Bernzott Capital Advisors

PERSPECTIVES

Fourth Quarter 2016

2017 Predictions? Not Here.

Many times during an election season we are asked how we think the markets will react if a certain candidate wins. It starts with the nomination of the candidates and continues through the general election. As we have written many times on these pages, we generally do not make predictions on how the market will react to specific events. We will not fashion a guess on the price of oil, where the Dow will be at the end of the year or the pace of change in interest rates. Even if we were able to make correct guesses, how would it change the way we assess the fair value of companies we own or are considering?

Time is better spent analyzing aspects of a business we know about. Our most important work is not predicting the future, but in correctly assessing the fair value of a potential investment, and then making sure there is a margin of safety present in case our analysis is not 100% correct. Benjamin Graham said "The purpose of the margin of safety is to render the forecast unnecessary." It is hard enough making a prediction that is mostly correct. However, if your investing thesis requires you to be absolutely correct, the odds are stacked against you.

2016 was a good year for Bernzott Capital clients, but a very tough year for those in the prediction business. In June, to the complete surprise of alleged experts who predicted an easy victory for the United Kingdom remaining in the European Union, the "exit" position won 52% of the votes, essentially forcing the resignation of Prime Minister David Cameron. In another case of zero analysis or thoughtfulness by investors, the U.S. stock market panicked, and the day after the surprise result, the Dow dropped 450 points. And again, while many investors ran for the exits, we considered what the vote meant, how it would affect our portfolio, and considered whether any action was necessary. We concluded that despite the gnashing of teeth by many, we saw no reason to make any moves. Considering where prices are now compared to where they were then, it was clearly the right decision.

The bigger surprise for the professional prognosticators was right here in the United States. As if the nomination of Donald Trump wasn't enough, most gave Mr. Trump next to no chance of winning the general election. Right up to election night most guessers had Hilary Clinton as our next president. And once again the pollsters got it wrong. Although the two examples cited above have to do with political estimates, observing a missed estimate by experts is something that we in the investing community are very familiar with. The forecasting track record of economists and financial analysts over the years has been abysmal. Economists constantly miss the mark by lagging reality, bond forecasters have historically been wrong about the direction of bond yields (let alone the degree of change), and equity analysts most often simply use the recent past to try and judge what will happen in the future.

Even if one were able to correctly predict an event or measurement, the next issue would be what you would do with it. For instance, in the Brexit example, if you correctly predicted (contrary to most people) that the "exit" vote would win, would you have bought or sold stocks? If you sold before the vote was taken, you would have been gloating for a week, at which point the prices started to rise again to a point above where they were before the vote. The end result was that even with the correct prediction, you would have made a mistake. On a short-term basis, markets are unpredictable, and the swing in the markets following the Brexit vote was a perfect example.

The next question is that if professional predictors are consistently wrong, and even with a correct prediction the markets are so fickle, why are there so many people making a living from guessing the results of everything from an election to the future price of oil? First of all, the person making the prediction very often suffers from overconfidence. And when he turns out to be wrong, he has an armful of excuses, from "my analysis was correct, but other forces caused a different result," to "my analysis was correct, but my timing was just a bit off." Secondly, the people who listen to the predictions are suffering a human characteristic called "anchoring" - holding on to anything, no matter how potentially incorrect or irrelevant – when faced with uncertainty.

While we tell clients that we are not in the prediction business, we still have to deal with the future. So how do we say we are not predicting, but at the same time making investments that we believe will be at a higher price in the future – something that some people might call predicting? Actually, what we do is figure out the price we believe the stock is worth right now. We do that by projecting cash flows into the future based on operations, markets, competition and potential for growth. Once we calculate what we feel is the fair value for that stock, we simply compare it to where it is currently trading. If the stock is trading at a significant discount to our calculation of fair value, it is a candidate for a buy.

Another difference is our time frame. We are patient investors and single events and short-term market gyrations do not change our valuation models. Going back to the Brexit example, after the vote and the ensuing market alarm, we asked ourselves some simple questions: 1) Does the event affect the revenue and cash flow of our portfolio companies?; 2) Is there a material macroeconomic effect that will cause a shift in demand or growth?; 3) Is the event such an abnormal occurrence that we can't forecast with any confidence?; and 4) Are traders acting rationally in reaction to basic fundamentals and intrinsic value? In the case of Brexit, we surmised that the answer to each of these questions was "no." So we didn't make any decisions or portfolio adjustments. Having a longer-term time horizon also will smooth out the inevitable cycles that many businesses experience, no matter their quality. No company is immune to a recession, a weather disaster or other life events. An investor with long-term vision will use these events to his advantage, not as a reason to change course.

Additionally, after any event, whether it is an election or another headline grabber, we ask ourselves the same questions. Possibly just as important, we ask ourselves the questions before the event takes place, if we are able. And realizing we are not in the prediction business, we ask ourselves whether an event would have an effect on the business operations of what we own. Since we understand the difficulty of predictions, we tend to stay away from companies that largely rely on certain events for stock appreciation. For instance, we do not own any energy companies because they are so reliant on the price of oil. We won't fashion a guess on where oil is going, so we stay away from companies that need expensive oil for strong margins. Highly regulated companies such as financials are also subject to the caprices of governments and regulators. Since we can't guess what is coming down the legal pike as it relates to these companies, it is very difficult for one of these companies to enter the portfolio.

We like transparent companies that will perform well regardless of the various inputs that cause price fluctuations. There will be times where there is no escaping the massive selling that occurs during a perceived meltdown. But a long-term investor with an appreciation for fundamentals and quality will be able to look past short-term issues and understand that most predictions are trying give people something to hold on to, no matter how flimsy the handle.