

PERCEPTIONS

4th Quarter, December 31, 2013			
	12/31/2013	% Change 4th Quarter	% Change Year
Dow Jones Industrials	16,576.66	10.22 % *	29.65 % *
S & P 500	1,848.36	10.51 % *	32.39 % *
Russell 2000	1,163.64	8.72 % *	38.82 % *
BC Aggregate BD Index		-0.14 %	-2.02 %
10 YR Treasury Yield	3.026 %		
30 YR Treasury Yield	3.964 %		

* *Includes reinvested dividends*

The Importance of Research

Shadow Divers by Robert Kurson is the mesmerizing story of the discovery of a sunken World War II German U-boat sixty miles off the coast of New Jersey. The U-boat had settled in 230 feet of water, a depth that limits exploration to a handful of elite divers on the Atlantic Coast. The book artfully documents the lives of the divers from the initial discovery of the wreck in 1991 through its positive identification in 1997. *Shadow Divers* presents the world of wreck diving in chilling terms, outlining the inherent dangers of ultra-deep dives including but not limited to the bends, narcosis and wreck disorientation. Three divers perished in the attempts to identify the U-boat.

Conventional wisdom and historical records indicated that no German submarines were ever reported lost or destroyed anywhere close to the New Jersey wreck. Since underwater observation had positively identified the wreck as a German submarine, the divers became obsessed with determining the exact identity of the German U-boat. In the six years between the initial discovery and final positive identification, numerous dives were made in an effort to retrieve any artifact that might reveal the submarine's identity. When no useful artifacts were forthcoming, the divers turned to intensive research of both United States and German Naval records.

John Chatterton and Richie Kohler were the divers leading the research. They showed dogged determination and used wide ranging strategies in looking for a solution to the U-boat's identity. The breakthrough link was an intercepted radio message dated January 17, 1945 which directed U-boat 869 (U-869) to a location 70 miles southeast of New York. Almost a week later, code breakers reported a communication problem between U-869 and German Control: while the U-

boat had been re-directed to Gibraltar, for some unknown reason it continued its path to New York. After the war, American investigators were scrambling to finalize the status of every German U-boat and they believed U-869 was last headed to Gibraltar. These investigators found original reports of action off the coast of Gibraltar that could have indicated an attack on a sub, and so the post-war investigators changed the attack report on U-869 (erroneously assumed to be off the coast of Gibraltar) from “G-No Damage” to “B-Probably Sunk.” More than 50 years later, the divers were finally able to retrieve a box from the engine room of the wreck off the shore of New Jersey that positively identified U-869. Muddled communications based on faulty interpretations had hindered the attempt to identify the U-boat off the coast of New Jersey.

The point of this meandering naval discourse is that successful research, whether at the bottom of the Atlantic or the canyons of Wall Street, requires the ability to examine a problem from a multitude of perspectives. In our quarterly reports we have often discussed and focused on individual companies, a “bottom up” type of research. In our everyday research process we also use any number of analytic tools that weigh various macro-economic trends, a more traditional “top down” methodology. After reviewing the euphoric rise in the markets in 2013, we felt that now is an appropriate time to introduce one of our best research tools: Investor Sentiment.

Investor Sentiment is a contrarian indicator that reflects investors’ attitudes toward financial markets. Surveys separate opinions into three categories: bull, bear and correction. A normal range is considered 45% bulls, 35% bears and 20% correction. Investor sentiment usually tells us very little except when we get into extreme readings. In the last few weeks, these measurements have registered notable extremes with bullish attitudes over 60% and bearish sentiment under 15%. The bearish readings were the lowest figures since March 20, 1987. While there is no single indicator we would ever rely on, the sentiment numbers are suggesting caution as we move forward. Interestingly, the growth and momentum stocks that outperformed in 2013 were the beneficiaries of the optimism and will more than likely regress to the mean (move lower) faster than value stocks.

In a well-regarded research paper co-authored by Malcolm Baker, an Associate Professor of Finance at Harvard Business School and Jeffrey Wurgler, Associate Professor of Finance at the Stern School of Business, New York University, investor sentiment was extensively discussed. One of the interesting observations was:

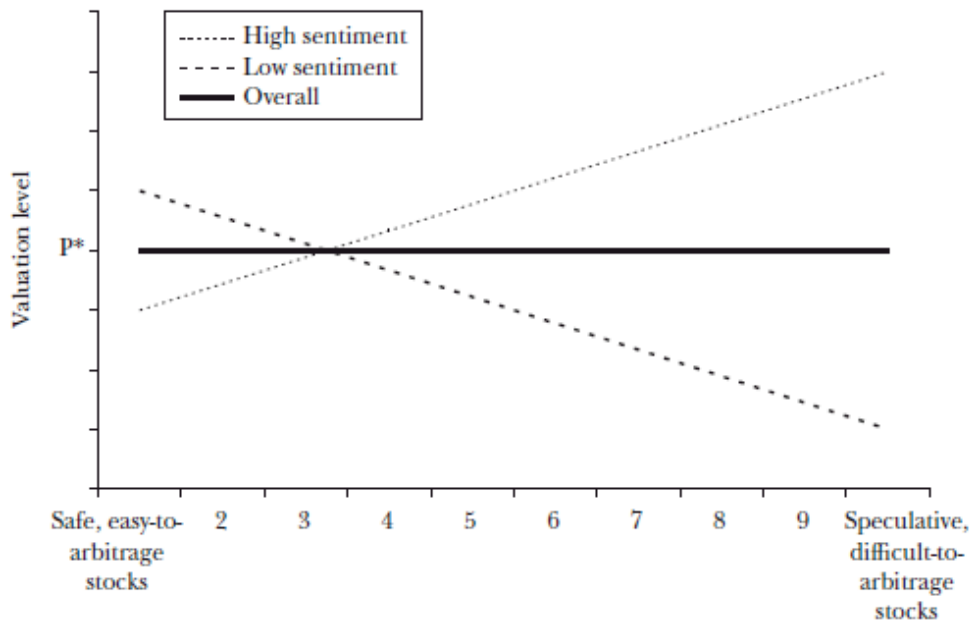
In particular, stocks of low capitalization, younger, unprofitable, high-volatility, non-dividend paying, growth companies or stocks of firms in financial distress are likely to be disproportionately sensitive to broad waves of investor sentiment.(1)

This might help to explain the surrealist rise in share prices of the likes of Twitter, Priceline and Tesla Motors.

(1) Baker, Malcolm and Jeffrey Wurgler. “Investor Sentiment in the Stock Market.” *Journal of Economic Perspectives* Spring 21.2 (2007): 129-151.

Figure 1

Theoretical Effects of Investor Sentiment on Different Types of Stocks



Note: Stocks that are speculative and difficult to value and arbitrage will have higher relative valuations when sentiment is high.

(2) Baker, Malcolm and Jeffrey Wurgler. "Investor Sentiment in the Stock Market." *Journal of Economic Perspectives* Spring 21.2 (2007): 129-151.

We are comfortable heading into the new year with value-oriented positions like Campbell Soup, Freeport McMoRan and eBay as opposed to Twitter, Priceline and Tesla Motors.

While Chatterton and Kohler were searching for the identifying object on the German U-boat, they also had to pay attention to shifting tides and currents. In our macro review of Investor Sentiment, the sentiment wave has shifted and the investing environment going forward will favor a value approach to investing.