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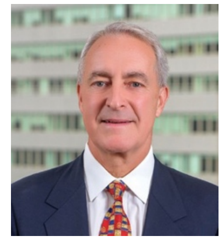
# Thoughts for Investors



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## Have We Simplified Investing Yet?

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***"Simplicity is the ultimate sophistication"***

– Leonardo da Vinci

Identify a stock's current or potential value, buy it at a price below that value and you should be a successful investor. It's that simple. But in reality, investing is not that simple. Investors, often with the help of Wall Street, complicate investing all the while thinking they are simplifying it. So it is, in my opinion, with ETFs and the "Efficient Market Theory," a combination meant to help you cheaply "get the return of the stock market." Sounds like a dream combination doesn't it? That should be your first red flag. In this newsletter I will discuss "Exchange Traded Funds" (ETFs) and the "Efficient Market Theory" (EMT), why I don't believe in either and how they have made investing more complicated.

ETFs are similar to mutual funds except they can be traded throughout the day like stocks whereas mutual funds can only be traded once a day. Originally, ETFs were invented after the Crash of '87. During Black Monday mutual fund investors were upset because the stock market was declining and they were unable to sell or even figure out the value of their funds. Theoretically, ETFs now give investors a more liquid means of investing in passive index funds or specific industries like oil, biotech or cybersecurity. Additionally, ETFs are supposedly cheaper because, if they are "passively managed" ETFs, you are not paying a portfolio manager to "pick stocks." However, with the advent of "actively managed" ETFs, these cost savings may be illusory.

The "Efficient Market Theory" (EMT) suggests that the stock market digests all known information about a stock and sets a price equal to its value. EMT implies that no one can "beat the market" because price and value are always aligned. Contrary to the EMT, I believe that discrepancies exist between the price of a stock and its value. While some investors define those discrepancies as risk, I believe they are opportunities.

***"Risk comes from not knowing what you are doing"***

– Warren Buffett

Risk is in the eye of the beholder and "not easily measured" as Benjamin Graham, the "father of value investing" reminded us. This is because each investor defines risk differently. For example, some investors thought Amazon's offer of free shipping was risky due to the cost. They thought this made the stock's value worth less than its price. Other investors, correctly as it turns out, thought the opposite. Time can be seen as a risk for some but not for others. Time may result in "Company A" being considered a high risk for one young investor needing money soon for tuition or a house down payment. Yet another young investor with few financial responsibilities may consider "Company A" a low risk since he is willing to wait for the stock's value to grow into the current price. The fundamentals of "Company A" are still the same for both investors.

Varying interpretations of risk result in a constant tug-of-war on the price of a stock. I call this volatility. Some investors mistakenly interpret volatility itself as risk. Volatility is not risk unless you don't know the difference. Risk is the potential for a permanent loss of capital whereas volatility describes a fluctuating stock price.

***"If you are shopping for common stocks, choose them the way you would buy groceries, not the way you would buy perfume"***

– Benjamin Graham

Perhaps the most significant creator of discrepancies between price and value is the emotional and potentially irrational investor. An emotional investor can create or magnify real or artificial discrepancies depending on their mood. How can the stock market be efficient with the presence of some investors choosing stocks the way they buy perfume?

Some investors believe they have reduced their risk by using ETFs and removing themselves from the stock selection process. It is my opinion they have often increased their risk. In the absence of "doing your homework" decisions often become based on emotion. Do you believe many investors understand the investment merits of the "Direxion Daily Junior Gold Miners Index Bear 3X Shares ETF?" Likewise, S&P 500 ETF investors don't differentiate between overpriced and overvalued stocks in the index because they indiscriminately buy all 500 stocks. That might be ok when the "rising tide lifts all boats" such as happened over the last five years or so. What happens when the tide goes out?

***"Invest, don't trade or speculate"***

– John Templeton

Eventually, the stock market moves to extremes of euphoria or pessimism and many investors either overpay or sell in a panic. In each case, I believe the liquidity of ETFs, fueled by emotion, actually works against them. It is my experience that investors are most interested in liquidity at market extremes. They just want to get in or out! While liquidity is always important, rarely is it smart to buy or sell based on emotion. Investment decisions should not be based on speculations such as: "I think oil prices will go up because China will use it all" or "I think 3-D printing will be big." Yet Wall Street stands ready to feed our appetite. There is now a restaurant ETF (BITE).

All companies are subject to individual business cycles within broader economic cycles. Our investment decisions are based on the Market Opportunity, Products and Execution Capabilities, Barriers to Entry, Financials and Quality of Management. We believe that, in the long run, these are the characteristics of successful companies that will survive broader economic cycles.

***"Don't panic. Sometimes you won't have sold when everyone else is buying, and you'll be caught in a market crash such as we had in 1987"***

***"Don't rush to sell the next day""***

– John Templeton

ETF investors, such as those who own the iShares Core S&P 500 index ETF, should also understand that they really don't own the stocks of the S&P 500 but rather a "creation unit," a "synthetic security" or "derivative" created by an ETF company which in turn owns the stocks. In a 9/7/15 article, Barron's magazine stated that on August 24, 2015 "when the S&P 500 fell as much as 5.3% in the opening minutes of trading, the iShares Core S&P 500 ETF fell as much as 26%, some 20 percentage points below its fair value." So at the market open on August 24, 2015, unless it could be proven that the value of all the stocks in the S&P 500 index really was worth 5.3% less than their price, there were two discrepancies, one between the price and value of the stocks in the S&P 500 Index (5.3%) and one between the price and value of the S&P 500 Index and the iShares S&P ETF (26%). Because they had "liquidity," panicked investors were able to sell their iShares Core S&P 500 ETF, at a sizable loss just a few minutes after the market opened, only to see a substantial rebound in the price of the ETF minutes later.

***"Do your homework or hire wise experts to help you. People will tell you: Investigate before you invest. Listen to them."***

– John Templeton

How did this happen? Do investors understand the role of the "Authorized Participant?" I believe the complexity of ETFs, combined with investors' incomplete understanding of ETFs and their new-found liquidity, actually worked against them. I believe ETFs have not been sufficiently stress-tested. Prior to August 24, 2015 had you read anything negative about ETFs? Doesn't this make you a little suspicious of the "Efficient Market Theory" as well?

***"Nothing is more deceptive than an obvious fact"***

– Sherlock Holmes

In summary, I believe investors' quest is not over. The combination of the "Efficient Market Theory" and ETFs has, unfortunately, not simplified investing as we had hoped. Many investors have trusted their financial future to ETFs without a clear understanding of how they work. Many investors believe that the "Efficient Market Theory" erases any discrepancy between a stock's price and its value and thus simply buying the whole stock market will guarantee investment success. It is my opinion that the combination of ETFs and EMT has made investing more complicated not less, and by extension has increased risk and volatility.

So is all lost for today's investor? No! Our Cardinal Rule of Investing is, "For every buyer there is a seller and for every seller there is a buyer, and they both think they're right." In Texas they say, "No matter how thin the tortilla, there are always two sides." The good news is that emotional, irrational, and often complicated investing often uncovers opportunity. Rather than perpetually seeking out new investment schemes in an effort to "simplify" investing, instead concentrate on finding opportunity. That is the other side of the tortilla.

***"Everything should be made as simple as possible, but not simpler"***

– Albert Einstein

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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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