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What do share prices mean?

When the stock market swooned earlier in the year I remembered an adage, attributed to the Emperor Tiberius, about holding a wolf by the ears. Now that you have him, what are you going to do? Continue to hold and experience discomfort? Or let loose and pray you are not harmed in the process? Either way, your options seem unpleasant. It certainly does not feel good.

A critical element in successful investing is how you react to feelings both of discomfort during the market's fear-cycle and invincibility when markets are booming. In the equation for investing success, Benjamin Graham tells us that temperament alone is more important than having a high IQ, specialized financial knowledge, or any other attribute one might think is important.

Looking at mutual fund outflow numbers from earlier in the year, we know millions of investors sold their stocks during the decline. Amid alarmist reports in the media and dire assessments from pundits, "letting the wolf loose" may have ended discomfort for these investors, but real harm was done. Paper losses were permanently transformed into real losses.

This year is not unique. Data confirms that time and again, during bouts of dropping share prices, most investors eventually just want to make the discomfit go away. That is why the average equity mutual fund investor underperforms the results of the funds they own, and by a large margin. Avoiding discomfort is the root cause of poor investment results.

I think there are three reasons investors get spooked by market swoons. First, our brains are hard-wired to avoid pain at all cost. That is why investors who rarely look at their portfolios, and therefore do not see volatility, do significantly better than those who do frequent reviews.

Second, people have unrealistic expectations of volatility. 'Normal' is for the stock market to drop by 10% in any given year. "Normal" is for the stock market to plunge by 20% (or more!) about every 3 ½ years. 'Normal' is to buy a stock and see its quoted value decline.

Finally, and most important, investors get spooked because of the prevalent belief taught at many business schools, and generally accepted by the public, that a company's share price always incorporates and reflects all relevant information. Like teenagers lacking an evolved philosophy, investors who place such importance on quotes are living by an outer score card. It is a form of validation-seeking, akin to trying to win popularity contests. For these investors, lower share prices is evidence the world has changed for the worse and proof they have made a mistake. This mindset leads to selling shares simply because they have declined.

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Investors seem to forget stock markets do only one thing. They provide a convenient way of buying and selling businesses. Nothing else. Long term, stock quotes on exchanges generally reflect the business results of the companies they trade. Short-term, stock prices mostly reflect investor opinion about the future, which is often dead wrong.

Investor sentiment changes more rapidly than business values. The market was down a tenth back in mid-February and has now rallied 15% from those lows. Corporate America did not suddenly destroy a tenth of its value back in mid-February and then, over the course of 6 weeks, do magical things that increased business values by 15% from those lows.

Stock market volatility is mostly driven by changing sentiment but not entirely. Going back to 1881, Professor Robert Shiller at Yale has quantified the source of volatility and shows that less than 10% of yearly stock market volatility is explained as a rational response to the changing value of company fortunes. The remainder is subject to the whims of sentiment.

Another thing many investors seem to forget: it is possible to buy and sell businesses even without a stock exchange. Admittedly it would be harder to trade companies, akin to trading an apartment, without a listing. More important, you might not be able to profit from the pendulum swings between stock quotes and actual company values that many find unnerving but is the basis of value investing.

Apart from those two things, important factors remain the same: ownership claims on profits and assets, the ability of a company to enjoy high returns on investment, and capital allocation decisions. All are unrelated to a stock market listing. Owners can still benefit from profits that compound over time.

In sum, the stock market is a place to buy and sell businesses. It is an emotional creature that is often wrong and prone to creating feelings that can result in real harm to participants. Businesses can grow and prosper without the stock market. Looked at in this light, what the stock market says your stocks are worth (the quoted price, or, mark-to-market value) seems to be of limited value. Unless, of course, you need to liquidate your holdings in order to meet a financial need.

As a portfolio manager, I try to avoid emotion-driven mistakes by remembering the image of having a wolf by the ears. It is a sort of pattern-recognition exercise that helps me to transform my emotions into just another data-point for the investment checklist. Rather than worry about things beyond our control, focusing on why we own what we own, otherwise known as the investment thesis, is always the most productive use of time.

What got me musing about share prices was a thought that came to me recently at the Berkshire Hathaway annual shareholders meeting. Sitting a few rows behind the VIP section, I recognized several billionaires and realized they all shared an important trait: even after they were rich, each has lived through 50%+ drops in their quoted wealth more than a couple of times. Thinking they can afford to see such fluctuation is missing the point. These investors have always lived by an inner score card, as mature people do, and know when to take stock prices with a grain of salt.

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‘Predictive Behaviors and Factors’

Predictive behaviors and factors are time-tested actions and attributes which have shown to result in long term results. Eating well and daily exercise will lead to a healthier life than a diet of junk food and consistent inactivity, for example.

They can apply to investing behaviors such as never selling shares when pessimism is wide-spread, they can be used in implementing strategies such as paying attention to the Capital Cycle, or they can be the basis of an investment checklist in identifying suitable companies to own.

Much energy is spent on unknowable issues such as where the market is headed or how long interest rates will remain at zero. Our focus is on predictive behaviors and factors because it is in the realm of the knowable.

When choosing companies to own, there are many predictive factors to consider, starting with paying a fair price. As a real estate investor once told me, you make your money when you buy the thing. Other attributes include consistent profitability, high returns-on-invested capital, modest debt levels, “skin-in-the-game” managers, family control, and money-making reinvestment opportunities for profits. Critically, a predictive factor is to avoid businesses that may face permanent loss from innovation. Think buggy-whip manufacturers at the turn of the last century. The automobile put even the best of them out of business.

The Block-Chain is Coming!

An innovation that should give pause for thought is the block-chain, or distributive ledger technology. It promises to make the exchanging of value such as money, loyalty points, music, and so forth as easy and as quick as the Internet made sending data. Promotors like Patrick Byrne at Overstock.com, which is applying the technology to the securities settlements business, say it will be bigger and more disruptive than the Internet.

It is unclear how block-chain will change the world but its potential to create innovation-driven deflation, the so-called “good deflation,” is substantial. The Head of the CFTC cites a report forecasting the loss of some 2 million jobs in the finance industry alone over the next decade. Some think it will make aggregators such as uber and Airbnb obsolete. Clearly, there will be winners and there will be losers. It will be years, if not longer, before we know who they are…

Portfolio Thoughts:

A recent addition to the portfolio is Richemont, owner of several of the world’s leading luxury goods companies and possessing the predictive factors mentioned. The Swiss-based company owns 13 companies that have been around for over 100 years, each of which enjoy long product cycles. Iconic jewelry businesses include Cartier and Van Cleef & Arpels, watchmakers including Baume & Mercier, IWC and Vacheron. Other brands include Chloé, Dunhill, Montblanc, Peter Millar, Purdey and Shaghai Tang. They also own 50% of Yoox.com.

Richemont has increased its dividend by 10% a year over the past decade and free-cash-flow by roughly the same amount. The balance sheet has net cash of over $5.5 billion which gives it

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plenty of fire power to make acquisitions. Business conditions are less than ideal, yet Richemont remains a highly profitable business with an 18% operating margin. We paid a "fair" price of 18X trailing earnings for the shares.

Richemont is controlled and run by the Rupert family that built it. If business conditions remain challenging for the luxury goods industry, they have the billions to make the most of potential opportunities. As for permanent loss from innovation? To paraphrase Johann Rupert, so long as boys like girls, there will be demand for their products.

We sold a few positions this year. Dreamworks Animation was sold at a nice price due to the pending acquisition by Comcast. We sold Greif, Inc. at basically break-even if you include dividends because the turnaround seems to be stagnating. Independence Realty Trust Inc was sold at a loss because they continue to earn less than their dividend and the management team has done nothing to inspire confidence.

BREXIT

There are many unknown consequences of Britain's vote to leave the EU. The only certitude? On the negative side, England will be worse off for losing tariff-free access to 450 million consumers. In the plus column, places like Amsterdam, France and Germany are poised to gain businesses that had used the UK as a European launching site. In financial services alone, the *Financial Times* says there are over 110,000 jobs involved. Bottom line: good businesses will continue to prosper.

SOURCES: Barron's February 22, 2016 issue for price decline data. Investors who look infrequently at their stocks data cited by Jason Zweig in the book Your Money & Your Brain. Capital Research and Management Company for average frequency of stock market declines data going back over a century. Gary Shilling Insights March 2016 for mutual investor returns. http://www.econ.yale.edu/~shiller/ for sources of share price volatility. Capital Cycle Investing, https://www.amazon.com/Capital-Returns-Investing-Through-Managers/dp/1137571640.