



PERSPECTIVES

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The Road Not Taken – by Robert Frost

*Two roads diverged in a yellow wood,
And sorry I could not travel both
And be one traveler, long I stood
And looked down one as far as I could
To where it bent in the undergrowth;*

*Then took the other, as just as fair
And having perhaps the better claim,
Because it was grassy and wanted wear;
Though as for that the passing there
Had worn them really about the same,*

*And both that morning equally lay
In leaves no step had trodden black.
Oh, I kept the first for another day!
Yet knowing how way leads on to way,
I doubted if I should ever come back.*

*I shall be telling this with a sigh
Somewhere ages and ages hence:
Two roads diverged in a wood, and I—
I took the one less traveled by,
And that has made all the difference.*

We doubt many investment newsletters start with a Robert Frost poem. Although considering this edition of *Perspectives* is about sometimes avoiding what is popular, it seems like a good way to commence this quarter's musings. The poem's narrator struggles with seemingly equal choices, a fear of regret, and a delay in action. Finally, with a sigh, he admits that taking a road less traveled has served him well. At the risk of over extending our

poetic license, it sounds very close to the typical successful investor.

Popularity in many professions is generally a good thing. Certainly in entertainment, in order to be successful you have to enjoy some level of popularity. In medicine, if the second or third opinion matches the first, it is likely the correct diagnosis. Even in science, gaining some consensus on how to approach a problem is likely a good thing. Successful investing on the other hand, requires a different mindset. Sound investing requires a trait that is very difficult for most humans: Not caring what others think of you and often avoiding what everyone else seems to think is prudent.

A great model for exploring this type of behavior is the Threshold Model. Stanford University sociologist Mark Granovetter, proposed the threshold model (Granovetter & Soong, 1983, 1986, 1988), which assumes that individuals' behavior depends on the number of other individuals already engaging in that behavior.

Imagine 100 potential rioters, each with a "riot threshold," the number of rioters that person would have to precede him in order to join the riot. Say the first person to throw the rock has a riot threshold of 0, the next has a threshold of 1, the next has a threshold of 2, and so on up to 99. Once the instigator with a 0 threshold breaks the window, the individual with a threshold of 1 will join in. Now there are 2 involved, and the individual with a threshold with 2 jumps in. The scenario repeats itself until the entire crowd has joined the madness. The point of this exercise is to note that other than the instigator, not one of the insurgents by himself thought it was a good idea to riot. But as each one joined in, even a person with a very high threshold (and seemingly a disdain for anything as boorish as

rioting) will join in. Now substitute the word “riot” with “sell stocks.”

For instance, in 2008 as investors began selling stocks without regard for the fundamentals, subsequent investors with allegedly very high thresholds began to sell also. Finally in March of 2009, people who had held out through almost all of the selling capitulated and the market reached a multi-year low.

We know now that the winners in the above scenario were the ones who avoided the crowd. The investor who was able to say “I am still invested, and I am buying more” was the one who came out with the greatest gains. The ability to avoid the mob and shape a thesis that went against the crowd was the correct move in 2008. It was also the correct move during the dot-com craze. It has been the right thing to do in almost every financial crisis that has ever occurred.

How do we avoid the popularity contest and run toward a stock when most people are running away? One thing we consider very important is an open mind. If you see an empty restaurant, do you surmise that the lack of customers is due to bad food and bad service? Or do you consider the possibility that the food and service are very good, but they simply need a better store front and improved signage? If a stock price of a company we have been watching is falling, what is the reason for the decrease? Is it an event, or is it a trend? Are there fundamental reasons for the decrease in price, or are investors running away from it because a number of them have reached their threshold? Using the restaurant metaphor, is the food horrible, or is the food excellent but the place needs a coat of paint? It is easier to watch other investors run away and do the same. In many professions, that is the correct move.

In investing, however, watching other people leave the party is often the best time to join in.

If you have ever visited our office in Camarillo, you may have noticed another attribute that allows us to think independently: It is awfully quiet in here. There are no TVs blasting CNBC or other “investment” shows. The idea of yelling “Buy! Buy! Buy!” or “Sell! Sell! Sell!” is completely foreign to us. The majority of time is spent reading. Reading financial statements, transcripts from earnings calls, interviews, company presentations or other high-quality financial articles. We read material that we agree with, and we read material that we disagree with. We spend time with cash flow models and ratio calculations. Our lunches usually consist of a sandwich at our desk with a balance sheet, not a power lunch with other analysts. The library likely has more action than this office. By removing ourselves from the noise, we are better able to concentrate on what is important.

Not all things are controllable. There will be times where an irrational competitor puts pressure on prices and sales. The macro economy ebbs and flows. Companies hit unseen road bumps all the time. But there are many things we can control. One of them is discipline and avoiding the traps of overconfidence, regret and other mental biases. We can control our instincts of the comfort of a crowd, and we can understand that the road less traveled can often make all the difference.



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