

Letter to Clients
May 2014

Vive la Différence

*"They sought it with thimbles, they sought it with care;
They pursued it with forks and hope;
They threatened its life with a railway-share;
They charmed it with smiles and soap."*

Lewis Carroll

Every once in a while we think it's worth taking the time to review (both for ourselves and for our clients) the foundations of our investment philosophy. This is an especially relevant task during those times, such as these, where finding great companies at inexpensive prices is like hunting the proverbial snark. During such periods, the gravitational pull toward the crowd is powerful; part of our ability to resist it lies in reminding ourselves of the value in being different.

Investing, like any kind of disciplined process, presupposes a goal or set of goals. In order to understand—and embrace—an investment philosophy, you have to be meticulous about understanding those objectives. Obviously, the goal at a very general level is to use your money to generate more money—to get a return on the dollars you start out with. But beyond that lie a series of questions that will inform how you achieve that return: are you satisfied with a market return or do you want to beat the market? Do you care about volatility? Does liquidity matter to you? Are you willing to put your principal at significant risk in exchange for a bigger potential return? Can you live with a permanent loss of principal? The list goes on....

Any goal that involves either outperforming the market, taking more or less risk than the market, or producing more or less volatility than the market presupposes a strategy that is *different* from the market. By "market", we are talking about the S & P 500 but it could equally be any system in which buyers and sellers, through their aggregated actions, collectively determine the price of a given type of security. The best way to think of the market is as a crowd-sourced list of prices for every stock that is a member of the market. Each day, market participants (the "crowd") vote through the purchases and sales they make. The sum of their "votes" determines the market price for the securities

and those prices in turn determine the relative weightings of each stock in relation to every other member stock that comprises the market. Simply following the crowd—and responding to the same stimuli and judgments as the crowd does—by definition will lead you toward market hugging performance. Yet it is through participating in the market that you, as an investor, make (or lose) money. *The core conundrum of public equity investing is that in order to outperform the market, you have to both distance yourself from it while accepting that, ultimately, it is the final arbiter as to how well your investments do.* This paradox leads to a series of questions with important strategic implications.

At Marshfield, we maintain the dual objectives of both outperforming the market over the long term and preserving principal better than the market. The first question we must ask in pursuit of these goals is: what strategies are sufficiently different to allow us (with reasonable reliability) to achieve our “better than the market” aims? Having 450 of the same stocks as the S & P 500 obviously can’t produce an outcome at much variance with that of the market, either in terms of performance or protection of principal. Similarly, feeling the obligation to own every sector of the market is unlikely to lead to substantially different results either. Perhaps most critically, embracing those companies that the market has anointed as “good” or “high quality” and that are in fact merely average by our lights (more on this below) is very likely to steer you toward replicating market performance. It seems, therefore, axiomatic that the more your investment philosophy and discipline differ from the market, the better the chance of having performance that is different from the market. But this also means that the more your investment approach differs from the market the wider the range of possible outcomes, including outcomes worse than the market. Clearly, therefore, though you need to be very different from the market in order to outperform it meaningfully, you should be different in some kind of thoughtful and prudent way that is rationally related to your specific goals.

And so the next question becomes: where does the boundary lie between the right kind of different and the wrong kind of different? If the market will never reward you—or will conclusively punish you—for the non-mainstream choices you’ve made, then you’ve embraced a losing strategy when you could have accepted an average strategy with an average outcome. This explains why so many institutional investors pursue market-tracing strategies; it’s hard to be criticized if you make typical choices resulting in typical outcomes. The trick lies in having the courage to pursue strategies that allow you to deploy a kind of jujitsu against the market, using its strengths against it but also taking advantage of its weaknesses.

Difference #1: Seek Better Value

That the market is often correct in its assessments of individual stocks makes it all the harder to understand where it makes sense to veer away from its orthodoxies. As with many examples of crowd-sourcing, the aggregated wisdom of the crowd is frequently superior to that of individuals. In addition, the market is excellent at absorbing new information quickly and, in large part, reasonably accurately. The bad news is that it’s tough to outpace a market that is generally correct in its assessments. The good news is that if you are able to exploit the market’s occasional misjudgment by buying something it dislikes more than it should as evidenced by too low a price relative to what a skilled assessment suggests the company should be worth, then you can rely on the crowd’s eventual correction of that judgment in order to make your bet pay off. Having a

longer timeframe than the market—whose time horizon is notoriously short—helps this process because the market’s myopia can breed attractive price discrepancies. And as events eventually prove out over time, the market’s focus on the near term is helpful in a different way by allowing the price to be nudged toward fair value. On the other side of the ledger, by steering clear of stocks the market likes either as much as or more than it should, as evidenced by a fair or excessive price, you can avoid buying stocks that are more likely to either simply keep pace with the market or decline in price relative to it than to appreciate in price relative to it.¹ It follows from this that one important way to beat the market is through the identification of errors in the judgment of the crowd. Buying unfairly cheap stocks also has an inherent risk-mitigating value that lessens the likelihood of permanent loss of capital. Accordingly, and assuming that the market gravitates over time toward the correct assessment of a stock, then:

- *Buying what the market has gotten right is unlikely to yield better than market results unless you’re willing to bet that the stock price will move from correctly valued to excessively valued.*
- *Buying what the market’s gotten wrong on the upside (i.e., excessive valuation) is likely to yield worse results than the market.*
- *Buying what the market’s gotten wrong on the downside (i.e., inadequate valuation) is likely to yield better results than the market.*

The rational response, therefore, is to buy only what the market dislikes without good reason and then to sell that position at some point after the market finally wises up as to its proper valuation. Clearly, if this is correct, you are forced to shun the vast majority of the market with some regularity. What this means in practice is that when the market, on average, is “high”, you will likely have a lot of cash on your hands and when the market is reeling and pessimistic, you’ll have to take a deep breath and plunge in to buy with gusto.

Difference #2: Be Willing to Hold Cash

By its very nature, the market is always fully invested. It has no cash position, no “sitting it out” default. The market limits its “nay” votes to sales by participants of less popular stocks, driving down their prices and therefore their market weighting, but the cash generated from those sales holds no place in the market’s portfolio. This works much like leverage, pushing the market toward greater extremes, amplifying performance when the market is rip-roaring ahead and providing no cushion when the market is spiraling downwards. This also forces the market to hold every stock within its universe, good, bad or indifferent. *Perhaps the single most critical difference an investor can establish between itself and the market is the willingness to hold cash, sometimes a lot of it.* Having the freedom to simply not play unless the pitch is right confers a powerful advantage over the market. Cash doesn’t just provide a buffer against a declining market and protection against the dissipation of principal, however. It makes it possible to exploit the systematic undervaluation of stocks, especially at those times when the crowd is running for the exits. No holdings need to be liquidated at fire sale prices in

¹ Note that avoiding fairly priced or overpriced stocks does not in itself guarantee outpacing the market, as even fully valued or overvalued stocks can have underlying fundamentals that continue to propel them ahead at faster than market (i.e., average) rates for as long as those fundamentals persist.

order to pay for such bargains. And when the market is hot, the willingness to hold cash, though it might look in the moment like a foolish reticence, protects an investor from the temptation to overpay for companies that, as described above, are likelier than their cheaper brethren to revert to lower valuations in due course.

Difference #3: Search for the Lone Wolves

The market's very breadth provides an important route to differentiation: investing in singular companies. To invest differently from the crowd one must avoid the kind of anodyne consensus stocks that result in a Nifty Fifty type portfolio. It means seeking out companies that are both resilient enough to withstand the inevitable jolts inherent in doing business and able, over time, to increase their intrinsic value. These companies are often characterized by themselves being crowd-averse—lone wolves, even. They typically possess such critical underlying characteristics as an intense (but appropriate to their business) corporate culture, thoughtful and disciplined capital management, and strong shareholder orientation. They do not find comfort in the crowd—they resist the temptations of quick and easy money that might beguile a competitor. Such companies are few and far between and it takes analytical insight and clarity to find them.

Over time, resilience and value generation tend to reveal themselves through better returns to shareholders. These standout companies lie in distinct contrast with companies that are popularly perceived as can't miss pillars of the economy, like the GEs of the world, which are consistent only in their tepid creation (and sometimes destruction) of shareholder value. The market ultimately tends to reward the lone wolves through differential stock price performance over time. But their singularity and aversion to following the group can make them unpopular, sometimes for longer than is comfortable. Especially if bought at a price below fair value, though, such companies ought not only to help provide a buffer against permanent loss of capital better than the broad market but also, in due time, to outperform it.

Difference #4: Construct a Better Portfolio

The very construction of the market's "portfolio" presents an opportunity to an investor seeking to differentiate itself from—and thereby outdo—the market. As noted above, the market is comprised of a disparate group of 500 companies in 11 economic sectors and 57 industries. While focusing on demonstrably better companies helps produce a different portfolio than the market, you also need to determine how to size positions and how many positions to hold. A highly concentrated portfolio of standout lone wolves ought to allow for outperformance of the broader market over time. Concentration has the further benefit of allowing each stock in the portfolio to have relatively greater influence on the portfolio's performance. It follows that the greater the concentration of outstanding companies², especially if bought when unfairly priced, the greater the likelihood of beating the market.

² Obviously, there exists such a thing as too much concentration, where a mistake can have an excessive impact on the portfolio. Optimal concentration is a subject of some debate; research has shown that as few as ten stocks can optimize diversification. We prefer to set our sights on twenty.



In addition, because the market is more heavily weighted toward the more expensive stocks in its universe, which are presumably less likely to continue appreciating over time than equally good stocks that are undervalued, a portfolio that weights its superior but less expensive stocks more heavily ought to have a decent shot at outperforming the market. Instead of allowing good but unpopular stocks to occupy a smaller and smaller portion of the portfolio, as the market inherently does, you can adopt the opposite strategy, as we do, and continue to purchase more of a stock we like (and we believe is unfairly priced by the market), assigning it larger positions as the discount to intrinsic value widens.

Caveat Emptor

Of course, each of the above strategies to distance yourself from the group presupposes proper execution and an aptitude for the requisite underlying analysis. None of this is trivial to accomplish, however simple or intuitive the above discussion might make it sound. It demands rigorous analysis and persistent skepticism, along with constant vigilance and the discipline to execute when the crowd is at odds with you. This requires far more than intellectual capability; it demands the emotional fortitude to withstand intense pressure to conform.

All of which brings us back to the present. As the comfort of the crowd beckons, it bears repeating that it is only through standing as far apart from the group as you can tolerate that you can hope to consistently outperform it. During times like these, the discomfort of doing so is palpable and intense. But we would submit that it is most critical to resist the siren call of belonging exactly when it is most painful to do so. Looking at our portfolio, we are struck by the fact that, by and large, our stocks continue to trade below or around intrinsic value. Many of them, in fact, are still actively disliked. But we continue to believe that it is a portfolio of intrinsic value-growing and resilient companies that are well prepared for the future. We're comfortable holding them and not fitting in. This is not a popularity contest.

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