DECALIA

INVESTMENT FOCUS

June 2018

The Difficult Journey of The Long-term Investor

Warren Buffett once famously said, *"The stock market is a device to transfer money from the impatient to the patient"*. Long-term investment though, is not for the fainthearted and far from easy. Yet it can be a very rewarding strategy. Undoubtedly, it was for him at least as in more than 50 years - from 1964 to 2017 - he achieved a compounded annual return of +20.9%, well above the market at +9.9%. As a matter of fact, $1'000 USD invested with him in 1964 would have become $24M by 2017.

The aspiring long-term investor needs to consider two important things before pursuing such a strategy. Actually, two things and a half. The first one is that volatility is not an enemy, but a friend of long-term capital allocators, a source of opportunity. The second is that long-term investors can often underperform momentum and trend-following investors for a long time (i.e. for years). The remaining half is that trading has a cost which can easily harm investment track records. In other words, impatience can be very expensive.

Long Term Investing

"The stock market is a device to transfer money from the impatient to the patient" W. Buffett

Panic selling, behavioral biases & *Mr. Market*

Most investors have witnessed, traded or suffered panic selling episodes at least once in their life when looming worries and spiking volatility lead to a collapse in equity prices. The 2008 sell-off was one of those moments. However, history tells us that such events have often provided (brave) investors with unique buying opportunities in shares of high-quality companies at undeserved depressed prices.

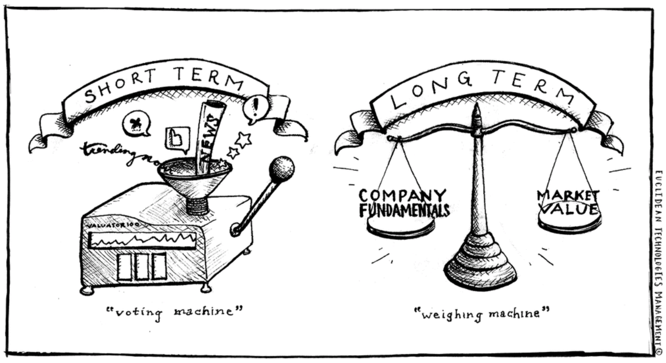
In order to illustrate this, Benjamin Graham introduced the concept of *Mr. Market*. He pictured the market as a moody individual quoting *Buy* and *Sell* prices for shares on a daily basis. On some occasions, Mr. Market is in a good mood and may offer to buy your shares at hyperbolic prices, whereas at other times he can get rid of your shares at ridiculously low levels, i.e. prices at which investors might think: "There must be something wrong in what I am buying".

The question is: "Why is it so difficult to buy when everyone else is selling and prices are collapsing?" There are many answers to that, but only few of them actually lie in finance, business, valuations or numbers. Indeed, most of them relate to psychology and behavioral patterns. Usually, when someone walks into a store and buys high-quality goods at a fire sale, he doesn't usually ask himself if discounts will be higher in the future. In fact, people often wait all year long for discounts and eventually end up queuing outside shops (or online) for special deals. So why is it not the same with the stock market?

First of all, humans weren't designed to be rational and, as such, investors tend to be greedy when markets have already done well. We could call this the "missing out fear". Indeed, nobody wants to miss out on a money-making opportunity when their buddies talk about the new car they just bought with the latest hot stock or cryptocurrency. But as the well-known saying goes, "once taxi drivers start talking about trading stocks, sell everything", suggesting inexperienced investors may now be driving irrational prices and therefore greater risk.

Conversely, investors tend to become more pessimistic after a market crash due to mounting "loss aversion". As such, they are more sensible to short-term losses than short-term gains. While this feeling may seem obvious and like "déjà vu" for many, the question is, however. what is really a loss?

Answering this brings into account the issue of *mark-to-market*, a key concept especially (but not only) for institutional investors and/or professional asset managers. Indeed, the marking to market of the legacy book or fund often influences investors' decisions. More specifically, should an investor have recorded a recent loss, he will be *naturally* less inclined to buy and more inclined to sell. Therefore, in order to be more effective in times of panic selling situations when Mr. Market discards stocks at irrational prices, smart long-term investors will need to be contrarian, patient, and unmoved by the mark-to-market of their portfolio.



Another issue is that most investors consider volatility the only measure of risk. While not untrue, volatility is first and foremost a measure of past price fluctuations. As such, it tends to be higher following recent stock crashes and lower if stocks have been steadily rising for years. For this reason, in some instances, a portfolio of undervalued high-quality stocks may appear as unduly volatile (and therefore risky) while both its *real* margin of safety and upside potential are actually huge. To this end, successful long-term investors view permanent loss of capital as the true measure of risk.

Warren would have been fired…

The second issue with long-term investing is that (unsurprisingly) it does not work all the time. Indeed, according to Joel Greenblatt (hedge fund manager and author of *The Little Book that Beats the Market*), the majority of today's top mutual fund managers have spent at least three years well behind others during their investment track record. In fact, more than 75% of them have been at the bottom of the performance distribution.

Long Term Investing

"When I think of risk, I think of permanent loss of capital" W. Buffett

Nonetheless, all these managers have outperformed in the long run. Even though this may sound obvious since no strategy works all the time, it is very hard to be a long-term investor because psychological and career pressures tend to influence decisions and impact rationality. Ideally, managers should not be evaluated on a short timeframe but rewarded for the consistency of their results over time. Only by sticking to their strategy in a disciplined manner have investors been able to outperform indexes and competition over the long run.

Keynes may well have said that everyone is always right in the long run but most of today's top notch investors would have probably been sacked in classical corporate asset management outfits, which are typically more short term oriented. Career risk thus has a meaningful impact on investment style with greater pressure to deliver near-term outperformance often preventing managers from implementing purer long-term investment strategies. Indeed, by being wrong along with everyone else, fund managers feel less at risk than being too contrarian and doing what nobody else is.

In his famous article, "The super investors of Graham and Doddsville", Buffett analyzed the amazing track records of some of his fellow classmates. The one common thread between all of them was their intellectual proximity to Benjamin Graham and his approach of buying undervalued securities with a strong margin of safety. Needless to say, they all beat the market consistently over time. However, that did not stop them from lagging behind their peers or the market for several years in a row (e.g. 40% of the years for some) during the period under review. This obviously raises the question about the relevance of evaluating investing skills over such a short time span. Acknowledging both increasingly short trial periods and more frequent performance reviews, money managers tend to invest in fashionable securities and momentum trends while avoiding unpopular or laggards.

But skill is not everything. Investing is a team sport where managers need to be committed to their process and clients to their managers in order to create trust. This was probably one of Buffet's key success ingredients, allowing him to secure *permanent* capital with the ability to deploy it at the right times (i.e. when other fund managers were suffering outflows).

In order to beat the market, most successful managers recommend the following:

1. Be patient & buy with a margin of safety
2. Know what you buy
3. Reduce the number of holdings

Regarding the structure of the portfolio, let us quote Buffett once again: *"risk can be greatly reduced by concentrating on only a few holdings"*. What does he exactly mean by that?

Risk can be broken down into main building blocks: *specific* business risk and *market* (or systemic) risk. Individual stocks prices are influenced both by endogenous factors (business, growth, margins, management, events) and exogenous ones (mainly market movements). If the long-term investor wants to outperform the market over time, he needs to minimize market correlation.

The return of a long-term concentrated portfolio of equities is intimately linked to the business performance of its holdings, which drives bottom-line growth and eventually trigger multiple expansion. The key assumption here is that the average investor can understand a business and evaluate its potential. Conversely, hedging market and systemic risk is simply not possible, leaving no one with a crystal ball.

At the risk of stating the obvious, it is therefore crucial that the portfolio is concentrated on the right holdings. And this is where the skill of successful fund managers really kicks in. As both David Einhorn of Greenlight Capital (one of the most successful hedge fund managers of all time) and Joel Greenblatt pointed out, *"holding 8 stocks eliminates 81% of the risk in owning just one, while holding 32 stocks eliminates 96% of that risk. After purchasing six or eight stocks of different industries in your portfolio, the benefit of adding even more stocks in an effort to decrease risk is small"*.

Admittedly, both entry prices and valuations of invested stocks are paramount in order to achieve attractive returns over time. However, the more holdings the investor adds to his portfolio, the closer the performance will be to that of the market and the lower the *alpha* generated. Ultimately, the market is an average of all stock performances and represents the return of the average investor.

The reality though, is that things are not all that easy and hence the reason why there are not many Warren Buffetts around today. For the average investor, both a reasonable level of diversification and an adequate asset allocation are key. However, the only way to predict future growth patterns and evaluate business prospects is to know and *understand* what you buy. As such, whereas (too) many investors do not even bother reading beyond the first page of their holdings' annual reports, a detailed due diligence is essential for long-term managers.

Patience & Finance

Coming back to the notion of patience and Buffett's famous quote about the stock market, we note that US investors' average holding periods have drastically shortened in recent years. One reason for this is the emergence of high frequency trading (HFT), which is now estimated to account for more than 70% of US equity volumes. As a result, the investors' average holding period has gone from 7 years in 1940 to less than 7 months in 2007 and probably less than 3 months as of today…

Trading platforms are designed to influence humans' cognitive functions with their eye-catching colors and fast-changing prices. Those beautifully crafted candle charts with colored arrows have one and only objective: convert investors into so-called speculators and short-term traders. After all, this is how these platforms make money. But this is also the reason why some of the most successful long-term investors try to protect themselves from market *noise* by not relying on real-time data providers such as Bloomberg terminals. Buffett is notoriously famous for not even having a computer on his desk.

Last but not least, trading has a cost. Both hefty fees and transaction taxes hamper performances of impatient investors with higher portfolio turnover levels. While Buffett, in his own words, may be making more money when snoozing than when he's active, most investors believe the more they trade, the better job they do for clients. Needless to say, timing the market is a real challenge, and history shows that average investors, usually following similar behavioral patterns, tend to sell at the least preferable moment (i.e. when prices are falling) and buy at the worst (i.e. after prices have risen) one.

Buy & Hold… if you can!

Unfortunately, it is not possible to distinguish the poor 3-year performance of a successful long-term manager from the one of a persistently underperforming manager. The selection criteria in such circumstances should therefore be the manager's proven investment discipline and approach consistency. They should never trade long-term performance for short-term success. *Buy & Hold* thus seems to be the way forward for long-term success but as seen above, contrarian inactivity can be difficult to implement in today's decision process and far from a good marketing tool for most managers. Indeed, not everyone has Warren Buffett's luxury of overlooking short-term market noise and focus on true value investments. In the end, it's all about trust, discipline and individuals' behavioral mindset. Would you be ready to pay a star long-term investment manager for investing your money in 20 stock ideas with an "infinite" holding period?

Contacts
DECALIA Asset Management SA

31, rue du Rhône
Case postale 3182
CH – 1204 Genève

Tél. +41 22 989 89 89
Fax +41 22 310 44 27
info@decaliagroup.com

External sources include: Berkshire Hathaway, SPIVA 2014 US Scorecard of investment funds, The Superinvestors of Graham and Doddsville - Columbia Business School magazine, Fooling some of the People all the Time – David Einhorn, The Little Book that beats the Market – Joel Greenblatt

Finished drafting on June 2018

Please see appendix at the end of this document for information on sources, important disclosures, and disclaimers