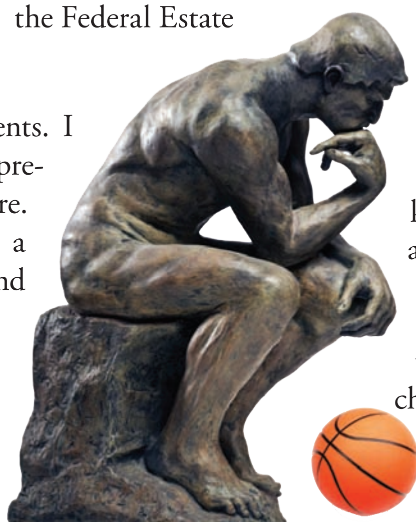
# Looking Ahead: The Predictive Science

Jack Davidson

When we put our last quarterly newsletter to bed, I decided to write a brief section on Estate Planning. I did not plan on discussing the implications for our clients ***if*** the Federal Estate tax law did not change before year-end. I simply assumed that the Congress would not allow for the complete repeal of this tax. I was wrong. We now have no federal estate tax, a new capital gains rule for assets passing upon death, and the potential for a significant increase in the Federal Estate tax in the year 2011.

I failed to predict this turn of events. I usually don't need to spend time predicting what will happen in the future. Estate Planning tends to move at a pace somewhere between a snail and a tortoise.



Looking ahead is the job of our investment managers. They need to be very good at balancing the need to predict which investments will do well moving forward while employing a risk avoidance strategy to counter the possible impact of the unpredictable. That is what many of our clients pay us to do on the premise that a managed portfolio will outperform a non-managed one over the long term.

Perhaps some of our readers are familiar with the *efficient-market hypothesis.* According to this theory, it is not possible to consistently achieve returns in excess of average market returns, on a risk-adjusted basis. Many adherents of this theory will suggest that an unmanaged, well-diversified fund will perform as well as, if not better, than a managed fund.

Our investment managers favor the selection of individual stocks and bonds rather than funds. Invariably, our portfolios are not so widely diversified as to test the efficient market hypothesis. We are prudently diversified and that will result in better long term performance if we make intelligent, informed choices. Thus, it should come as no surprise that all our managers believe that over the long term randomness will result in less than ideal performance. So you won't find any managers throwing darts at the Wall Street Journal stock tables. When it comes to predicting the future, they are very consistent in their approach.

Or are they? March has been truly mad here at the Trust Company of Vermont. Some managers are throwing darts, metaphorically speaking; not at the Wall Street Journal but at the New York Times Bracket Challenge. This all started last year when one of our investment managers, Chris Cassidy, introduced a company-wide pool and most of us were persuaded to join in predicting who would win in each round of the NCAA Basketball Tournament. Mr. Cassidy is a basketball expert. He studies the game, the teams and the players. He also plays the game and is the JV coach for Rice High School (17 wins and 3 losses) and, as the Head Coach for 17 year olds, won the 2009 Vermont State AAU championship.

Yours truly was persuaded by Chris to enter the bracket challenge last year on the assurance that lack of knowledge would not be a detriment. He suggested that the randomness could be a strength. Alas, I followed his advice, finished last, and picked up the nickname "Caboose ".

This year I decided to study the entire process on the theory that if I could identify parallels in the selection process to those employed by our managers in the selection of assets, I could shed both the random approach and my nickname.

So I interviewed a few participants. For contrast I included our administrators as well.

Starting with last year's winner, **Andrea Freeman:** "I used the expertise of my twelve year old son Tanner. He's the family expert." In a family of basketball aficionados, that says a lot.

Just a few points shy of first place was **Chris Cassidy.** Chris spends countless hours studying both stocks and basketball. When asked about the latter he responded: "It's pretty much my life outside of here." (Note to file: make sure Chris gets out more.)

**Peter Sherlock:** "There is too much randomness to have a reasonable prospect of success and there is not enough at stake to let me pick a team I do not want to cheer for even though I think they will probably win." Pete brings a whole new dimension to value investing.

**David DeBellis:** "I like to study other people's analysis of potential outcomes. I use the same approach I use in investing assets."

**Bobi Flynn**: "I thought the higher seeds were the better team." We thank Bobi for allowing us to test the contrarian investment approach, inadvertent as it might have been.

**John Abel** eschewing fancy algorithms: "Nothing special. I just chose the better-ranked teams."

**Ashley Ferrone** on the merits of phonic investing: "I sounded out the names to Ella (her two year old daughter) and chose the ones she could repeat."

**Jane Waysville:** Jane made the mistake of kidding Chris after his choice, Kansas, lost. He immediately coined her first ever nickname "Trash Talking Jane". Although Jane's vocabulary remains respectful and respectable, she no longer gives interviews.

**George von Trapp,** who was willing to play to show group solidarity even though he doesn't like the game: "As a relatively short person, I was never any good at the game. My wife played in high school and can beat me consistently when we play H-O-R-S-E." Geroge's methodology for selection was quite complex and I can only conclude that CPAs inherently know the threat of March Madness to an April 15 dealine.

After many interviews, I developed a rating chart whereby I assessed the personal expertise of the participant, including members of their household who might be available to them, and I examined their methodology. Then I assigned a level from 1 to 10, with 1 being the most random and ten being the highest level of expertise and methodology. Then I compared this rating to the actual performance. Here are the results:

| Rank | Name | Score | Level |
|---|---|---|---|
| 1 | David DeBellis | 464 | 8 |
| 2 | Jane Waysville | 410 | 8 |
| 3 | Chris Cassidy | 396 | 10 |
| 4 | Jack Davidson | 396 | 1 |
| 5 | John Abel | 375 | 7 |
| 6 | Ellen Lowery | 373 | 7 |
| 7 | Angie Freeman | 351 | 8 |
| 8 | George von Trapp | 351 | 3 |
| 9 | Ashley Ferrone | 350 | 1 |
| 10 | Steve Singiser | 334 | 5 |
| 11 | Deb Brown | 332 | 4 |
| 12 | Lori Miller | 319 | 5 |
| 13 | Kathy Patenaude | 312 | 2 |
| 14 | Pat von Trapp | 307 | 8 |
| 15 | Harold Hebert | 286 | 4 |
| 16 | Mike Rafferty | 276 | 4 |
| 17 | Peter Sherlock | 267 | 5 |
| 18 | Rich Pearce | 257 | 5 |
| 19 | Bonnie McLellan | 250 | 5 |
| 20 | Greg McConahey | 232 | 1 |
| 21 | Bobi Flynn | 144 | 1 |

After seeing the results, I felt comforted knowing that the person who used the same methodology for basketball as he does for investment management finished in first place as well as the evident correlation between expertise and success. That said, my third place finish in a tie with Chris, our company expert, may at first appear as an anomaly. My understanding of basketball is certainly very low. However, this year I hired the 12 year old Tanner Freeman, who advised his mother Andrea last year, to make all my picks. So perhaps the moral of this story is that if you do not have the expertise, hire someone who does.

Tanner Freeman