Thoughts that count

April 2022

A giant in the bullpen

In the late-1980's you did not want to be facing *Terminator* Tom Henke at the plate. As the closing pitcher for the Toronto Blue Jays, he was a batters' nightmare. Henke threw two varieties of pitches: a fastball and a forkball, both high velocity pitches. He was a hard throwing, 6'5" giant, and was a strikeout machine. Among my fondest childhood memories was riding the GO Train down to Exhibition Stadium hoping to see Tom Henke humiliate the visiting team.

As a kid I couldn't throw a ball 100 miles an hour, but I emulated Henke's approach in my little league games. When I pitched, I had only one thought; throw the ball as hard as you can. I was pretty good. I struck out a lot of kids, and my coach consistently encouraged me to work on increasing pitch velocity. I thought if I could master the fastball and just throw the ball harder than hitters could swing, I could become the next *Terminator*.

My general understanding of baseball has been coloured by my fascination of players who can throw the hardest. I have always thought the best fastball pitchers were the most exciting players and appeared to receive the greatest notoriety. They also seemed to make the most money. To me, baseball success was simple and binary; the best teams had the hardest throwing pitchers.

A few years ago, I attended a Jays' game with a friend of mine who had played professional baseball. As we watched the game, he gave me a running commentary about what he thought the pitcher was thinking about before each pitch. I had presumed there wasn't much thinking happening at all, other than suppressing nerves and trying to muster up enough energy to throw the next pitch as hard as possible. Turns out I didn't know much about pitching at all.

My friend talked about having a plan for each batter before they stepped up to the plate. He explained mixing up pitch selection, delivery, and location to make batters uncomfortable. The pitcher would also be considering their own history with each hitter; how many times had they faced each other, the batters' strengths, and weaknesses, and their most recent hitting streak. He noted how there is a game within the game; each pitch plays a specific role depending on the current count (the number of balls and strikes), the inning, the number of outs, whether players were on base (and if so where), the score, and who was next to bat. Even the weather, time of day, and stadium configuration made a difference.

I felt I was discovering baseball for the first time. I was learning that every pitch involved speed, but speed was not the primary focus. All my life I had been thinking about baseball in terms of blunt force; throwing hard. I was missing the larger picture. There was so much more to baseball that I hadn't considered.

Many investors fixate on one question when considering an investment: how much, and when, will it increase in value? This thinking is often too simplistic, similar to judging a pitcher's worth solely on their ability to throw hard. Of course, all investments are purchased with increased value as the end goal, but rarely is investing as simple as 'just buy the thing that goes up the fastest'. In baseball, fastballs are the most powerful pitch, but they aren't always the wisest choice. Tom Henke did give up a home run every 12.5 innings pitched. Like a pitcher's mindset before throwing the ball, investors must consider context.

Context is a tricky thing. The only frameworks life provides are based on emotion, which we know is prone to all manners of pitfall. Instead, we must build a conscious context by taking a step back; looking at the forest, not the trees. In my opinion, using history as a guide is the most useful investment analyzing framework; the attributes that have consistently worked (or not) in the past over the long term, are likely repeatable. A pitcher uses knowledge their predecessors, coaches and teammates gleaned over many thousands of games, so too can investors use proven historical lessons to build a framework to approach current markets.

Investors have a lot to think about right now. An awful war in Europe, higher than expected inflation, and rising interest rates are top of mind. These are big, serious issues. For most, it is appropriate to have some positions dedicated to mitigating each of these problems. However, each of these issues are incredibly complex and knowing the exact conclusion to any of them is impossible. As worrying as these issues are, in time they will pass and will be replaced by new problems. One of the dangers of trying to outmanoeuver each new problem too specifically, is that enacted solutions may only be appropriate for a short time. Often, the solution to one problem is counterproductive to the next issue to come along. Investors can be stuck chasing solutions to a never-ending cycle of changing problems, never fully positioned properly for the longer term, which is where compound growth occurs.

Instead of trying to throw a fastball at each problem that arises, it is best to focus the bulk of the portfolio on the ‘big issues’ that have staying power. ‘Big issues’ are themes that have a high probability of remaining true over the long term. Big issues that permeate our portfolios are things like; only invest in highly profitable companies, be diversified at all times, don’t make bets so large they can ruin a portfolio, be mindful of debt.

While the bulk of the portfolio is focused on big issues, there is room to tilt part of the portfolio to address shorter term issues. These tilts should always form a smaller portion of the portfolio however and should have a bias towards flexibility should the need arise to change course.

A few comments on some of the issues we currently face:

- War: Armed conflict is never good. From an investment perspective, the effect of Russia’s invasion has meant already stretched global supply chains are further stressed. It also means energy prices are under pressure, especially in Europe, as Russia is a major producer/supplier.
- Inflation: The general rise of goods and services has accelerated over the past 12 months, principally because the world was shut down for 2 years due to Covid disruptions, and supply chains are damaged. As the world continues to open, everyone would like “normal” life to recommence. Unfortunately, this does not happen overnight, and so prices rise as too many people are chasing too few goods.
- Interest rates: The world’s central banks have been tinkering with interest rates for decades but have accelerated their fiddling since the financial crisis in 2008 and again in 2020 as they cut rates to zero. This has been an accelerant to all asset prices; stocks, bonds, real estate, and alternatives like art and fine wine. This process is now starting to unwind as central banks are beginning to take away the punch bowl by raising interest costs. No one knows for sure how high interest rates will increase, but central banks don’t want to upset the apple cart too much. Should they raise rates too high, they know they would have to cut rates again.

Given the uncertainty in the current environment, we have enacted some portfolio changes to help smooth our portfolio returns. However, this is not a message of bad news, the economy is still healthy and interest rates, while increasing, are still at historic lows. Most of our investments have not changed, though we have made some tilts to our asset allocation to account for the challenges we currently face. I still like our fastball, but given the environment, some defensive pitches are called for.

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During the second half of last year, we added positions to several defensive and undervalued sectors (gold, energy) and reduced exposure to sectors which were beginning to exceed their true worth (widely held large US companies). During the first quarter of this year, we increased our equity hedges, which pay off should the market decline. These were added because overall stock market valuations reached overbought levels. We have also increased the amount of cash we are holding in case volatility accelerates and provides additional opportunities. We eliminated some of the bonds we were holding, as they will be challenged as interest rates and inflation rise. Lastly, we added some preferred shares, which pay an attractive fixed interest rate, and are generally insulated from rising rates.

It is during periods of volatility that investors have the greatest chance to purchase quality assets that panic stricken investors are haphazardly selling. This is never easy in the moment, and only becomes obvious with hindsight; every past decline looks like an opportunity, every future decline looks like risk.

Fastball pitchers get into trouble because the consequence of missing their target is significant. The harder a ball is thrown, the further the ball will travel if a batter connects. Throwing hard is a high risk/reward scenario. If a pitcher can consistently throw faster then the batter can swing, many strikeouts are likely. But it only takes one slightly off pitch, or one better than usual swing for a pitcher’s night to be ruined by a home run. The same rule applies in investing, when high-growth investments work out, everyone is happy, when they fail, they can be ruinous. Situational pitching, where the pitch type is selected to fit the context works best for most pitchers. Situational investing works best for most investors too.

Your *happy baseball season is back, Go Jays Go* portfolio manager,

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