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A successful investing life

People often ask what I think of the market and whether or not it's going up. Taken at face value, the question is like asking how well the Red Sox might perform next season, or who will win the Presidency in 2016. It may be part of our common language, and it can make for some fun speculation, but everyone already knows the answer to such questions. It's anyone's guess.

So why do we insist on asking the question anyway, on discussing the unknowable? I think the question is always out there because people want to know what the future might look like for them personally. Asking about the direction of the markets is really code for: am I going to be OK? Is financial peace in the cards, or am I doomed to a future of fearfulness and worry? It is about wondering if your investing life will be successful or not.

A successful investing life depends on two variables and the irony is that neither one of them has to do with the stock market's direction in the months ahead, or even in the next several years for that matter.

The first variable involves things that can be counted such as your savings rate, the amount of money you already have, and how well that money is managed over *years and years*. Most people think this is the tough stuff but it's not. You can always hire someone (like me!) to help.

The second variable is much harder because it can't be delegated and it often requires that you act against your instincts. What really counts in investing, and it has nothing to do with numbers, is your own personal behavior.

When investor/teacher Benjamin Graham said years ago that "the investor's chief problem—even his worst enemy—is likely to be himself," he was referring to the fact most people are instinctively programmed to be terrible investors. And it has nothing to do with IQ.

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It is generally accepted people make decisions based on emotions and then justify them by facts. Most of us give too little credit to the role emotion plays in our life. Think about your teenage years. Do you remember anything that happened that wasn't tied to an emotion? No emotion no memory.

Emotions include our instinctive biases and can lead to various sorts of mistakes. Labelling an investment as good or bad based on its recent stock market performance is a mistake. Instead you should look at the performance, and the prospects relative to valuation, of the company's underlying business.

Worrying when the markets decline and feeling good when they go up is another error. To paraphrase John Templeton, the best time to worry about your investments is when they make you feel good. The most profitable time to invest, though counter-intuitive, is when your investments are generating a sort

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of misery for you. There is an adage you make your money during bear markets but just don't know it at the time.

Other behavioral errors include obsessing over bad memories of previous market downturns and thinking luck, good or bad, plays no role in your success. Believing past performance predicts future success is also wrong because studies show it is the investment process that is of greatest significance.

I believe the biggest investment mistake is not being patient. This is a mistake people make, regardless if IQ, and they do so for three reasons. First, they do not have confidence in what they own. Second, they do not fully appreciate that stock prices are vastly more volatile than the performance of the business its ownership represents. Finally, they do not understand the root of volatility. All this is anxiety-inducing and often leads to bad investment decisions such as selling low, or embracing strategies solely designed to lessen volatility.

Why are security prices so inherently volatile? In one word: liquidity. There is always a price for your security in the public markets. This constant price discovery allows you to sell it pretty much at any time and get paid within 3 days. Even though you may not like the price quoted for your asset, it is hard to argue liquidity is anything but a good thing.

Assets such as an investment property or private business lack this constant price discovery. The result is that many owners of illiquid assets come to think their property is worth some price other than what the harsh realities of the marketplace might dictate. Somehow this lack of price discovery is wrongfully equated with a lack of volatility. Some even consider it a good thing.

When it comes to the financial markets people often behave contrary to how they might act in their everyday affairs. Views around the meaning of systemic volatility is an example. Imagine going into a store and all the price tags have been removed. Do you feel price ignorance is better than knowing what things cost? In the financial markets there is always a price tag. Volatility is simply the price you pay for always being able to see those price tags.

A Brutal Bear Market

The zeitgeist of a decade starts to reveal itself in the 4th or 5th year. Think 'Roaring 20s' or 'Swinging 60s'or 'Greed is Good 80s.' Given we are at such a point in this decade, we may be at an important junction as the 'teens' takes shape and new trends are established.

We may be beginning to glimpse something which could come to define the 'teens.' It is innovation-driven deflation, a phenomenon that is not dissimilar to what happened in the latter part of the 19th century and is replete with all sorts of ramifications I have not yet begun to think through.

Innovation is the application of invention. Innovation-driven deflation is caused by the acceleration of this trend resulting in lower prices, wages and jobs. Though it creates some winners, innovation-driven deflation can be destructive to many.

I mention this because collapsing oil prices, down nearly 50% in just a few months, could be an example of innovation-driven deflation, as both the supply of energy and the demand for energy have been greatly affected by recent innovations. Just for oil, new drilling technologies have increased production by over 5 million barrels a day during the past 5 years in the US alone. Natural gas volumes have soared commensurately and, since 2011, the cost of alternative energy generation has plummeted. On the

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demand side, technology has enabled consumers of energy to become more efficient. Companies generally need less energy to produce more stuff.

It is anyone's guess as to where oil prices are headed and analysts making oil price predictions have one thing in common: they are 'anchoring.' This is a behavioral investment mistake that relies on subjective reference points such as the cost of production or the price at which the Saudis will decrease production.

We sometimes forget oil is a commodity like any other and ultimately the old adage will triumph: the cure for low prices will be low prices, meaning production will eventually drop due to bankruptcies among the less efficient and financially weak companies. This process will set the stage for ultimately higher prices but it could take years.

Based on what worked after a similar period of dropping oil prices in 1986, the way to invest in the industry now is to own only the strongest firms. They typically pay attractive dividends and should follow oil stocks higher if prices rebound. If things remain depressed they could be in a position to buy energy assets on the cheap. Paradoxically, lower prices may result in higher dividends for the strong firms because they will spend less on investments. An example is Royal Dutch Shell.

The broad lesson of innovation-driven deflation is to own the industry leaders with the greatest financial strength and most efficient business models. If this trend is to hit other industries, apart from segments of technology that have dealt with deflation for decades, then boring and blue-chip might become the new sexy. Dividends take on a greater role as investors look to stocks to help them meet income objectives. Real growth, though less common, obviously becomes more valuable.

Will this time be different?

The US stock market is currently expensive and, unless it is different this time, will probably become more expensive. We are three months into the 3rd year of the US Presidential cycle and history is on our side: since 1896, the market has gained an average of 15%, rising 80% of the time, during the 3rd year of the President's term. For all other years the stock market rose by 4.4% on average, according to Mark Hulbert.

The US economy shows little signs of excess and all indications point to an economy that continues to chug ahead. Clearly falling oil prices will put more money into the hands of consumers. This is important because since World War II the market peaks on average 7 ½ months before the economy peaks. In other words, a bet that we're headed for a bear market implies a recession will begin next summer.

Interest rates continue to be favorable. Even if the Federal Reserve begins to raise interest rates, since WWII, the S&P 500 doesn't usually peak for over 2 years on average. The shortest time between an interest rate hike and a market high was in 1961 when the market took 10 months to top out.

To be pessimistic on US stocks in the coming year, you need to both believe we are entering into a recession and this time is different: interest rates and politics do not matter.

Strategy:

In the US, the best opportunities in the stock market include companies perceived to be boring and pay high dividends out of their cash earnings. Also attractive are high quality growth stocks valued less expensively than the general market. Perhaps it is the ubiquity of ETFs, but nowadays many of these great

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companies are cheaper than mediocre ones. Great companies are defined as consistently and highly profitable ones that have been able to grow their earnings per share at a high rate for a long time.

An example of a boring American company that pays a high dividend is Grief Brothers Class B shares. The firm is a world leader in industrial packaging, established in 1877 and publicly traded since 1926. Products include steel containers, fiber and plastic drums, rigid and flexible bulk containers, water cooler bottles and containerboard and corrugated products. Grief provides services such as container lifecycle management and owns about 285,000 acres of timberland in the US and Canada. Insiders own a healthy 23% of the shares. The business is unglamorous but consistently profitable. Earnings have been lumpy and admittedly there are things management needs to do to improve results. Meanwhile, the dividend of $2.48 per share appears solid and works out to be a 5.1% yield on its recent price.

Great companies with strong financials and 10-year growth rates above 10%, but at discounts to the stock market, include firms like Baxter International, Deere & Co., The Gap, IBM, Qualcomm and Valmont Industries. Using 10% earnings per share growth as a threshold should be seen in the context of reality. According to Ibbotson, the average rate of EPS growth since 1926 has only been slightly above 4% per year.

In Asia, particularly Singapore, as well as in “old” Europe opportunities to acquire and hold suitable securities at good prices are vastly greater than here in the US. Common sense tells us that a situation where the US is overvalued relative to history and most everywhere else is not overvalued can last indefinitely.
