

Investors and Speculators

Over the last three months, an anticipated mild correction has turned into a nasty major decline that threatened to put at risk the world financial system. After serious problems had affected Asia and Russia, the contagion spread to Latin-American countries and put their financial markets into turmoil. This time, the crisis affected in a negative way both of our investment pillars, blue chip stocks and high yielding bonds. Accordingly, portfolio values plunged. Many investors are uncertain whether this is still only a correction or whether this decline will not stop and ultimately lead to a prolonged bear market. We don't know it either but will share our thoughts with you.

An investor should know about the dangers of wide and prolonged fluctuations and prepare himself psychologically and financially. The eventual investment success depends to a large degree on his attitude, staying power and discipline during a crisis and whether he is able to profit from extreme price fluctuations or at least won't be hurt by them.

The attitude of holders of marketable securities to fluctuations depends on whether they are traders and speculators or investors. The trader or speculator tries to time the market. He endeavors to anticipate the swings of the market and to profit from them – to buy or hold securities when their future move is expected to be upward and to refrain from buying or to sell when it is downward. The investor on the other hand values the market. It's his goal to acquire participations in successful enterprises at favorable prices. He acquires stocks when he perceives them to be below (or at most at) their intrinsic value, to keep them and to profit from their long-term appreciation. His attention is focused primarily on the business results, a sufficiently strong financial position and a reasonable conviction, that their earnings will grow over the years. An investor whose portfolio contains a number of such stocks can take a much more independent and relaxed attitude than the nervous, fast moving trader and speculator. Ideally market fluctuations affect him only in the sense that they allow him to buy at low prices or to sell at high prices. He forms his opinion of their value by analyzing the company's quarterly and annual reports and considers himself a minority owner and a silent partner. Short-term fluctuations of the market price are of minor concern, what counts is the long-term progress. Quite different the trader, who buys a paper that he can sell anytime and whose opinion of value depends largely on the general mood and the market price, which fluctuates constantly and, at times, is far away from a rational business value. Timing is important to the speculator's mind set because he wants to become wealthy in a hurry, the idea to have to wait more than a year for his commitments to work out scares him off. The investor is patient, he enjoys the journey, he loves to own wonderful businesses; in the end he will become wealthy as an added benefit. While the market timing approach to investing is much more popular and followed by a majority of the investment community it is nevertheless a fact that they often will lose money in the end. Long-term investors, sometimes holding only a few successful positions, have built most of the big fortunes.

The same differentiation applies to investments in high yielding bonds. The trader invests with a short to medium term capital gain in mind. If prices turn down unexpectedly, he sells to cut his losses. The long-term investor analyzes the capacity and reliability of the debtor to pay interest and principal. He invests only, if his conclusion is positive and normally with the intention to keep it until maturity. Fluctuations in prices do not change his mind. He is not infallible, so he acts if he concludes that the situation has deteriorated to such an extent that his payments are at risk. We have witnessed in our case a severe crisis in emerging country bonds with prices being marked down precipitously at times, but with very few exceptions (e.g. Russian bonds), we do not expect lasting damage.

It is a pleasant fact that the relaxed, long-term investor in stocks and bonds does much better than the speculator and trader with their permanent switching. He is usually also better informed and more understanding of essential values, he is more patient and less emotional. Accepting the probability of significant rises and equal declines in his investor's life, he considers them a price he has to pay for success and pays little attention to them unless he may even be able to exploit them by buying low and selling high.

An analysis of past bear markets of the Dow Jones Industrial Average (see table below) reveals that they vary in extent and length of decline and time needed to recover. As a general observation, corrections of 10% may recur annually. A decline of 20% or more is normal on average every 5 years. The last big sell off happened in 1990 and, therefore, after so many boom years a sharp and extended downturn should not shock us. It often brings out people who say this is the beginning of the end. Even a faithful investor is hard pressed if the shrinkage lasts more than a year. It is often interrupted by a recovery, which if followed by a new decline unnerves even the courageous.

Breaking Down the Bear (DJIA)			
Date of Peak	%Decline	Months to Trough	Years to Return to last Peak
16.07.1990	-21.2	3	0.75
25.08.1987	-36.1	2	2.00
27.04.1981	-24.1	16	1.50
21.09.1976	-26.9	17	4.50
11.01.1973	-45.1	23	9.80
03.12.1968	-35.9	18	3.90
09.02.1966	-25.2	8	6.80
13.12.1961	-27.1	6	1.75
29.05.1946	-23.2	12	3.90
03.09.1929	-47.9	2*	25.20
*Market eventually fell again; DJIA's cumulative decline by 1932 was 89%			
Sources: Ned Davis Research, WSJ Statistics			

Looking at the table you may wonder why we did not attempt to take profits when the market started to decline and to sit out the correction in cash? This is what the speculator and trader tries to do. But to do it successfully you have to be able to anticipate the next move of the market. And at that the best brains have failed, although it seems to be so easy. Nobody is able to predict the market with sufficient accuracy. Instead of trying to time the market it is much more rewarding to search and value promising investments, to acquire them at a reasonable price and to stick with them through ups and downs until they are really overvalued. The art is to pick the exceptional business and not skillfully moving in and out of the market. A few hedge fund managers may constitute an exception to this rule. But they too often dazzle with a meteoric rise and an equally steep fall as exemplified recently by John Meriwether with his LTCM hedge fund.

Only during the Great Depression (1929-33) was it advisable to have ample cash reserves, because the correction was huge and the recovery took a long time. During this most trying bear market the quality of one's investment, avoidance of leverage and ample cash were of paramount importance to survive the ordeal. The crisis was caused by poor financial policy decisions taken by the leading industrial nations (e.g. rising interest rates, increased taxation and high import duties) that choked off economic activity and led to widespread bankruptcies, unemployment and impoverishment. It is interesting to note that the DJIA, after hitting its trough in 1932, doubled within the next six months.

Despite the serious problems confronting the world in 1998, the decline of the Asian and Russian economies and the problems facing Latin America, it definitely doesn't look like a replay of the thirties. More to the point may be a resemblance to the problems in 1973-74. The industrial nations are, thanks to the low inflation and the low interest rates, in relatively good shape to address a slump in activity. Some emerging countries have, after a precipitous fall, started to stabilize. It is also a positive fact that the humbling experience of the downturn teaches all involved a healthy lesson how not to conduct their affairs and therefore may form the basis for a more prosperous future. A good example is the period after 1973-74: In the aftermath of this bear market the DJIA rose from below 700 to 8'000 or more than tenfold in 24 years. Such figures show the attractiveness of the long-term "buy-and-hold" concept, and any market timer would be hard pressed to show an equivalent performance. The story is similar for our bonds. We have invested between 20% and 30% in high yielding debentures of emerging countries, mainly from Latin America. Their quotes are at present under pressure out of fear that some may have problems. We believe that this fear is exaggerated and most debtors will honor their obligations; in addition, the crisis will force them to pursue a somewhat more conservative policy in the future and this will be positive for investors.

We don't know how long the correction will last or at which level the market will stop declining. The problems are considerable and will not quickly disappear. It is also hard to see how to resolve them. The market and time however are good healers. The world economy will revert to moderate growth. The exceptional companies, which we own, will resume their profitable growth and this will not go unnoticed in the market. Our bond holdings have a high recovery potential and we should make money even if there is an occasional writedown, which is the cost of doing business. A setback is never a pleasant affair, but the important thing is that it's limited and, since we are not leveraged, we can wait confidently for better markets.

Roland Schwab, October 26, 1998

(Source: Benjamin Graham, The intelligent Investor, Harper & Row 1973)