# This is the Story of a "Slam Dunk" and "Can't Lose" Stock

In 1958, an iconic photograph of a Boeing 707 flying over the Golden Gate Bridge changed the way many felt about air travel, and certainly how they felt about Pan Am.

Three years earlier, a gentleman named Juan Trippe had led Pan Am into the Jet Age when he ordered 23 Boeing 707 jets and 25 Douglas DC-8 jets. The new swept-wing aircraft were powered by experimental engines, originally developed for military use. With a cruising speed of 600 miles per hour, the jet plane was nearly twice as fast as the piston-engine plane, and the move stunned Pan Am's competitors, all of whom were still operating propeller-driven fleets.

In 1958, Pan Am initiated the first jet service from New York to Paris. On October 28, Clipper America, commanded by Captain Samuel H. Miller, took off from rain-soaked Idlewild International Airport (now known as JFK), and flew to Paris with 11 passengers aboard. It was the first scheduled jet flight by any United States airline. The Boeing jet reduced the Atlantic crossing time to just seven hours, compared with the 23 it took on a propeller-driven plane.

The traveling public lined up for tickets, and during the first three months of 1959 the Pan Am 707s carried 33,400 passengers around the world, racking up a 90.8 percent seat occupancy rate, an all-time record. The Pan Am blue globe logo, created by New York architect Edward Larrabee Barnes in 1955, soon became one of the most famous symbols in the world.

Pan Am stock prices soared. Investors congratulated each other for their prescience in investing in such an equally dominant and forward-looking company. They talked about passing shares down to their children and grandchildren.

As if to prove their point, in 1973 Trippe opened the largest air terminal created by any individual carrier, Pan Am's futuristic terminal at John F. Kennedy International Airport in New York. The Worldport was distinguished by its giant disk-shaped roof made of reinforced concrete.

Pan Am was now a worldwide corporation with 44,000 employees and 114,000 stockholders. The airline flew to over 160 countries and owned a mammoth chain of hotels.

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Heady days led CEO Juan Trippe to declare in 1955 that "mass travel by air may prove to be more significant to world destiny than the atom bomb. For there can be no atom bomb potentially more powerful than the air tourist, charged with curiosity, enthusiasm and goodwill."

The stats were impressive and so was the stock price, but behind the scenes all was not well. Trippe stepped aside to bring in new blood to run the company. You may recall that in 1985 Pan Am employees went on strike, and later that year the company sold all its Asian and Australian routes for a whopping $750 million. Then tragically in 1988, a Libyan terrorist's bomb exploded inside a Pan Am 747 as it flew over the rural Scottish town of Lockerbie.

***The moral of the story here is that blue chip stocks do not always stay blue. They age. They fade. They are generally propped up in their final hours by financial maneuvering.***

Passengers simply stopped flying Pan Am, and by 1991 Pan American World Airways, for more than five decades an unofficial symbol of the United States abroad, filed for Chapter 11 bankruptcy. Reasons cited included spiraling fuel prices, the deteriorating economy, and the terrorist bombing of its Flight 103 over Scotland two years previously.

The company's combined assets totaled $2.1 billion, but its liabilities added up to $2.8 billion. Shareholders were wiped out – their stock was effectively worth nothing. The harsh reality was that Pan Am had been running in the red for years. Its losses in 1986 alone were estimated at $346 million, and since 1980 in fact Pan Am had racked up losses of more than $1 billion.

To make up for those losses, it had been divesting its prize assets. In desperation, Pan Am sold its Intercontinental Hotel chain for $500 million and its Manhattan headquarters, the largest commercial office building in the world, for $249 million. Besides having sold its ultraprofitable Pacific routes, the new CEO had to use all of Pan Am's fleet as collateral for expensively borrowed capital. Banks stopped lending to Pan Am. And the airline could not sell the bonds offered in a $125 million junk bond issue. The junk bonds, secured by obsolete aircraft, languished on the shelf at Merrill Lynch (and in the brokerage accounts of its clients) with no willing buyers in the marketplace.

Once the darling of the industry, Pan Am had been forced to depend on other airlines for its survival in its final years. It joined the Sabre reservation system, owned by American Airlines, because few travel agents used Pan Am's own outmoded system. With virtually no liquid financial resources, Pan Am was ill-prepared for any unforeseen calamity in the highly unpredictable airline business.

The nails in the proverbial coffin were the dual economic devastations brought about by the 1986 bombing of a TWA jetliner and the Chernobyl nuclear plant accident in the Soviet Union. Both events caused a plunge in travel to Europe, on which routes Pan Am earned 60 percent of its revenue. As if to punctuate the bad luck, the Chernobyl reactor melted down the very day that Pan Am resurrected its service to Moscow.

The moral of the story here is that blue chip stocks do not always stay blue. They age. They fade. They are generally propped up in their final hours by financial maneuvering. They fall – sometimes all the way down to zero. They are replaced by nimble, newer, upstart companies – most of which never get off the ground – but some of which grew up to be the next Southwest Airlines. Investing in a handful of blue-chip stocks because it feels good was a poor strategy in the past and is even less prudent today when a global economy offers investors low-cost access to 12,000+ stocks in 45 countries, which provides the tools to diversify away the risk of unwittingly owning too much of the next Pan Am.

## Track Record

We routinely get calls at our office from mutual fund or hedge fund wholesalers that want to speak to the decision makers at the firm because they want to present the track record of the funds they happen to be pitching in that particular round of sales calls.

Though we recognize those individuals have very difficult day jobs, we never take those calls. We are not interested in flash-in-the-pan performance. We cannot be wooed by one-year, three-year, five-year time periods, etc. As stewards of our clients' assets we require

| First full month[1] through 6/30/2014 | ANNUALIZED RETURN | |
|---|---|---|
| | Fund(%) | Benchmark(%) |
| **US EQUITY** | | |
| **US Micro Cap**, since 1/82 | 12.47 | 10.75 |
| **US Small Cap**, since 4/92 | 11.26 | 9.77 |
| **US Large Cap Value**, since 3/93 | 10.58 | 10.01 |
| **US Small Cap Value**, since 4/93 | 12.91 | 10.82 |
| **NON-US EQUITY** | | |
| **International Small Company**, since 10/96 | 7.79 | 4.64 |
| **International Small Cap Value**, since 1/95 | 8.50 | 4.44 |
| **International Value**, since 3/94 | 7.28 | 5.68 |
| **Emerging Markets Small Cap**, since 4/98 | 12.96 | 8.36 |
| **Emerging Markets Value**, since 5/98 | 12.54 | 8.47 |
| **Emerging Markets**, since 5/94 | 7.87 | 6.58 |
| **FIXED INCOME** | | |
| **One-Year Fixed**, since 8/83 | 5.09 | 5.00 |
| **Intermediate Government**, since 11/90 | 6.73 | 6.25 |
| **Five-Year Global**, since 12/90 | 5.78 | 5.11 |

investment vehicles to provide consistent, reliable, low-cost exposure to the markets in which we seek to invest.

As a Rockwood client, you know you almost never hear us talk about the track record of a manager or a particular fund we recommend. The reason is simple – it is incredibly easy to look at past performance and filter for a recently glamorous track record. Using that method in isolation to invest simply doesn't work – in fact, it hurts returns.

Instead, we espouse utilizing managers like Dimensional Fund Advisors, who feature low-cost evidence-based approaches to reduce trading costs, adhere to asset class discipline, and reject conventional market-cap-weighted indexes, all of which will add value to long-term portfolios.

To demonstrate the impact of prudent implementation, we decided to analyze the longest-standing mutual funds at Dimensional Fund Advisors – and compare their performance since inception with the relevant benchmark[1] for the respective asset class. We wanted a broad sample from the spectrum of asset classes that illustrate the underlying tools in the portfolios we create for our clients.

The findings are absolutely incredible. The funds described above have track records of nearly 33 years and have outperformed their benchmarks by wide margins. This kind of data just does not exist at other fund companies. The long-time horizons coupled with the wide margins of added value are unparalleled in the mutual fund landscape.

***To put it another way, we are keenly interested in empirically what will work well for your portfolio over the next 33 years.***

We don't talk about it much, because our value proposition has never been that the underlying funds within the strategies we recommend will blow the doors off their relevant benchmarks (though it is nice if it happens from time to time). Instead, we focus on getting reliable exposure to the market segments we require in order to build prudent portfolios.

Perhaps even more interesting than the results themselves is understanding a bit about how they were achieved. These results were *not* realized by picking stocks, taking undue risks, timing markets, making sector rotations, hiring rock-star managers or any other aspects of common mutual fund chicanery.

The results were achieved because of the excellent implementation of an evidence-based approach. Yes – implementation matters. Controlling expenses matters, patient trading matters, asset class discipline matters, and avoiding index fund reconstitution friction matters. To put it another way, we are keenly interested in discovering empirically what will work well for your portfolio over the next 33 years.

## California's Pension Fund – Finally Getting it Right

As CalPERS is the nation's largest public pension fund with assets totaling $300.3 billion as of June 30, 2014, it would be sensible to assume that the investment professionals running CalPERS would be good at picking winners. Or at least reasonably skilled at picking smart people to pick winners for them. But in the past year CalPERS has made two decisions that are harbingers for all of us investors when it comes to trying to outperform the market using conventional means.

We applauded when late last year the pension fund giant signaled its intention to move more assets from active management into passively managed index funds and to Dimensional Fund Advisors. More recently, we find ourselves applauding again because CalPERS announced it would also pull out the billions of dollars it has invested in hedge funds. That's a smart move, because if you read their disclosures you would find that last year CalPERS paid nearly $135 million in fees to hedge fund managers.

Although hedge fund owners make headlines with their stratospheric wealth, that particular part of the market has significantly lagged the public market in the past three years or so – causing investors small and large to question the enormous fees that hedge funds charge. *Time Magazine* ran a great quote from Mitch Tuchman, who said of the CalPERS move, "Call it capitulation or sobriety: it's saying that we can't beat the market and we can't find managers who can beat the market, and even if they can, their fee structures are overwhelming."

We couldn't help but smile when *Time Magazine* also mentioned that the CalPERS move is a nod to University of Chicago economist Eugene Fama, who recently won a Nobel for his lifelong

work on efficient markets. You may recall from our previous writings that Eugene Fama is the principal scholar whose groundbreaking work inspired the founding of Dimensional Funds in the early 1980s.

Widely recognized as the father of modern finance, he serves on Dimensional's board of directors and investment policy committee. John Augenblick had lunch with Gene Fama last week, and he recounted that the prize committee called his house at 6:00 AM to tell him that he had won the Nobel Prize. At 6:02 AM the press showed up in droves. Not bad for a humble finance professor.

It looks like with his help CalPERS finally figured out that they should invest as you do.

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*Any performance data represents past performance. Past performance is no guarantee of future results, and current performance may be higher or lower than the performance displayed. The investment return and principal value of an investment will fluctuate such that an investor's shares may be worth more or less than their original cost.*

*1: US Micro Cap benchmark is Russell 2000 Index. US Small Cap benchmark is Russell 2000 Index. US Large Cap Value benchmark is Russell 1000 Value Index. US Small Cap Value benchmark is Russell 2000 Value Index. International Small Company benchmark is MSCI World ex USA Small Cap Index. International Small Cap Value benchmark is MSCI World ex USA Small Cap Index. International Value benchmark is MSCI World ex USA Index. Emerging Markets Small Cap benchmark is MSCI Emerging Markets Index. Emerging Markets Value benchmark is MSCI Emerging Markets Index. One-Year Fixed benchmark is BofA Merrill Lynch 6-Month US Treasury Bill Index. Intermediate Government benchmark is Barclays US Government Bond Index. Five-Year Global benchmark is Citigroup World Government Bond Index 1-5 Years (hedged to USD). Russell data © Russell Investment Group 1995–2013, all rights reserved.   Other sources: Yahoo!, Time Magazine, Morningstar, Dimensional L.P.*