Bernzott Capital Advisors

PERSPECTIVES

January 2019

The Profitability of Being an Optimist

Last month brought us the worst performing December in history for equity investors. On Christmas Eve, (in only a half a day of trading, mind you) the broad market went down about 3%. But if the Grinch took it away on December 24, Santa Claus came through on December 26 with the biggest one-day gain in the history of the Dow Industrial Average. And our reaction to all the activity? Yawn.

As we have written on these pages many times, we are long-term investors. We don't let one quarter, or one year for that matter, knock us off our path of buying great companies at the right price. Although the past three months have not been nearly as much fun as the previous 24, the volatility gives us an opportunity to buy some companies that have been on our watch list for many years. We don't buy if the stock is too expensive, so if people are willing to panic in the short-run and sell good companies at reasonable prices, then we are happy to take the shares off their hands.

What caused the selloff in the fourth quarter? People have pointed to trade wars, the possibility of a recession, looming government shutdown and uncertainty in Washington. Whatever is was, it certainly wasn't due to thoughtful analysis by experienced investors. A great example is the price of Microsoft stock. Microsoft is one of the world's biggest companies and it has done a fantastic job navigating the changes in software and information as the cloud becomes more integral to daily life.

On September 30, MSFT was selling for over $115 per share. On Christmas Eve, the stock - masquerading as a lump of coal – closed a little above $94. With no new information specific to Microsoft, the market decided over a period of less than three months, the company was worth 18% less. That is not investing. That is succumbing to human nature's curse of fear and panic. In addition, with so much of the market being traded by passive investors and computers, once things start to unravel, very often there is no human there to stop it.

If so much of the research indicates that timing the market is a fool's game, and if being invested in the U.S stock market has been such a winner over the past several decades, why do people continue to panic when they should be calm, sell when they should be buying and cautious when they should be greedy? One reason is that humans generally think pessimism is the more intelligent stance.

John Stuart Mill wrote 150 years ago, "I have observed that not the man who hopes when others despair, but the man who despairs when other hope, is admired by a large class of personas as a sage." Like it or not, the speaker who sees tough times ahead is deemed one who has insight, while the one who says all is clear is seen as a mark. In investing, bullish investors who see the glass half full are often seen as naïve, while bearish investors seem sharp and aware. We need to look no further than any news outlet to see what sells. Periodicals and television are filled with heck-in-a-handbasket stories. Musing about level-headed, low volatility buy-and-hold investing is never even given a chance. A big movie hit in 2015 was based on a book by Michael Lewis named "The Big Short." The book and movie tell the story of profiting from the collapse of the housing market. Good luck finding a movie written about a long-term steady performing company in a sleepy, but profitable industry. Boring!

Why does pessimism get most of the attention? One reason is that pessimism generally requires action, which makes one feel as if they are doing something. Optimism usually means staying the course, and therefore no action. This could feel lazy and ineffective to some. In investing, while doing nothing is often exactly the right thing to do, for some the inactivity seems ineffectual. The bias known as "recency" also makes the pessimist appear aware during tough times. If the most recent results are poor, the pessimist appears to be aware, while the optimist appears to be a clueless Pollyanna.

Another reason humans tend to be pessimists is because the pain of losing is much greater than the joy of winning. This is an emotional bias known as loss aversion and it causes investors to sell winners too quickly and hold on to losers too long. Human nature clearly indicates that it is better to not lose $5 than it is to find $5. The safety desired by the pessimist is not always a bad thing. But the perennial pessimist in the investing world will most likely get left behind.

We admit to being optimists. We are stock pickers who believe in the long-term health of the U.S. economy and the long-term success of patient investors. We have never proclaimed that we see grave danger ahead and it is time to get out of the market. Almost all of our presentations concern why we believe we should be invested and how we think our portfolio will be to the benefit of our clients. And despite the less glamorous role of being the optimist, clearly this has been the right position. The pessimist who had his investment in cash over the past 10 years has missed out in a very meaningful way. In fact, over any significant period of time, the real sage is the investing optimist, not the pessimist who gets more air time.

Unsurprisingly, we think the market dive experienced in late 2018 was an overreaction to minor pieces of news and driven by large passive positions and program trading. We understand the headwinds such as uncertainty in politics, a slower growing China or an economic slowdown in Europe. But we consider all these factors – and much more – when we calculate the fair value of the stocks we own or are considering. The fact that we see more good times ahead than bad does not mean we invest blindly, oblivious to an imperfect world. It means we have done our homework, we understand the companies we own, we have studied how these companies will perform in most environments, and we have concluded owning a basket of high quality companies is the best way to build long-term wealth.

We don't make predictions, but we do understand where we think prices are relative to fair value. And we believe our portfolio is trading at a significant discount to our calculation of what the companies are worth. Timing is not our thing either, but we do believe that over a significant period of time the market will close this gap between where prices are today and what we believe the fair value of the stocks are. In the end, it doesn't matter that the pessimists tend to get more consideration. In fact, there are thousands of stocks we have no desire in owning. But historically – and we believe going forward – the investing optimist is the person who deserves the attention.

***

With the new year upon us, it is a good time to review your portfolio, make sure all items are up to date (contact information, IRA beneficiaries, changing personal situation, etc.) and let us know if you want to make any changes. We are always available to talk about what is in your portfolio, why we have bought or sold any security or how we build your portfolio. We have an investment thesis for every position and we are happy to share our ideas and rationale. If you have any questions about your account, feel free to reach out and have a conversation.

About the Firm

Bernzott Capital Advisors is an independent institutional money manager serving foundations, endowments, public and private retirement plans including Taft-Hartley plans, and businesses, individuals, trusts and families. Please feel free to call with questions and comments, or visit us at **www.bernzott.com.**