REFOCUS

PORTFOLIO MANAGER MONTHLY - OCTOBER 2018

Piet Viljoen

This document describes our thinking behind selected recent portfolio management actions in our portfolios and provides context to their current positioning against the backdrop of their investment opportunity set. Our funds always consist of a diversified portfolio of opportunities and risks; please bear that in mind when evaluating our commentary about individual positions.

If you can keep your head when all about you are losing theirs

If you can keep your head when all about you
Are losing theirs and blaming it on the Fed;
If you can trust yourself when guests on CNBC shout anew,
But make allowance for their shouting dread;

If you can wait and not be tired by waiting,
Or, surrounded by nonsense, don't deal in nonsense,
Or, inundated in indicators, scoff at what they're indicating,
And cherish the thought that uncertainty is immense;

If you can fill the unforgiving minute
With sixty seconds' worth of resolve right to the end—
Yours is the Market and everything that's in it,
And—which is more—you'll be an Investor, my friend!

Jason Zweig, with apologies to Rudyard Kipling

For most animals, congregating in large numbers is generally a good idea. Large numbers offer protection from adversaries. Large numbers hunt more effectively. In large groups, the strong help protect the weak. The presence of large numbers can also be a useful decision-making tool - after all, if large numbers are eating a particular foodstuff, it's unlikely to be harmful. Being part of a crowd is a pretty good survival strategy for most animals.

In nature, voting – or collective decision-making - works. The most popular strategies, such as where to live, where to forage and what foodstuffs to eat or avoid, have most likely proven to be winning strategies. Investing is different. Over time, investments do not respond to votes. Popularity does not generally indicate success. Rather, markets are weighing machines. They take information from diverse sources, weight it all up, and come to a conclusion regarding the value of an investment on a daily basis – and then set a price for it according to that judgement.

"People strive to make their world comprehensible, predictable, and rewarding, but their locus of control extends only so far. No matter who you are, what you do, or the resources you have at your disposal, you have to learn to live with uncertainty, complexity, ambiguity, and fear of the unknown. That's the cause of our discontent: we want to be assured of the outcome before we invest."

Josh Kaufman, author of "how to fight a hydra"

Human beings also instinctively herd together. Human beings hate uncertainty. We like knowing the "truth", and being in a crowd makes us feel like we have discovered it. After all, if there are so many of us here, how can we possibly all be wrong?

In the short term, popularity can set the price of an asset. After all, if the herd decides to buy something, the price/value relationship becomes irrelevant and a higher price is generally taken to be a good sign – it denotes widespread acceptance. And the herd is always right, right? The problem with this is that the real outcome of our investment decisions are ultimately not determined by what the crowd thinks or says. Rather, the outcome is determined by the difference between the price paid for an asset, and all the future cash flows you will receive in return. In other words, it's value. So the crowd can set the price of an investment, but once we have bought and paid for the investment, ultimately it is the underlying value that will determine the outcome.

If we accept that there is a difference between how prices are determined and what comprises the actual value of an investment, we can then think more clearly about what the determinants of a successful investment decision might be.

Firstly, the cash flows of most assets are reasonably stable. Think about renting out a property. There might be the odd vacancy where no rent is received – but over a cycle rental income is fairly predictable, and not hugely variable. Company earnings might be a bit more volatile, but have a similar pattern. And if the cash flows are fairly stable, it follows that their present value must also be reasonably stable.

What is not stable is the share price, or the crowd's estimate of the value. More precisely, in the short term, markets are driven by the emotions of the crowds. And emotional crowds are not very rational. It is this "irrationality" that causes share prices to diverge – often significantly – from the value of the investment, both on the upside and on the downside.

Good investment opportunities are created when share prices are below the values of the assets.

This leaves us with an interesting conundrum. To be a successful human being, one is well-advised to stick with the crowd. It is safer and smarter. But to be a successful investor one often has to stay away from the crowd, or act differently to the crowd. When the crowd is negative, driving the prices of assets down, it can be a good buying opportunity. Conversely, when the crowd is positive, driving the prices of assets up, it can be a good selling opportunity.

Of course the best buying and selling opportunities don't come around all that often.

"Great investing requires a lot of delayed gratification. It's waiting that helps you as an investor, and a lot of people just can't stand to wait. If you didn't get the deferred-gratification gene, you've got to work very hard to overcome that."

Charlie Munger

The market is filled with information that ultimately doesn't directly impact the underlying valuations of companies. We all quite enjoy discussing the latest GDP or inflation numbers; complaining about the most recent political faux pas or even analysing arcane numbers like US non-farm payrolls (what is that, even?). But does this really assist us in making better investment decisions?

These "talking points" all effectively amount to one thing: noise. We may feel that trying to wrap our heads around them reduces uncertainty, but all this amounts to is a false sense of comfort. They are all thinly veiled attempts to forecast or anticipate the future, which is unknowable and impossible to determine. The fact that this truth makes us human beings uncomfortable does not make it any less true.

Instead of speculating about what the future may look like – something that is unduly stressful because it is so hard to - surely it makes sense to focus on the things we know to be true already: Things like currencies depreciating in line with inflation differentials over time, economies growing at low single digits above inflation over time, earnings growth of companies being quite closely linked to economic growth over time, equity returns being closely linked to long term earnings growth of companies. Instead of focusing on the variation of share prices, which is extremely hard to anticipate, we should focus on the things we know to be fairly stable – and use oscillating share prices as an opportunity to capitalise on this knowledge.

If that sounds simple, it is. It is not our inability to understand what we need to do that gets us into trouble, it is our inability to implement Munger's concept of delayed gratification. The difficult thing to do is to do nothing while we wait for these inevitable opportunities.

"I spend about half of my time wondering why I have so much in stocks, and about half wondering why I have so little."

Jack Bogle, founder and retired CEO of Vanguard

The fact is, no-one knows what the future holds. But allocating assets in a sensible way more often means investing away from the crowd, being patient, not having unrealistic expectations and not letting market noise distract or upset you. If you stick to these principles, you have the formula for a successful strategy to get through volatile and uncertain times. Of course, in the short term, it might feel like you are incorrectly positioned for what is going on in the market – take comfort that even Jack Bogle feels uncomfortable most of the time! But a *sensible* strategy will work out just fine.