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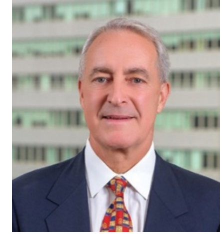
# Thoughts for Investors



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## Spring Newsletter

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***"To buy when others are despondently selling and to sell when others are avidly buying requires the greatest fortitude and pays the greatest ultimate rewards."***

– Sir John Templeton

As of this writing, most major stock market indices are off sharply for the year. The normally bubbly banter of the CNBC commentators has been replaced by hand wringing and reviews of the graphs of stocks that seem to be in a death spiral. CNBC's coverage of sports and the weather seems to have lengthened. The finger pointing has begun in earnest. Is Greenspan the problem, or the Clinton's and their family members? Or is it the now burst, speculative "bubble"?

In this newsletter I would like to address two issues. First, I would like to introduce what I call the Cardinal Rule of Investing. The rule keeps emotional investors from wreaking havoc on their portfolios and their investment psyche. Second, I would like to show investors how to use emotions to their benefit in an investment portfolio.

The Cardinal Rule of Investing:

**For every buyer there has to be a seller and for every seller there has to be a buyer. This is the primary determinant of the price of a share of stock on a minute by minute basis.**

You can't sell a stock unless and until you can find someone who is willing to buy it from you and you can't buy a stock unless and until you can find someone who owns it now and is willing to sell it to you. In other words, every time a stock is sold, someone else is buying it. The company whose stock you are buying or selling neither knows or particularly cares about your intentions and gives you no guidance as to an appropriate price for the shares. Furthermore, there is no such thing as a "supply" or "pile" of stocks to be bought or sold.

This is a somewhat foreign concept to Americans – the ultimate consumer. Since the early days of the United States if you wanted land there was an ample "supply". You just jumped in your wagon, headed west, and "claimed" or "grabbed" some. In today's consumer-oriented society there exists various "supplies" of goods and services. General Motors makes a "supply" of cars, McDonalds makes a supply of hamburgers, and Nike makes a supply of sneakers. To buy any of these you ask the company for the price and if acceptable you reach into the "supply" pile, take one out, and put your money in. The price you pay is determined by the company. It is set by adding some profit margin above and beyond the cost to manufacture the product. For the most part, prices remain stable over long periods of time so you can promise the kids a McDonald's happy meal and not worry that it will be $50 per child by the time you get there.

Emotions vs. Evaluation (plus the laws of Physics)

Decades ago the United States was known as the manufacturing capital of the world and it was easier to determine the "price" or "value" of a stock. The total value consisted of some "book" value – which contained the value of such hard assets as plants, equipment, trucks, finished goods inventory, raw material inventory, etc, and the value of items that were

more intangible – patents, know-how, customer lists, etc. The stock price consisted of both those tangible and intangible values plus some premium for management's ability to put all the parts together and sell the product at a profit. Today, however, to update President Woodrow Wilson's famous saying, much of the "Business of the American people….." is knowledge. The value of a stock today is more difficult to determine. Much of the value is "intellectual property" since companies such as Microsoft don't even have the capability to make their own products. The result is that on a second by second basis the price of a stock can't possibly be determined by valuing intellectual property and is therefore determined by the same forces at work during any fast-moving auction – EMOTION.

Recall again the Cardinal Rule of Investing. For every buyer there has to be a seller and for every seller there has to be a buyer. If a value is difficult to determine and CNBC and the financial press constantly bombard us with unfiltered data, tips, and rumors on companies, it's easy to see how emotions replace evaluation. Sellers panic and drive prices down quickly while emotional buyers can be too euphoric and push prices up quickly. Most often short-term stock prices are determined by which side is more emotional. That's why the market has swung so violently the past several years. To make it even more complicated are physics involved as well.

A well-known law of physics states that a body in motion tends to remain in motion and a body at rest tends to remain at rest unless acted upon by an equal and opposing force.

Corollary #1 to the Cardinal Rule of Investing is as follows: a stock going down (or up) tends to continue going down (or up) until acted upon by an equal or opposing force. Greenspan's third rate cut perhaps?

Corollary #2 is as follows: before you buy or sell, you had better know (or have a very good idea) what the other side of the transaction knows. If you want to buy a stock you had better know why the seller is so eager to sell it to you and visa-versa.

Emotions are not all bad

As I stated at the outset, the goal of this newsletter was to identify how emotions interfere with investment decision making. Now I'd like to identify how this behavior can be harnessed to one's advantage.

Richard Thaler of the University of Chicago and Russell Fuller of RJF Asset Management have written extensively about the behavioral aspects of investing. In a recent New York Times article Thaler makes the case that emotions drive our decision making much more than we realize. One example is how he and a friend decide not to go to a basketball game in a snowstorm because they had not purchased the tickets yet rather than because of the hazardous driving condition. Furthermore, Fuller has written about the ability of money managers to add value above and beyond what the market itself is giving all investors. This is called the alpha. He states that managers (or any investor) can achieve higher returns than the market in three different ways.

1. Differentiation by having information that no one else has. This is less likely in the age of the Internet and search engines and Financial Disclosure rules. I'd be cautious of professional money managers who claim this as the source of their performance.

2. Differentiation by processing known information better. This is much more likely.

3. Differentiation by exploiting the behavioral inconsistencies of investors. Most investors alternate between greed and fear, euphoria and panic. In my study of the greatest investors of all time – Fisher, Templeton, Price, Buffett, Graham, Tisch, Cabot, Kroll and Wilson, each one uses his own style of investing, capitalizing on behavioral mistakes made by investors who were buying or selling stocks to them.

Last year Warren Buffett doubled his net income at Berkshire Hathaway one year after his worst performance ever. Even he was not invincible. Rather than succumbing to emotions and the advice of pundits, he stayed his course and let time work for him as the pendulum eventually swung back in his direction. Many investors with a long-term winning approach will mistakenly change because they believe their approach must surely have run its course. Other investors will abandon their approach without giving it a real chance to prove it's worth. Ten years ago the average investor held a mutual fund for a decade. Today the average investor holds a fund two years and an individual stock six months. This is not enough time to allow a company to move through at least one complete business cycle and thereby prove its value to an investor.

Over the years I've witnessed investors deposit into their account large numbers of shares of a stock or stocks. These investors felt fortunate that someone before them had, over generations usually, acquired these stocks. Generations from now the list will grow even longer to include the stocks of today's growth companies – if people use emotions to their benefit when investing.

In summary, this market has been driven to extremes on both ends by emotion. During these times investors need to dust off their game plan. If your goals are still the same (save the time that has passed) then this is the time to make only minor course corrections. As John Templeton said in 1978, "the time to reflect on your investing methods is when you are most successful, not when you are making the most mistakes."

***"Looking back, most of my money was made in bear markets, I just didn't realize it at the time."***
– Shelby Cullom Davis, founder, Davis Fund

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*Hear the Other Side*

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If you would like to discuss the topic of this newsletter, or our team's approach to investing, please feel free to contact us by email at al.boris@alexbrown.com.

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