PRICE **VALUE** PARTNERS

Winning the wrong game **31st August 2020**

"We have a forest fire and are borrowing trillions from future generations to Venmo people sitting at home as the inferno in their neighbour's yard rages. Personal income was 7.3% higher in Q2 versus Q1 because of stimulus payments and extra unemployment benefits. The personal savings rate hit a historic 33% in April, the highest by far since the department started tracking in the 1960s. Do the 89% of people who still have their job need additional stimulus? It appears, as is the case the last several decades, that the only bipartisan action is reckless spending that flattens the curve for rich people while throwing some funds at the neediest for optics.

"And the enemy marches on.

"Donald Trump was right, the wars in Iraq and Afghanistan were mistakes. Mistakes that cost us almost 7,000 American souls, 208,102 Iraqi and 111,000 Afghan civilian lives, and $1.9 trillion (inflation adjusted). But Covid-19 will register an even greater toll of American blood and treasure. The response to the novel coronavirus would have been swifter and more disciplined if the pathogen had brown skin and worshipped a different god. Americans can't seem to wrap their head around an enemy 10,000 times smaller than the width of human hair."

- Scott Galloway, *The Great Distancing.*

"An investment operation is one which, upon thorough analysis, promises safety of principal and an adequate return. Operations not meeting these requirements are speculative." Thus did Benjamin Graham, the godfather of value investing, distinguish between the 'business' of investing and the 'game' of speculation. We don't think Graham was casting moral judgments upon speculators, so much as simply trying to codify the nature of capital allocation and define some of the ground rules. We have no problem with shorter term speculation either, and indeed we incorporate it within our bespoke managed account service in the form of systematic trend-following managers. We would argue that there are, in essence, only really two ways of attempting to secure enhanced returns versus the market itself with any reasonable chance of success: ***value investing***, which we would define briefly as "obtaining superior cash flows cheaply", and ***momentum investing***, or exploiting the various price trends manifest in markets, but doing so without any concern as to underlying valuation during the process, albeit incorporating a defined algorithmic approach and a selection of standardised rules in the context of price evolution, position sizing and risk management. Pretty much everything else, we would argue, comes down to ***gambling***.

According to the mainstream media, value investing has been dead for years. Given that the mainstream media are also the inciting actors that have successfully fuelled governments' hysterical response to Coronavirus and have indirectly managed to kill off tens of thousands of people prematurely in their blind and craven pursuit of attention, they are hardly in a position to take the moral high ground about anything any more. Nevertheless, perhaps we should define, or redefine, our terms. As Joel Greenblatt puts it,

> ***All*** investing is value investing. The rest is speculation.

Fund management practitioners, especially after having garnered a few billion by way of assets, start to hawk adjectives around: growth, value, and so on. This enables them to market even more types of funds and garner even more assets. But the only essential distinction then comes down to what Benjamin Graham called a "margin of safety": the characteristic that a listed share, for example, possesses when it is bought for less than the underlying business is intrinsically worth.

One of the many infuriatingly wrong things about something called the *Efficient Market Hypothesis* – a sort of Flat Earthers' guide to investing designed by data nerds – is the presumption that everybody in the marketplace is identical, behaves in the same way, and is after the same thing. (In Flat Earth Finance World, there are also no transactional costs or taxes and everyone gets access to all information simultaneously.) This is, even to the disinterested layperson, palpably absurd.

So the EMH essentially assumes that everybody wants to own everything and doesn't much care about the price. (This type of scientific thinking is why Long Term Capital Management blew up and why the Global Financial Crisis happened.) But, at the risk of stating the bleedin' obvious, it simply isn't true. What are our motives as fiduciary, discretionary investment managers, for example ? We seek to protect and grow the irreplaceable capital of our clients using the broadest range of diverse investments available to us. Because of the secular distortion of capital markets and valuations inflicted by clueless inflationists at the world's central banks, we consciously focus on what Ben Graham called a "margin of safety" because we do not wish to incur the significant drawdowns that inevitably come from overpaying for poor quality investments. (Right now, that includes all forms of bonds, along with many individual stocks.) We complement these holdings of 'value' shares (i.e. superior cash-flows bought at a discount, ideally being generated by companies with little or no attendant debt) with real assets (notably the monetary metals, gold and silver, and related companies with the same attributes of superior cash flow generation and no debt), and diversify further with systematic trend-following funds that can be confidently predicted to possess little or no outright price correlation with the world's stock or bond markets. The value stocks are a claim on the real economy and on human ingenuity. The real assets are a hedge of sorts against politicians. The uncorrelated funds are a hedge against our own overconfidence.

The 'wrinkle' with legitimate value investing is that, as Keynes correctly observed, markets can remain irrational longer than market participants can remain solvent. The solution, we humbly suggest, is to combine a defensive posture with patience, and then to make sure your clients are fully aware of the approach. As the value manager Peter Cundill once observed,

> The most important attribute for success in value investing is **patience**, **patience**, and more **patience**. THE MAJORITY OF INVESTORS DO NOT POSSESS THIS CHARACTERISTIC.

In reading the output of the mainstream media (never a good idea), one might be forgiven for concluding that over recent years, speculators chasing growth stocks have made out like bandits while value managers have been haemorrhaging capital through their eyeballs. The reality is that any value managers worthy of their name have simply made less money than they might have done by owning stocks such as Facebook, Amazon, Netflix and Tesla. We have been content with the returns of our own equity portfolio, and we haven't bought stocks in companies that we consider either wildly overpriced, fraudulent or, in some notorious instances, probably both.

It turns out that the mainstream media is dependent on inculcating fear in its consumers – whether of dying from a disease with a mortality rate akin to a bad case of flu, or of missing out on a rally by stocks that is likely to end in a loss-making cataclysm akin to that of the Nasdaq Composite between 2000 and 2002, when that index lost 77% of its value. There is an easy way of dealing with these risks, namely not engaging with the mainstream media in the first place.

We recommend reading Harris Kupperman's recent cautionary letter:

> ..over the past few weeks, a surprising number of the Ponzi stocks, the SAAS stocks, the FraudCos and growth names have put in various topping patterns. These patterns are everything from "blow-off top reversals" to "double tops" to "failing rallies." On Friday, many of these names broke lower and the leakage has accelerated Monday morning. I don't know if this is the start of a trend, or a minor shake-out on the way to new highs. I also have noticed a surprising number of days in the past few weeks where the spread between IWN and QQQ was over 300bps. Clearly, something is happening under the surface here. When you take FAANGM out of the mix, the divergence is even wider. I think the market is giving a subtle message here that ought to be listened to.
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> I'm the last man standing with a value book and everyone else is overweight growth. Maybe I'm suffering from a case of wishful thinking as I analyze the tape, but as inflation begins to rear its head, I think we may be in for some real fireworks. If you're long crap, be careful.

Or to put it a little more delicately, if you are currently picking up nickels in front of steamrollers, you may wish to start playing a different game. Lucius Annaeus Seneca:

> If one does not know to which port one is sailing, no wind is favourable.

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