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ON GOLF AND INVESTING: AN ANALOGY

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As the 2007 PGA Tour came to a close, Tiger Woods topped the leaders earning a total of \$10,867,000 in prize money. By contrast, golfer Charley Hoffman rounded out 2007 ranked number #50, with total winnings of \$1,689,000. Charley Hoffman's total take for the year was roughly one-tenth of Tiger Wood's.

At first glance, these results seem reasonable to most. A first place finish nets you \$10 million; whereas a 50th place finish garners just over \$1.5 million. What you may find surprising is each player's average score for the 2007 season. Tiger's average score was 69.1 strokes per round and Charley Hoffman averaged 71.5 per round. This scant 2.4 stroke difference, per round, is all that separates the top finisher from 50th place. This difference, regardless of how slim, netted Tiger a cool \$9 million dollars more in prize money than Charley Hoffman. That's \$3.8 million per stroke!

THE SPREAD

Most people, golfers and non-golfers alike, don't realize just how tight the spread is separating the top PGA finisher from 50th place. This brings to mind two great questions. Why is the spread so close and how does this relate to investing?

On the PGA tour, all players are required to follow the same set of rules. Each golfer can only carry 14 clubs and all equipment, including golf balls, must be PGA-approved. Every stroke must be counted and all scores are tallied in the same, strict fashion. PGA golfers are not given any leeway in how they play the game.

Just imagine if each golfer were allowed to use as many clubs as desired. What would happen if they could swap their golf ball after each shot? What if their equipment wasn't PGA-approved? By removing equipment restrictions and relaxing the rules, you can see how scores could begin to vary widely. Average scores would likely come down as golfers start to experiment with different types of equipment.

THE PARALLELS OF PERFORMANCE

There are parallels between the game of golf and the business of investing. Like the PGA tour, most investment managers are required to play by the same set of rules; those established by the government and other regulatory bodies. They also use the same types of equipment as the rest of the investing community to make their decisions.

Investment managers are ranked, not by total prize money, but by how they perform relative to their respective index. They are also judged by how they perform against managers, within their peer group, whose investment objectives and strategies most closely resemble their own. The consulting community has developed a number of ways to analyze manager performance. These measurements have names such as "tracking error" or "style drift". These comparisons are an attempt to make sure that the manager is doing their job and not straying from their stated objectives. While this sounds like a good idea, with further reflection, we realize is that all this does is encourages the manager to invest just like their respective index in order to keep in line with it.

IMITATING THE INDEX

When you “invest like the index” you end up with the same results as the PGA tour; very little separation between managers (golfers). Very few managers who invest like a particular index ever actually beat it, because it’s difficult to beat what you are copying. Modern Portfolio Theory says that the markets are basically efficient. Similarly, the rules of golf make it “efficient” too. If you restrict golfers to playing the same way, you should expect them to achieve similar outcomes.

When you review the successes of some of the most famous investors, such as Sir John Templeton and Warren Buffett, you’ll discover they do not try to mimic a particular index. Both men are happy to have their performance compared to a particular index, but they don’t look to an index for investment ideas or strategy.

One of Templeton’s basic tenets is essentially, “If you invest in the same stocks as everyone else, you’re going to get the same return as everyone else.” Sir John was one of the first to invest globally, while all others were sticking close to home. One of those investors who stuck close to home was Warren Buffett. Buffett amassed a fortune well before he took over Berkshire Hathaway. His approach to investing was simple; invest in good companies that are underrated or undervalued and avoid investing those that are not. By contrast, Modern Portfolio Theory says that managers must diversify among various investments; even if they don’t understand them or don’t how to value those investments. This is one of the root causes of poor or average manager performance.

OUR BELIEF: A VALUATION BIAS

At CapTrust, we believe in finding ways to temper volatility through the use of different asset classes and managers. However, unlike our perceived competitors, we subscribe to many of the same philosophies as Sir John Templeton and Warren Buffett. We seek out investment managers that have a bias toward valuation and who look to gain a competitive edge by investing ways that may not follow the norms of “index investing.” We feel this is the best way to achieve investment success in order to earn higher rates of return and with less volatility.

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