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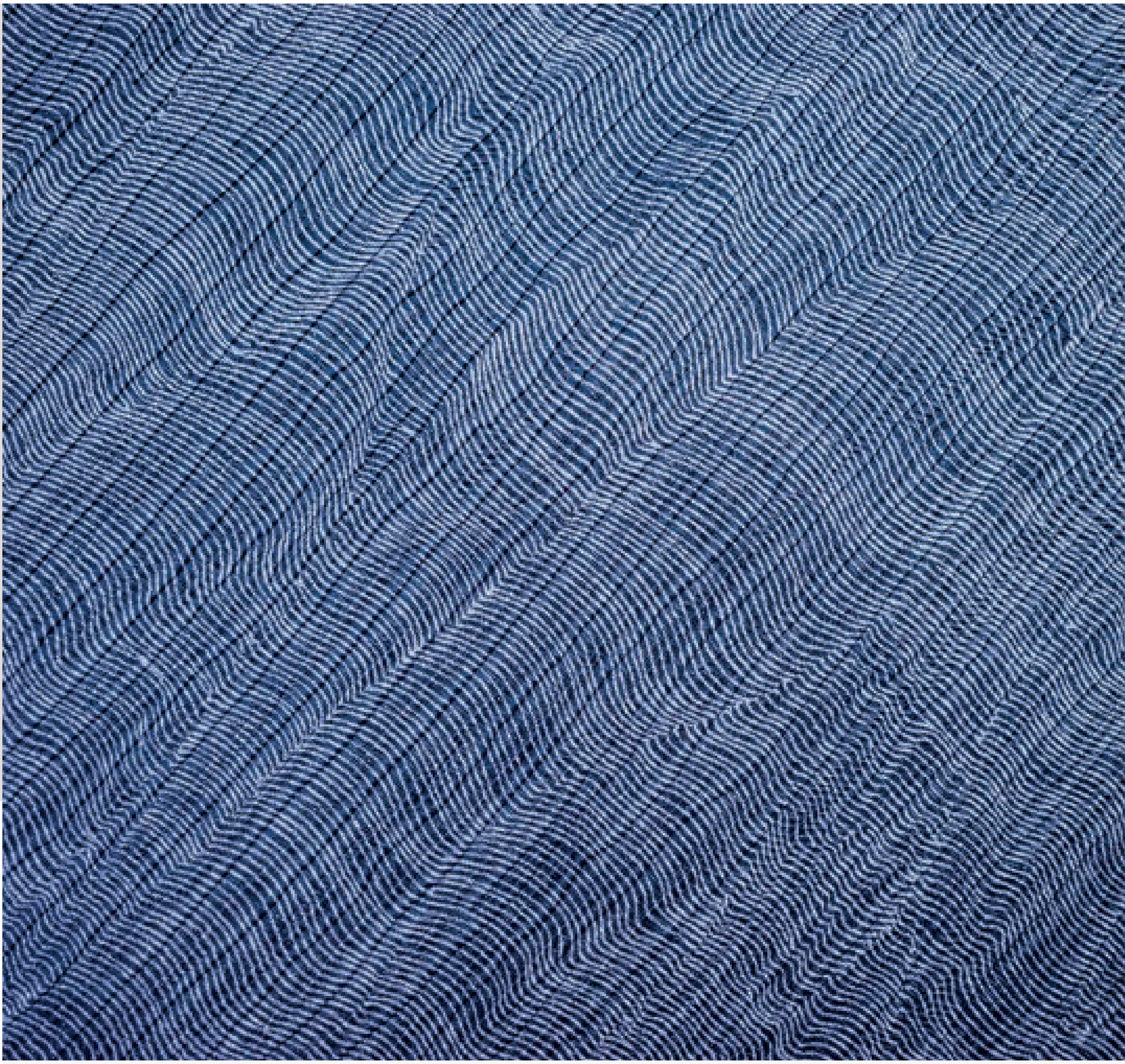
Wealth Management



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Meeting Mr. Market

Foreword

We live in a noisy world. In the modern era of information abundance, it's easy to feel overwhelmed when there's an endless stream of news tickers, talking heads and social media notifications bombarding us from every direction.

Many of the world's most influential entrepreneurs claim the secret to their success is the ability to block out these meaningless distractions and focus on what's important.

For example, Bill Gates stopped watching TV and listening to the radio for five years while he tried to get Microsoft off the ground. He didn't want anything to divert his attention away from software.

Susan Wojcicki, the former CEO of YouTube, takes a similar approach. Susan and her husband have an agreement to not check their phones between 6pm and 9pm when they're at home in the evenings. According to Wojcicki, avoiding emails and other distractions outside of work helps her stay productive during the day.

"Success is not based on the number of hours that you've worked," she says. "If you are working 24/7, you're not going to have any interesting ideas."[1]

For investors, however, tuning out market noise can be more difficult, especially when it reaches fever-pitch during times of significant volatility. Amid all that background static, how do we continue to pick up the right investment signals?

As always, we must remind our clients that markets are cyclical; every peak will have a corresponding trough, and it's impossible to know exactly when these will be. That's why we look to preserve and grow your wealth over the long term rather than try to predict how markets will react on any given day, month or even year.

In this *Quarterly Letter*, we'd like to illustrate our investment approach by revisiting one of our favourite parables about financial market noise – Benjamin Graham's 'Mr. Market'.

We hope you find this an enlightening read, and thank you for your continued support.

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[1] The Wall Street Journal: 'YouTube's Susan Wojcicki on Transforming the Video Service', 8 June 2016

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Meeting Mr. Market

Congratulations, you've done it. You've moved into your dream home. All the paperwork is finished, the boxes are unpacked, and you've introduced yourself to the new neighbours.

It's been a hectic day, but the dust is finally beginning to settle. You can now sit back, relax and enjoy a cup of tea. This is it – the place that you and your family hope to call home for many years to come.

Sadly, the tranquillity doesn't last. The shrill peal of the telephone interrupts your daydreams of new décor and furnishings. You pick up the receiver. It's a real estate broker, and he wants to buy your house. What's more, he's willing to pay well above what you paid.

His offer is tempting, but you've only just moved in! Selling up isn't part of your long-term plan, despite the allure of a quick profit. You politely decline and hang up.

The handset is barely back in its cradle before it rings again. It's the same broker, but he's not interested in buying your house anymore. Now he wants to sell you an identical property to yours at a much-reduced price.

And it doesn't end there. Every time you pick up your phone, check your inbox or open the front door, the broker is ready and waiting with another proposal to buy your home or sell you a new one.

There appears to be neither rhyme nor reason to his offers. Sometimes, he's in high spirits, and his prices are remarkably generous. Within moments, his mood can darken and the sums he suggests appear outrageously low.

Try as you might, it's almost impossible to block out his incessant chatter. Who is this bizarre broker and why won't he leave you alone?

Say hello to Mr. Market.

He's loud, capricious and unpredictable. In our example, his actions probably seem erratic and utterly absurd – a crude caricature. But are they all that different to the fluctuations we see in financial markets every day?

Benjamin Graham certainly didn't think so. It was the renowned value investor himself who first concocted the Mr. Market concept in his 1949 book *The Intelligent Investor*.

Mr. Market represents the fickleness of markets, and the impact this can have on an investor's own mindset and behaviour.

In Graham's original parable, Mr. Market isn't a real estate broker but a business partner. And he's not trying to buy or sell a house; he's offering you a daily price on a $1,000 stake you own in a company.

But both examples raise a similar question: how should prudent investors react to Mr. Market's mercurial nature? On this, we believe Benjamin Graham's advice is as true now as it was when he first wrote it more than 70 years ago:

> "The investor with a portfolio of sound stocks should expect their prices to fluctuate and should neither be concerned by sizable declines nor become excited by sizable advances."

As we all know, however, remaining unflappable in the face of extreme market volatility is easier said than done.

MR. MARKET IN ACTION

Stories of rambunctious real estate brokers are one thing, but let's look at Mr. Market's irrational behaviour in the real world.

A classic example is Inktomi Corporation, an early pioneer of search engine technology. After arriving on the market in June 1998 at $18[2], the company's shares had climbed a staggering 1,240% by March 2000, peaking at $241 per share in late March 2000.[3]

Why was Mr. Market so bullish about a company that was just a few years old?

In a word: growth. Over the three months to December 1999, Inktomi had sold $36 million worth of products and services. According to financial journalist Jason Zweig, this was more trade than it had done in all of 1998.[4]

[2] https://www.cnet.com/tech/tech-industry/inktomi-doubles-ipo-price/

[3] https://www.latimes.com/archives/la-xpm-2000-sep-05-fi-15567-story.html

[4] The Intelligent Investor, p241

If Inktomi could sustain this pace of growth, it would be earning $5 billion a month in just five years.[5] The company also had an impressive roster of big-name clients, such as Microsoft, Yahoo! and Disney.

Inktomi's future seemed promising, or at least Mr. Market thought so.

But on 30th September 2002, just two-and-a-half years later, the company's stock closed at a mere 25 cents each, with its total market value plummeting from $25 billion to $40 million.

The dot-com bubble had burst, and Mr. Market's attitude towards many internet companies, including Inktomi, had clearly soured. However, Inktomi was still generating revenues of $113 million a year in 2002 – was it really only worth 25 cents a share?

Apparently not, as Yahoo! purchased the company for $235 million in 2003, which was seven times more than Mr. Market's most downbeat pricing.[6]

Ultimately, investors who were unduly influenced by Mr. Market were stung twice. First when they bought Inktomi at a vastly inflated price, and once again when they sold at the stock's nadir, crystallising a 99% loss on their investment.

THE REAL VALUE OF INKTOMI

If we retroactively apply our bottom-up approach to the Inktomi example from earlier, we quickly see the error of Mr. Market's ways. A number of key fundamentals about the business and its management were overlooked during the dot-com boom, leading to an inflated price well above its true value.

First, Inktomi had never turned a profit; in the two years prior to 2000, it had lost more than $50 million.[7] Second, its technology was already losing ground to rivals – the company's competitive advantages appeared temporary.

In fact, it later emerged that even Inktomi's own engineers preferred using Google's search engine rather than its own.[8] Senior executives also reportedly ignored employee recommendations about how to improve the user experience.

RECOGNISING REAL VALUE

Given Mr. Market's often irrational behaviour, would investors be better off ignoring him altogether? The simple answer is no.

To understand why, we again turn to the wise words of Benjamin Graham, who said: "In the short run, the market is a voting machine, but in the long run, it is a weighing machine."

Put simply, market prices often reflect how investors *feel* about a stock on any given day. These sentiments may be justified or completely off the mark; Mr. Market is sometimes right, sometimes wrong. Only over the long term do markets accurately portray the true value – the weight – of an investment.

However, when there are large discrepancies between a company's current quoted share price and its underlying value, it can create excellent investment opportunities.

A sensible investor should therefore be willing to listen to what Mr. Market has to say, but only do business with him when it's in their best interests to do so.

At Rothschild & Co, we have a 'bottom-up' investment approach that focuses on establishing the real value of assets. Our aim is to own only high-quality companies and funds that we're confident will perform well over the long term.

We do not rely on Mr. Market to inspire or temper our confidence. Our conviction is a product of the deep research we conduct into every business that we consider adding to our portfolios.

Estimating the real value of a company takes time. We must learn more about its operating performance and extensively review its financial position, including profitability, cash flows and balance sheets. The numbers must make sense.

We also assess any sustainable competitive advantages a business may have, such as strong branding, efficient scale or uniquely low costs. This suggests that a company has staying power and will not be easily displaced by rivals.

The quality of a company's management is also a crucial concern. Longevity and experience within the leadership structure is reassuring, as is a proven track record of sensible capital allocation and succession planning.

These and many other factors regarding a business and its key people enable us to gauge a company's future growth, earnings power and forward returns.

[5] The Intelligent Investor, p241

[6] https://www.sec.gov/Archives/edgar/data/1024302/000089161802005695/f86734e10vk.htm

[7] The Intelligent Investor, p242

[8] https://diegobasch.com/a-relevant-tale-how-google-killed-inktomi

Once we are confident that a company meets our high threshold for investment, it's time to tune in to what Mr. Market is saying. That's because our third criteria for investing in our return assets, which are the main driver of growth in our portfolios, is price.

We believe in being patient and are willing to wait until a company is attractively priced before we act.

Typically, that means buying when its market price is below our estimate of its intrinsic worth or selling when we believe a holding is overvalued and our clients' money would be better invested elsewhere.

Scouring spreadsheets, calculating real value, tracking market prices – these are some of the more technical aspects of our investment approach. But it's also important not to forget the psychological side of investing.

Mr. Market's emotions often get the better of him, so to maintain a clear advantage as investors in real value, we must maintain good control over our own.

MR. MARKET NOISE

Back when Benjamin Graham first wrote *The Intelligent Investor*, many people were still keeping track of stock market prices through the morning newspapers. Tuning out Mr. Market was much easier when he beat his drum to a daily rhythm.

Today, investors have uninterrupted access to up-to-the-second stock market news, meaning they are continually bombarded with information about how their investments are performing.

As a result, Mr. Market is noisier than ever – transmitting a perpetual siren's song that can easily lead investors astray. But what makes Mr. Market so seductive? Why do even the best investors feel the temptation to act when prices surge or slump?

A leading theory is that our brains are hard-wired to react quickly to danger. It's an evolutionary advantage that prevented our ancestors from becoming a hungry predator's dinner.

Psychologists Keith Stanovich and Richard West were the first experts to claim that the human mind has two ways of processing information: System 1 and System 2.

System 1 operates instantly and automatically, with no conscious effort and little voluntary control. System 2 takes its time, focusing on tasks that take cognitive effort, like complex calculations.

Given that lions can rarely be fended off with flawless calculus, it'll come as no surprise to our readers that System 1 is what kicks into gear when facing a threat to our survival. Knee-jerk reactions are what have kept us alive for hundreds of thousands of years.

Unfortunately, System 1 struggles to tell the difference between a very tangible, immediate danger – such as a snake or tiger – and the more abstract threats posed by, say, volatility in equity markets.

Evolutionarily speaking, we're still playing catch up. So when Mr. Market shouts doom and gloom, System 1 reacts, firing warning shots to the amygdala, the brain's emotional hub, which triggers our fight-or-flight response.

Our natural reaction is to flee, selling any investments we perceive to be dangerous. This impulse is often exacerbated by our herding instinct – a social tendency that drives us to seek the safety of crowds in times of excitement or stress.

And as more and more people offload an unpopular stock (or purchase a surging one), it merely adds fuel to the fire, ramping up Mr. Market's rhetoric and ratcheting up our emotional responses.

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BREAKING THE (NEWS) CYCLE

System 1 is an unrepentant pessimist because being prepared for worst-case scenarios is what keeps us safe.

But a feature of our intrinsic survival-based scepticism is that humans have developed a 'negativity bias', whereby negative events have a greater psychological impact on us than positive ones.

Missing out on a good opportunity is merely bothersome; failing to spot a danger is potentially life-threatening.

The human tendency to pay more attention to hazards inevitably shapes the news cycle. People may privately complain that media reports are never positive, but multiple studies have shown we're actively compelled to seek out bad news.[9,10]

A Russian online newspaper once launched a "Good News Day" in 2014, and promptly saw its readership drop by 66%.[11]

It's therefore in the media's best interests to keep us regularly consuming a diet of negative news, and they duly comply. But that means our fight-or-flight systems are permanently whipped up into a state of panic when exposed to around-the-clock news, which, unsurprisingly, isn't conducive to sensible investment decision-making.

Taking a more long-term perspective can help break this feedback loop of negativity.

In a 1965 paper, Norwegian sociologist Johan Galtung argued that media outlets publish news with such rapid frequency that it's difficult for them to convey positive social trends, many of which are only newsworthy over a long time.

Take global poverty levels, for example. From 1990 to 2015, the extreme poverty rate dropped from 36% to 10%. A phenomenal achievement, but this type of incremental progress is tough to report on a minute-by-minute, hour-by-hour basis.

"Poverty rates dropped 0.019% this week" is hardly an attention-grabbing headline.

To counter this problem, economist Max Rosen proposed the idea of a 50-year newspaper, in which only the most important stories of the last half-century would be included. Rosen believed that this would cut through the arbitrary noise of daily and weekly reporting, instead focusing on the bigger picture.

Imagine a 50-year newspaper for wealth management. Let's call it The Investor's Semicentennial. What story would grace its front page?

Perhaps it would be the revelation that if you had invested $10,000 in the S&P 500 in 1972 – and reinvested all dividends – it would be worth nearly $1.5 million today.[12] That represents inflation-adjusted returns of approximately 6% per year.

By comparison, the 2008 Global Financial Crisis, the bursting of the dot-com bubble and other major downturns would likely be relegated to the inner pages. They were notable events, and yet only temporary disruptions in a long-term upward trend for markets. Black Monday might not even warrant a brief filler article on page 10.

Similarly, when we invest at Rothschild & Co, our view is always over the long term.

We seek to own companies and funds for at least a decade, preferably longer. This approach enables us to put Mr. Market's latest outbursts into perspective. Quarterly performance fluctuations that might seem serious today are unlikely to be anything more than a footnote in a company's ten-year horizon.

RISK AND MR. MARKET

No investors are immune to their emotions or psychological biases, us included.

That's why we have robust processes in place to ensure our investment decision-making is based on evidence and logic, rather than gut feelings. System 2 thinking, rather than System 1.

Our approach gives a more nuanced and holistic view of risk. As such, we can better differentiate between what financial theorist William J. Bernstein calls 'deep' and 'shallow' risk.

Bernstein argued that the intensity of an investment loss can be calculated by its magnitude and duration. How large was the loss and how long did it last? The answers to these questions can define whether a risk is deep or shallow.

A shallow risk is temporary, meaning a portfolio or asset may experience losses, but they are often manageable and recover reasonably quickly – usually in a few weeks or months, although, occasionally, after a year or two. A lot of Mr. Market's monologues are influenced by shallow risk.

[9] https://www.cpsa-acsp.ca/papers-2013/Trussler-Soroka.pdf

[10] https://journals.sagepub.com/doi/abs/10.1111/1467-9280.t01-1-01412

[11] https://www.bbc.co.uk/news/blogs-news-from-elsewhere-30318261

[12] https://www.officialdata.org/us/stocks/s-p-500/1972?amount=10000&endYear=2022

Deep risks are more serious. These are high-magnitude, long-duration losses, which may be irrecoverable. Investors face deep risk at an individual investment level when an asset's price falls and never recovers.

This may be because the company collapsed due to corporate corruption, fraud or competitive disruption. More commonly though, investors inflict deep risk on themselves when they over-react to market commentary.

For example, if a holding is sold in a System 1 panic when its price bottoms out, what was potentially only a temporary loss becomes irreversibly permanent. The investor has now locked themself out of any rebound in the asset's performance.

Our aim is to preserve and grow our clients' wealth over the long term, so large losses are anathema to our investment approach. They must be avoided at all costs.

Meanwhile, shallow risks can feel uncomfortable, granted, but if we believe the underlying fundamentals of an investment are still sound, we can remain confident its price will bounce back once Mr. Market's latest bout of melancholy lifts.

In fact, rather than see a market downturn as a portent of doom, it's often an ideal time to increase our positions in businesses we like at a cheaper price.

Ashtead is a good example. We first invested in the industrial equipment rental company in December 2019 at just shy of £23 a share.

Soon after, the COVID-19 pandemic struck. By March 2020, multiple countries were enforcing lockdowns to prevent the spread of coronavirus and safeguard people's health and wellbeing.

It was a troubling time, and Mr. Market was in a despairing mood. "Sell, sell, sell" was his message, and global stock markets experienced a number of severe daily drops in March.

Ashtead was one of the many companies that saw a dramatic slump in its share price, tumbling from heights of nearly £28 in February to just above £10 prior to the first UK lockdown in March – a 64% drop.

But was Mr. Market's pessimism warranted?

To find out, we conducted a stress test on Ashtead that explored a number of different scenarios. Our conclusion was that the business remained very resilient to even a prolonged lockdown and could survive three to four quarters with an assumed 80% fall in its revenues.

With a high level of conviction in Ashtead's ability to weather the storm, we felt it was actually an excellent time to shore up our investment and purchased more of the company at a compelling price in March.

As the crisis continued to unfold, further discussions with Ashtead and its competitors uncovered some important details that Mr. Market seemed to be overlooking.

Not only was Ashtead considered an 'essential' business – allowing it to stay open during lockdown – it was directly assisting governments by supplying generators, air scrubbers and other crucial equipment used in hospitals and drive-through testing areas. For many outlets, both in the UK and the US, it was almost business as usual.

The upshot was that Ashtead's performance in 2020 was better than Mr. Market or even we anticipated, with revenues up 9% and pre-tax profit down a modest 4%. By July 2021, the company's share price had climbed to more than £53.

FINAL THOUGHTS

By focusing on real value, derived from our independent research and bottom-up investment approach, we seek to generate reliable above-inflation returns over the long term, while avoiding any large losses along the way.

Short-term volatility in share prices is to be expected. Mr. Market is an emotional fellow, after all.

But as wealth managers, our goal is to ensure Mr. Market's miscalculations benefit our clients and their portfolios, rather than allow ourselves to get swept up in his frequent flights of fancy.

As Benjamin Graham so aptly said:

> "The investor who permits himself to be stampeded or unduly worried by unjustified market declines in his holdings is perversely transforming his basic advantage into a basic disadvantage."

Notes

At Rothschild & Co Wealth Management we offer an objective long-term perspective on investing, structuring and safeguarding assets, to preserve and grow our clients' wealth.

We provide a comprehensive range of services to some of the world's wealthiest and most successful families, entrepreneurs, foundations and charities.

In an environment where short-term thinking often dominates, our long-term perspective sets us apart. We believe preservation first is the right approach to managing wealth.

Important information