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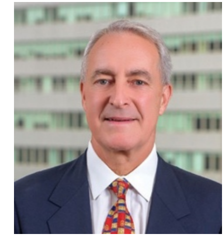
Thoughts for Investors



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Today's Greater Risk: Missing an Opportunity, or Losing Money?

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"I am always willing to learn, though I am not always willing to be taught"

– Winston Churchill

I write these newsletters for the education of investors (and as a reminder to myself as well). I have written about risk many times because as every teacher and parent knows, lessons don't always sink in the first time. Here is another, hopefully timely, take on that important topic.

In his book "The Most Important Thing", the great investor Howard Marks of Oaktree Capital identifies two kinds of investment risk: 1. Risk of losing money, and 2. Risk of missing an opportunity. Often while guarding against one, investors are tripped up by the other. I believe the risk of losing money is greater today and in this newsletter I will explain potential ways to protect yourself.

"It's not what you don't know that hurts you. It's what you do know that ain't so"

– Mark Twain

Back in 2008-2009 when investors were pessimistic, most of the discussion centered on how not to lose money or how to stop losing any more money. Indeed money was even lost on schemes about how not to lose money! Today the Dow Jones Industrial Average has recovered from near 6,000 to over 15,000 as many (though not all) stocks have recovered. Let's look at one example of a stock that has recovered. In 2009, GE stock traded down to $5.73 per share because many investors sold it fearing it was going lower. John Templeton once chided that "Stocks go down for one reason only, everyone is selling". In reality, there can never be more sellers than buyers. Every "seller" must be matched with a "buyer" or a "trade" cannot take place. Now General Electric stock is around $24 per share. What did the buyer know? What did the seller think they knew? At the time, a singular focus on the fear of losing money gripped some GE shareholders. Now let's look at an example of the fear of missing an opportunity. At 4:01PM on October 21, 2013 Netflix released their third quarter 2013 financial results. On October 22, 2013 Netflix traded at $389 per share in reaction to those results. Two days later on October 24 it traded at $324, down approximately 16%. Can it be said that the fear of missing an opportunity gripped some Netflix investors?

"Markets can remain irrational longer than you can remain solvent"

– James Maynard Keyes

Has the fear of losing money been replaced by the fear of missing an opportunity? Stock markets worldwide have been rising and many investors now fear being left behind or "underperforming a benchmark". Doesn't this remind you of the real estate craze of not long ago or Apple or Tesla Motors stock? Are we humans capable of learning anything? Yet be careful if you intend to bet against this market. If it is in fact irrational, it can remain irrational for longer than you think.

If investor's accounts are rising and/or "beating the benchmark", they are delighted. On the other hand, if accounts are "underperforming", investors are upset and want to change something. In either case it is important to identify what level of risk is being taken. While lower performance can be caused by bad fundamentals of the investments in a portfolio, it can also be caused by taking less risk. Two of the biggest

components of portfolio return are investment fundamentals and investment risk. For example, most investors can appreciate that a portfolio of 50% stocks and 50% cash will underperform a portfolio of 100% stocks in a bull market. They intuitively know that much less risk is being taken on a portfolio with 50% cash. How does one measure the risk of a portfolio of 100% (or any percentage of) stocks? Decades ago Bethlehem Steel stock was not considered a "risky" investment yet today it is bankrupt. "Risk" is difficult to "quantify" because as Benjamin Graham, the "father of value investing" observed, "risk is not a number that can easily be measured". It seems some investors automatically believe stocks that go up are not risky whereas stocks that go down are risky. Thus today, when everything seems to be going up, the fear of losing money fades. Remember though, portfolios are like gardens, if everything is blooming at the same time something unnatural is happening.

"People don't stay pessimistic forever"

– John Templeton

As Templeton observed, pessimism slowly gives way until euphoria ultimately replaces it at the end of a bull market. Though I believe it is safe to say the market today is not euphoric, because of its continued rise, there seem to be more ways to lose money today than to make money. First, investment alternatives with reasonable risk and return potential are more limited. Bonds and CDs just don't return much. Consequently investors are crowding into stocks, sometimes at any price. Paying too much raises the risk of losing money even on a stock with good fundamentals.

"The enemy of the truth is not the lie but the myth"

– John F Kennedy

Another way to lose money in a portfolio is with investments that promise diversification but don't deliver. Some investments are packaged as "alternative" investments to stocks and bonds when in fact their performance is correlated to stocks and bonds. We saw evidence of this in the past bear market when many investments (except for cash) went down in unison. Regardless of the packaging, stocks, stock mutual funds, stock ETFs, hedge funds of stocks (long and short), and stock index funds are all still stocks at their core. Again, like a garden, a true diversified portfolio means not everything will bloom at the same time. Finally, money can be lost when the "rising tide" ceases to "lift all boats". Stock selectivity again matters as it becoming a "market of stocks not a stock market".

So how can investors protect their portfolios today yet continue to invest wisely? One step is to consider that the dramatic and broad-based rise in the stock market should make investors cautious. The Dow Jones Industrial Average has more than doubled in a little over four years (from near 6000 to over 15000). This is clearly different from the normal ebbs and flows of the market. Have the fundamentals of all stocks improved so dramatically as to justify the price rise of each of them? Often, experienced investors sense a change in the market while inexperienced investors just believe they have gotten "smarter". More than ever, what investments you buy or continue to own is critical to both portfolio performance and protection.

"If the job has been correctly done when a common stock has been purchased, the time to sell it is—almost never"

– Phillip Fisher

Another step in safeguarding you investment portfolio in these times is to beware of fancying yourself an economist. For many investors, after believing they have "conquered" the secrets to fundamental investing they turn their attention to making their investment decisions based on forecasts of interest rates, the business cycle, inflation, or politics. This can be very distracting as information about these factors is usually widely dispersed, often incorrect, irresistible, and reflects what everyone else is thinking or doing. Within reason, I believe "buy-and-hold" investing based on the fundamentals of a company still works. Just ask long term owners of stocks. Investors who debate this are usually short term traders who haven't owned investments long enough to see the answer.

In summary, while macroeconomic factors seem to be improving, caution and thoughtfulness is even more important now because the risks have been reversed. Be on your guard. The risk of losing money is now greater than the risk of missing an opportunity.

"Any fool can know. The point is to understand"

– Albert Einstein

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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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