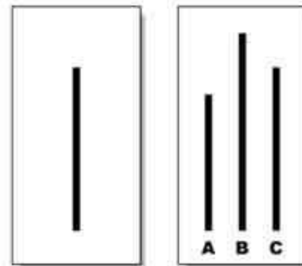
PERSPECTA TRUST

February 4, 2016

4Q 2015 Investor Letter

Building the Herd

In the early 1950's, Solomon E. Asch, the late psychologist and professor at Swarthmore, conducted an investigation of "the conditions of independence and submission to group pressure."[1] The goal of the study was to assess (and ideally quantify) the extent to which individuals would conform to the group or herd mentality despite the group's opinion being incorrect. The study involved groups of 8-10 individuals reviewing and answering a seemingly simple problem – match one line of a certain length to another line of the same length, such as the following:



Of the 8-10 participants in each trial, only one was the subject of the experiment; the rest of the participants were informed of the study and told to give an incorrect answer. Each of the participants answered aloud in order, with the subject answering second-to-last, hence having ample time to hear at least six incorrect responses.

The results were astounding and frightening. 37 of the 50 subjects (74%) went along with the obviously incorrect majority at least once during the 12 trials. 15 of the 50 subjects (30%) joined the majority at least 50% of the time. Altogether, *one-third of the responses of the subjects incorrectly went along with the majority.* Further, the question they were asked to answer was an obvious one – which line (A, B, or C) is the same length as the subject line? The average line was 5 inches in length, and the average majority error (incorrectly selected line) was more than an inch longer or shorter than the target.

Imagine the impact of groupthink when introduced to the arcane world of equity and debt markets. Sell-side analysts, market strategists, CNBC talking heads, and the like offer their words of wisdom to the investing public like Phil Helmuth offering Texas Hold'em advice for a future home game.[2] Investors, both amateur and professional, absorb the plethora of information spouting from 'industry professionals' as law, neglecting to take the time and effort required to develop a substantiated and possibly contrary position.

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[1] Asch, Solomon. *Effects of Group Pressure Upon the Modification and Distortion of Judgments*. **Documents of Gestalt Psychology**. Ed. Mary Henle. University of California Press: 1961.

[2] I admittedly read "Play Poker Like the Pros" by Phil Helmuth. While it offered a few good tips, its value in educating the masses on being successful in poker is questionable at best.

Filtering the Noise

Navigating through the noise is no easy task. "Noise" in this context is present in almost any decision making process – whether it be personal, professional, financial, investment, or some combination thereof. When I began my investment career on a trading desk in Harvard Square, it was almost nauseating how fast markets moved and how quickly economic and financial data became absorbed and integrated – a slight miss on earnings or economic releases could affect an individual stock or broader market by multiple percentage points. Global financial centers are almost addicted to those releases.

For those of you that may have thought otherwise, Hampton, New Hampshire is not a global financial center. This brings with it certain advantages and disadvantages that can be debated much like the anticipated direction of equity markets or the strength of the US economy. One of the most notable aspects (for me anyway) is how *quiet* the office seems relative to offices in global financial centers. We have Bloomberg terminals and meetings going on all day (and even a helipad that stays moderately busy), but there is an overriding sense of calm and clarity that differs materially from the frenzy of Wall Street and its ilk. With that calm and clarity, the noise seems less piercing, the groupthink less pervasive, and the decision making (whether financial or otherwise) more decisive.

Outlook and Positioning

That's not to suggest by any stretch that our crystal ball is perfectly clear. 2015 featured many surprises to both us and the broader market – crude oil prices were down more than 30%, master limited partnerships ("MLPs"; a relative overweight of ours) were down 33%, high yield was down 5%, and 10-year US Treasury yields were flat. One of the questions going into 2016 (or any new year) is whether asset class returns (both absolute and relative) of the previous year are indicative of *sentiment* or *fundamentals*. Most of you have likely seen the following chart (or some version of it):[3]

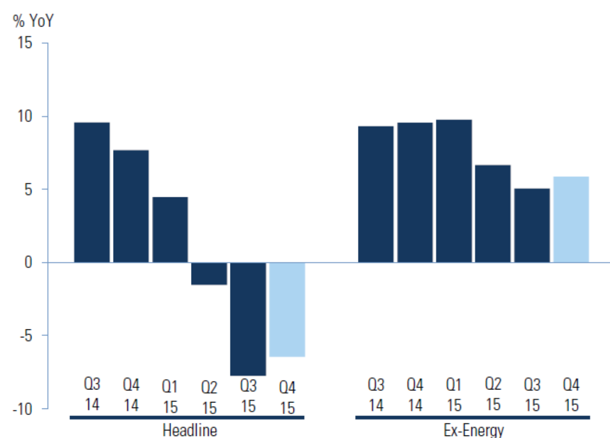
2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2000 - 2015 Ann.	2000 - 2015 Vol.
Comdty. 31.8%	REITs 13.9%	Comdty. 25.9%	EM Equity 56.3%	REITs 31.6%	EM Equity 34.5%	REITs 35.1%	EM Equity 39.8%	Fixed Income 5.2%	EM Equity 79.0%	REITs 27.9%	REITs 8.3%	REITs 19.7%	Small Cap 38.8%	REITs 28.0%	REITs 2.8%	REITs 12.9%	REITs 22.0%
REITs 26.4%	Fixed Income 8.4%	Fixed Income 10.3%	Small Cap 47.3%	EM Equity 26.0%	Comdty. 21.4%	EM Equity 32.6%	Comdty. 16.2%	Cash 1.8%	High Yield 59.4%	Small Cap 26.9%	Fixed Income 7.8%	High Yield 19.6%	Large Cap 32.4%	Large Cap 13.7%	Large Cap 1.4%	High Yield 8.5%	Small Cap 21.2%
Fixed Income 11.6%	Cash 4.1%	High Yield 4.1%	DM Equity 39.2%	DM Equity 20.7%	DM Equity 14.0%	DM Equity 26.9%	DM Equity 11.6%	Asset Alloc. -25.4%	DM Equity 32.5%	EM Equity 19.2%	High Yield 3.1%	EM Equity 18.6%	DM Equity 23.3%	Fixed Income 6.0%	Fixed Income 0.5%	Small Cap 7.1%	EM Equity 20.6%
Cash 6.1%	Small Cap 2.5%	REITs 3.8%	REITs 37.1%	Small Cap 18.3%	REITs 12.2%	Small Cap 18.4%	Asset Alloc. 7.1%	High Yield -26.9%	REITs 28.0%	Comdty. 16.8%	Large Cap 2.1%	DM Equity 17.9%	Asset Alloc. 14.9%	Asset Alloc. 5.2%	Cash 0.0%	EM Equity 6.3%	Comdty. 18.7%
High Yield 1.0%	High Yield 2.3%	Cash 1.7%	High Yield 32.4%	High Yield 13.2%	Asset Alloc. 8.1%	Large Cap 15.8%	Fixed Income 7.0%	Small Cap -33.8%	Small Cap 27.2%	Large Cap 15.1%	Cash 0.1%	Small Cap 16.3%	High Yield 7.3%	Small Cap 4.9%	DM Equity -0.4%	Fixed Income 5.7%	DM Equity 16.9%
Asset Alloc. 0.0%	EM Equity -2.4%	Asset Alloc. -5.9%	Large Cap 28.7%	Asset Alloc. 12.8%	Large Cap 4.9%	Asset Alloc. 15.3%	Large Cap 5.5%	Comdty. -35.6%	Large Cap 26.5%	High Yield 14.8%	Asset Alloc. -0.7%	Large Cap 16.0%	REITs 2.9%	Cash 0.0%	Asset Alloc. -2.0%	Asset Alloc. 5.2%	Large Cap 16.7%
Small Cap -3.0%	Asset Alloc. -3.9%	EM Equity -6.0%	Asset Alloc. 26.3%	Large Cap 10.9%	Small Cap 4.6%	High Yield 13.7%	Cash 4.8%	Large Cap -37.0%	Asset Alloc. 25.0%	Asset Alloc. 13.3%	Small Cap -4.2%	Asset Alloc. 12.2%	Cash 0.0%	High Yield 0.0%	High Yield -2.7%	Large Cap 4.3%	Asset Alloc. 13.4%
Large Cap -9.1%	Large Cap -11.9%	DM Equity -15.7%	Comdty. 23.9%	Comdty. 9.1%	High Yield 3.6%	Cash 4.8%	High Yield 3.2%	REITs -37.7%	Comdty. 18.9%	DM Equity 8.2%	DM Equity -11.7%	Fixed Income 4.2%	Fixed Income -2.0%	EM Equity -1.8%	Small Cap -4.4%	DM Equity 2.9%	High Yield 11.5%
DM Equity -14.0%	Comdty. -19.5%	Small Cap -20.5%	Fixed Income 4.1%	Fixed Income 4.3%	Cash 3.0%	Fixed Income 4.3%	Small Cap -1.6%	DM Equity -43.1%	Fixed Income 5.9%	Fixed Income 6.5%	Comdty. -13.3%	Cash 0.1%	EM Equity -2.3%	DM Equity -4.5%	EM Equity -14.6%	Cash 1.9%	Fixed Income 3.4%
EM Equity -30.6%	DM Equity -21.2%	Large Cap -22.1%	Cash 1.0%	Cash 1.2%	Fixed Income 2.4%	Comdty. 2.1%	REITs -15.7%	EM Equity -53.2%	Cash 0.1%	Cash 0.1%	EM Equity -18.2%	Comdty. -1.1%	Comdty. -9.5%	Comdty. -17.0%	Comdty. -24.7%	Comdty. 0.8%	Cash 1.0%

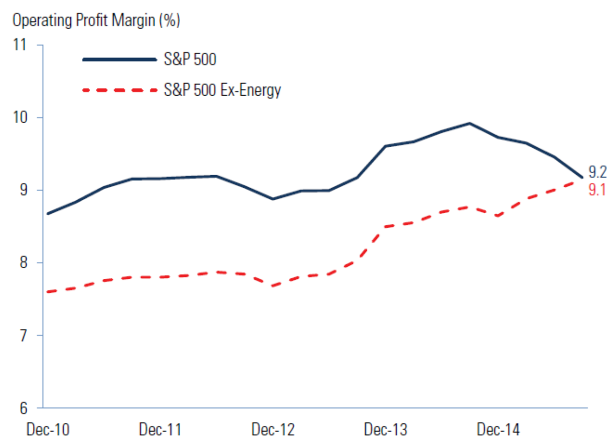
While sentiment tends to drive performance over relatively short periods, understanding the fundamentals is essential for successful asset class selection. Consider, for instance, emerging market equities and real

[3] JPMorgan Guide to the Markets as of 12/31/15

estate investment trusts (REITs) over the post-recession 2010 to 2015 period. Both asset classes performed well in 2010, and expectations were high going into 2011. Morgan Stanley, who by its own admission was *less* bullish on emerging markets in 2011 than most on Wall Street, *forecasted below-consensus returns of 19% for 2011*.[4] Expectations for 2011 were more muted on REITs – Goldman had return expectations of around 5%.[5] Despite high expectations, emerging market equities were not only the worst performing asset class in 2011 (down 18%) but, with the exception of commodities, were the worst performing asset class over the following four years. REITs, on the other hand, were the best performing asset class in both 2011 and the ensuing four years. With the benefit of hindsight, the difference in the *fundamentals* of the two asset classes is (if not *was*) clear: emerging markets are highly tied to commodities (Brazil / Russia), global demand from the developed world (China), and volatile political regimes; REITs are largely US-centric, serve as an inflation-protected store of value, and produce tax-efficient income in a world of high taxes and no income. If I had my hindsight in 2011, our overweight to REITs and underweight to emerging markets would have been more significant.

So what parallels are there in today's markets? As it relates to global equities, returns were roughly flat in 2015 – the S&P 500 advanced marginally (+1.4%) while the MSCI All-Country World and MSCI EAFE indices were down 1.8% and 0.2% respectively. The flat return numbers mask significant dispersion amongst individual equities – the top 10 holdings in the S&P appreciated by 10%, while the remaining 490 stocks declined by 5%.[6] Given flat markets in 2015, high dispersion, average valuations, increased volatility into year-end, and mixed sentiment, 2016 calendar year performance will likely be driven more by corporate operating results (and less Fed policy) than it has been in recent memory. Further, a big part of that operating performance is dependent upon the energy sector. Following are two charts from Goldman Sachs:[7]





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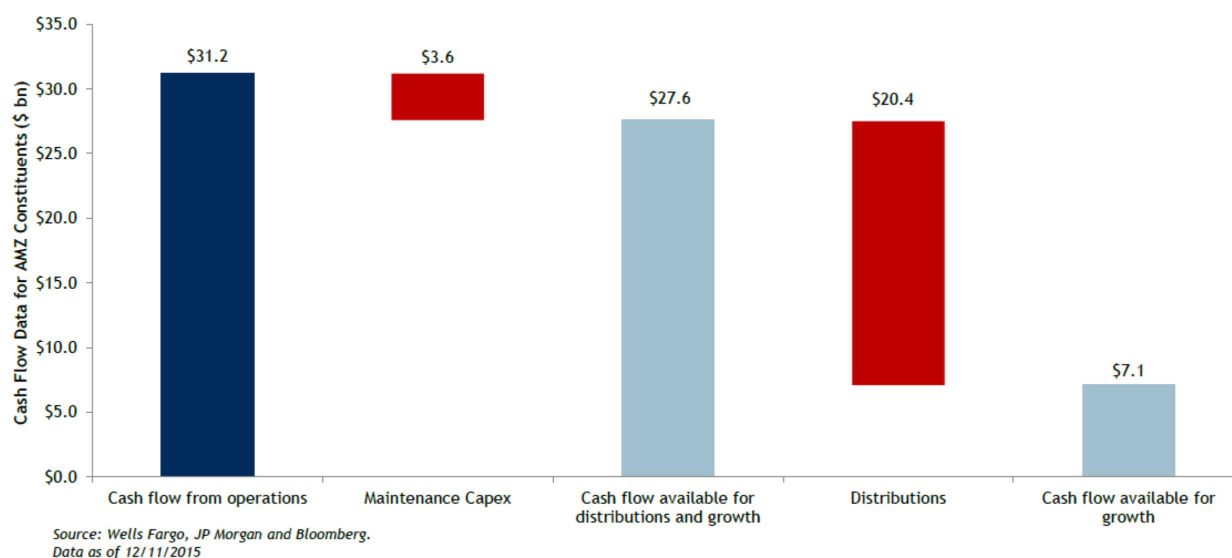
[4] Morgan Stanley. *Asia/GEMs Strategy*. 12/1/10
[5] Goldman Sachs. *United States: Real Estate: REITs*. 1/12/11
[6] Bloomberg
[7] Goldman Sachs. *Outlook: The Last Innings*. 1/2016

Excluding the impact of the energy sector, operating earnings for the S&P 500 have advanced 5-10% year-over-year in each of the last six quarters. Further, operating margins ex-energy are at or near peaks from the last five years, and per Yardeni, aggregate operating margins are near peaks from the last 20+ years.[8] Although energy's weighting in the S&P 500 has been reduced to 6.5% following 20%+ declines in 2015, at the margin, there is little room for operating improvement amongst the remaining sectors given historically high margins and few revenue growth opportunities. Our position remains where it did at the end of the first quarter – conservatism is warranted in global equities.

As it relates to sentiment versus fundamentals, two of the hardest hit sectors last year were the aforementioned MLPs and corporate high yield. Sentiment obviously wasn't on their side in 2015: the decline in crude oil prices, fear of distribution cuts, and fear over the accessibility of capital markets drove MLPs down more than 30%, while the decline in energy prices (and its impact on highly-levered energy producers), lack of liquidity, and rising rate fears drove high yield prices down 10%. Further, both groups had highly-visible 'casualties' over the course of the year that exacerbated negative sentiment. Kinder Morgan, a behemoth in the pipeline transportation and energy storage space, cut its dividend in early-December after advising less than six months earlier that it would *grow* its dividend by 10% in 2015. The news sent ripples through an already decimated MLP space. Around the same time, Third Avenue Management, a manager of high yield bond mutual funds, announced that it was blocking investors from getting their money back, citing difficult trading conditions for its securities.[9] Naturally, the market reacted in haste, declining an additional 2%.

In separating the wheat from the chaff, both asset classes offer fundamentally-driven opportunity over the next eighteen months. Despite significant crude oil and natural gas price declines, crude oil production is expected to be *flat* and natural gas production *up* in 2015.[10] For reasons I can't explain, the commodity price-linked sectors of the MLP space *outperformed* the volume-linked sectors in 2015. Further, aggregate distributions from MLPs are expected to *grow* in 2016 despite Kinder Morgan's troubles. Following is a chart from Tudor Pickering Holt & Co that analyzes cash flow for the Alerian MLP index constituents over the last year:[11]



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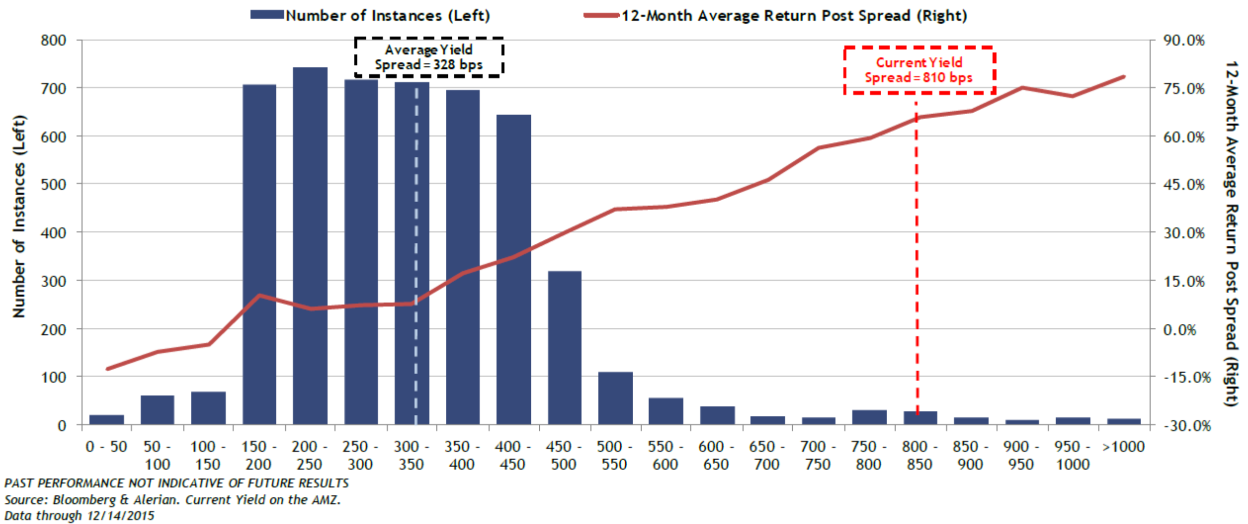
[8] Yardeni Research. *Stock Market Briefing: S&P 500 Profit Margins, Sectors & Industries*. 1/28/16

[9] New York Times. 12/10/15

[10] Tudor Pickering Holt & Co. "The Time is Now: Midstream and MLP Update". 12/17/15

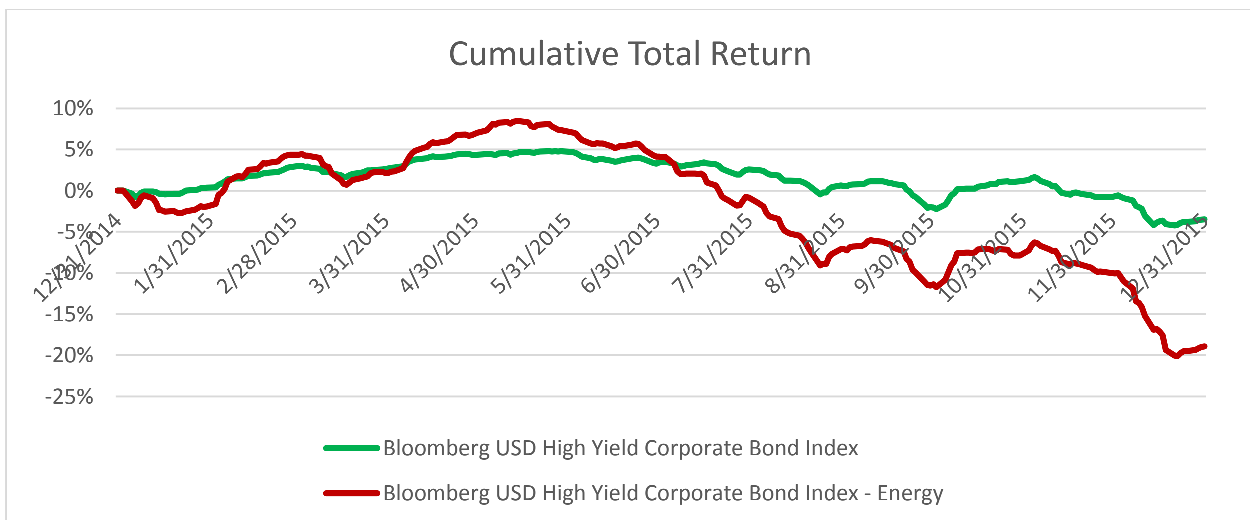
[11] Ibid.

Fundamentally, MLPs have ample cash available to fund both maintenance capital expenditures and provide solid distributions to investors. Further, the excess of cash generated over cash distributed can be used to fund individual company growth plans in the event capital market access declines further. In light of the limited income sources available to taxable investors, the tax-efficient ~8% distribution rate that MLPs currently offer seems adequate compensation to wait for a rebound, regardless of whether that rebound ultimately arrives. Following is another chart from the same Tudor Pickering presentation that shows average returns depending upon the yield spread between MLPs and Treasuries:



While fundamentals and outlook change with the times, depressed MLPs with great management teams, strong balance sheets, good cash flow, limited funding needs, and leverage to volume versus price should be worthwhile investments over the coming years (even if not the 60%+ referenced in the above chart).

Turning to high yield, the iShares High Yield Corporate Bond ETF (HYG) was down 5.0% in 2015. Declines were driven by several factors – the Federal Reserve's decision to commence a rate hike cycle, the nearly 25% decline in commodity prices, and the aforementioned closing of a few high-profile credit funds late in the year. The energy and metals/mining sectors were particularly weak as these companies struggled to manage a more challenging commodity price environment (see chart below).



As a result, the yield to worst on high-yield corporate debt rose more than 300 basis points during 2015 and stood at more than 9% as of the end of the year. The index has not reached this level since October 2011 when the yield to worst briefly crossed 10%.[12] While we recognize the uncertainty surrounding the potential depth of the economic contraction in China, the outcome of the U.S. Presidential election, the timing / pace of interest rate hikes in the U.S., and the timing of a potential recovery in global energy prices, we are encouraged by the outlook for the U.S. economy (if not necessarily equity prices). U.S. real GDP is expected to grow +2.1% in 2016 driven by a +2.5% increase in real consumer spending. The recovery in residential real estate remains on track, as U.S. housing starts are expected to increase by over +15% in 2016. Although the high-yield default rate is projected to increase +120 basis points to 4.5%, we note that this rate falls to just 1.5% after excluding the highly stressed energy and metals/mining sectors. Moreover, 4.5% is broadly in line with the historic average of 4.3%, while both absolute yields and relative spreads are as high and wide as they have been since 2012.

Lastly, as we wrote about in our first quarter 2015 letter, bond market liquidity (especially in high yield corporate debt) has dried up significantly over the last five years. Lack of liquidity coupled with negative sentiment leads to opportunity. Per Loomis Sayles, 21.1% of the broad high yield market was trading at distressed levels (defined as greater than 10% spread over Treasuries) as of mid-December, which is as high as it's been since 2011. Despite the seeming distress, interest coverage ratios of many high yield issuers are strong, as good companies have been able to refinance at low rates over the last few years. Refinancings also pushed out maturities meaningfully, with the next big wave of corporate debt not due until around 2020.[13] For the intermediate / long-term investor, allocating capital to *active* managers in the space with the ability to pick through the rubble should yield attractive returns in the coming years.

Conclusion

Returning to the Ashe experiment from earlier, the decision-making of 'yielding' subjects (those that went with the majority during at least half of the trials) generally fell into three categories: (1) distortion of perception under the stress of group pressure; (2) distortion of judgment; and (3) distortion of action. Very few fell into the first category, which was seemingly unaware that their answers had been distorted and truly believed that both their and the majority responses were correct. Amongst other things, this group needs an eye exam. Distortion of judgment and action (groups 2 and 3) had more subtle explanations for deviance from the obvious truth. Those with 'distortion of judgment' typically perceived the correct solution but opted to go with the group, believing such a strong majority simply must be correct. 'Distortion of action' was arguably the worst form of distortion: subjects knew the correct answer but opted to go along with the majority anyway "because of an inability to tolerate the appearance of defectiveness in the eyes of the group". To draw the investment comparisons, those suffering from distortion of judgment in group 2 are right more often than you might think – the consensus is often right. However, those suffering from distortion of action will likely miss out on an abundance of opportunity over their investment horizons, as conviction is dwarfed by conformity.

On the flip side, *independence based upon confidence in one's perception and experience* is what drives successful decision making, in investing or otherwise. In discussing a group of 'independent' subjects (those that did not yield to the groupthink), Ashe wrote "though [these subjects] are sensitive to the group and experience the conflict, they show a resilience in coping with it, which is expressed in their continuing reliance on their perception and the effectiveness with which they shake off the oppressive

[12] Bloomberg

[13] Loomis Sayles. *Comments on the High Yield Sector and Market Liquidity*. 12/16/15

group opposition". The subject seated at the table second from the right in the below photograph is one such subject:

If you are or know of anyone with such capacity to think independently while acknowledging the majority, please direct them to the 'careers' section of our website.

Please let us know if you have questions, and thanks as always for your continued support.

Anthony J. Annino
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