Wealth Management

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March 2018 Investment Commentary

During March, U.S. stocks extended the volatility of the first two months of the year. However, the forces that drove March's volatility differed significantly from those that drove the volatility of January and February. Whereas the volatility of the first two months of the year mostly represented a general pause in the stock market's advance, which impacted almost all stocks equally, a large part of March's volatility resulted from fundamental weaknesses in particular industries, specifically the technology industry, which did not impact all stocks equally. In this commentary, we discuss March's market activity in more detail, and describe some important lessons learned.

As of the end of March, U.S. stocks declined slightly year-to-date, with the S&P 500 index, a widely followed group of U.S. stocks, down 1.2% year-to-date. Although this represents a modest decline, it has had an outsized impact on investor emotions, due to the length of time U.S. stocks had gone without sustained declines. As always, investors need to keep this decline in perspective. This level represents a 10% decline from the highest level ever reached by the S&P 500. Taking a long-term perspective, which is the only intelligent way to invest, a 10% decline isn't much compared to the 100% increase over the past ten years, 140% increase over the past twenty years, and 920% increase over the past thirty years. Further, intra-year declines in stock prices happen every year. Over the past thirty-eight years, the average intra-year decline has equaled 13.8%. So thus far, the 2018 intra-year decline is actually less than the long-term average. And again remaining focused on the long-term, intra-year declines don't keep stocks from going up over time, as stocks generated positive returns in twenty-nine of the past thirty-eight years, despite an intra-year decline every year[1][2].

So, maintaining a long-term perspective, and not allowing short-term volatility to lead to poor investment decision making, are two important takeaways from March. But March provided another critical lesson in investing: if you want to grow your assets in a conservative manner, in order to overcome inflation and achieve your financial goals, while preventing permanent losses, you should invest in companies and industries with proven, established long-term competitive and profit dynamics, and avoid those companies and industries with unproven and uncertain competitive and profit dynamics. Said differently, by Andrew

Carnegie, “pioneering don’t pay”. In March, cracks began to appear on the surface of companies whose entire existence involves pioneering. Companies that many investors blindly poured money into on the basis of hope for future growth, and on the basis of recent returns, but without a proven long-term track record of profitability and competitive dynamics. Of course, we’re talking about technology companies. In March, while the S&P 500 declined 3%, technology companies led the stock declines, with prominent companies such as Facebook falling 10%, Google falling 7%, Apple falling 6%, and Tesla falling 22%[1][3].

These declines represent a small taste of what can happen when investors come to their senses with regards to overextended valuations. Last month, investors began to question the long-term sustainability of technology businesses whose long-term fundamentals are not yet established. They began to question how tighter privacy controls may impact the profits of these companies. Customers and governments publicly sought to understand the extent to which these businesses benefit society, and more importantly, how they may harm society. These circumstances highlight the problem with new industries – no one knows what obstacles will develop, and how those obstacles will impact long-term profits. Sure, short-term profits have looked great, and that’s why these stocks have done well over the short-term. But the longer-term remains unestablished. And while you can certainly bet your money on an uncertain future, we think prudent investors should instead place their money in companies with established long-term profit and competitive dynamics. Investing in this manner allows you to grow your assets in a conservative manner that will overcome inflation and allow you to achieve your financial goals, while avoiding permanent losses that can come from obsolescence and new and rapidly changing technologies and industries. Yes, some technology companies will do great over the long term. But can you afford the risk? Can you afford the losses when you’re wrong?

Warren Buffett has described two periods in the past when over enthusiasm for the latest technology resulted in no long-term gains for shareholders. When investors saw the revenue potential of the developing auto and airline industries, people thought those were the places to invest. Yet those industries ended up earning no long-term profits, and Buffett specifically cited the overvaluation of those industries as a large part of the reason the Dow Jones Industrial Average returned nothing over the time period 1964 to 1981. Similar overenthusiasm for the latest technology contributed to the S&P 500 index returning nothing over the time period 2000 to 2013. Today, investors pour money into industries such as cloud computing, social networking, and internet-based advertising, with large revenue potential but unproven long-term profit dynamics. We don’t know when an above-average market correction will come, nor what form it will take, and neither does anyone else. What we do know is that the investments that have gone up the most, often without fundamental underpinnings, have historically fallen the most during large corrections[1][4].

Our Group reduces the risk of participating in a bubble by only investing in companies with established long-term profit dynamics, which allows us to calculate what those investments are worth with a high degree of certainty. We will not invest in a company if we can’t develop a reasonable picture of what their long-term profits will look like. We believe this is the best way to grow our clients’ assets above inflation while reducing the risk of participating in a “lost decade” of no returns. In Warren Buffett’s 2017 letter to shareholders, he wrote that “what investors then need instead is an ability to both disregard mob fears or enthusiasms and to focus on a few simple fundamentals. A willingness to look unimaginative for a sustained period – or even to look foolish – is also essential.” Buffett knows what it’s like to look foolish over a short period of time. From August 1998 to March 2000, Berkshire Hathaway’s stock declined 47% while the S&P 500 increased 28%. But over the following nearly ten years, Berkshire stock increased 344% through February 2018, while the S&P 500 increased 149%[5].

As a final note, although many investors understandably find the recent market volatility unnerving, we would still describe the recent market declines as healthy. If stocks kept going higher and higher with no pause, we would find ourselves headed for a massive correction. Having pauses like the one we’ve experienced this year helps prevent a crisis scenario from developing. Unfortunately, successful long-term investing requires putting up with short-term volatility on a somewhat regular basis. The good news is that volatility in stocks has never and will never prevent stocks from going up over time.

Best Regards,

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Sources:

(1) S&P Dow Jones Indices LLC
(2) JP Morgan
(3) Andrew Carnegie (Joseph Wall)
(4) The Snowball (Alice Schroeder)
(5) Berkshire Hathaway 2017 Chairman's Letter

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