

Investment, Speculation, and Market Timing

The stock market has been more volatile this month than it has been in over 2½ years. That is not saying much. The stock market since 2012 has been remarkable for both its trajectory and placidity. Given the chatter of market pundits who are calling this a great buying opportunity, some investors may be wondering why we didn't buy more.

A 10% correction is generally not enough to put a major one-time dent in our cash holdings, with the exception of newer portfolios. In high-priced markets with only 5-10% corrections, we will still typically invest one company at a time rather than suddenly investing in several new positions. A 20% or larger decline in today's market would likely be necessary to put a major one-time dent in our cash holdings.

Our lack of buying today underscores the difference between ACR's patient approach to investing and market timing. *Market timing* is the attempt to buy before the market goes up, and sell before it goes down. *Patient investing* is waiting for the right price before you buy to avoid losing principal.

Market timing is to us an exercise in futility. We have no idea when the market will decline, rebound, or bottom. Patient investing, on the other hand, is doable but not easy. It requires knowledge of corporate values and the discipline to wait until a stock's price is sufficiently low relative to its value before buying.

Our discussion of patient investing and market timing cuts to the heart of the most important distinction in investing: investment versus speculation. Market timers are speculators. Patient investors are not. Two great economic thinkers, Benjamin Graham and John Maynard Keynes, were very interested in this distinction, and each left us with excellent definitions on the subject.

Graham was a highly successful investor in the early 1900s. He lost nearly all during the Great Depression, yet ultimately posted an outstanding long term investment performance record. Today Graham is probably best known as Warren Buffett's mentor. Most investment practitioners also know Graham as the author of *Security Analysis* and *The Intelligent Investor*.

Graham first defined investment, and speculation by omission, in the 1934 edition of *Security Analysis* (emphasis in the original text):

An investment operation is one which, upon thorough analysis, promises safety of principal and a satisfactory return. Operations not meeting these requirements are speculative.

Several pages could be devoted to this definition. Mercifully we will limit our thoughts to several paragraphs.

Graham refers to an “investment operation” rather than a single investment. One reason is to acknowledge that, for common stocks, diversification is necessary “to reduce the risk involved in the separate issues.” Individual securities should be scrutinized to determine whether or not they are of investment quality or speculative, but a single common stock holding is “not sufficiently safe” in itself. Only a group of stocks can be compatible with safety of principal.

“Thorough analysis” refers to the “study of the facts in the light of established standards of safety and value.” According to Graham, the analysis of an investment must be “justified on both qualitative and quantitative grounds.” The 725 page first edition of *Security Analysis* is a practical discourse on how to thoroughly analyze securities.

“Safety of principal” seems to be a definite standard, at least until common stocks are considered. The subject then becomes far less definite, which we will address momentarily. A “satisfactory return” is very indefinite. The latter is actually easier to explain since it is subjective – only the investor can ultimately judge if a return is satisfactory. The key is that there is a sensible return above principal value, and it is earned within a reasonable period of time. This brings us back to the issue of safety of principal and common stocks.

Common stocks fluctuate in price every day, both up and down. If safety of principal referred solely to a stock’s price, all common stock purchases would be speculative. However, Graham advocated in the depths of the Great Depression that common stocks can be of investment quality. How can that be?

Safety of principal must refer to both the intrinsic value of a stock and the price paid for it. Intrinsic value is determined by the net asset value of the company or the present value of the cash flows the company is likely to generate for its stockholders. *A stock can be an investment if the intrinsic value of the company is sound and the price paid is low or reasonable compared to its value.* A more refined explanation by Graham will help drive the point home:

It may be helpful to elaborate our definition from a somewhat different angle, which will stress the fact that investment must always consider the *price* as well as the *quality* of the security. Strictly speaking, there can be no such thing as an “investment issue” in the absolute sense, *i.e.*, implying that it remains an investment regardless of price. In the case of high-grade bonds, this point may not be important, for it is rare that their prices are so inflated as to introduce serious risk of loss of principal. But in the common-stock field this risk may frequently be created by an undue advance in price – so much so, indeed, that in our opinion the great majority of common stocks of strong companies must be considered speculative during most of the time, simply because their price is too high to warrant safety of principal in any intelligible sense of the phrase. We must warn the reader that prevailing Wall Street opinion does not agree with us on this point; and he must make up his own mind which of us is wrong.

How little has changed in the past 80 years! Graham asserts that certain stocks may be investments if their price is in proper relation to their intrinsic value. There may also be times when “the great majority of common stocks of strong companies must be considered speculative.” We believe one of those times is today. Nevertheless one would be hard pressed to find a research analyst or stock fund manager who would admit that the vast majority of stocks are speculatively priced today. Before further discussing our view of today’s prices, we will turn to John Maynard Keynes and his definition of investment versus speculation.

Keynes’s economic ideas were so transforming that an entire school of economic thought, Keynesian economics, has been included in economic text books for decades. Some economists today strongly agree with Keynes’s economic theories, others strongly disagree with them. We would argue that the events of the past decade provide very credible evidence that many of Keynes’s ideas are right. Regardless, very few would argue against his brilliance or against his ideas about investment and speculation.

In Chapter 12 of *The General Theory of Employment and Interest*, Keynes articulates the distinction between investment and speculation:

If I may be allowed to appropriate the term speculation for the activity of forecasting the psychology of the market, and the term enterprise for the activity of forecasting the prospective yield of assets over their whole life, it is by no means always the case that speculation predominates over enterprise.

Keynes refers to “speculation” as forecasting the psychology behind market prices. He refers to “enterprise,” or investment, as forecasting how much profit an enterprise will earn over the amount invested in it. Keynes qualifies these definitions by suggesting that markets are not always speculative, but is clear about potential deleterious consequences when they are:

Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a whirlpool of speculation. When the capital development of a country becomes the by-product of the activities of a casino, the job is likely to be ill-done.

So where are we today? Is speculation relegated to small, harmless bubbles on the stream of enterprise? Or is enterprise the bubble on a whirlpool of speculation? Our belief is that the vast majority of common stocks are speculatively priced today, although not necessarily because of the rampant speculation Keynes describes. One reason for speculative prices is the myopic focus on current corporate profits and current interest rates rather than the assessment of long term corporate profits and long term interest rates.

Profits can only be properly forecasted by adjusting for economic cycles and interest rate fluctuations (interest rates being a key variable for discounting long term profits in stock valuation models). We

have written extensively on these issues, most recently in our commentaries of October 2013 (“What Corporate Profits are Telling Us”) and April 2014 (“Revisiting the Impact of Low Interest Rates on Equities”), both of which can be accessed on our web site. Rather than going over ground previously covered, we will update a few key numbers.

The average large company as measured by the S&P 500 is selling at a price approximately 27.3x higher than its cyclically adjusted As Reported Earnings. The average historical price-to-earnings multiple is 16.7x, 39% lower than today’s price. Worse, a 63% return would be required to go from 16.7x back to 27.3x. Based on these relationships, the risk today is purchasing a stock at an elevated price, and either ending up with significant short term losses, or waiting far too many years to reach breakeven. Important to note, this risk may not be realized for some time. We simply do not know. *The key is to protect against the risk, regardless of when or if it is realized.*

While it might be an exaggeration to suggest that enterprise is a bubble on a whirlpool of speculation today, as it was in 1999 or 2007, speculation defined as the attempt to forecast short term stock prices is alive and well in every corner of Wall Street and the financial press. The price forecasting type of speculation may be more insidious, since it is a structural element of our financial markets, rather than a more typical and easier to identify speculative mania. Let us cite a few examples.

The vast majority of company research reports are written with short term price targets. Such targets are by definition speculative, since predicting short term price changes is established by market sentiment, not by long term corporate profit generation. Nonetheless, professional and amateur alike continue to obsess over short term price forecasts, ignorant of their complicity in speculative behavior.

The ACR investment team often feels like we are operating in a parallel universe compared to most research analysts. The majority of analysts spend a great deal of time forecasting quarterly and yearly earnings per share, with the idea that unexpected variances in short term earnings per share can significantly impact the current stock price. ACR is focused on the factors which are most likely to drive the future earnings of the company over the coming decade, not the next quarter, or even in the next year or two.

The different perspectives taken by the typical research analyst and the ACR investment team often result in polar opposite activities. The typical research analyst is likely to recommend the sale of a company’s stock based on a short term downward trajectory in earnings, then attempt to forecast when the slump will end before recommending purchase again. ACR examines the company’s longer term prospects, and if we believe its economic characteristics remain sound, use the earnings disappointment and lower share price to buy rather than sell.

Another area of unwitting speculation is performance measurement. Leading financial publications regularly measure and publish research analyst and fund manager performance. Almost invariably they focus on the past quarter and year. Two leading financial journals solely measure Wall Street research analyst performance for one year. In this world three years is considered long, five years an eternity.

The problem is particularly acute today. The market has been going up for over five years, so almost all analyst stock picks and fund manager portfolios are posting double-digit annualized returns over one, three and five year periods. This reminds us of Warren Buffett's famous quote, "Only when the tide goes out do you discover who's been swimming naked."

Confusion between investment and speculation prevails today, despite clarity on the subject from great economic thinkers like Graham and Keynes. Confusion prevails not just in determining whether prices are speculative, but in the very fabric of stock analysis and performance measurement. Perhaps this is understandable. Human nature being what it is, instant gratification and the prospect of a quick buck are hard to resist. The ACR investment team will not give in to such predilections.

Contrary to the vast majority of market participants, ACR will continue to stubbornly practice our patient form of investing, waiting for the right price before we invest. We would rather fall behind the market in the short run and protect our client capital from the risk of loss, than greedily reach for a return which in the end may prove fleeting.

*Nick Tompras, CFA
October 2014*

IMPORTANT DISCLOSURES

ACR Alpine Capital Research LLC is an SEC registered investment adviser. For more information please refer to Form ADV on file with the SEC at www.adviserinfo.sec.gov. Registration with the SEC does not imply any particular level of skill or training.

All statistics highlighted in this research note are sourced from ACR's analysis unless otherwise noted.

It should not be assumed that recommendations made in the future will be profitable or will equal the performance of the examples discussed. You should consider any strategy's investment objectives, risks, and charges and expenses carefully before you invest.

This information should not be used as a general guide to investing or as a source of any specific investment recommendations, and makes no implied or expressed recommendations concerning the manner in which an account should or would be handled, as appropriate investment strategies depend upon specific investment guidelines and objectives. This is not an offer to sell or a solicitation to invest.

This information is intended solely to report on investment strategies implemented by Alpine Capital Research ("ACR"). Opinions and estimates offered constitute our judgment as of the date set forth above and are subject to change without notice, as are statements of financial market trends, which are based on current market conditions. There are risks associated with purchasing and selling securities and options thereon, including the risk that you could lose money. All material presented is compiled from sources believed to be reliable, but no guarantee is given as to its accuracy.

The Equity Quality Return (EQR) Advised / SMA Composite consists of equity portfolios managed for non-wrap fee and wrap fee clients according to the Firm's published investment policy. The composite investment policy includes the objective of providing satisfactory absolute and relative results in the long run, and to preserve capital from permanent loss during periods of economic decline. EQR invests only in publicly traded marketable common stocks. Total Return performance includes unrealized gains, realized gains, dividends, interest, and the re-investment of all income. Please refer to our full composite performance presentation with disclosures published under the performance section of our web site at www.acr-invest.com.

The S&P 500 TR Index is a broad-based stock index including reinvestment of dividends and has been presented as an indication of domestic stock market performance. The S&P 500 TR index is unmanaged and cannot be purchased by investors.