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WHAT MAKES A SUCCESFUL VALUE INVESTOR?

PART IV – THE WILLINGNESS TO BE LONELY

In this, Part IV of our Multi-Part Series (published monthly), we are going to observe what it takes to be a contrarian investor, or to put it another way the willingness to be lonely. Being different from the herd is a required skill to outperform the market and a key part in answering the question:

What makes a successful value investor?

Simply put, to beat the market you have to do something different to what the rest of the investors in the market are doing, you have to be a contrarian. As David Swenson the former CIO of the Yale University Endowment Fund wrote: 'Investment success requires sticking with positions made uncomfortable by their variance with popular opinion.' This aside, it is not enough to just consistently take positions against the crowd, you also have to be right. In principle this seems a simple concept to accept and to implement. But then why is it that so few can replicate the returns of Sir John Templeton, who returned an average of 15% a year for 38 years' to the investors in his Templeton Growth Fund? When asked how he was so successful he quipped: 'Buy when others are despondently selling and sell when others are euphorically buying…it takes the greatest courage, but provides the greatest profit.' Why for a strategy that is so intuitive, is it so hard to implement as a contrarian investor?

The first reason I believe was alluded to (in last month's piece) regarding an investor's temperament. On average we can expect to fail in our investment selection even as the very best of investors, about 40% of the time. This does not mean that we will lose money 40% of the time, but that our investments will not live up to our thesis about 40% of the time. It is therefore inevitable that investors will go through periods of poor performance or even extended periods of poor performance. As Howard Marks the founder of Oak Tree one of the world's best performing multi-asset funds (and writer of one of the best monthly investor letters in the industry, subscribe here if you don't read this already) observed:

'It matters enormously how the fund manager reacts to these poor periods. The combination of client pressure and peer pressure can be intense. You need deep reserves of resilience. Confidence in your convictions. Confidence in yourself to come through the valley. A strong character will use the period of underperformance to lay the foundation for the next period of good performance, be re-examining every assumption, every thesis, discarding some and doubling down on others. A weak character will freeze, their decision-making impaired. Or they might take flight, mentally at least, and avoid the difficult thinking…You need to keep your feet on the ground at all times and always remember that you are never as good or as bad as you (or others) think you are…Ultimately, of course, it is all about character. If you do not begin your fund management career with a sense of your fallibility, you are likely to learn it. If you do not learn it, you are likely to fail.'

Human beings biologically as we have already discussed in previous publications of this Series, are conditioned to be sociable, herd animals. As we know, the human genetic code developed over hundreds of thousands of years to support the primary objective of survival. One lesson human beings learnt at least two hundred thousand years ago is that it's safer to belong to a tribe. That unconscious instinct tends to kick in almost irresistibly when we feel under threat. For example, when stocks plummet, the average investor sees others panicking and instinctively follows the tribe by selling stocks and fleeing to the safe haven of cash. What the tribe followers fail to recognise is the counterintuitive truth that this might be the perfect time to buy stocks since they are now on sale. As the famous Canadian Fund Manager Francois Rochon surmises:

‘The stock market is the only market in the world, where everyone runs away when things go on sale.’

The influence of the crowd clearly has a strong hold on most investors, Buffett however, I would argue is entirely unemotional when it comes to his stock selection and investment decision making processes. One of the main criticisms of the Efficient Market Hypothesis is that it has been proven time and again that both individually and in groups human beings rarely fulfil the requirement of objectivity. Rising prices induce feelings of: greed, over-confidence and euphoria, while falling prices conversely induce feelings of: fear, panic and depression. Investors like to buy when the price is rising and sell when the price is falling, regardless of the fundamentals of the underlying business.

Human beings also have a tendency to judge themselves by their peers. Envy of the success of others, or the ease with which a (former) friend of colleague is making money in the latest fad causes people to follow the crowd into investments that they know nothing about. Buffett, however, is entirely immune to the emotional vicissitudes of the markets caused by rising or falling prices. In fact, he advises to: ‘Be greedy when others are fearful and fearful when others are greedy…The less prudence with which others conduct their affairs, the greater the prudence with which we should conduct our own.’ He judges his success by the long-term share price of Berkshire Hathaway, everything else to him is just noise. As investors we have to be very specific about how we measure our success, tune out the rest and embrace the willingness to be lonely.

When it comes to concentrated investing then, most human beings let alone investors will be temperamentally unsuited to it. To be able to practice it requires both complete faith in your investment process and the patience to wait until the market confirms for your view to be correct. In the interim the media, other investors and supposed ‘market experts’ will constantly be telling you that you are wrong. To constantly deflect this stream of criticism requires an inner strength and belief in yourself, your values and your process. Only by knowing this to your core, by being able to be lonely and at peace with it, can you withstand the incessant noise and peer pressures of the investing world.

When it comes to receiving solicited or unsolicited advice and opinions of others, I like to remember another line from Peter Lynch: ‘Stop listening to professionals! Dumb money is only dumb when it listens to the smart money.’ The harsh reality is that investors are the determiners of their own destiny in markets and yet time and again the evidence shows that investors fail to match the market averages over time. As Lynch concludes on the subject: ‘Ultimately it is not the stock market nor even the companies themselves that determine an investor’s fate. It is the investor.’

The ability to be lonely and comfortable with it, seems to stem from a core sense of identity that all of the great investors possess. They have the courage to take a position, when others are likely selling, often when only incomplete information has been available with which to make a decision. It is in situations like these where the big money is made. Rigid, scientific minds who require complete or perfect information, will paralyse themselves through overanalyses. If you are a true value investor, then the worst of times in the markets in terms of price performance are the best of times for you in terms of opportunities available. It is this contrarian mindset which sets apart the investors from the speculators.

Any student of market history will have noticed the paradox that ‘Once in a lifetime’ market extremes seem to occur about every 5-10 years. Now this may not be often enough for an investor to build a career around, but attempting to capitalize on them when they do occur should be an important component of any investors approach. To profit during these episodes requires cash to deploy and this involves courage both in its deployment into falling markets but also the courage to have sat on the cash on the melt up, when all around you people were throwing cash into the markets and making seemingly easy returns in the bubble.

Value investing at its core is the combination of a contrarian streak with a calculator. In terms of value investing, the fad stocks of the day reaching new all-time highs are unlikely to represent value. It is actually the out-of-favour securities that most investors are pessimistic about where the best value will likely be found. All value investing is therefore contrarian investing. When the market turns and the herd begins to sell this can quickly turn into a stampede for the exit, creating investment opportunities for those focussed on the fundamentals of the business. It is for this same reason why value can often be found in obscure places, in ‘un-glamorous’ industries, in out-of-favour securities or in businesses going through distress.

Going against the crowd, it is almost inevitable that in the short run at least the contrarian investor will be wrong and lose money on paper. They may even be wrong more often and for longer periods of time than those that chase momentum and trends. These periods of price dominance over business fundamentals can continue for significant periods of time. In contrast, the herd is usually right initially as the trend plays out, but it is during this period where the contrarian value investor remains committed knowing that ultimately the business fundamentals will prove superior to any short-to-medium term market fads or momentum trends.

Thus, one of the tools for successfully managing money, is to accept that there will be significant periods of time when your investment performance will lag from the broader markets or those of your peers. It is at these times when the criticism is coming thick and fast that we need to be like Buffett with our inner scorecard (see Publication I for a refresh) and have utter faith in our investment process. This will allow us to persevere over the long-term. It is at these critical junctures where we are most at risk of failing to remain true to our core ideals and beliefs, this can lead to serious damage to both our financial and emotional wellbeing. Value investor’s primary goal is to preserve their capital through investing with a margin of safety. In fact, it is through this commitment to avoid losses that value investors ensure the margin of safety. This is done by recognising that business valuation is an inexact science, the future is never entirely predictable and to err is human. As the Austrian economist Ludwig Von Mises wrote back in 1912:

'Although the future is unknowable, it is not unimaginable. The entrepreneurial idea that carries on and brings profit is precisely that idea which did not occur to the majority. It is not correct foresight as such that yields profits, but foresight better than that of the rest. The prize goes only to the dissenters, who do not let themselves be misled by the errors accepted by the multitude.'

The greatest investors are truly able to separate themselves from the herd, whether that be physically like Buffett having his office far away from the hustle and bustle of Wall Street, being based in Omaha, Nebraska. Or emotionally, by creating distance between themselves and the opinions and judgements of others. It is in this relative isolation that they are most comfortable, where most investors crave the warmth of the centre of the herd, these unique personalities are at their core willing to be lonely.

I trust you have enjoyed our journey together so far however, if our paths diverge from here, then as the investing legend, Charlie Munger says, 'In the investment business, all knowledge is cumulative' and in this spirit, we wish you continued success on your journey!

Yours sincerely

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