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VALUE INVESTING

Ben Graham, the father of value investing described this simple formula for investment success:

"Buy cheap and sell dear."

Would anyone do it differently? Amazingly, yes. It appears that most people do the exact opposite. The fact is that the volume of stock purchases increases dramatically as stock prices go up and decrease as they decline. Clearly the stock market is dominated by momentum investors who buy what has gone up and sell what has gone down, the exact opposite of what Ben Graham recommended and logic would dictate. Why?

The answer is that in the short run, the market is dominated not by investors, but by speculators. Or as Graham put it in 1949 when he wrote "The Intelligent Investor:"

"In the short run the market is a voting machine, but in the long run, it is a weighing machine. In the short run a stock is worth whatever the market is willing to pay for it, but in the long run equities are valued on sounder principles."

Still, the gullible and uninformed think they can trade their way to unlimited profits. Don't they realize that if there was a magic formula it would be owned by the likes of Goldman Sachs, and being run on a super computer programed by an MIT grad, who would be paid a bonus big enough to buy a small country if it worked? Apparently not, but they keep trying anyway because if you're goal is short term profits, you don't have any choice.

Through that lens, momentum speculators are not being illogical. They are after all, not investors. Their time frame is not long enough to see sounder principles applied to their trading. The problem occurs when we confuse speculation with investing. It's like using a speed boat to try to cross an ocean. Nothing wrong with speed boats, they are just the wrong vehicle for the job. There is nothing wrong with momentum investing, it is just the wrong way try to accumulate long term wealth.

They go by a lot of fancy names, but technicians, quants, chartists and market timers are just plain short term speculators. Of course they believe they can win, but in the long run buying high and selling low is a losers game. Try to find a momentum investor who has accumulated wealth anywhere near what long term value investors like Warren Buffett have amassed. If he was a trader, the taxes alone would have eaten up more than half his profits. But the real secret of Buffett's success lies in finding value and matching his expected returns, measured in decades, with his investment horizon.

Buffett has an interesting take on value investing. He said:

"…we think the term "value investing" is redundant. What is 'investing' if not the act of seeking value at least sufficient to justify the amount paid? Consciously paying more for a stock than its calculated value –in the hope that it can be sold for a still-higher price—should be labeled speculation…"

The fact that traders dominate the market in the short term works to the value investors advantage. What an investor wants when he buys is a deal. When one of our favorite companies has a minor disappointment and gets crushed, we love it! All the really great investments we have made happened when a company or the whole market was driven down by speculators. Fortunately, they can be as illogical when they are euphoric as when they panic. They often give us a great opportunity to trim positions when what we think is a good company gets priced for perfection. We love speculators!

STOCKS ARE NEVER GOING UP OR DOWN

The English language conspires to confuse investors. The momentum guys say: " I buy stocks that are going up and sell stocks that are going down." But, to be precise, there is no such thing. There are stocks that have gone up or down, but to infer that therefore they are "going" to do that the next moment, or much less the next year, is a terrible mistake. Still, people say it all the time.

What they should say is; "I buy stocks that have gone up, making it more likely they will continue in that direction in the short run, realizing that they are likely to be bad long term investments, but I don't care, because I am a short term speculator." If every talking head that came on CNBC touting his latest trade came with that warning label, there would be a lot fewer disappointed investors.

NEVER PLAY A LOSERS GAME

Speculators have no need to have confidence in their ability to value a company. Graham understood the difference between speculators and investors:

"A stock is not a ticker symbol or an electronic blip; it is an actual business, with an underlying value that does not depend on its share price."

A value investor who is willing to buy what speculators are falling all over each other to sell must have confidence in: One, the investor's ability to value a company independent of its stock quote. Two, the fact that in the long run, companies will be fairly valued by the market. If that sounds difficult or risky, it is nothing compared to the steep odds the speculator is up against.

The speculator has to overcome trading costs, taxes and his own propensity for fear and greed to make a profit. Investors have time on their side because the market increases in value with the growth in the economy and earnings. But in the short run, the market is a zero sum game. The market has as many down days as up days, but in the long run even a randomly selected portfolio will make money.

As Graham said:
"You can not lose in the end, as long as you play by the rules and put the odds squarely in your favor."

The rules are: Buy low, sell high. Buy only good companies at fair prices. Don't follow the crowd, you are likely to get trampled. Try to find companies you can own for generations, not days.

GROWTH INVESTING

If you don't want to be a trader, the alternative to value investing is growth investing. It sounds simple enough. Just buy the fastest growing companies you can find (everybody knows who they are) and watch their stock prices follow their success. Given the recent performance of the FAANG stocks (Facebook, Amazon, Apple, Netflix and Google) it is hard to argue against the logic of this approach to investing. These stocks trade not on the seemingly archaic formulas of current sales and earnings, but on projections well beyond what any rational investor can predict. But look, they are "going" up! That is, until they don't!

Investing is about weighing risk vs reward. If you buy a stock that is up 50 to 100% in a short period of time, you must assume that whatever euphoria caused the stock to go up can quickly be reversed, with disastrous results. These stocks trade on expectations and expectations can easily change.

Nevertheless, every generation finds it appealing to own the hottest companies making the trendiest products. In the short run, they are rewarded as they were in the nifty fifty bubble, the big cap growth bubble, the tech bubble, the internet bubble, and the financial bubble. In the long run, they are disappointed when, as it always does, the bubble bursts. It bursts because there are two major risks in growth stocks. One is that the company fails to realize the totally unrealistic growth assumptions that were made to justify its valuation. The second is that the market, as it often does, becomes unwilling to pay for inflated assumptions about future growth.

We would argue that attempting to predict earnings ten to fifteen years out based on the trajectory of a company growing at hyper speed is not investing. We would remind investors that for every growth company that proved to be a good long term investment there are dozens that had their day and faded. Our skepticism is backed by studies that have shown that buying companies with the fastest past growth rates and highest valuations is a sure way to underperform the market. And finally, that when we are told that this industry and these companies are different than all the others that have risen to epic valuations only to come crashing down to earth, we are sure that buying what is popular is not investing.

We have plenty of stocks in our portfolios that have great growth rates. To that extent we overlap with growth managers, but we refuse to overpay for that growth. Or as Graham said:

"While enthusiasm may be necessary for great accomplishments elsewhere, on Wall Street it almost invariably leads to disaster."

If the investor's object is to find bargains it is unlikely that they will be found among today's most popular growth stocks, but we are often able to find a few. The difference in our approach and that of true growth investors, is that we require an investment to make economic sense. More than that, the investment has to make more economic sense than the thousands of others we could choose instead.

WE BUILD PORTFOLIOS

We are portfolio builders before we are stock pickers. It's how a whole portfolio of stocks performs over many years that counts, not what one or two stocks do in the short run. We are always amused when investors review their portfolios stock by stock and point out the big winners and losers over a short periods of time. How could we have picked those great winners and bought those dogs? The answer, of course, is that even in a flat market there will be stocks that soar and ones that disappoint for more reasons than we can count. We own at least eight industry groups in just about every portfolio because we believe diversification is one of the only sure ways to limit risk, but groups will perform quite differently over short periods of time. That's just the way markets perform. It has nothing to do with our ability, or lack thereof, in stock selection.

Graham understood what investor's need to know about the way markets perform.

"Most investors experience great anxiety over large scale sudden losses in portfolio value primarily because they have not been informed in advance that such events are a part of how markets will sometime behave. Sharp losses are to be expected and even considered normal by those that have studied and understand the long history of stock markets."

Indeed, corrections work in an investor's favor.

"The logic is simple: If you are going to be a net buyer of stocks in the future, either directly with your own money or indirectly (through your ownership of a company that is repurchasing shares), you are hurt when stocks rise. You benefit when stocks swoon."

PHILOSOPHY IS MORE IMPORTANT THAN PERFORMANCE

We have had the same investment philosophy for over thirty-five years. Sometimes it outperforms the market and sometimes it doesn't, but when it doesn't, we aren't tempted to change. Are we that stubborn? No, we just have enough gray hair to realize that without a consistent investment philosophy, good long term investment returns can not be realized.

Or, as Graham put it:

"The important part of an investment concept or philosophy is the manager's ability to adhere persistently to a consistent method for valid, long term reasons even when the short-term results are disagreeable."

We know when results will be disagreeable. When the markets are in mania territory we fully expect to underperform. Our discipline does not allow us to hold a portfolio of stocks that are selling at all time high valuations, even if they were the best performing last quarter. If that means we have a few quarters where we underperform the market averages, so be it. Because, the only way to avoid the brutal correction that typically follows the euphoria is to lighten up on the high flyers well before they fall.

Similarly, when the market has narrow leadership with only a few popular stocks accounting for the majority of its gains it is also unlikely that we will outperform. In times like these, it doesn't pay to be diversified, and it is unlikely that we would have as high a percentage of the winners as they get more and more expensive.

When results are disagreeable we just try to remember that philosophy is more important than performance, and eventually the tide will turn. In every bear market the old market leaders get hit the hardest. It would be lovely if you could get out before that happened, but corrections are always too swift and brutal to do that.

Our experience has been that because we tend to have a healthy skepticism of manias, we tend to do better in panics than if we just chased performance. The great thing about panics is that they create bargains. Sometimes it's just a single stock or industry group that gets sold down to bargain levels, and occasionally it is the whole market.   That's when we have the opportunity to make great investments and outperform as valuations are normalized.

VALUE WITH A SMALL v

We describe ourselves as vALUE investors, by which we mean; we are not limited to the rules many value investors hold to. We don't just buy companies that have a prescribed price to earnings ratio, or price to sales, or book value. The problem with deep value portfolios that is that they violate the first rule of risk management which is diversification. There are a lot of great companies and whole industries that don't fit the strict definitions of value, but need to be represented in a well diversified portfolio.

We were perfectly willing to own cable stocks when they didn't have any earnings because they were building out their networks.   We fully understand that companies that are transformational and fast growing like Alphabet (Google), Broadcom, Baidu and Adobe deserve to be valued differently than slower growing companies. We own them because we think their valuations are justified by reasonable projections of future growth.

The question of owning a deep value or good relative value portfolio boils down to the investor's time horizon. We have no doubt that a concentrated portfolio of deep value stocks, selected by a competent money manager, will have great returns over the very long run, but there will be long periods of time that it doesn't. That period of time may well be longer than we, and most of our clients can tolerate.

Because a deep value portfolio is concentrated both in the number of positions held, and industry groups, the skill of the manager becomes of paramount importance. We see stock selection as a compliment to our portfolio returns which are designed to closely track the overall market. We know the market will give us an adequate rate of return in the long run.   We hope to improve marginally on that through portfolio management and prudent stock selection.

THE FUTURE

We'd be the first to admit that the markets have changed dramatically since Ben Graham wrote his books and even since we began our careers.   Passive indexing, options and futures, cyber traders, the Internet and social media's information explosion have all changed markets. Still, value investing remains the most viable investment philosophy.   As long as there are panics and manias it will work. As long as there are market participants too lazy or incompetent to value a company based on its intrinsic value instead of its stock price, we can find value. As long as investors and corporations are free to allocate their capital to the most productive investments, value will be translated to future stock prices. In short, the future looks bright for value investing.

COMPASS ASSET MANAGEMENT LLC • 10 Water St. Guilford, CT 06437 • (203) 453-7000