The Tao of the Turtle

September 2014

Why the Market Gets it So Wrong, So Often

This Tao will be a bit of a departure for us. Typically, we write about Turtle Creek's investing approach rather than pontificate on the market. To long time followers of Turtle Creek, it will come as no surprise that we believe that markets are terribly imperfect. Yet, many of our investors are told by others that the market is efficient and rational. Our experiences suggest just the opposite and so we thought we would take the time to explain some of the reasons the stock market gets it so wrong, so often.

Investing is focusing on the cash you will receive from your holdings. Speculating is trying to predict what others will pay you for your holdings.

The market is comprised of both investors and speculators (with many more of the latter). Let's define the two terms. Investing is focusing on the quantity, quality and timing of the cash that will be returned to you from your holdings. Speculating is worrying about what other people will pay you for your holdings. Investors treat stocks as fractional ownerships of underlying businesses. Speculators don't think about the fundamentals of a business but rather focus on how they believe others are going to next act; they partake in a 'greater fool' world, viewing stocks as pieces of paper to be swapped back and forth. Investors take a long term view and don't spend any time or energy trying to predict price movements. Speculators, on the other hand, are wholly consumed with predicting the direction of share prices. In reality, no one knows what the market will do and trying to predict it is a waste of time and pure speculation. With so many market participants trying to predict the unpredictable (i.e. speculating) it's not surprising that security prices often become so disconnected from fundamentals.

As well, there are elements of human psychology that work against one's ability to act as a rational investor. For example, people over-anchor on some information they might have, despite the fact that there are many more important factors affecting the value of a business, or they grab onto evidence that their own preconceived views are correct and ignore evidence to the contrary. As an example, someone convinced that markets are poised for sharp declines will seek out the views of market doomsayers rather than the views of more balanced commentators. As well, most people exhibit hindsight bias where a person believes (after the fact) that the onset of some past event was predictable and completely obvious, whereas in fact, the event could not have been reasonably predicted.

Oftentimes, participants in the stock market overreact to new information, creating a larger-than-appropriate effect on a security's price which typically reverses over time. This overreaction occurs because people tend to heavily weight their decisions toward more recent information, making any opinion biased toward the latest news. They also exhibit an asymmetric aversion to losses. In other words, for these investors, the heartache of a decline in stock prices is significantly stronger than the joy of an increase in stock prices. The consequence of this is that people don't optimize their investments.

Perhaps the most famous market related human bias is herd behaviour, which is the tendency for individuals to mimic the actions of a larger group even when the individual would not make the same choice alone. Part of the reason for herd behaviour is the social pressure to conform; however, the stronger factor is the rationale that it's unlikely such a large group could be wrong. After all, even if you are convinced that a particular idea or course of action is irrational or incorrect, you might still follow the herd, believing they know something that you don't.

There are many human behavioural biases that pollute an 'investor' mindset.

These are but a few of many biases, and so it would be bad enough if these were the only things polluting an investor mindset, but there are other powerful forces, of more recent development, at work as well.

Over the past 60 years, there has been a remarkable shift in the stock market from individuals investing directly to handing over the management of their investments to others. In 1950, individual investors held 92% of U.S. stocks and institutional investors held 8%. Today, individuals hold less than 30% of stocks and institutions more than 70%. This represents a fundamental shift in the markets, from that of principals managing their own money to that of agents managing money for others.

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The institutionalization of money management has introduced ‘agency’ issues that have made the market less patient and rational.

Much has been written about the ‘institutionalization’ of investing, and not much of it positive. Institutional mindsets result when the decision makers pay attention to things other than trying to optimize the portfolio. Not surprisingly, being an agent instead of a principal, these professional money managers have to defend their ‘performance’ to their clients. As such, decisions are often taken that are more in the interest of their business of money management than in the interest of the client. For instance, since many clients are terrified of price volatility, institutional money managers may attempt to minimize volatility so as to hold on to their clients, with the result being that investment returns are sub-optimized due to this volatility management.

This relatively recent professionalization of money management and its attendant ’agency’ effects introduce levels of short-termism and speculation that are not yet fully appreciated by most people. Perversely, the institutionalization of the market may, in aggregate, have made it less patient and rational. We aren’t aware of any individuals who have fired themselves from the job of overseeing the management of their own money, and yet every day we see professionals who are fired by their clients for poor ‘performance’. Regardless of whose fault it is (the client for being short term focused or the manager for succumbing to the pressures to think short term), this agency effect forces most managers into chasing short term performance since otherwise they may lose their job. A number of institutional managers have commented to us – “I’d love to do what you guys do, but I can’t. My clients would fire me because they wouldn’t give me enough time”. Leaving aside the question of whether or not they could do what we do, it’s worth noting the institutional pressures they face.

Markets are becoming more speculative, not less.

If anything, the level of speculation in the market is increasing, not declining. There is so much immediacy in our modern lives and this translates into an increasing inability for investors (professional or amateur) to take a longer term view. Modern information and communications technologies make it increasingly easy for people to engage in frequent and rapid movement of their investment assets. Arguably, a contributor to the extremely high market valuations and gyrations in the late 1990’s was the advent of the internet which enabled ‘day traders’ to buy and sell their investments at the click of a mouse.

In an odd development, the main reaction to the difficulty in dealing with all of these factors is to adopt a completely passive strategy of owning index funds. We understand the argument and have ourselves expressed the view in a prior Tao that it is a good starting point for many investors and where some should stop. But it is the classic case where what may make sense for one investor makes no sense for everyone. If everyone invested in passive index funds there would be no one left to think rationally and independently about allocating capital.

In the long run, fundamental investing is the only thing that matters.

When you add it all up: (1) the fact that most market participants are speculating; (2) the numerous human biases that drive most people away from an investment mindset; (3) the increasing ‘agency’ nature of the markets and its attendant short-termism and lack of alignment; (4) the immediacy of information in the modern world combined with the human need for instant gratification; and, (5) the mindless, passive nature of indexing as an increasing proportion of the market, it isn’t surprising that the market often gets it wrong (in the short term). Indeed, while the speculative instinct and human biases such as those described above have been around since the creation of markets, the other three influences are relatively new and are undoubtedly causing markets to be less ‘efficient’ over time. Of course, all of this relates to the shorter term – in the long run, fundamental investing is the only thing that matters. Frankly, for true investors, all of this will simply mean even greater opportunities to outperform.

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