The Times that Try Stock-Pickers' Souls

On first principles, there is one way to generate excess stock market returns over the long term, and it isn't to "own winners at any price."

Sure, in *hindsight* it was, but that is very convenient. It's very convenient to now ignore the stocks we thought were winners, but weren't. It's also very convenient to draw parallels between past winners and newer companies as if it is a foregone conclusion they too will win in similar fashion. Not everyone can be Amazon, in fact, no one else may *ever* be Amazon[1].

Nor do excess returns come from "owning good companies at any price" or "owning high-quality[2] companies at any price." The "one way" to outperform is to buy a concentrated portfolio of securities that Mr. Market doesn't own; names which are shunned because Mr. Market has become overly pessimistic about the fundamental prospects for businesses that are better than he believes or realizes.

That's it. That's the formula.

This often isn't sexy, it often isn't fashionable, and it often isn't fun. March of 2020 wasn't very fun at all. However, a successful investor outperforming Mr. Market over the long term owns companies that, by definition, Mr. Market believes are pretty stupid to own.

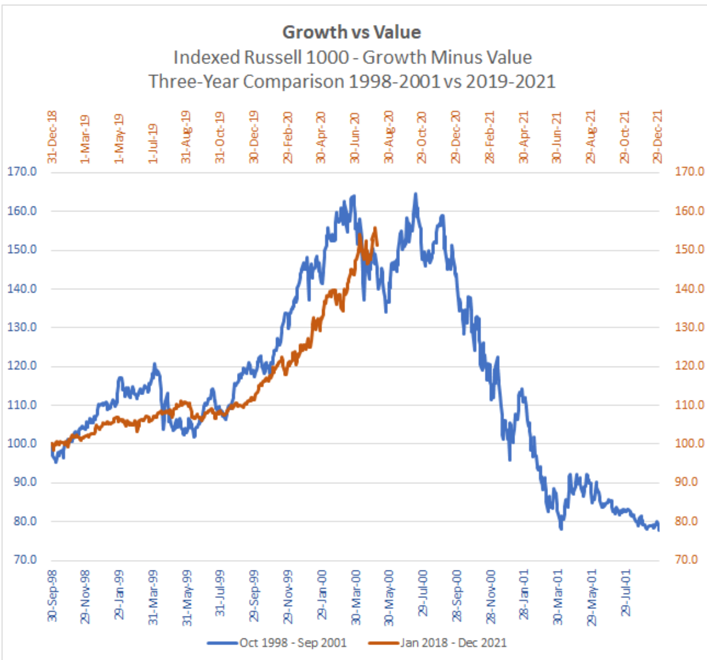
Instead, Mr. Market often thinks growthy, glamorous, names are much smarter to own. They definitely are smarter looking. And it is surely more entertaining to own these stocks. It's also easier to sleep at night[3]. They are obviously more dynamic companies and, in many cases, they indeed are *better* companies.

And there are periods where these growthy, good and glamorous names do tremendously, well. During these episodes, it downright sucks to be a fundamentally-driven value investor.

Equity markets had one of those periods in 1998-1999, and – in our view – they may be having another one of them now.

Paraphrasing Thomas Paine, these are the times that try stock-pickers' souls.

The stock market, at least at the moment, seems mostly sensitive to whether or not a company is classified as a "good" or "bad" business.



[1] *And even in Amazon's case, the stock price performance has mostly been about producing fundamentals that surprised not only the bears, but even the bulls. With perfect 10-year foresight, on the actual numbers Amazon printed, they too were a value stock for a very long time.* *https://www.albertbridgecapital.com/post/secular-winners-and-value-investing*

[2] *https://www.albertbridgecapital.com/post/peak-quality*

[3] *https://www.albertbridgecapital.com/post/wed-rather-not-sleep*

And “good” means your stock has *already* appreciated, is *already* expensive, and is showing even the slightest degree of business momentum.

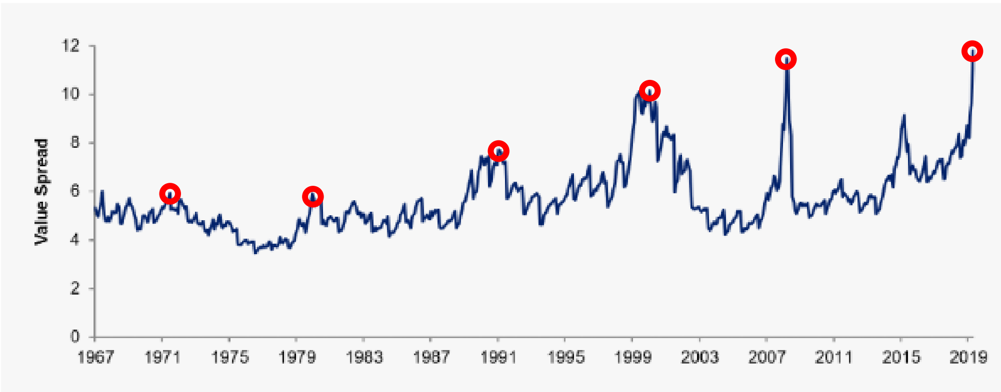
And no price is high enough for “good”. Because good is good, so why *wouldn’t* you own it?

“Bad” is the opposite. Bad is an *already*-inexpensive stock that has *already* sold off, and one that has *already* exhibited fundamental weakness, even if it’s likely a short-term phenomenon.

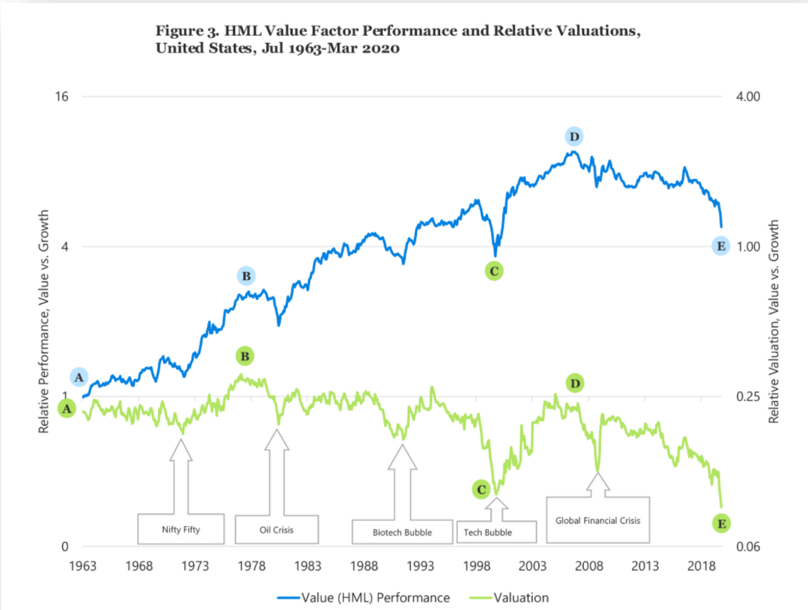
And no price is low enough for “bad”. Because bad is bad, so why *would* you own it?

As maddening as this behavior is, it is typical of investor psychology at peaks and troughs; and consequently, the “price” of growth is higher than it has ever been.

The Price of Growth
Price-to-Book Spread, Source AQR, CRSP, Through March 2020



That one above is from AQR, and this one below from their quant-competitor Research Affiliates.



In other words, in terms of entry points, at least from a historical perspective, this is about as good as it gets for the “value” of value – even better than at the peak of the tech bubble.

People shouted about the “new era” in 1972 and again in 1999; and they are shouting about a new era in 2020.

There is no new era. Stocks are still worth the present value of their future cash flows.

While narratives can dominate in the short term, and while the short term is sometimes longer than we like, the fundamentals eventually matter. They have to. Although it may feel like it to some shareholders (Tesla shareholders, perhaps), we just aren't buying pieces of art here. We are buying fractions of the equity value of large, liquid, listed, enterprises. The fundamentals "have to matter" because these fractions of equity, these shares, are worth the present value of all future cash flows to that fraction of ownership.

This may be a novel concept to Robinhood traders, I know, but that's where we always end up. Sure, there are greater fools in any short run, and even smart folks may join in, hoping to sell to someone else at a higher price (and some are so smart and have such high conviction that they may not even realize that is what they are doing). Similarly, in other cases, these smart folks may be shorting, hoping to cover as greater-panicking fools sell after the price has fallen more.

That's basically the paradigm today for growth and value today.

Ben Graham is famously (although incorrectly) attributed for writing that the market was a voting machine in the short term, but a weighing machine in the long term. However apocryphal, as we wrote in Voting Machines and Weighing Machines[4] "we 100% agree with Graham on this, but admit there is a wonderful debate to be had about when 'eventually' arrives."

We have no idea when "eventually" is going to arrive. Whether or not we are three days or three years away from this growth bubble popping, we don't know. But we are tremendously confident that it isn't "different this time."

[4] https://www.albertbridgecapital.com/post/voting-machines-and-weighing-machines