SweetSpot Investments LLC

Refining our Method, January 2015

For the first time since trading began in 1999, SweetSpot investors have seen lackluster relative returns over a multi-year period. By January 2014, four of the five holdings due to be sold trailed their market benchmark. A question arose:

If our strategy is to invest on the cheap, why would we want to sell something that's cheaper at the end of our holding period than it was at the beginning?

A quick-and-dirty test gave us a clear answer: we wouldn't. This is easy enough to verify: In the list of completed SweetSpot trades, simply find the eight trades that underperformed the market (out of 39 total trades through 2013). What would have happened if we had not sold when we did? Here's what we found:

- Three of the eight trades needed just one year to transform themselves into market-beaters;
- Two trades needed two years;
- One trade needed four years;
- One trade made weak progress after two years;
- One trade made good progress in the one year since we sold; and
- All three unprofitable trades became profitable.

Most significantly, the average return on a total of 14 hypothetical one-year holds was +25.8 percent, or 12.2 points better than the market's +13.6-percent corresponding gain.

A cursory look at historical data from 1989-1999 — before real-time trading began — yielded similar findings.** Holding onto underperforming trades would have produced average annual returns of +13.0 percent, more than double the market's average +5.7-percent gain. Results were consistent, as average returns in *every* trade year were positive and exceeded market returns.

These initial findings convinced us to hold onto our underperformers, which is why only one position entered in 2011 is shown among the completed trades listed above. We also felt motivated to dig deeper into the data, and what we found felt like a breakthrough of sorts.

> "The things we are doing will not go away. We may have bad years, we may have a terrible year sometimes. But the principles we've discovered are valid."
>
> *James Simons, Ph.D, mathematician and hedge-fund manager*

The Review

In 2014 SSI conducted a comprehensive review of its investment process, drawing on current literature, 25 years of historical fund data, and 15 years of experience trading SweetSpot in real time. We looked at 77 completed multi-year trades that either were, or would have been, entered between 1989 and 2011 using SSI's established method.** Each trade was held for an initial three-year period, and longer if: 1) it was renewed (that is, identified as a new buy in subsequent years); or 2) it underperformed the market in its first three years. Between renewals and underperformers, 41 of 77 completed trades were held for longer than three years.

The numbers were clear: Most underperformers became market-beaters overall within one to six years (or four to nine years after they were first bought). Average annual trade returns in years four through nine would have been +18.0 percent, doubling the market's corresponding returns (+8.9 percent).*** These numbers far exceeded what we saw from positions in their initial three years, averaging +13.7 percent (or +5.7 percent better than the market). Aggregating the returns for all 77 trades, we see:

*Backtest: Completed SweetSpot Trades, 1989-2014****

- Average annual return per trade: +15.1 percent
- Corresponding market return: +8.3 percent
- Excess annual return: +6.8 percentage points
- Sixty-nine of 77 completed trades outperformed the market. That's a win rate of 89.6 percent, meaning the odds that any given trade would outperform were 9-1.
- Excess returns would have been achieved while taking on a small fraction of market risk [see "The Risks of Investing (in SweetSpot and Otherwise)"].
- Results were consistent throughout the test period. Average returns in all trade years (one through nine) were positive and exceeded market returns.

Implications for the SweetSpot method

> "Price is what you pay. Value is what you get."
>
> *Warren Buffett*

The decision we made in 2014 to treat underperforming trades as deserving of special handling is an elegant refinement of SSI's method. The reality is that every trade is subject to its own unique circumstances, and its own optimal holding period. Granted, only in hindsight can we know for certain what was optimal. But we must act (or not) in the present. Returns relative to the market are an intuitive, vetted metric that can inform our sell decisions and improve our ability to account for trade-specific factors.

Past performance is not an assurance of similar future returns. Nonetheless, the results of SSI's backtest are significant, providing historical evidence that:

- A contrarian investment philosophy that favors investing in undervalued assets can deliver superior absolute and relative returns over time;
- SSI's reliance on negative fund flows as a means to identify undervalued assets has been effective;
- Optimal holding periods — that allow cheap assets to recover their value — often vary from trade to trade; and

- Once an asset has been identified as undervalued, relative returns can inform an estimation of the asset's optimal holding period.

Conclusion

SSI's review in 2014 was prompted largely by SweetSpot's mediocre returns in the past few years. We sought to answer the questions: Has the strategy lost its edge? What has changed?

The short answer is that nothing has changed but the times, and the times haven't changed in a way that calls into question SweetSpot's long-term prospects. Indeed, SweetSpot suffered more than one multi-year period of weakness in SSI's 25-year backtest, yet we still saw outstanding overall results.

A key finding: Any strategy that seeks to outperform the market — even the best long-term performers — will experience occasional extended periods of underperformance. It is fortuitous that SSI has refined its method in a way that will better accommodate such periods. SSI's research — on which this refinement was based — didn't consider annual portfolio returns, but instead focused on individual trades. Addressing the latter just happened to enhance our perspective on the former.

SweetSpot's historical advantage is rooted in the foibles of human nature — specifically, the predictable irrationality of investors that is most pronounced as down markets approach a bottom.

> "The irrationality of a thing is not an argument against its existence; rather a condition of it."
>
> *Friedrich Nietzsche*

SSI sought to determine if investors somehow learned from their mistakes and corrected them, neutralizing our trading edge. A survey of the relevant literature uncovered no reason to believe that they have.

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****Except as noted, all reported returns are gross and assume the reinvestment of dividends and other fund distributions.***

*****Disclaimer: Backtests do not represent actual trading; they may not reflect the impact that material economic and market factors might have had on your adviser's decisions if your adviser were actually managing the tested strategy during the backtest period. No representation is made that investors will see profits similar to hypothetical past results.***

******In SSI's backtest, yearly data refers to calendar years. Reported returns represent total returns. "Market Return" is: S&P 500 index, 1989-'90; Fidelity S&P 500 Index Fund (FSMKX), 1991-2007 (verified numbers provided by Investors FastTrack); and the All-Country World Index ETF (ACWI) thereafter. (Domestic stocks were SweetSpot's most-representative market benchmark until 2008, when a majority of portfolio positions was first drawn from a global universe.)***