Letter to Clients
November 2013

Opportunity Knocks[1]

"You'll get mixed up, of course, as you already know… So be sure when you step... Just never forget to be dexterous and deft. And never mix up your right foot with your left."

Dr. Seuss, Oh the Places You'll Go

What will happen in the future is reasonably difficult to know in advance—in fact, a lot more difficult than many people understand—and this has implications for investing. Now, some things about the future can be pretty reliably predicted. Take population. Knowing what we know now about how demographics work, if we found ourselves in 1910, we could reliably predict what the population of the United States would be in 1920 and we could also pretty reliably predict what the population would be in 1930 or 1940. Therefore, we could feel confident today in our ability to reliably predict what the population will be in 2023 or 2033, barring of course the occurrence of some very rare event such as a pandemic.

Let's look at a different example, though. If we again found ourselves in 1910, knowing what we know now about the workings of the economy and the stock market, we could not reliably predict the state of the economy—let alone the level of the stock market—in 1920 and almost certainly not in 1930. Some of us were in this business in 1980, when the economy was in pretty bad shape and inflation rampant, and no one then came close to predicting or anticipating the level of the market in 1990 or 2000. Nor was anyone in 1999 expecting what 2009 would be like.

Nonetheless, people predict the general future as well as the specific future of the economy and the markets all the time. When we say people we mean all sorts of people, some of whom you and we wouldn't expect to be very good at forecasting. But what continues to surprise us is the number of apparently (or even demonstrably) intelligent people who are also unafraid of making predictions. Here are a couple of examples.

John Authers writes a column in the Financial Times which he calls, and we don't think he means to be ironic, The Long View. Nonetheless, a week ago he wrote a column entitled, "This is no time to get off the equity train". His logic, such as it was, went as follows: the economy is not so bad that profits will collapse, but it's weak enough to force the Fed to keep intervening in the bond market. Therefore, investors will be forced to buy stocks, so you should buy them now.

[1] Many thanks to Ann Marie Etergino, who helped bring the talk from which this newsletter was adapted to fruition.

What's wrong with this? Well, to start with, he is not just predicting the future but making an extremely specific prediction about the future. The economy will continue to creep along. It will not get worse, but it will not get very much better. GDP will presumably continue to increase at a tepid 2-3% per year. Unemployment will continue to decline, but only very slowly. Consumer and business confidence will remain weak, reinforcing the low-growth, highish unemployment trend.

As it happens, this is exactly what has been going on for the last few years, ever since the downturn of 2008/09. Authers is assuming that the future will be just like the recent past, which is what many people do when they try to predict the future. This is often right until it is terribly wrong. It would not have been a good idea in 2007, for example. As it also happens, this is what many market participants also believe today, so much so that, even with low GDP and earnings growth, the equity markets are trading at all-time highs. And the S&P 500 is trading at about 17 times 2013 earnings. So Authers is saying that the future will be just like the recent past, and you should buy—or at least not sell—stocks even though they are somewhat expensive. What could possibly go wrong? Not to mention the illogic of wanting to buy stocks because economic growth will be tepid.

We should make clear that we don't want to fall into the same trap. We try hard not to have a specific view of what the future will bring. It is certainly possible that the current low growth economy will continue, at least for a while. But it seems implausible that it will continue that way indefinitely—that is, that growth will neither accelerate, bringing higher interest rates, nor will it decline. And, since most investors seem to share Authers' view (and his expectation is very much priced into today's market), following his logic and recommendation seems reasonably risky.

We said that Authers is making the classic mistake of assuming that what has been going on will continue indefinitely. There is another category of forecasting which you might call "attention-getting". If you go on the CNBC website on almost any day, you will find a story with a headline something like "Pro says S&P will fall to 400", that is, 80 percent down from the current level. These forecasts are almost always very wrong and they are then immediately forgotten. Once in a very long while, when markets do decline significantly, the predictor is hailed as a seer and becomes, for a while anyway, famous.

Another person who sometimes believes he can predict the future is Alan Greenspan. Greenspan is noted for saying at the start of a presentation and presumably only partly in jest, "I guess I should warn you, if I turn out to be particularly clear, you've probably misunderstood what I've said."

That quote resonates with us. Greenspan's latest book, <u>The Map and the Territory: Risk, Human Nature, and the Future of Forecasting</u>, just came out. In this book, Greenspan is kind of all over the map on the topic of predicting the future. He talks about animal spirits and creative destruction. He actually says, "Regulations embodying a forecast fail with regularity", meaning in effect that a plan which presupposes a specific future is more likely to fail than one that doesn't. But Greenspan made his name and fortune as an economic forecaster and that is still, if you will, his first love. His firm, Townsend-Greenspan, was well-known as a macro-economic forecaster in the 60's, 70's and 80’s. Greenspan then joined the Fed at the end of the 80’s. He says in his book that he soon realized that the Fed had perhaps 250 of the most skilled PhDs in economics, and having known a couple of them we share that assessment. So Greenspan had a large group of very intelligent people trying to predict the economy. What was the result? To quote the book, “Despite the fact that the model missed the collapse of 2008 along with virtually all other models, its historical record has been better than most.” Talk about damning with faint praise. Is it really useful to have a model that works most of the time, but fails when you need it most?

We don’t mean to make fun of Authers or Greenspan. They are neither stupid nor wrongheaded. There is a deep human need to know the future so that we can feel more certain that we can provide for ourselves and our loved ones. Nonetheless, we don’t think that we are able to predict the future—that is, the economic and investing future—right now. It is possible that we will learn to do so over time. After all, in our lifetimes meteorologists have learned to predict the weather (well, sort of). It is also possible that the future will always remain “slippery” and out of our reach. The difficulty in predicting the future doesn’t only come from the incredible complexity of our economic and political systems. It also comes from the fact that our predictions and assumptions about the future cause us to act in ways that often shift the future away from the one we have imagined. People believed that houses were and would remain very safe investments, and so bid up the prices of houses and borrowed against those inflated valuations, thereby helping to cause the biggest decline in house prices in generations.

So if we can’t know important facts about the future, what are the implications of that for investing? That leads to our second topic: opportunism.

Opportunism, which has a bad name in some circles, means being ready, willing and able to take advantage of opportunities. One of us (perhaps you can guess which) was once called an opportunist by the father of a high school girlfriend. We should explain that he was working in the father’s store (in no small part because he was dating the boss’s daughter) but he was also working at another job and the two schedules conflicted. We don’t think this term was meant as a compliment. Opportunism in investing is kind of the same thing—taking advantage of attractive opportunities—without the potential negative emotional consequences, or at least emotional consequences of a certain kind.

Opportunism in investing is a rational response to an uncertain future. We noted above that opportunism requires one to be ready, willing and able to take advantage of opportunities. Let’s address “ready” and “able” first, and then “willing”, which is more difficult. To be ready and able to invest intelligently requires that you know what you are buying and that you have cash with which to buy. We find that to know what you are buying, you have to prepare in advance—often well in advance. When stocks get inexpensive, they often do so quickly and for unanticipated reasons. So we prepare the way we have for 24 years. We relentlessly look for interesting and/or troubled investments, analyzing about 100 companies per year. We have a process to which we adhere, which emphasizes reading corporate filings and talking to corporate managements. We check and re-check the assumptions in our valuations, and we have a detailed checklist which we go through to make sure we have properly analyzed the company and its prospects, most particularly its risks.

Our standards are high. Very few companies even make it onto our “shopping list”, meaning the list of companies we would buy but at a different, usually much lower, price. In an optimistic, (if not euphoric) stock market like this year’s, we can if we are lucky find one or two companies we are actually able to buy. But we are ready for opportunities with our list.

On the topic of cash: there is a saying “cash is trash”. You might actually have cause to believe that this year when stocks are up 25 percent and cash is up essentially zero percent. But for us, not having cash in a portfolio is like going out of the house without your wallet. You might be fine, say, if you are just going to work. But you might find you need or want to buy something, and then what would you do? The same is true in investing. In a chaotic market environment, which is when bargains are often found, having to sell something to buy something else, and by doing so increase returns, is in practice nearly impossible. So when our companies are fully valued, or when we find we own companies that we shouldn’t have bought after all, we sell them. We don’t then feel any obligation to buy something. The money doesn’t burn a hole in our pockets.

“Willing” is the last and often the hardest part of opportunism, at least in investing. Sometimes good investment opportunities exist because a company is unknown or poorly understood. Most of the time, though, stocks are inexpensive because something bad is happening at the company, in the market or in the economy—or perhaps all three at once. Sometimes what is happening is very bad and then the stock is very inexpensive. Even if you are analytically prepared and have cash, it is difficult but critical to be willing to invest at times of great uncertainty. This is why we often talk about the importance of discomfort in investing. It’s like a compass for us, which works something like this: if we’re waking up at night in a sweat about the market, we should be putting our cash to work; if we’re sleeping well, we should be letting it accumulate.

Which brings us full circle. When markets and investors are forced to abandon their previous predictions, such as in 2008, dislocations occur. If you look at history, this happens with some regularity. If you and we are ready, willing and able to be opportunistic, those gyrations will, we believe, benefit us in the long run.

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