Stewart Financial

Thoughts that count

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Many games, one field of play

Bulgaria's society is believed to have begun more than 6,500 years ago, approximately 4,600 years before the creation of organized ice hockey. This small European nation has advanced considerably over the centuries, but their hockey program is still barely existent. While soccer is far more popular, Bulgaria does have an international hockey club. In fact, in 2010, Bulgaria was invited to send a team to participate in the Winter Olympics qualifying hockey tournament. They probably should have stayed home. The Bulgarian national hockey team played 4 games, their worst loss was to Slovakia, an 82-0 drubbing. The shots on net in that game were 139 – 0. I think it's fair to say that whatever Bulgaria was playing on the ice that day, it wasn't hockey. They were playing a different game.

Of all the mistakes an investor can make, misunderstanding the game they are playing is the most seductive. It is also one of the most common missteps, because it takes significant conscious effort to avoid. The problem is the intersection between human behaviour and the investing field of play. Investors too often think they are playing a friendly game of shinny, when without knowing, they are really playing elite level athletics.

Consider the question "how much should you pay for a particular stock, Microsoft, for example?". The price in the open market for one share of Microsoft is currently $335. Is this a 'smart' price for you to pay? The answer depends on who '*you*' are?

If *you* have a 30-year time horizon, the 'smart' price will be based on your analysis of how much profit Microsoft can generate and compound over the next 3 decades.

If *you* have a 10-year time horizon, your analysis will look at the attractiveness of the software sector in general and Microsoft's specific competitive place within it.

If *you* have a 1-year time horizon, your analysis will centre around Microsoft's immediate sales cycle and whether the broader stock market is likely to suffer a significant correction this year.

If *you* are a day-trader, you wouldn't perform any analysis at all because all you care about is selling for a few pennies higher than you bought a few minutes earlier, which can be accomplished at any stock price.

When it comes to analyzing stock price worthiness, understanding who *you* are, is far more important than anything else. How fast Microsoft is growing, its sales prospects and its dividend yield are all unimportant attributes until you have defined your personal objectives and time horizon, yet many investors skip this step.

I didn't see the Bulgaria vs Slovakia hockey game, but I can imagine the difference between skill levels would have been painfully obvious as early as warmup. Someone should have stepped forward and urged the Bulgarian team to "re-think the game you are about to play". Both teams were dressed for a hockey game, but clearly their abilities were so different they should have been playing on different ice rinks. The problem with investing is that there is only one field of play, and the rank amateurs are forced to play alongside legitimate Olympians.

For 18 years, from 1999 to 2016, Microsoft stock traded at close to the same price, $50. In other words, for almost 2 decades Microsoft's stock return was 0%. In the last 5 years it has returned 435%. The day-trader will happily pay $335 for a share today, because they think they can sell it for $335.01 or more sometime before 4pm when the market closes. For them, $335 is a rational price and is completely in line with their objectives.

Now consider the person diligently saving for retirement, trying hard to accumulate enough to secure a future multi-decade income stream. If they want to buy Microsoft stock, $335 is the price they must pay because there is only one venue to buy it. There is only one market; it is not sub-divided into investor types. But purchasing stock after such a massive runup may materially affect this saver's ability to retire at the time of their choosing.

The day-trader and the retirement saver don't know the are trading with each other. They are playing completely different games, but they are on the same ice pad, skating towards each other and if they collide, someone is likely to get hurt.

Money chases returns, which causes stock market prices to have an inverse relationship with investor time horizons. As prices rise, investor time horizons shorten as the lure of easy gains grinds down investor patience. Slowly, longer term investors, often unconsciously, shift their preferences towards what shorter term investors want, price action. The longer the market rises, the more aggregate time horizon whittles away. Momentum ensues. Eventually, most of the market is taking price signals from the shortest time horizon players, even though those investors might be playing an entirely different game. When this process continues long enough, it forms a bubble, which eventually pops. However, if investors stick to their own game, they will not be seduced into paying a price out of line with who *they* are.

It's difficult to recognize that other people have different objectives from ours. Part of being human is assuming others should see things the way we do, and this is also true with investment attitudes. When momentum entices short-term investors, and short-term thinking dominates market prices, long-term investors are at risk to see rising prices as a buying signal. What this momentum hides, is the risk that long-term investors will cross over into a game that is not for them. They risk thinking they can compete with Slovakia, when they won't even get a shot on net.

Over the past few years, the prices investors have been willing to pay for all stocks has increased significantly. Good and bad companies alike have seen their share prices rise. This is largely a function of rock bottom interest rates, which has been fuel on the fire for short term thinking. The length of time investors hold any particular stock has dropped precipitously while volume (sales turnover) has increased. Both metrics suggest investment time horizons are shrinking. Short term activities are the dominate actions.

Stewart Financial portfolios embrace a longer-term bias and when the price of a security exceeds what we think is acceptable for our investors, we will refuse to buy. Instead, we will look for other more appropriately priced opportunities, or we will hold cash, fixed income or alternative vehicles. We can help our clients reach their long-term goals without participating in the setbacks short termism inevitably bring. We have seen this game played many times before. Above all, we will only participate in games we intend to play.

Your *wishing I could attend a sporting event in person* portfolio manager,

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