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Anyone who has shopped for groceries, clothing, a car, or an array of other consumer products, knows that when quality brands are sold on sale, the sale doesn't last long, and the products soon return to their higher pre-sale prices. Most consumers react advantageously to sales of their favorite products, trying to buy more or all of the product when on sale, and less or none when off sale. Yet when it comes to investing, many investors act in the exact opposite manner, a behavior that unfortunately works against them, typically leading them to buy high and sell low. In this commentary, we discuss what some of history's most successful investors have had to say about buying quality companies on sale, and we'll discuss how our clients have recently benefited from buying quality companies on sale.

One major factor contributes to the different behaviors seen in reaction to a consumer product on sale versus a company on sale. That difference mostly has to do with the fact that investors typically find a company on sale when the company has a problem, and that problem leads to pessimism and fear, which pushes the share price down. By contrast, when you find a consumer product on sale, there's typically no problem with the product, as manufacturers usually try to recall products that have flaws in order to protect the value of their brand.

It's understandable why investors don't like buying companies that have problems. Often when a company encounters a problem, the share price falls even further. When an investor sees a holding that has fallen, the gut reaction is to cut their losses and sell, or hold until it returns to their purchase price and then sell.

But if you listen to some of history's most successful investors, you learn that buying companies that have problems can help to protect against investment losses and help you achieve profits. The first example we provide was given by Warren Buffett's teacher Ben Graham, as retold by another Graham student, Walter Schloss, in an interview: "Graham used a great example of two companies - one popular and one unpopular selling at wildly different valuations.

One was a very popular company with a book value of $10 selling at $45. The second was exactly the reverse - it had a book value of $40 and was selling for $25.

In fact, it was exactly the same company, Boeing, in two very different periods of time. In 1939, Boeing was selling at $45 with a book of $10 and earning very little. But the outlook was great. In 1947, after World War II, investors saw no future for Boeing, thinking no one was going to buy all these airplanes.

If you'd bought Boeing in 1939 at $45, you would have done rather badly. But if you'd bought Boeing in 1945 when the outlook was bad, you would have done very well."[1]

So Boeing had a great outlook in 1939, and ended up falling from $45 to $25. Then it had a negative outlook at $25 in 1945, and that was actually a very good time to buy them.

We hear similar words from other investors. As Schloss himself said in a 2008 interview: "I don't like to lose money. And therefore, I try to buy stocks which I think are protected on the downside, and then the upside sort of takes care of itself…Lots of times you buy a stock, and if it's having a problem, which is the reason the stock is depressed, it can go lower. What you wanna do is to be satisfied that buying it at a lower price is a good idea… If I like a company, and if I think it's a good little company, I'll buy more on the way down."[2]

Warren Buffett probably put it best in a 1999 Businessweek article when he stated that "the best thing that happens to us is when a great company gets into temporary trouble... We want to buy them when they're on the operating table."[3]

Buying companies that have temporary problems, and selling them when they get past those problems, isn't an investment strategy limited to long-term value investors. Even investors known for having a short-term outlook talk about the benefits of investing in companies with temporary problems. As Carl Icahn stated in a New York Times interview: "The real money that I made over the years is holding companies for seven, eight, nine years and keeping 'em...You gotta buy 'em when nobody wants them really. I mean, that's the real secret...It sounds very simple, but it's very hard to do. When everybody hates it, you buy 'em. And then when everybody wants 'em, you sell it to 'em."[4]

Within our Group's client portfolios, we've seen the power of buying great brands when other investors don't want them. Last month, one of our largest holdings increased more than 24% in one day. Last year, the same thing happened to our largest holding at the time. These large upward corrections were set up by intense pessimism about short-term problems that caused investors to forget about each company's stellar long-term track record. We're thankful for the short-term problems and pessimism, which allowed us to buy these companies at discount and clearance prices. Of course, it took time for each company's share price to correct upward, and both declined to even lower prices while we owned them, which allowed us to buy even more shares at lower prices. As Icahn stated above, buying a company when no one wants it looks easy, but it's very hard to do. It requires an independent and stable temperament that is unaffected by the actions of others. It requires solitary logical analysis to the point where you know why you're right and why others are wrong. And it requires you to potentially watch stocks fall further than you thought they would. This goes against human nature.

Companies crashing as a result of temporary problems also brings up an important point: some investors think they have to wait for a market crash to find great investment opportunities. Not so. Great companies crash 30%, 40%, 50%, and more on a regular basis. As U.S. stocks as a whole reached record high levels last year and this year, we were able to buy great brand-name companies at multi-year-low prices.

Finally, in addition to providing a mechanism for outsized gains, buying companies when they encounter temporary problems and pessimism helps protect against investment losses. Even with U.S. stocks at record high levels, several prominent U.S. companies sell at lower prices than they did during the peak of the U.S. technology bubble eighteen years ago. At the time, two of these companies were the largest companies in the world by market value. Investors who bought these companies during periods of outsized optimism still nurse losses from nearly twenty years ago[5].

The Crescent Group will continue to avoid the most popular investments, and will continue to look for great companies facing temporary problems and pessimism, in order to help achieve strong long-term investment returns for our clients, and protect them from buying high and selling low.

Best Regards,

The Crescent Group
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Sources:

(1) Outstanding Investor Digest
(2) ValueWalk
(3) Businessweek
(4) The New York Times
(5) S&P Dow Jones Indices LLC