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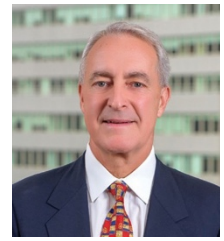

Albert C. Boris, III
Managing Director, Investments

Thoughts for Investors

The Cardinal Rule of Investing For These Times

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"In the end, how your investments behave is much less important than how you behave"

-Value investor Benjamin Graham (Warren Buffett's teacher)

There is no doubt these times can be called "unprecedented". Yet while the situation is unknown and scary, human reaction remains consistent over history: fight or flight. When it comes to investing, the decision is basically the same. Do you hold onto what you own or do you sell? Before making that decision, I think it is helpful to remember our "Cardinal Rule of Investing": *For every seller there is a buyer and for every buyer there is a seller and they both think they're right.* The Rule reminds us that the entire stock market is underpinned by the fact that there are two sides (and two investors) to every trade. While simple, the Cardinal Rule's implications need further explanation which I will do in this newsletter. When anxious about the stock market, understanding the Cardinal Rule may help investors remain patient, perhaps even allowing them to capitalize on the less patient.

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

-Value investor Warren Buffett

One way to understand the Rule is to compare the stock market to a grocery store. Suppose you run into a grocery store frantically looking for a box of Cheerios for your inconsolable child who won't eat anything else. Suppose the sign on a pile of Cheerios boxes says "Cheerios - $20". Deep down you believe they are overpriced. At the same time you can hear your spouse's voice saying, "Don't come back without them" so you either pay $20 for the Cheerios or don't go home.

The grocery store is a "facilitator", matching a <u>supply</u> of manufacturer's products with <u>demand</u> from consumers. The grocery store doesn't know the "value" of any item. It only knows the "price", as set by the manufacturer, although they often have leeway to tempt shoppers with discounts. You decide how badly you want it.

"Price is what you pay. Value is what you get"

-Value investor Warren Buffett

The stock market is also a "facilitator", but a different type. It is an "auction market". There are no "piles" of stocks that you can grab and leave some money. There are a limited number of shares of any stock and they are **already owned** by someone. Likewise, there are no piles of cash you can exchange for stocks you don't want. If you want to buy a particular stock, you need to find someone who owns that stock and convince them to sell it to you at a price you are willing to pay. If you want to sell a stock you must find a buyer who is willing to pay the price you demand.

Like the grocery store, the stock market doesn't know the "value" of a stock. Nor does the stock market know whether it was the buyer or the seller who paid the "right price". It is the mutual agreement between the two that determines the "price". The stock market's only job is to facilitate a transaction. This is something to keep in mind when you watch the stock market go down (or up) and think it is telling you what stocks are "worth".

Might consumers be less likely today to hoard toilet paper and hand sanitizer during this coronavirus crisis if the grocery store were an auction market? In that situation, an unusually high demand by consumers (buyers) would allow the manufacturers (sellers) to raise prices (though that would be a public relations nightmare). Hoarding would slow. In the meantime, the potential for higher profits may also motivate manufacturers to quickly shift production to satisfy increased demand. Eventually, a return to full shelves would signal supply was back in balance with demand, buyers would stop hoarding and manufacturers would lower prices.

"In the short run, emotions drive stock prices. In the long run, fundamentals drive stock prices"

-Value investor Sir John Templeton

If it isn't the job of the stock market to know the "value" of a stock, what drives stock prices? Sir John Templeton is right. Fundamentals (unit volume growth, earnings, profit margins, etc.) drive prices in the long run. However, before you get to the long run, you must get through the short run. If one is crossing the street immersed in thought about what is happening to their 401(k) and doesn't pay attention to that bus… there is no "long run". So it is human, and natural, to focus on the present as we are doing today.

"Be fearful when others are greedy and greedy when others are fearful"

-Value investor Warren Buffett

The stock market is in a never-ending cycle of fear and greed. Guess where we are now? Emotion creates volatility. More importantly, emotion can create opportunity if you can harness the inability of other investors to control their emotion.

"This time is different' are perhaps the four costliest words in investment history"

-Value investor Sir John Templeton

These are challenging times for even the most seasoned investors and no one's emotions should be dismissed. In bear markets it is tempting to conclude that it is the sellers who are acting rationally and intelligently. "This time is different" is a powerful argument and sellers can always point to statistics about potential or actual declining economic health, negative implications of the coronavirus, a Fed "out of ammunition" or any of a number of educated observations. Countering these arguments is the brainpower and unprecedented level of public/private partnerships working on the problem. I will worry when mankind has exhausted the capacity of the human brain.

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

-Value investor Sir John Templeton

The Cardinal Rule states there is a buyer for every seller. Strange as it may first appear, in a bear market buyers have the upper hand! They dictate to sellers the price they will accept. That's why every trade seemingly happens at a lower price. So as not to be taken advantage of in a bear market, sellers should be asking the question: What does that buyer know? If the great investors are correct, buyers are signaling we may be at the beginning of the next bull market. Are you ready? No one is going to blow a whistle to signal its start.

"You make most of your money in a bear market, you just don't realize it at the time"

-Value investor Shelby Davis

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The Boris-Kaplan Group // 1735 Market Street, Suite 1400 // Philadelphia, PA 19103 // T 215.563.2300
www.alexbrown.com/boriskaplan

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