When You Can't Wait For Tomorrow

We're mulling this morning over what it is that makes stock prices, and stock-picking, work. The first-order argument is that fundamentals basically happen, and eventually the market will have to confront cash flows (or a lack thereof) when determining the future value of a company. But the big issue here is that no one knows when "eventually" is.


You know....let's just.....fast-forward things a bit.

In the case of market levels, generally, "eventually" can be so far away that Keynes' observation becomes relevant, where the "markets can remain irrational a lot longer than you and I can remain solvent." This maxim holds for individual securities as well, as anyone short internet stocks in 1999 can attest. People are having the same debate today, in fact, about some individual securities in the tech space as well as some recent/forthcoming IPOs. And while the valuation debate rages over these sexy, glamorous "winners" (and everyone knows they are "winners", even the shorts) there is a potentially more interesting area for stock-pickers to spend their time. You know, the place where there are regular companies that do regular things and aren't dealing with winner-take all dynamics. For some of these firms, there is tremendous disagreement over their fundamental prospects, what one should pay for them, and how long it might take for the market to wake up to the story, if ever.

It is in these battleground stocks where we like to spend as much of our time as possible. Is company XYZ worth €38, or is it worth €83? Is ABC worth 802p, or is it worth 208p? And, perhaps most importantly, how long is it going to take before Mr. Market sees the truth (whatever that truth may be), and eventually proves that we are right or wrong?

Our default strategy as we "wait for eventually" is to continually test and probe our investment theses, and if we can maintain conviction, to let fundamental developments happen. Then we watch the market wake up to whatever the reality may be, and witness the stock price arrive at "eventually" during that awakening process. Sometimes Mr. Market wakes up very quickly, sometimes he sleeps, and sleeps, and sleeps.

And in this game, some "watchers" are less patient than others, and actually have a strategy where they try to bring "eventually" a little bit closer, helping Mr. Market along by getting the word out with a wake-up call or two. There is nothing sinister here (typically), it is just a matter of hoping to change the narrative of how Mr. Market views an investment. It might start with telling your buddy at another shop your favorite idea, and her telling you hers. One might advance things further by sharing it at an idea dinner with *several* investors. In fact, there are many hedge funds where the business models principally (or at least somewhat) ride each other's coattails, share information, and "get on board" the same ideas; sometimes trying to get ahead of the quarter[1]; sometimes for longer-term, fundamental reasons.

The next step in getting the word out is to share ideas in investor letters. Some firms have just a few dozen folks on their distribution list, while others have hundreds of institutional, FoF, and family office investors. Sharing information about a favorite idea in these letters is not merely a means to show how smart, thorough, differentiated or unconventional a portfolio manager might be. This transparency is a tool.

[1]In one of these examples while still a student at Oxford University, Anthony Clarke actually developed a system anticipating this "network" process. His bosses originally called it "TIPS" and sell-side analysts would input their recommendations (aka "tips") into the system, and "TIPS" would quantitatively measure which banks, specific analysts or salestraders had the most impact, and then shift capital toward their forthcoming "tip" the next time around. This was a brilliant means of not only getting into a closed network of information-sharing, but actually getting ahead of others in the network. Interestingly, for this type of system to be successful, it doesn't require the analyst or salestrader being right about the fundamentals, or even having a reasonable, educated thesis; what simply matters here is if other people are going to buy into it or not. Obviously, these things are probably related over the long run, but in the short run, they often aren't. The system was obviously ripe for abuse, and surely Anthony's firm will have established protocols to ensure fair play; but the overall, general motivation made perfect sense, and was (and presumably still is) extremely profitable. Needless to say, Anthony was quickly hired full-time by Paul Marshall and Ian Wace, and became a partner of their firm in short order, all before turning 25 years old.

Granted, part of the motivation is to highlight how the process works, and the result of that process; but in nearly all cases where a portfolio manager is sharing an investment idea in a monthly, quarterly, or annual letter, there is at least some degree of attempting to shape the narrative. We've done it ourselves.

It steps up from there to the 50-100 slide PowerPoint presentation to a roomful of investors hanging on your every word. As an example, over 3,000 people now attend the Ira Sohn conference in New York (so it is a reasonably-sized room) and the ideas presented are immediately broadcast and debated throughout the investment community. The Sohn conference has gone global now (we've done one of these too), and there are of course many others with a similar format. At these conferences and in other forums there have been many famous presentations, and many infamous presentations. Some of have been right, and some have been dead wrong – but Mr. Market didn't know if they were right or wrong immediately, and in some cases for quite some time.

David Einhorn who has been right about a great many things (most famously Lehman Brothers), adamantly, and we should say quite thoroughly, pitched Green Mountain as a short back in late 2011. He gracefully admitted defeat in 2014, but in the interim, everyone and their brother followed him into it, at first cutting GMCR in half, and then cutting it nearly in half again.

When he pitched the short at the Value Investing Congress in October of that year, GMCR was trading at $70 per share. It fell to $40 on the day of his presentation, recovered over the next few months, but thereafter plummeted. Admittedly, some of the short-term datapoints were disappointing, most notably their May 2012 profit warning, but the market had been primed to pounce (the shorts controlled the narrative), and the stock went as low as $18 per share by early August. The shares didn't get back up to $70 until May of 2013, a full 18 months after Greenlight's original short pitch, and then was taken out at ~$90 a year later. The moral of the story – at least on the GMCR misdirection - is that the tail can wag the dog for an inconveniently long time.[2] But this can be an opportunity as much as a risk.

The next step after the "PowerPoint" stage is to go full-blown activist. Bill Ackman unveiled his Herbalife short pitch to the world, and subsequently went to work on the legal front, hiring lobbyists, financing documentaries, and battling with Carl Icahn on live TV. Other activists will be more discreet and publish "open letters" to management. If these letters were strictly just simple recommendations to the management team of ways to improve their businesses, they wouldn't have been "open". Open letters are an attempt to capture and control the narrative, and are broadcast to anyone that will listen. The hope is to bring "eventually" closer to today, and get other investors on board with your view.

Finally, and this has nothing to do with outright activism, share registers and disclosure requirements also reveal to the world the long or short positions of large investors in specific names. This of course has both positive and negative implications for those disclosing their holdings, but the bottom line is that this is another means of getting the word out. Some investors, particularly at the FoF level, will even have strategies where they mimic disclosed holdings of the investors they like – and can do so without paying performance fees.

So basically, we're all competing inside this feedback loop, where fundamentals may one day be known, and will matter – but in the meantime the game is as much about being ahead of the other guy as it is about being smarter about what the business might look like in a time horizon beyond the lock-up of our AUM. If your peer gets to buy the stock cheaper than you do, she wins, and you lose.

So, with this setup, let's envision a world where there is a clearinghouse for ideas. A world where everyone out there is pitching his or her stocks at a virtual Ira Sohn conference. What would happen? How would things change? Would they change? Would the quants pay to get direct access to the data, so that they could front-run the idea (or, more diplomatically, become a part of the network)? Would investors start buying or shorting the ideas with the most clicks, or time spent? Would company management teams take notice? Would "eventually" get closer to today?

Or would things not change much at all?

[2] *In fact, we'll bet that the "GMCR is a fraud" narrative lasted much longer for Mr. Market than it did for David Einhorn. His impact was so strong, and the market was so desperate for guidance, this the thesis took on a life of its own; and while we don't know for sure, it wouldn't be silly to assume that Greenlight may have been covering at least a portion of their position near the bottom.*

Image Source: Click (2006), Columbia Pictures, Revolution Studios, Happy Madison Productions