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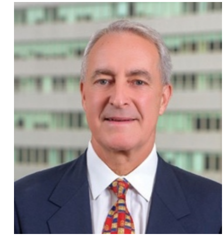
Thoughts for Investors



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Smooth Seas does not a Skilled Mariner Make

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"Individuals who cannot master their emotions are ill-suited to profit from the investment process."

"What's needed (to invest successfully) is a sound intellectual framework for making decisions and the ability to keep emotions from corroding that framework."

– Benjamin Graham, great value investor, teacher of Warren Buffett, "The Intelligent Investor" author

In the last newsletter I wrote how as investment advisors, we concern ourselves more with the stocks in your portfolio than with "the stock market" as a whole. Yet as fellow humans, we also are not invincible or unsusceptible to the emotion that surrounds "the stock market." Volatile markets bother our clients. They also bother us because we know they bother our clients. After all, we believe one of the most important things we need to remember is OPM; we are dealing with "Other People's Money," your money. So how do we remain in control of our own emotions so as to benefit you and what tips can we give you to control your emotions? That is the focus of this newsletter.

We believe that to successfully navigate through the storms of bear markets and financial obligations, look to the great investors for inspiration and guidance, and follow these three steps: recognize, control and harness when dealing with your emotions.

An old English proverb states, "Smooth seas does not a skilled mariner make." There will be many storms investors must navigate through: death, divorce, tuitions, repaying student loans and house-buying are some storms that are independent of "the stock market" yet will often influence your investment decision-making. The more "storms" you successfully navigate through, the better prepared you will be for the next one. We believe that to successfully navigate through the storms of bear markets and financial obligations, look to the great investors for inspiration and guidance, and follow these three steps: recognize, control and harness when dealing with your emotions.

"Bull markets are born on pessimism, grow on skepticism, mature on optimism and die on euphoria."

– John Templeton, great value investor

The first step is to recognize that emotion is a basic human trait that will always be present and a part of the investment decision-making process. None other than John Templeton, one of the greatest value investors, understood this. Notice Templeton didn't say bull markets are born when PE ratios are under 10 or oil is above $100/bbl or the Fed is easing interest rates. Nor did he say that bull markets die when the opposite is happening. He was very deliberate when he included emotions of pessimism, skepticism, optimism and euphoria to describe phases of "the stock market" cycle. He understood the role that emotions play when investing. He also understood that decisions based upon numbers are relative and can change with the times.

"Doing what everyone else is doing at the moment, and therefore what you have an almost irresistible urge to do, is often the wrong thing to do at all."

– Philip Fisher, great growth stock investor

The second step is to learn to control your investment emotions and urges, of which there are many and most

are not good for your portfolio. A short list includes feelings of paranoia, pessimism, helplessness, avoidance, regret, over-confidence, euphoria, blame, relief, doubt, safety and worst of all, panic. For an investor, the root of these emotions is the fear of being alone and the "irresistible" comfort, as Philip Fisher said, of "Doing what everyone else is doing at the moment." Whether bull or bear market, it is hard to control emotions when there is a constant flow of oftentimes extraneous news and spurious "advice" doing your thinking for you.

"If the job has been done correctly when a common stock is bought, the time to sell is almost never."

– Philip Fisher

"Loss avoidance" is a very strong emotion. In bull markets, it can cause you to sell stocks that have gained in order to "lock in your profit" before the gains are lost. In bear markets it can cause you to sell stocks that have declined in order to "minimize your loss." We believe in both scenarios this is an incorrect decision and based on emotion rather than a sound investment framework. We believe that the best action, in bear markets as in bull markets, is to make buy/sell decisions based on a disciplined Investment Process which assesses fundamental merits of the stocks such as the quality of their management, the market opportunity, barriers to entry they possess, attractive financial metrics and the superior nature of their products and R&D spend. "If the job has been done correctly," when assessing a stock's fundamental merits, and "a common stock is bought" as a result of that assessment, then as Fisher points out, "the time to sell is almost never." Selling should occur when you need the money, the fundamentals of the company have deteriorated, you have made a mistake in your analysis or most often, because you have found a better opportunity.

"Investors have been so oversold on diversification that fear of having too many eggs in one basket has caused them to put far too little into companies they thoroughly know and far too much in others which they know nothing about."

– Philip Fisher

The urge to "diversify" or "rebalance" your portfolio is also tied to the emotion of "loss avoidance." We believe, if your apple tree is providing you with an overabundance of apples, give some away, don't start cutting off the branches! Besides, automatically diversifying or rebalancing for its own sake assumes you have found a better investment than the one you already have. That's not necessarily true. We have found that some investors compound the mistake of selling good companies by buying something that is popular, that they "know nothing about" and that is possibly overpriced.

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

– John Templeton

The third, and perhaps most fruitful step of all to successfully navigate stock market and financial obligation "storms" is to harness the emotional shortcomings of fellow investors. As Templeton said so simply, the time to buy is when others are "despondently" selling (as in bear markets) and sell when they are "avidly" buying (as in bull markets). In a similar vein, Warren Buffett said to be greedy when others are fearful and fearful when others are greedy. Some call this a "contrarian" approach, doing the opposite of the crowd or what your emotions want you to do. Unfortunately, many investors are often more emotionally comfortable if they are following the crowd. Yet seldom is following the crowd successful.

"I made most of my money in bear markets. I just didn't realize it at the time."

– Shelby Davis, Founder, Davis Advisors

In theory being a contrarian makes a lot of sense. In practice it is very hard to do because it requires a great deal of patience and doesn't guarantee success. Contrarian investments often take a long time to bear fruit, sometimes years. My experience is that many investors start second-guessing themselves and often run out of patience waiting. Even the great investor Shelby Davis recognized that.

In summary, investors are generally happy, and complacent, when the "stock market" is rising. That's why, as I said in the last newsletter, it is imperative during the good times to use that time wisely and concentrate on making sure your Investment Process is sound. It is also important to understand that patience is an investor's greatest friend and emotion is their greatest enemy. When the storms come, as they invariably do, they will test your patience, and many otherwise patient investors will succumb to their emotions. We believe during stormy times you need to recognize the presence of emotions in your investment decision-making and learn to control the urge to act on them. And if your investment obligations are great and you require a good return to meet your responsibilities, learn the third step, to harness the lack of emotional control by other investors. This will not only give you a better chance of making it through this and other storms, you might even emerge a skilled mariner!

For more advice from the great investors quoted here, read John Train's original book "The Money Masters," available on Amazon.

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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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