Quiet Counsel

Spring 2019
Investment Outlook

Leith Wheeler
INVESTMENT COUNSEL LTD.
Quiet Money.®

Visit our new website, **LeithWheeler.com**, to download previous Newsletters and read our latest Insights.

Battling Short-Termism

The past eight months have provided investors with an important reminder of what volatility in capital markets actually looks like. For nascent investors – even those with upwards of 10 years of experience in the gently rising equity markets – all the stories of the Great Recession and the Internet Bubble, Long-Term Capital and the '87 crash were important to know about but difficult to *understand.*

So when markets shed over 10% in a few short months, experienced investors, ourselves included, came out in force warning our clients not to panic. "Ignore the noise," we counseled. "It may hurt more yet but long-term it won't matter as long as you stay the course."

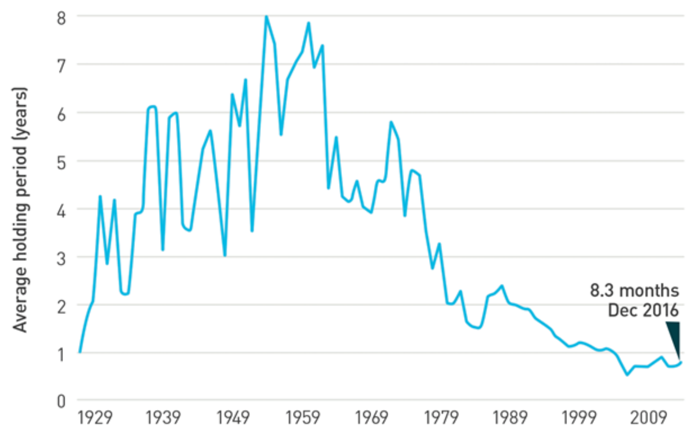
That visceral response, though, to cut your losses and run, is hard to ignore. Structural and psychological forces conspire to undermine rationality among investors, to give confidence where it's unwarranted and create bogeymen out of thin air

Central among these issues is the focus on the short-term. Short-termism takes many forms and permeates the investment process from the companies being considered for investment to the fund managers selecting stocks to the end investor assessing those managers.

Companies – While one would hope every CEO would have the vision necessary to manage their business for the long-term, when they are subject to quarterly reporting requirements they cannot help but be influenced by it. The risk is that painful cost cutting exercises or long-lead investments in innovative new products may be skipped in favour of pleasing the analyst community and therefore supporting the short-term prospects for the stock price. The father of Value investing Ben Graham put it best, though, when he said that "In the short-term the stock market is a voting machine; in the long term it is a weighing machine." The business (and the stock price) will ultimately be determined by long-term value creation, so companies that do what's necessary (short-term pain notwithstanding) will ultimately win. Freedom from distractions of outside stakeholders is one reason why companies opt to go private.

Asset Managers – Asset managers are similarly required to report quarterly on fund performance to clients. This frequent assessment of short-term performance can cause portfolio managers to lose focus on what's important: the long-term prospects of their holdings. And so they may trade instead of invest, and the component of trading activity driving stock prices that is "noise" ratchets up. As Figure 1 shows, this problem has been endemic for many years: at the peak in the 1950s, the average holding period for NYSE stocks was eight years. As of a couple of years ago, it was just over eight months. At Leith Wheeler, we work hard to ignore noise. Our weighted average holding period for Canadian equity stocks is over 10 years.

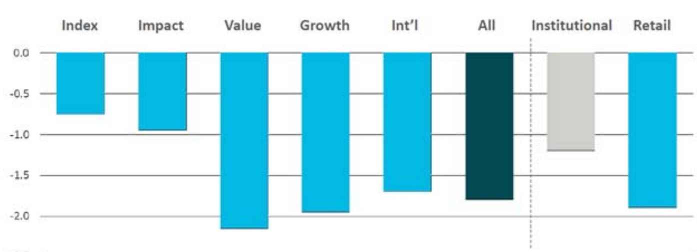
Figure 1: NYSE Average Holding Periods, 1929 – 2016



Source: Ned Davis Research. Dec 2016.

End Investors – Investors have a bad habit of trying to time the market and/or change their managers at exactly the wrong time. Figure 2 shows the results of a recent study that documented the "return gap" for investors in various mutual fund types over a 10-year period – that is, performance that was lost strictly as a result of changing managers or strategies. For example, if the average Value investor had not switched funds during the decade, their performance would have been over 2% higher *per year.* Retail investors on average lost nearly that amount and even institutions, with the benefit of consulting help, still zigged when they should have just stayed put – and lost over 1% per year themselves as a result. In a world where equities may return 5-10% per year, this leakage is enormous.

Figure 2: 10-Year "Return Gap" for Investors



Source: Derek Horstmeyer, George Mason University.

The stakes are high, but what can we do? Only by recognizing the symptoms of short-termism, and our pre-disposition to it, can we avoid its corrosive effects. Here are a few tricks to avoid the behavioural biases that can push your attention to the short term.

Beware of Representation Bias – Representation bias occurs when you confuse cause and effect for two similar but not-necessarily linked things. One way investors fall victim to it is when they think that "a good company will have a rising stock price (eventually)" so therefore "a rising stock price represents a good company." Many factors can drive a stock's price in the short-term, however, many of which have nothing to do with the quality of the company. Technical factors like index rebalancing, large fund flows from one or two managers, or – yes – the momentum of the rising stock price itself spurring others to pile in, can be the reason.

These stock price patterns also feed into a very powerful bias that is hard to avoid, and which compounds most other biases: confirmation bias. As the price rises, investors feel they have more "confirmation" that buying it is correct.

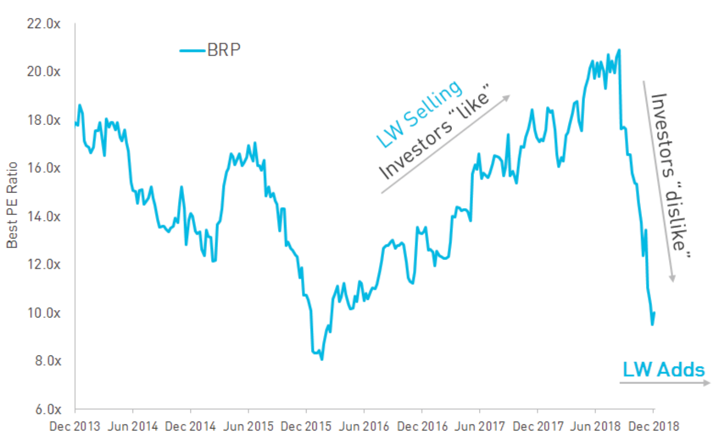
You don't want to be the last dollar into a short-term rally. To avoid these traps, we focus on the long-term intrinsic value of the company so that we can recognize when its valuation gets ahead of that. Figure 3 shows how we responded to recent volatility in portfolio holding, BRP: when the recreational products company was becoming very "popular" with investors, we were trimming our position and after it had reset to lower valuation levels (it was suddenly "unpopular"), we began adding back. This blind spot by other market players thus created an opportunity for our clients.

Appoint a Devil's Advocate to Provide You with an "Outside View" – One of the best ways to ensure you make a sound decision – in investments or otherwise – is to actively seek opposing views to help you try to "disconfirm" your own views. This tactic can be especially valuable when confronting the pressure to adhere to prevailing short-term market wisdom, even when it begs belief, and helps battle the most pervasive, toxic combination of confirmation bias and overconfidence.

One example of its application is in testing the assumptions in the investment thesis behind Amazon. Based on recent price data, one could infer that Amazon would need to grow its sales by over 50% per year *every year for 10 years* in order to justify its valuation. Sounds like a tall order. Is it?

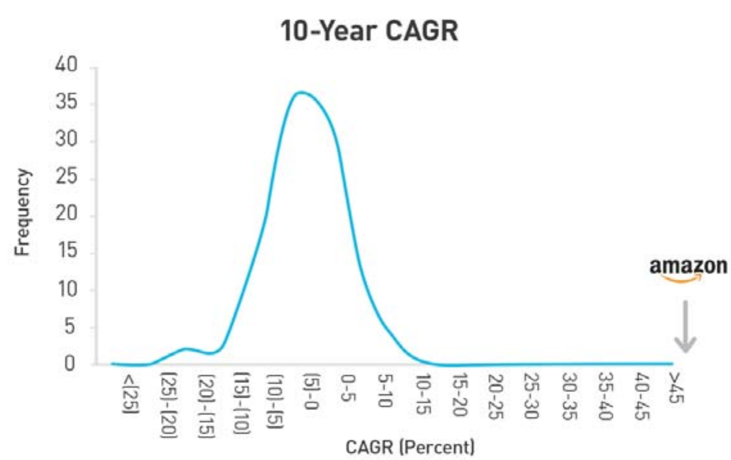
Figure 4 shows what one outside view that a devil's advocate, gathering stats on the history of company earnings, could show: over 70 years of data, the most common (frequent) 10-year compounded annual growth rate (CAGR) for corporate sales in the US was between minus-10% per year and plus-five percent per year. One or two companies earned 10-15% per year and no companies earned above that. At over 50% per year, Amazon's required growth is *off the chart of the study.* Your confidence in a positive "inside view" of the qualitative merits of Amazon's business model would therefore be challenged by the outside view's warning signals about valuation.

Figure 3: BRP Valuations



Source: Bloomberg and Leith Wheeler

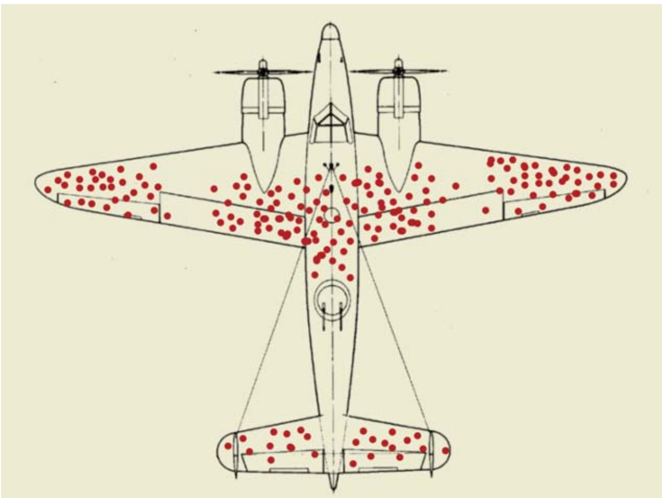
Figure 4: Base Rate Analysis of Sales Growth Rates



Source: Michael J. Mauboussin, Dan Callahan, and Darius Majd, "The Base Rate Book: Integrating the Past to Better Anticipate the Future," Credit Suisse Global Financial Strategies, September 26, 2016.

Availability Bias: Beware the data you don't have... and the data you have – British engineers mapped the gunfire patterns on fighter planes returning from the front in WWII in order to decide the most effective placement of scarce armour plating. You can see one of these diagrams in Figure 5. Where would you put the plates? On the wing tips? The tail?

Figure 5: Gunfire Patterns on WWII Planes



Source: Daniel G. Siegel. The bullet hole misconception.

You'd be wrong – the problem with zeroing in on the red dots is that these data are from planes that *returned from the front*. The planes that didn't return probably had the best data on them. Notice zero data points on the engines!

You have lots of data but little of it is useful, or at worst, it could point you to the exact wrong conclusion. The same is true for investors parsing the barrage of market data available today. Don't let the availability of data fool you into thinking it provides you insight.

To be successful investors, we need to be vigilant. Vigilant not to let structural norms like quarterly reporting patterns affect our judgment of a company's value, a stock's attractiveness, or a manager's skill. But we also need to be vigilant of ourselves. "The first principal is that you must not fool yourself," once wrote Richard Feynman, the Nobel Laurate (1965) for Physics, "and you are the easiest person to fool." By applying some of these techniques, investors can refocus their attention on what actually matters – adding value over the long term – and not allow short-term distractions to make fools of us all.

The research for this article was completed and presented by Marc Williams, CFA, FCIA as part of Leith Wheeler's 2019 Institutional Investor Forum.

Authors: Daren Atkinson, CFA
VP, Portfolio Manager

Michael Job, CFA
VP, Portfolio Manager

Editor: Marc Williams, CFA, FCIA
VP, Portfolio Manager

SPRING 2019 EDITION

Vancouver Office
Suite 1500 – 400 Burrard Street
Vancouver, BC V6C 3A6
Tel: 604.683.3391
Fax: 604.683.0323

Calgary Office
Suite 570 – 1100 1st Street SE
Calgary, Alberta T2G 1B1
Tel: 403.648.4846
Fax: 403.648.4862

Toronto Office
Suite 1801 – 145 King Street W
Toronto, Ontario M5H 1J8
Tel: 416.646.8240
Fax: 416.646.8249