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In Pursuit of Value

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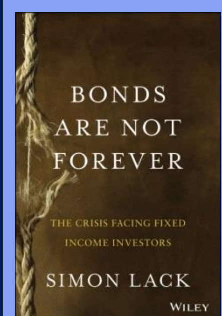


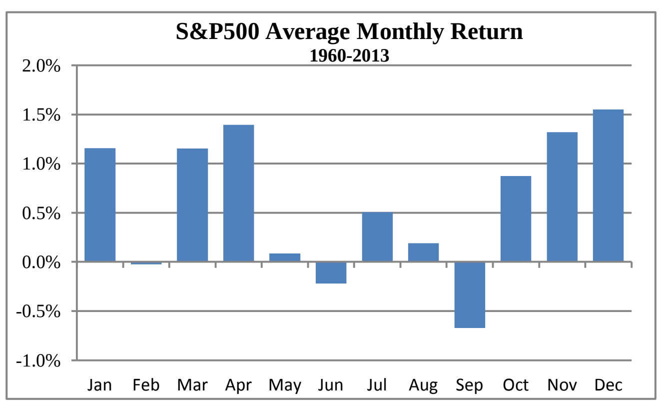
September's Pattern

There's something very appealing, very human, about pattern recognition. We inhabit a world that is full of unpredictability and chaos. The notion that certain events repeat, that "history rhymes" (as Mark Twain said) is short of a monotheistic explanation for how the world works and is still appealing all the same. It's as if accepting the randomness of life is to reject the very essence of being alive, and is instead to process information as if made of silicon. We expend much energy improving upon the disorder around us. Why, there's even a Pattern Recognition Society whose mission is to help researchers working on such things.

Investing produces all kinds of patterns. The entire field of technical analysis rests of the belief that past performance ***IS*** an indicator of future returns (quite contrary to the warnings on every investment offering you've probably ever seen). And in case you think you detect some skepticism leaking into these words, let me note that I have friends whom I greatly respect that make a very good living out of practicing just that. It's not what drives us at SL Advisors, but it works well enough to retain its adherents.

Seasonal patterns are fascinating, because there are often plausible explanations for them. A pattern that works without a clear reason why runs the risk familiar to statisticians of exhibiting a correlation without causation. Ronald Coase, an economist, has been quoted as saying that, "If you torture the data long enough, it will always confess." Identifying a statistical relationship can often fall frustratingly short of finding a predictive one. I've always felt that if you don't know why it works, you may find that when it stops working you won't know why that happened either.

Seasonal patterns may exist in part because humans are creatures of habit. For example, Mondays are believed by some to be a bad time to sell. Perhaps it's because investors use the earliest opportunity to exit what they spent the weekend worrying about. Or maybe it's because some traders go home with smaller than average long positions on Fridays given the two days' of possible geopolitical events with no available liquidity. In his 1987 book *Don't sell stocks on Monday* Yale Hirsch made the case. I don't know if it's worked since.



The Financial Analysts Journal (FAJ) recently published an article titled "Sell in May and Go Away". It's in the July/August edition so unfortunately too late to be useful for this Summer. However, it caught my interest because the authors found that it's a good rule to follow. Observant readers of this newsletter may recall that a year ago we wrote on this topic and reached the opposite conclusion. The contrasting opinions of SL Advisors and the FAJ probably bother me more than them. So I looked at the data a little more closely.

It turns out that most of the difference depends on when you repurchase what you sold (the other difference is that the time period analyzed by the FAJ article begins in 1970 whereas we went back to 1960). We thought of the rule as implying a Summer free of investment worries and calculated a "Sell Before Memorial Day and Buy Back By Labor Day" rule. It turns out that holding stocks in September can be one of the poorest times of the year to be invested. A Dollar conventionally invested in the S&P 500 on January 1, 1960 would have grown to $28.18 (with the Utopian assumptions of reinvested dividends and no taxes). Nimbly skipping September would have resulted in $42.53 (and that's without factoring in the interest income from holding cash one month each year).

Of course, one month is bound to be the worst just as one will be the best. Critically though, is there a reason for it? Otherwise, it's just another of life's random events and may not persist. The January effect is well documented, although surprisingly over the past fifty years it's been only the fourth most profitable month (1, 2 and 3 are December, April and November). Its 1.2% return is still double the average for all months, and missing every January since 1960 would have caused the invested dollar to limp along to only $17.02. The January effect does have credible explanations. Many investors make allocation decisions on a calendar year basis, and that perhaps with a modest lift from year-end bonuses seems to provide a valid reason for the January effect.

September is harder to figure. Half the market's annual return is historically earned by April. Perhaps a Summer of complacency combined with imprudent decisions by those whose performance has lagged result in a little less cash than is needed to scoop up cheap securities? The Romans associated September with fire and volcanic eruptions, since its God was Vulcan, the God of Fire. Roman investors would undoubtedly have sold stocks in August. Over the last fifty years poor returns in September are fairly consistent though. During each decade from the 1960s to the 2000s September was lousy. The 1990s was the only decade when Septembers were even positive, and that was largely because from 1997-99 the market was up virtually every month as it rode the dot com bubble. The corollary of poor September returns is that it's therefore a bad time to sell. On average you'll do better by waiting.

SL Advisors, LLC focuses on identifying securities that are trading at a discount to intrinsic value.

We're about to find out if this pattern will be repeated, and unlike the FAJ analysis this one does at least arrive in time to be actionable. For our part, we have no opinion on whether this September will be typically bad, but remain curious for possible explanations. There's no shortage of reasons to be cautious, including Mid East turmoil, weakness in Emerging Markets and another imminent fight in Washington over the debt ceiling. But there are always things to worry about. Moreover, profitably exploiting seasonal patterns once you figure transactions costs and taxes can be mighty difficult. Going to cash every September would result in all of an investor's capital gains being taxed at the short term rate, a significant drag. Fortunately though, for the real investor who doesn't seek to profit from short term market moves and is sensitive to the tax liability caused by frequent buying and selling, September can be a good time to buy.

Website Upgrade

We recently overhauled our website so as to provide more information, navigate more logically and provide an improved "look and feel". We're very happy with the results and encourage you to check it out (www.sl-advisors.com). Notable additions include a more detailed description of each of our investment strategies, a link to our Investment Philosophy and a fully integrated blog. I post to the blog periodically, about twice a week as long as there's something useful to say. Anyone that's interested can sign up to receive e-mailed updates.

After much agonizing I also joined Twitter several months ago, once a journalist explained to me that it's really a personalized news feed. I've learned that Twitter isn't just for followers of Justin Bieber or Katy Perry (currently the most followed), and by "following" news sources (NY Times, FT, Economist etc.) it can become a personalized, scrolling newsfeed. Our embrace of social media has stopped short of using Facebook though. Gathering "Likes" and "FB Friends" seems too juvenile, or maybe I'm just too old for it.

Clients will also note that the website's home page has a Client Login link at the top which will take you easily to information on your own account(s). We think you'll like it, and welcome any feedback.