which were instrumental in helping Francis Crick to decipher the structure of DNA with James Watson. Benzer concocted a device called a countercurrent apparatus, essentially a complicated series of tubes, to sort fruit flies according to how strongly they fly towards the light. Then he was able to link the intensity of the phototactic response to specific genetic variations. Interestingly, he found a small group of fruit flies which were genetically predisposed to fly away from the light. Seth Klarman, the noted value investor who heads up the largest hedge fund in Boston, the Baupost Group, has jokingly referred to these flies as "tiny contrarians," the insect equivalent of "deep-value investors." They march to their own drummer, eschewing the behavior of the crowd.

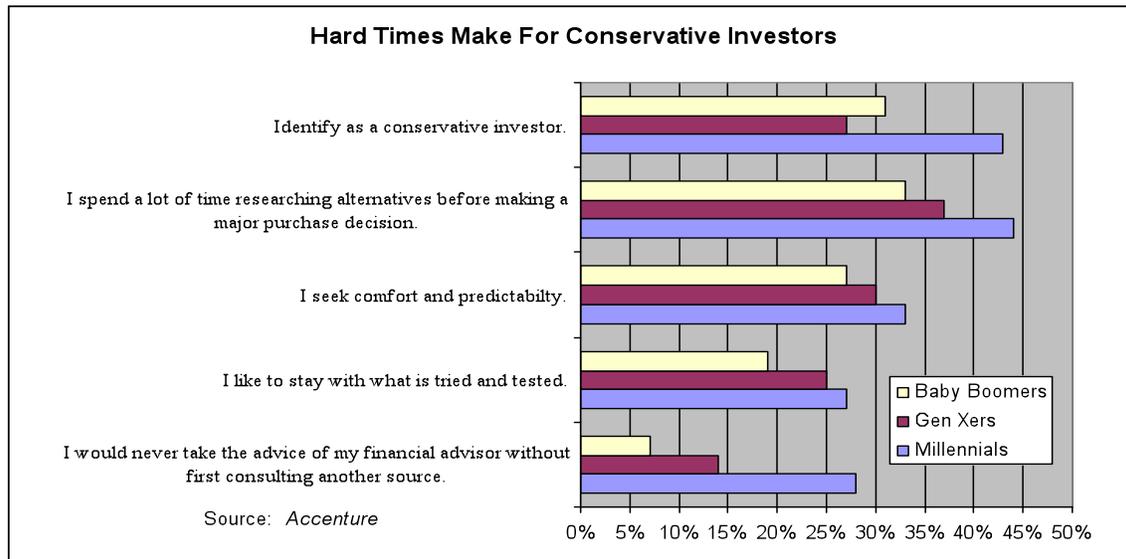
This analogy is not far-fetched. It appears that much of our approach to investing has a genetic basis. In a recent study, Stephan Siegel of Arizona State University and Henrik Cronqvist of Claremont McKenna College studied the investment styles and portfolios of 15,208 pairs of Swedish twins, 4,636 pairs of which were identical. The Swedish Twin Registry is the largest twin registry in the world, and the Swedish Tax Authority (equivalent to our IRS) maintains detailed records of individuals' financial portfolios, as well as all transactions during each year.

According to Siegel and Cronqvist's findings, identical twins display investing patterns and biases that are more similar than those of fraternal twins. Because identical twins are genetically identical whereas fraternal twins share approximately 50 percent of each others genes, the researchers argue that genetics explains between 25 and 50 percent of the variation in investment style, including such biases as the reluctance to realize losses, basing investments on past performance, and the desire to invest primarily in familiar companies based in their home country.

For example, twins who showed a bias towards buying familiar shares rather than taking a flyer on less familiar companies also showed a preference for living closer to their place of birth and for marrying a spouse from the same region. Investors with large portfolios were particularly susceptible to genetic influences.

But if genes explain up to a half of the variations in investment behavior, what governs the rest? Common childhood experiences like schooling were found to have almost no influence on investment behavior. But individual experiences seem to explain half of the variations between twin pairs, as much as, and often more than, genes.

Consider, for example, the behavior of so-called Millennials, an age cohort generally defined as those between 25 and 34 years of age. This generation's investment attitudes have been shaped by the bursting of the dot-com bubble, massive frauds like Enron, WorldCom and Bernie Madoff, and the most severe recession in 70 years after the collapse of the housing market. As a result, Millennials exhibit behavior reminiscent of those who grew up in the Great Depression, rather than Baby Boomers or Generation Xers. A recent survey by the Boston mutual fund company MFS Investment Management, found that nearly half of Millennials said they “never feel comfortable investing in the stock market.” The survey also showed Millennials keep more of their assets in cash, less in stocks, and have a shorter time horizon — less than five years — for their investments than boomers or Gen Xers.



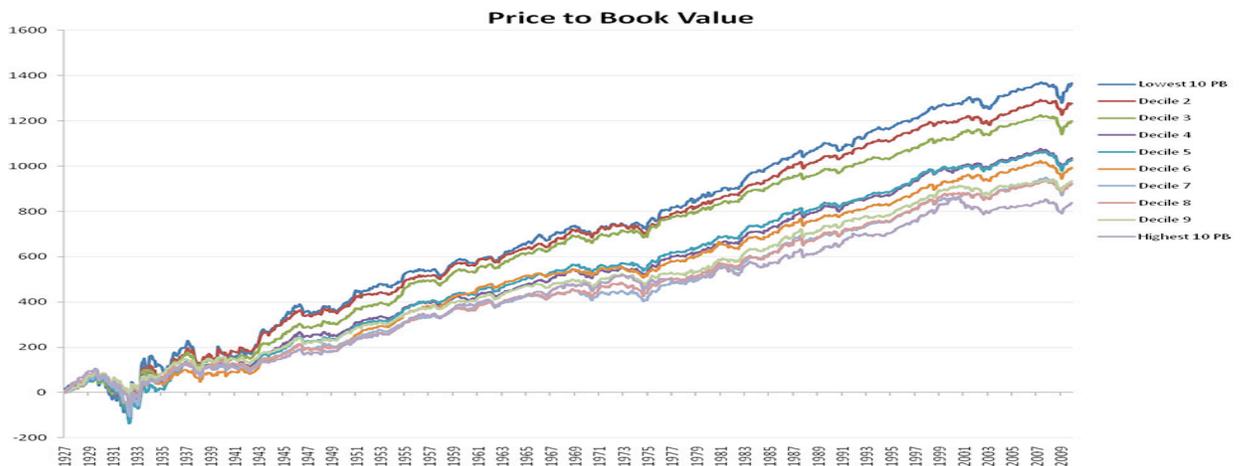
In a 2013 study by Accenture, a multinational consulting firm, 43 percent of Millennials identified themselves as conservative investors, compared with 27 percent for Gen X and 31 percent for Boomers. The survey also found high levels of mistrust among Millennials for financial institutions and a greater reliance on the Internet, social media, and personal networks for financial advice.

We began this essay with a brief discussion of the tendency of animals to cluster together. Human beings share this same propensity, which helps explain the near simultaneous

adoption of new clothing styles, or the rise of extreme political groups. Recent research by a Dutch team at the FC Donders Centre for Cognitive Neuroimaging found that holding an opinion different than one's group generates activity in the brain similar to that created by conflict, and the stronger that activity the more likely one is to change one's views to conform to peer pressure. But just like fruit flies, it seems likely that some individuals have a genetic predisposition to independent thinking. If coupled with the right life experience (because investment style like most complex behaviors is a combination of nature and nurture), these contrarians become value investors.

A good value investor tends to buy what is out of favor, rather than in favor. After all, beating the market over a long time period requires a portfolio that is different from the major indices. Success is generally measured over a multi-year horizon, rather than monthly, or quarter-by-quarter. Even Warren Buffett, the greatest investor of all time, has underperformed the Standard & Poor's 500 for several years consecutively on several occasions, but his long term track record is spectacular. Investment decisions are made based upon intensive company analysis, not by relying on tips from friends or business associates.

This type of approach has been well-rewarded over time. Every study of value versus growth has shown the superiority of the former over the latter over long periods. Below we have copied a graph from Professor Kenneth French's web site at Dartmouth University, showing the performance of stocks sorted into deciles by price-to-book ratios, a traditional metric used to measure value.



But value investing requires the careful reading of annual reports and government filings. Practitioners need to block out the noise of an endless stream of “pundits” on CNBC and Bloomberg TV. Basing investment decisions on the same sound bites being given simultaneously to millions of other viewers is unlikely to produce superior performance. Investors who must own stocks of social media, solar power or electric car producers would be better served to delegate their portfolio to those who, because of nature and nurture, are able to resist the urge to run with the crowd, and instead methodically apply an approach which has delivered superior results for decades.