



Brad's Musings *Charlie's Poor Clients*

If you want to learn about investing by studying one of the greatest investors of all time, I recommend you pick up a book called "Poor Charlie's Almanack". In case you don't know, Charlie Munger has been Warren Buffet's business partner, advisor and friend for more than 50 years. He is wise, principled and has produced Gretzky-like investment returns over his career. He is simply one of the best. From 1962 to 1975, Charlie Munger managed an investment partnership. Over that time, Mr. Munger produced an impressive compounded annual return of 13.7% for his Limited Partners. An investment of \$1 million in 1962 would have been worth \$6.0 million after 14 years. I can't emphasize enough how significant and rare investment results like those are. In bull markets you will find numbers like that over shorter terms such as 5 years, but not many can do it over 14 years. Take a look at Mr. Munger's exceptional track record below:

Charlie Munger Investment Partnership Limited Partner Returns

	<u>Yearly Return</u>
1962	20.1%
1963	47.8%
1964	33.1%
1965	6.0%
1966	8.3%
1967	37.5%
1968	27.0%
1969	21.3%
1970	(0.1%)
1971	20.6%
1972	7.3%
1973	(31.9%)
1974	(31.5%)
1975	73.2%
CAGR	13.7%

Source: Munger, Charles T. *Poor Charlie's Almanack: The Wit and Wisdom of Charles T. Munger*. Ed. Peter D. Kaufman. Donning Company Publishers, 2006, page 21

You may have noticed that he had two back-to-back years of being down almost 32%. At first glance that doesn't appear to matter much. The 13.7% compounded return factors those years into the calculation and he made good with an up 73% year in 1975 (that's the investing equivalent of Gretzky's 92 goal season back in 1981-82). However, consider the following observations that flow from his track record:

1. If you invested on January 1, 1973, you would have lost a little more than 53% of your money by the end of 1974.
2. At the end of 1974, you would have to go all the way back to 1967 to find someone who could say they had made money investing with Mr. Munger.
3. Even with the heroic 73% final year return, anyone who invested in 1973 was still down more than 19% on their investment when Mr. Munger dissolved the partnership.



At Waratah, we have new investors every month who place their trust in us to look after their savings. If we ever lose 53% of their money, it will give them no comfort to tell them how well all the earlier investors did; I can't imagine the conversations with day-one investors being any more pleasant. Even day-one clients don't want to hear about compounded returns when their \$9 million account turns into a \$4.2 million account. Here's a little secret about the money management business: there aren't that many day-one investors. Every successful investment manager starts out small and grows. The reality is that when the investing disaster happens (and with all due respect to Mr. Munger, that's exactly what the loss of 53% of your money is), the star manager is at an all-time high in assets under management.

This pattern of assets under management ("AUM") growth and decline can lead to a scenario where the investment manager's track record remains solid even after the investing disaster and yet the average client (on a dollar weighted basis) has experienced a loss.

Consider the following hypothetical example:

Life Cycle of a High-Torque Manager

Year	AUM (\$MM)	Investment Return	Since Inception Compound Return	Client Profit (\$MM)	Cumulative Client Profit (\$MM)
1	25	15%	15%	4	4
2	60	25%	20%	15	19
3	120	13%	18%	16	34
4	250	8%	15%	20	54
5	550	30%	18%	165	219
6	750	25%	19%	188	407
7	1,500	17%	19%	255	662
8	2,500	(32%)	11%	(800)	(138)
9	1,000	(32%)	5%	(320)	(458)
10	500	73%	10%	365	(93)

After the first seven years, this hypothetical firm has produced a fantastic 19% compound annual return. These returns attracted many clients and assets under management have grown to \$2.5 billion from only \$250 million four years earlier. The cumulative client profit from the first seven years is \$662 million. Things start to go downhill in year eight with a negative 32% return. The first negative year in the firm's history has dropped the compound annual return from 19% to a still respectable 11%. However, the cumulative profit earned for clients since the inception of the firm has turned into a loss of \$138 million after only one down year. The large in-flows from new clients are 'late to the party' and losses incurred by these clients dwarf the profits of the smaller pool of earlier investors. The following year things get even worse with a cumulative client dollar loss of \$458 million. Finally, the manager has an amazing 73% return restoring the compound annual return to a very respectable ten year track record of 10%. So there you have it: a great ten year track record and yet the average client lost money.



The highest compound annual return that we've generated so far at Waratah is in our Waratah Performance Fund, which has achieved 13.6% over 4.7 years. However, we consider drawdown and volatility management to be just as important as the return component. That's why the Performance Fund has averaged only 50.9% net market exposure since its inception. It's also the reason why we use stop-loss strategies and sell during market dips. Quite frankly, we'd rather produce lower returns and avoid being in the uncomfortable position of trying to explain to you how we lost 53% of your money.

Brad Dunkley

March 11, 2015



Legal Information and Disclosures

This letter expresses the views of the author as of the date indicated and such views are subject to change without notice. Waratah has no duty or obligation to update the information contained herein. Further, Waratah makes no representation, and it should not be assumed, that past investment performance is an indication of future results. Moreover, wherever there is the potential for profit there is also the possibility of loss.

This letter is being made available for educational purposes only and should not be used for any other purpose. The information contained herein does not constitute and should not be construed as an offering of advisory services or an offer to sell or solicitation to buy any securities or related financial instruments in any jurisdiction. Certain information contained herein concerning economic trends and performance is based on or derived from information provided by independent third-party sources. Waratah Capital Advisors ("Waratah") believes that the sources from which such information has been obtained are reliable; however, it cannot guarantee the accuracy of such information and has not independently verified the accuracy or completeness of such information or the assumptions on which such information is based.

This memorandum, including the information contained herein, may not be copied, reproduced, republished, or posted in whole or in part, in any form without the prior written consent of Waratah Capital Advisors.