Letter to Clients
December 2012

Show Time

"Each minute bursts in the burning room…
Spinning the trivial and unique away"

Delmore Schwartz

Recently, a prestigious investment society asked one of our principals to join an investment contest where the winner was to be awarded a "cash prize". The rules of the contest were simple:

1. Only U.S. equities could be included in the model portfolio.
2. Each portfolio could have up to five names and you could take a long or short position in each name.
3. The length of the competition was approximately 2.5 months.

You might think a contest like this would appeal to us. We are extremely competitive and like to win, especially where cash is involved. Ostensibly, we are in the business of "picking stocks," and we are highly focused on U.S. companies. We can certainly think of five that we like. So why didn't we enter? Well, actually, because we thought it would be more fun and more useful to sit at a roulette wheel in Vegas, "investing" in red or black and eating "free" food.[1]

The fundamental problem with this competition is the short timeframe for assessing stock performance. A stock's price can be thought of as a piece of laminated wood,[2] a composite of actual and anticipated events, glued together with rational analysis and irrational fears, hopes and biases. To make matters even murkier, the veneer topping off this laminate is randomness. On any given day, trading volume, macroeconomic news, a big earnings "miss" by a completely unrelated company – the list is nearly endless – can have a substantial impact on a company's stock price. The more constricted the holding period of a stock, the less likely the combination of randomness, reality, and emotion will change the price in a way that reflects rational longer-term expectations for it.

The perversity of this contest, not just for us – but particularly for us – is that, if we have done our work correctly, time works in our favor. As someone here said the other day, "we have the luxury of time."

[1] Warning: this newsletter is metaphor-intensive.
[2] We warned you.

Time works for us in three ways. First, and perhaps most obviously, we buy stocks when many other people don't like them. Most but not all of the time the focus of the market's disapproval changes after a while, so the stock price increases to be closer to intrinsic value. People still hate **Goldman Sachs**, but they don't hate it as much as they used to, so the stock has risen some (it is now, according to The Economist, merely "unloved").

Sometimes the disapproval never goes away. Perhaps surprisingly, some of those situations have been our very best investments. That is because of the second (and most important) way that time works for us. If we have chosen our businesses correctly, the value of those businesses will increase over time. Therefore, even if the market is forever unwilling to pay us what we consider to be a fair price for the stock, the stock price goes up anyway. If the value of the business goes up a lot, the stock price goes up a lot.

Our favorite example, with which many of you are familiar, was **Odyssey Re**. Odyssey, a small reinsurance company, was relatively unknown when we first bought it and was still relatively unknown when it was bought from us eight years later. We bought it around book value. Notwithstanding the fact that it grew book at a compounded 20 percent for the next eight years, it was still trading around book just before it was acquired. (To save you the math, that's a 340 percent gain.) How, you might ask, did it grow book at 20 percent per year? The answer is partly luck – the years from 2001 through 2009 were very good for the reinsurance industry, notwithstanding the occurrences of 9/11 and Katrina. The answer is also that Odyssey was a disciplined reinsurer which priced its business properly and was not overly exposed to any one disaster. And the answer is further that, because the stock was permanently underpriced, the company was consistently able to buy back stock at prices that significantly benefitted the shareholders. It is still early days, but we have hopes that **Arch Capital**, another disciplined reinsurance company that we own, might, with the help of an improving insurance cycle, become another Odyssey.

The third way that time helps us is in some ways an amalgam of the first two; that is, when we allow ourselves to buy stocks that we are reasonably sure may not "work" for several years but we believe will work powerfully when they do. Our homebuilder stocks felt like that to us when we bought them over the past several years. For a while in the middle of that period, we had to explain to clients that we really did know that the real estate market was a mess and that people couldn't afford their mortgages and that there had been an enormous amount of overbuilding in the years leading up to the downturn (not to speak of the dreaded "overhang" of foreclosures that banks were just waiting to drop on the market). But we also knew, or believed, that the stocks were cheap. We knew that the population was continuing to grow and that people had to live somewhere, so that eventually houses had to be built again, and that when that happened our companies would make money. A year ago we were already pretty happy, for example, when **Toll Brothers** announced that their sales were up six percent over the previous year. Fast forward to today, Toll Brothers' sales are up 48 percent over last year and their backlog is up 70 percent. That pace of increase cannot continue, but it doesn't have to, to justify our investment.

Devon today reminds us of the homebuilders two or three years ago. Devon produces oil and gas, and this country is a little bit awash in oil and completely awash in natural gas (we still use more oil than we produce, and anyway it can be transported to other markets, while we produce more natural gas than we need and at least at the moment it can't be transported elsewhere). So oil prices in the U.S. are kind of okay and natural gas prices are terrible – it sells for less than it costs to produce. That explains why the stock is cheap but not why we'd want to own it. As someone might have said, the cure for low prices is low prices, meaning that often when a commodity becomes inexpensive, people find more uses for it. Just the other week, Sasol, a South African oil company, announced plans to invest $21 billion in two plants in Louisiana to convert natural gas and one of its by-products into diesel fuel and ethylene, respectively. The plants are expected to come on stream by 2018, which tells you something about our timeframe for our Devon investment (meaning the "cure" is likely but also expensive and time-consuming). But in the meantime they make passable money[3] and it is possible that natural gas prices and the price of Devon's stock will rise earlier than 2018, as the market builds some of the new sources of demand into its forecasts. But not right away.

So, then, back to the contest. From our point of view, it is no different from playing roulette or any other game of chance, save that they aren't giving out free food (and that it's probably less fun). In a short time – and two and a half months is a very short time in investing – nothing much really changes. The value of the underlying company changes very little from when you bought it to two and a half months later, and management is very likely to be the same, as is the macroeconomic backdrop. What, then, can change? Why, the very things that are always distracting investors from the actual values of the companies they own — the waves of pessimism and optimism and rumor that drive day-to-day market movements. Or else utter surprises, which are of course unexpected and unpredictable and which have, cumulatively, random effects on stock prices.[4] In the short term, as Ben Graham might have said, the market is a slot machine.

So if several months aren't enough time to provide a bit more clarity to the market, and if randomness and high emotion are always part of the composite that makes up share price, what makes us so sure that our stock choices will eventually succeed? If success means that the share price will eventually reach intrinsic value, as we said above, the answer is that we don't. In fact, it doesn't actually matter whether it does or not, as our primary purpose is not to wait for the market to recognize the underlying value of a stock but to invest in a company that we believe will significantly increase in value over time. We buy at a discount not because we expect to make up the difference between that price and today's estimate of intrinsic value but because we know that negative developments are always a possibility and one of the best ways to mute the impact of such developments is to embed a margin of safety in our purchase price.

[3] As of this writing, the stock is trading at just over $50 per share. They likely will make something over $3 per share this year, compared to about $6 last year.

[4] And anyone who tells you that they have cornered the market in unanticipated surprises is selling you a bridge to a borough full of hipsters.

A final quibble: the term "picking stocks" has a pejorative meaning to us. Yes, our job is to select stocks that will provide long-term risk-adjusted return for our clients (and for us, investing in the same portfolio). However, we prefer to view our job as selecting excellent *businesses*, rather than *stocks*, that are temporarily unloved by the market and that will generate cash over time that can be reinvested profitably in the business and/or returned to us, the owners of those businesses. The market, happily, doesn't pay much attention to this kind of thing and is merely mediocre at assessing performance over the short-term; it is only important to us as a provider of opportunities to buy these attractive businesses with a margin of safety.

All of this is to say that if we choose to participate in this contest, we would have to become speculators rather than investors. The primary interest of speculators, according to Ben Graham, is "anticipating and profiting from market fluctuations." In contrast, an investor's primary interest "lies in acquiring and holding suitable securities at suitable prices." As long-term investors, speculation, even if in a contest where there's little to lose, is antithetical to our thinking. There is money to be made (and lost) in speculation and short-term trading and there may be a few people out there who are reasonably good at it (just not nearly as many as claim to be). Perhaps there is some skill involved, but more likely the skill is akin to correctly choosing red or black at our roulette table. In any case, we will allow them do what they do, while we continue to be patient and allow opportunities to come to us, and hold onto our identity as *investors*, rather than *speculators*, and win the three, five, and ten year competitions that truly matter to us. Investing isn't a game, and it would muddy our thinking to treat it as if it were, even as a lark.

By the way, one of the many quirky things about Vegas is that slot machines are required *by law* to have random outcomes, i.e., no skill can be involved. Some of the newer machines mimic popular video games in their action and feel, but it doesn't matter how much of your youth you wasted on video games, you are just as likely to win or lose as some oldster who's never played one. The contest above is like that. It appears to involve skill, but the outcome is pretty much random.

Free food anyone?

Marshfield Associates

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