

## TIME IN THE MARKETS



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## LESSONS FROM THE FIRST 30 YEARS

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## INTRODUCTION

When I began my career in 1978 I made a plan to save and invest. My goal was to achieve a capital base of R100 000 and I worked out I could do it in 10 years. At the time I was earning a gross salary of R100 a month. You can imagine how little I could spare for investments.

In 1981, I co-founded Foord Asset Management with Liston Meintjes. I recall that we targeted assets under management of R5 million for the partners to be comfortable. To break even, we required even fewer assets under management.

I share these anecdotes to show how silly these numbers look in the cost of money today. Therein lies the most important lesson of investing and one I was fortunate to learn early on: the biggest destroyer of capital is inflation!

The best way to protect capital from inflation is to invest capital in assets that earn income. More importantly, invest in assets that produce an income that can rise with inflation. Leases with adequate inflation escalation and companies with pricing power can work in your favour. However, fixed rate investments are unlikely to do the job and will destroy wealth if the interest rate is at or below the expected inflation rate.

It has been said by more than one successful investor that investing is simple, but not easy. I agree that it is simple and the facts of limited success prove that it is not easy. But this should not be so. This is counterintuitive: if it is simple, it should be easy.

In this book, celebrating Foord's thirtieth anniversary, we hope to demonstrate where people fail in what should be easy. We can lay out the guidelines to help you become a better investor, but you need to do the hard work yourself. Hard work, discipline and common sense will turn the uncertainty of the future into well-earned wealth.

On behalf of all of us at Foord, happy reading and good investing.

Dave Foord

## KEY LESSONS

### ONE

The first lesson that all prospective investors should learn is that there is no simple formula to make you rich. The markets certainly do not exist to make you rich. On the contrary, there is a friction, a cost or vigorish<sup>1</sup> against you. The capital markets are there to raise capital and match buyers with sellers. They are also good at transferring wealth. The cost of the infrastructure supporting this system plus your transaction costs is much higher than you think. The game is tilted against you. Just being aware of this and reducing your costs will help improve your net returns and make you a better investor.

### TWO

Study the great investors; John Templeton, Philip Fisher, Bernard Baruch, Bill Gross, John M. Keynes and of course Warren Buffett and Charlie Munger are investors we respect and admire. Understand their methodologies, their developments, early accomplishments and how they progressed to become great. Read as much about them as you can. You'll see a common thread of energy, persistence, hard work and independent thought. For the most part, individuals produce better results than teams. Committees tend to dilute investment ability because the right decision is unlikely to meet with consensus approval. In this regard, less is definitely greater than more.



<sup>1</sup> The amount that bookmakers charge for their services is known as the vigorish. It is the amount they would earn irrespective of the outcome of their wagers. The word is Yiddish slang and has its origins in the Russian term for winnings, vyigrish.

### THREE

Know thyself. Set investment objectives that are realistic, within your budget and within your intellectual and emotional range. Know and understand the difference between investing and speculating. The difference is enormous. Investment is easy to do and to succeed in; speculation is even easier to do but extremely difficult to succeed in. Speculation is a short holding period and an uncertain result. An investment is a long holding period and a more certain result.

“I GROW OLD  
LEARNING  
SOMETHING NEW  
EVERY DAY.”

Solon 630-560BC

This covers the money market as an investment because of the certainty of a positive result.

What is a long holding period?  
Different things for different folks, but it should be at least 18 months and preferably longer. You need to be in it to win it. Studies show that 80% of equity returns occur on

2% of the days. Jumping in and out means you will probably miss the best up days, particularly as they often occur at the point of maximum pessimism. So focus on investment. We suggest you leave speculation to those with the temperament and the capital to withstand adverse results.

### FOUR

Always remember that as investors we are dealing with the future. It is the future return that we seek. The past does not easily extrapolate into the future, which is intrinsically uncertain. We are therefore seeking certainty where very little certainty exists. To be successful you will need to manage this uncertainty.

### FIVE

You should be aware that cycles do exist – they are a natural part of life, like the seasons, like the tides and like breathing in and out. Economic cycles also exist and it is important that you recognise this as fact. We find it surprising how many people still deny this. Standing in the way of market cycles, you will not only suffer the ignominy of a King Canute but you will do yourself serious financial harm. Market cycles are driven by interest rate cycles (valuation impact) and the business cycle (earnings impact). These two cycles are interconnected, but not exclusively so.



## MARKETS

Securities exchanges the world over provide access to listed securities for long-term investors and speculators alike. As you will know, markets rise and fall. In our experience, market levels are determined by four main elements:

1. The money available for investment is driven by excess profits and liquidity amongst other factors. Note that this may act as either a positive or a negative force.
2. Interest rates are key because all investments compete with each other on yield comparisons.
3. Confidence affects the investment time horizon and also brings in the greed-fear trade-off, so often visible in the markets. Note that confidence may behave as either a positive or a negative force and has many elements.
4. Return on the asset: in the case of equities, return refers to dividends; on property it is rent; and on bonds it is the coupon. This is the actual yield and is crucial for multiple reasons, including comparison.

These four factors are by far the most relevant determinants of market levels, jointly accounting for nearly all the attribution. Unfortunately not all of this is quantifiable, and where quantity can be measured the importance of quality is often overlooked.

## PRICE VS VALUE

Price is offered to you by the market every day. It is often said that price is what you pay, value is what you get. Price may be volatile. Value on the other hand is in the eye of the beholder and is far more stable. The markets afford one the opportunity to compare value to price on a frequent basis.

It is our view that the markets are not efficient and therefore opportunities exist to buy great value at great prices from time to time. You may not get such opportunities every year, however. This brings in the need for patience and vigilance when investing for the long term.

## JUDGEMENT

There is some debate about whether investing is an art or a science. We certainly have plenty of data to crunch and manipulate in many ways to get to a scientific answer. Yet few finite answers have come to the fore from the financial scientists. Those answers that have do not stand the test of time because they are not relevant enough to work at all times in all markets. There are opinions everywhere

– everybody has at least one, but they are seldom right for long.

Without doubt, investing successfully takes good judgement. The better your judgement, the more successful you will be as an investor. But good judgement, surprisingly, is in short

supply. This increases market inefficiency and volatility. Therefore it also increases opportunities for those with longer time horizons and better judgement.

“THE TROUBLE WITH COMMON SENSE IS IT ISN'T SO COMMON.”

## MARKET EFFICIENCY

A question that has stymied economists and finance experts for decades is whether investment markets are efficient<sup>1</sup>. We believe that markets are efficient – efficient only at transferring wealth: squeezing you out of a bull market, sucking you into a bear market.

However, we do not believe they are efficient at pricing securities. For evidence of this, look how often the forward interest rate curve is wrong. Also, prices on some multi-billion dollar companies change by more than 5% in a day with little or no material news flow. That is greater than the annual return on US dollar cash in a single day!

“THE CYNIC KNOWS THE PRICE OF EVERYTHING AND THE VALUE OF NOTHING.”

Oscar Wilde

It's important to understand that individual market participants have different time horizons. Probably because of this, they have different valuations. Prices are set by the last seller and buyer. Often their motivations have nothing to do with valuation. In fact, the majority of trade is for speculative purposes and not for investment. Therefore the majority of trade does not take any account of the long-term value of the asset. Why then should the price set by the marginal buyer and seller be correct for all?

<sup>1</sup> The efficient-market hypothesis (EMH) states that financial markets are “informationally efficient.” EMH asserts that given the information available to the market at the time of the trade, market participants cannot consistently achieve returns in excess of average market returns on a risk-adjusted basis.



## COMPOUNDING

Compound interest certainly competes with the wheel as one of the most important tools of man. You need to harness this force to become a successful investor.

We've all read about the Lenape Indians who sold Manhattan for a bunch of beads to the Dutch in 1626. But who got the better trade? It can be argued the Lenape Indians did (and not because the Indians were quasi-nomadic and the concept of private land ownership was unknown) despite Manhattan now being amongst the most expensive real estate in the world. The result comes from the return the Indians could have achieved from the then value of the beads, estimated to have been worth about 60 guilders at the date of trade. At a 7% per annum rate of return the current value would be about 5.4 trillion euros<sup>1</sup>. The Indians' descendants would probably be able to buy Manhattan back with that and still have much capital left over<sup>2</sup>!

Makes you think, doesn't it? At least it should, but you can blow that apart by challenging the valuation assumptions at both ends of the time horizon and by introducing inflation. So here follows a better one that holds up in the face of these challenges.

Take the weight of gold entombed with Tutankhamun in 1323 BC and compound it to its current weight at 2% per annum. The result is more gold than there is in the world today, by a factor exceeding a trillion trillion<sup>3</sup>. Bear in mind that King Tut was a juvenile and minor pharaoh, that he did not have much wealth, that the tomb held much more than gold and the value of the workmanship is not brought to account. What's going on here? Compound interest does not work over long periods? No. Man has not increased his wealth in 3000 years? Perhaps. Is 2% a high real rate of return over long periods? Yes!

<sup>1</sup> The euro replaced the Dutch guilder on 1 January 1999 with one euro being equivalent to 2.20371 guilders at that date.

<sup>2</sup> The total taxable value of Manhattan real estate was estimated to have been \$257 billion in 2008 according to a New York City Department of Finance publication dated 15 January 2007.

<sup>3</sup> King Tut's body was placed within three mummiform coffins. The innermost coffin is composed of 110.4 kg of pure gold. His famous gold burial mask weighs 11 kg. If one ignores all other gold artifacts and gilding, compounding this 121.4 kg of gold at 2% per annum for 3,333 years results in a number almost too large to print – 5,602 trillion trillion tonnes of gold! By contrast, it has been estimated that all the gold mined in the world by the end of 2009 totalled 165,000 tonnes with unmined reserves approximating 31,000 tonnes.



Man is a destructive as well as a creative force. Societies crumble and wealth is destroyed. If you are going to compound, it is important to compound positive numbers. Compounding negative numbers is as severely destructive an exercise as compounding positive numbers is beneficial.

This brings us to the importance of time and risk. We will cover these concepts later, but it is very important to note that the certainty of positive returns is essential. You should be prepared to take lower rates of return for this certainty, especially where you have time on your side.



“COMPOUND  
INTEREST  
IS THE MOST  
POWERFUL  
FORCE IN THE  
UNIVERSE.”

Albert Einstein (allegedly)

# VALUATION

In the next three sections we guide you through the valuation principles of the three main asset classes: bonds and interest bearing investments, property investments and share investments. The principles of valuation are similar but the valuation complexity increases with the degree of uncertainty inherent in the valuation of the different securities.

We start with investments in bonds because there are very few unknowns and the valuation exercise is therefore simpler. Determining an accurate expected return on available bond investments provides all investors with a base case scenario with which to compare the investment returns on other asset classes and investments.

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## VALUATION PRINCIPLES OF THE **THREE MAIN ASSET CLASSES**

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- Bonds and interest bearing investments

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- Property investments

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- Equity investments





## BONDS

Before we proceed it's important to understand that a bond is a debt security. The bond issuer (borrower) owes the bond holders (investors or lenders) a debt. Depending on the terms of the bond, the issuer is obliged to pay interest (the coupon) to the investors periodically and to repay the principal at a future date, termed maturity. A bond is therefore a formal contract to repay borrowed money at a future date with interest paid at fixed intervals.

Investing in bonds is both simple and easy. All investors should understand the parameters within which bond valuations exist. The maths is made complex with the introduction of duration, convexity, the steepness of the curve and other factors but these are minor and only useful for fine-tuning.

With bonds, you know the price, the yield to maturity, the coupon, the redemption amount and the maturity date. The big uncertainty is whether the issuer (borrower) will pay you on time, in whole or in part. This is known as the default risk.

Bonds therefore have very few uncertain components, especially when compared to other asset classes. At Foord, we use bonds as a framework in which to measure other investments. This may not work for everybody, but we find it useful to have a base and a possibility framework.

In our view, the most important variable in valuing any asset is the risk-free interest rate over the term of the investment. Those who can anticipate the change to the cost of money will have the opportunity to be great investors.

The use of government bonds to determine a risk-free rate is appropriate. The rate is certain and you have a range of maturities to help match the duration of the investment you are comparing or measuring. Governments typically should not default as they control the fiscal policies of their currencies and can typically print money on demand. Having said that, bear in mind that there is no absolute concept of being "risk free." Governments do go bust and fail to pay. Inflation is an important risk and may be material in any period over five years<sup>1</sup>.

Let's expand on bonds a bit more. The decision to invest comes down to whether or not the "certain" return meets your investment requirements. You simply need to match your required rate of return and the term you require with what's available in the market. If you do not find a match, then stay in the money market until you do.

<sup>1</sup> Note that there are some further problems with estimating the risk-free rate from government bonds. The government should have no material debt in foreign currency (this introduces the risk it may go insolvent and fail to pay). Also, the comparison is only valid for the currency of the government (using the government A-rated risk-free rate to measure investments in another country or currency is likely to provide weak information).

What should your required rate of return be? The answer is different things for different people who have different requirements and objectives. For the so-called risk-free government bonds, we generally look for inflation plus 2% (long-term real return) plus another 2% (uncertainty premium). The uncertainty premium is to cover the inflation risk and the risk of inaccuracy of the reinvestment guesstimate. The uncertainty premium should not cover default risk, although it can get mixed up in that.

So we have kept it as simple as possible, but we still have uncertainty. What will future inflation average? Accept that you do not know. The future is, by definition, uncertain and there are other issues such as accurate measurement of your particular inflation rate, amongst others.

Successful investors must learn to deal with uncertainty. There are different ways of coping with uncertainty, but we find using probability analysis useful. The real issue of course is that you need to apply judgement to guess what inflation

will be for the period until the bond matures. Those of you with better judgement will be better investors.

The risk of default is seldom measured correctly by the market. In our experience, the market tends to understate default risk in corporate bonds. For a binary event<sup>1</sup> this is understandable. Bonds pricing in a 1% default premium only cover you

for losing your capital every 100 years, a 2% premium every 50 years, and so on. Bonds offering more than a 5% default premium probably have a greater than 50% chance of not paying back your principal.

“THERE ARE DIFFERENT WAYS OF COPING WITH **UNCERTAINTY**, BUT WE FIND USING PROBABILITY ANALYSIS USEFUL.”

<sup>1</sup> A binary event has only two outcomes. In the case of a bond, these events are payment in full and partial or full default.


By buying a bond and holding it to maturity you only have to deal with the current interest rate curve. Yes, if your holding period exceeds three years you may need to take the reinvestment rate on the coupon into account for yield to maturity calculations. But what if interest rates change? Well they do and they will. Not only that, but there will be different changes at different maturities. The yield curve<sup>1</sup> will change shape. How do we cope with that? Again, we use our judgement to guess the future shape of the yield curve. Using probabilities helps, but one should not rely on them exclusively. You do not have to be accurate – the approximate amount and direction may be good enough.

This information is very important: you can compare the return on bonds if you were to sell them at your future estimated price. How does that compare to a bond maturity on that future date? Note that your guesstimate of future interest rates may be different to that of the market. If it is not then you are probably not thinking, but getting your information from the market. Inefficient markets misprice assets. Therefore getting your information directly from an inefficient market will lead to an inaccurate valuation.

We have mentioned market efficiency already but to repeat – we do not believe the markets are that efficient. Those who do should compare the forward yield curves on interest rate futures with the actual rates achieved. Interest rates are far more significant to the markets than a share price and you have more players with more transparent information. If the markets can't get future interest rates right then they have less chance of accurately pricing a single share.

You can use this bond framework for valuing all investment opportunities. Each of the three main asset classes (bonds and interest bearing investments such as cash, shares and property) has different levels of uncertainty in the main variables of capitalisation rate, income and future value. Therefore each asset class has a different risk premium.

<sup>1</sup> A yield curve is the graphical representation of the relationship between interest rates and the time to maturity of a bond security. For a given issuer in a given currency, one can plot the interest rates applicable to different maturities on the graph's vertical axis and the time to maturity on the horizontal axis. In normal market conditions the graph slopes up with higher interest rates offered for bonds of longer maturities.



## PROPERTY

The elements of property valuation include the price or initial cost, the rental income stream and the future value of the property. With property investments, it is only the initial cost that is certain. Rental income received over the holding period is less certain than with bond investments, but easier to forecast and more certain than dividends on shares.

The future value of the property is also less certain than with bonds (which also have a specific date of maturity), but the range is narrower (therefore easier to forecast) than share investments.

So there are more unknowns with property investments than with bonds. In order to cope with these unknowns we have found it useful to use a probability matrix. The range of future income streams and the future values forms the basis of the matrix with each level being afforded a different probability.

You may have noticed that a recurring theme in investing is the use of judgement. Again, use judgement to estimate the probabilities of each level of the matrix. Weigh each variable by its probability, but always be aware they are only estimates.

Select the appropriate time horizon (use several preferably), guesstimate the unknowns, apply an appropriate discount rate (use several as well) and calculate the net present value of the property investment. Compare this to the price offered in the market for this investment.

Note that bringing forecasts and valuations down to one number creates the problem of "anchoring". The fixation with a single valuation or forecast is a problem because it denies the investor flexibility needed to deal with the future.

Test your valuation result using alternative valuation approaches. For example, calculate the replacement cost of a property investment. The replacement cost has implications for the net asset value, as well as future supply of properties, which will affect the price.

A simpler way to deal with property is to use a capitalisation rate<sup>1</sup>, known as a “cap rate”. Dividing the current annual net rental income on the property by the cap rate will give you an approximate valuation.

Estimating the most appropriate cap rate takes practice and judgement. Within this the elements of risk, rental growth, inflation and error need to be brought into account. In applying judgement to these elements, investors can often benefit unintentionally from compensating errors. Start with the risk-free rate (see section on bonds) and work from there.

As a prospective investor in property you are thus able to do a discounted cash flow (DCF) that brings the elements down to a single valuation. Compare this valuation to the market price and list it in a ranking table of similar investments.

But that is not enough. In property you are not only buying bricks and mortar, but also leases (or the ability to lease). That’s where “location, location, location” comes in. This is the vernacular for “pay attention to quality.”

There is also a link back to bonds here: the lessee’s credit rating and ability to pay (default risk) become important. These need to be factored into your valuation, typically by using a default premium when determining an appropriate cap rate.

Because the starting point for determining the cap rate is the risk-free rate on government bonds, listed property valuations tend to correlate closely with the valuations of government bonds. Both asset classes follow the interest rate cycle.

<sup>1</sup> The capitalisation rate of an investment is calculated as the ratio of net operating income to the cost price of the investment, or alternatively its current market value.

PAY ATTENTION TO  
**QUALITY**



In property you are not only buying bricks and mortar, but also leases (or the ability to lease)

“LOCATION  
LOCATION  
**LOCATION.**”



## EQUITY

Let's have a look at equity investments. The elements are similar to those of property and bonds: price or initial cost, income stream and future value. As with property investments, it is only the initial cost that is certain.

The income stream on shares is more uncertain than with property which makes the valuation more complex. The income on a share investment is the earnings of the company. But the income stream to a minority shareholder is the dividend. Yet there is a complicating factor: retained earnings, if employed wisely, will produce more dividends in the future. Therefore, both dividends and earnings matter.

Estimating the future dividend stream is fraught with error. This can be dealt with in a number of ways. Several studies imply that a significant proportion of the return from equities comes from dividends received. This confirms our view derived from experience that dividends are important.

The future value of a listed company is less certain than with bonds (which also have a specific date of maturity) and more difficult to estimate than with property. The valuation process is largely the same as the one described for property, but is worth repeating here. The unknowns of equity valuation can be better addressed using probability analysis. The range of future income streams (earnings and values) and the future values forms the basis of the matrix with each level being afforded a different probability.

You may use judgement or whatever you like to estimate the probabilities and then weigh each variable by its probability. Remember again that they are only estimates and recall the problems associated with anchoring around a specific valuation.

Select the appropriate time horizon (use several preferably), guesstimate the unknowns, apply an appropriate discount rate (again, use several) and calculate the net present value. Compare this to the price offered in the market for this share investment.

This is merely the discounted cash flow valuation of equities. This is just one of many methods to use, but in this method, success is achieved or lost in selecting an appropriate discount rate. Just as there are many futures and many possible outcomes, we should look at valuation in as many ways and apply as many as possible on each occasion. Be aware that no single valuation method is perfect.

In our experience, replacement cost to book value, PE multiples<sup>1</sup>, PEG ratios<sup>2</sup>, price to cash flow and dividend yield to 12-month money rate are all valid valuation exercises. Importantly, do not prioritise any one over another.

All the valuation methods are good and should be used. They provide a one-dimensional number or valuation that can then be compared to the market price and a ranking table of alternative investments. But this is not nearly enough. Two crucial aspects must be taken into consideration. First, the quality of the business and its life expectancy should be used to judge the quality of earnings. Second, the ability of management should not be overlooked. The range of management ability is wider than most people think and these people are the custodians of the wealth of those who invest in the company. Management needs to be trustworthy and capable of handling the risks and identifying and acting on opportunities. Good judgement is required to make good investment decisions.

Throughout all the estimates and comparisons, we have learnt that there is no single, straight, easy formula. In our experience, some of the best investment returns occurred in shares where analysis showed a high level of confidence that a sustainable level of dividends would occur within three to four years providing a 10% yield on original cost. These opportunities do not prevail often, but when they do, hesitation is inappropriate.

<sup>1</sup> A share's P/E multiple refers to its price-to-earnings ratio (or just called its "multiple"). It is a measure of the number of years' annual earnings paid for the share. The P/E ratio is typically higher for a company with a higher growth rate.

<sup>2</sup> The P/E-to-Growth ratio introduces the expected earnings growth metric to the P/E multiple. The PEG ratio is calculated by dividing the P/E ratio by the expected earnings growth rate, which allows for better comparison of companies with different growth rates.

## EARNINGS, EARNINGS, EARNINGS

Just as property is all about "location, location, location," investing in shares is all about "earnings, earnings, earnings." P/E multiples move mostly within a small range of 5 to 25. But often earnings can rise by more than 500% or fall by more than 100%.

So it is crucial to get the forward earnings right, but herein lies the problem. Valuations require the forward earnings for at least 10 years and even the best analysts have a problem getting second year earnings within 10% of the outcome and third year earnings within 20%. Most analysts do not even attempt to forecast fourth or fifth year earnings.

Unfortunately, despite the accounting profession (and probably because of it), earnings are not easily comparable, either inter-year or inter-company. So you will need to understand how the accounting standards can be manipulated (see Annexure A). Companies that use suspect accounting practices should be avoided.

In the 1970's and 1980's, changes to accounting standards were an attempt to improve the income statement validity and fairness, but these changes

had a negative impact on balance sheet reporting. Further changes in the 1990's tried to rectify the imbalance. The recent move of marking to market is a culmination of this effort. On the face of it you get a better balance sheet and NAV (Net Asset Value) leading in turn to better ROE (Return on Equity) numbers, but the law of unintended consequences is rife in accounting. Accurate measurement of real earnings has become a problem again.

“IN THE SHORT RUN,  
THE MARKET IS A  
VOTING MACHINE, BUT  
IN THE LONG RUN IT IS A  
WEIGHING MACHINE.”





## TIME

Time is one of the most important elements in the compounding formula. Time is a scarce resource but it is always available. It is the limited amount of it that makes it scarce and precious.

The effect of time is demonstrated in retirement saving scenarios. If you started saving at age 20 at a return of 11.35% per annum, you would have double the retirement capital at age 60 than that of someone who started saving at age 30 (all other parameters equal – see Annexure B). Thus, 10 years can appear to do the work of 30 years, yet it is the 10 years' saving compounded for 30 years that creates the result.

Our advice to all investors is to give your investments time. Be patient with them. Trees take tens of years to grow. How would they grow if you transplanted them every 28 months?<sup>1</sup>

The statisticians tell us that we need 72 data points to give a result that is 95% certain of being correct. Plenty of people have used monthly, weekly and even daily frequencies to get data points. When it comes to measuring investment skill or success, those data points are inappropriate. Investors are not (and should not be) adjusting their portfolios daily. Where timing decisions are involved, a full investment cycle of three to seven years is more appropriate. You therefore need on average  $5 \times 72 = 360$  years to get a result that has 95% confidence levels. This is probably why it is so difficult to get reliable statistics on investment skill.

It is evident that most people have a very poor concept of time and are not able to see past Friday (payday for those paid weekly and weekend for the nine-to-fivers). Those of you who can think in years and comprehend in decades will fare better than most.

Take time to think about time. Understand the difference between the market's time horizon (it changes) and a reasonable time to apply to a valuation formula. The equity market's time horizon is nearly always shorter than reality. That is, the time assumptions embedded in the daily price are usually shorter than the outcome that eventuates. This may be because risk is overestimated and it may be because people over-discount uncertainty, which is why the historical returns on equity have been so high.

<sup>1</sup> Research indicates that the average term of a unit trust fund investor in the United States and South Africa is less than 28 months.



## RISK

Stirling Moss said that in order to finish first, first you have to finish. Similarly, in order to win in the investment game you must first survive. We used to think we managed money or investments. Managing risk is what we actually do. As we have come to realise the importance of risk, we spend more time managing it.

Risk is different things to different people, but it most assuredly is not volatility. Those who have been fooled by theoreticians into believing that volatility equals risk have suffered the consequences of lower returns.

We are taught that the more risk we take the higher reward we should expect. This implies a linear relationship in which many believe. In our experience there is no such linear relationship. There are times when high returns can be achieved with very little risk.

So what is risk? At Foord we see it as the chance or possibility of not making the returns you expect. This is more than, but also includes, the risk of losing capital. All risks involve uncertainty and we live in a world of uncertainty. Understand this fact, embrace it, study it and use it to your advantage.

We generally advise investors to spend more time worrying about the downside risk in their investments than dreaming about the upside potential. Most people battle to understand risk and as a consequence they ignore it. Often it is ignored until an extreme point and then investments are sold after the market has fallen, when the risk of further loss is reduced. This may partly explain why investing is simple but not easy.

“IT’S STRANGE THAT  
THE ‘50-YEAR FLOOD’  
SEEMS TO APPEAR EVERY  
THREE TO FIVE YEARS.”

Dave Foord



## TIMING AND ASSET ALLOCATION

Timing is not to be confused with time or day trading. Timing involves up-weighting or down-weighting exposures to certain asset classes based on the relative attractiveness of the market as a whole.

Some academics believe they have proved that timing the market is not possible, that it is even a loser's game. We strongly disagree. To be successful at it you need patience and a long time horizon. And few investors have either.

To be effective at timing, all you need to understand is the interest rate cycle and to estimate it (even roughly). The newspapers and other media usually ring a very loud bell at the turning point in interest rates.

The interest rate cycle is important because all capital assets are priced off short-term interest rates (probably incorrectly, but that's the way we see it). So even with a bit of a lag you can see the changes in interest rates unfolding slowly. And they do change slowly and in a smooth pattern.

Efficient markets? We've established that it is not so. Timing can be done and it's simple. It is complicated somewhat by humans, the noise, the news hounds and the vested interests, but the smart money sees through all that. Again use judgement, probability theory and allow for error. The benefits of success will outweigh the costs of errors.

Asset allocation is merely an application of timing decisions within a multiple asset class portfolio, such as a balanced fund or flexible fund. Use judgement to estimate probability-weighted returns for each asset class, preferably over multiple time periods. Estimate the likely deviations or ranges. Use diversification to reduce the risk of being wrong. Use conviction where appropriate. Calculate the optimum mix. Allocate the assets. Apply "wait" to the weighting.



## OTHER OBSERVATIONS

### MEAN REVERSION

All investors should understand the concept of mean reversion. In general terms, it refers to the assumption that both the high and low points in a variable's time series are temporary and that the variable<sup>1</sup> will tend to move towards the long-run average over time.

Mean reversion is not only mathematically true (it has to be, in fact) but it can be used to good effect by investors. Because variables often take a long time to revert, it provides time and opportunity to take advantage of mispricing evident in the market.

There are several problems with it, though. First, where is the mean? Means tend to migrate. Many people mistakenly use 10-year or even 5-year numbers to calculate the mean. Second, it often takes a long time (usually longer than most investors' patience) to mean revert. Third, there is often an overshoot of considerable proportion.

Learn to use it because the gains can be material, but be warned that it is neither easy nor foolproof.

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<sup>1</sup> Often mean reversion refers to a share price but the concept is equally applicable to other variables such as P/E multiples, equity risk premiums, real interest rates, etc.

## GETTING IT WRONG

We all make mistakes. Investment mistakes are expensive. Stubbornness is not a good personality trait in this situation. In investing, the errors come fast and furiously, which is strange, really, in a binary environment (there is only buy or sell and up or down).

So you need to be able to recognise mistakes early and then act to limit the damage. “Pay and the pain goes away” is a good motto that has often worked for us in these situations.

We believe that a major part of Foord’s success has come from risk management and, in particular, managing the risk of being wrong. How you manage your mistakes will have a big impact on your investment result. How you do it is up to you and your personality.

## ASSUMPTIONS

As soon as there is uncertainty it is necessary (or usual) for man to start making assumptions. The investment game is full of uncertainty and we should try to anticipate an uncertain future. You therefore need to understand the assumptions being made, both the explicit assumptions and the implicit assumptions. We have found many well-regarded theories to be complete bunk because the assumptions do not have credibility or withstand scrutiny.

For example, economists assume that man is rational and his marginal utility<sup>1</sup> is evenly spread. The Capital Asset Pricing Model’s (CAPM) assumptions on market price, liquidity and indifference are clearly unsupportable.

In our experience, we have found that understanding the assumptions and why they are inappropriate has helped us understand why certain assets are mispriced. Opportunities to make good investment decisions followed.

“TO ERR IS  
HUMAN...”  
Alexander Pope

So understand your own assumptions and the market’s implied assumptions.

<sup>1</sup> Utility is an economics term describing the relative satisfaction derived from the use of a good or service. Marginal utility measures the satisfaction gained (or lost) from an increase (or decrease) in the consumption of an additional unit of that good or service. The law of diminishing marginal utility describes the condition whereby consumption of subsequent units of a good or service results in diminished satisfaction relative to the utility gained from the immediately preceding unit consumed.

## DIVERSIFICATION

Diversification means reducing risk of loss by investing in a variety of assets. A diversified portfolio as a whole will often display less risk than the least risky of the component investments.

Diversification is the only “free lunch” available to investors. It is critically important in risk reduction. Use it as often as possible, but not as much as

possible, because too much diversification reduces return (“divorsification”).

Note that the more conviction you have, the less diversification you need. Again, it comes down to one’s judgement of when and how much diversification to use.

“DIVERSIFICATION  
IS THE **ONLY FREE  
LUNCH** AVAILABLE  
TO INVESTORS.”

## MOMENTUM

Momentum is a trend following system used by speculators. Hence you hear of “momentum trading.” It is not for long-term investors. While it can be successful in certain circumstances, you should be able to improve on a system that buys higher than yesterday and sells lower than yesterday. “Buy high and sell low” does not sit well with one’s intuition.

## BEHAVIOURAL SCIENCE

Long before it became in vogue, it was evident to us that human behaviour made markets irrational and inefficient. If more than 75% of people believe they are above average at a particular task, then a third of those people are wrong. So study human behaviour.

Change is a constant in the markets and people resist change; the older people get, the more they resist change. One path to success is to be ahead of the curve of change. This is often a solo achievement as teams and committees tend to resist change.

## MAXIMS AND CLICHÉS

The markets are full of axioms and sayings. They may often seem trite, but are crystals of knowledge learnt the hard way. Distinguish between those about investing and those about trading. Not surprisingly, there are more about trading than investing, but note these as well. We have often heard them and paid attention to them and yet did not fully comprehend the depth in them until faced with reality in the heat of market tensions.

If you hold the same securities as everybody else, then your returns will be the same as everybody else's.

**SELL IN MAY AND GO AWAY.**

You wouldn't go poor taking a profit, but then you wouldn't get rich taking a two-point turn in a bull market.



Bulls make money in bull markets, bears make money in bear markets, and hogs get slaughtered.

**SEEK FACTS DILIGENTLY, OPINIONS NEVER.**

*Never bet the farm (this is very important: survival is more difficult than you think and winning is even harder; why are there so few successful managers?).*

First loss ...  
**best loss.**



The more things change, the more they stay the same.

The markets, like the sea, are dangerous if you think them safe, but safe if you know them to be dangerous.

Patience is a virtue with good investments.

**PRICES VARY MORE THAN VALUES.**

Bear markets have always ended.

 Fads never last.

**THE CROWD IS USUALLY WRONG.**

**PAY AND THE PAIN GOES AWAY.**

**THE MARKETS WILL GO WHERE THEY SHOULD GO, BUT SELDOM WHEN YOU EXPECT THEM TO GO.**

If it sounds too good to be true, it probably is.

Nobody is bigger than the market.

Study the mood of the market.

The most expensive phrase is "this time it's different."

## ARE WE OVER REGULATED?

I started off believing that all regulation is bad. I have since modified my beliefs. There is some evidence to support the view that the Great Depression was a result of the laissez faire policies of the then US Secretary of the Treasury, Andrew Mellon. And with the abuse that certain people still impose on the unsuspecting public I believe there is need for some regulation.

However, I strongly believe that too much regulation is worse, far worse, than no regulation at all. With no regulation the general public soon learns “caveat emptor” and word of mouth makes people cautious. With regulation, people are lulled into a false sense of security: “If it is regulated, I must be getting a fair deal.” Not so. The number of abuses goes on and increases even as the regulators pump out more regulations.

We are seeing a glut of regulation and I am convinced that it does more harm than good. Who is, in fact, regulating the regulators? There is no measure of their efficiency or destruction.

There is promotion of regulation from government because they seem to be doing something good and it is measurable in terms of numbers of statutes and other readily available statistics. It is also employment-friendly in that it creates jobs in government, in law and in the private sector, which needs to demonstrate compliance.

The burden on small businesses can be acute and therefore large business endorses regulation, not just because it wants to be a good citizen, but because there is no better anti-competitive practice than the cost burden of meeting the regulators’ requirements. There is plenty of evidence to back the belief that small businesses are the main engine of the economy. I am strongly of the opinion that over-regulation is discouraging the growth of small businesses. The cost to the economy is large.



What to do?

1. Fewer regulations and more, much more, enforcement. Meting out strict punishment for serious offences (not meaningless misdemeanours) will be far more effective than adding regulations, which have little or no impact on the crooks, who do not obey the regulations in the first place.
2. The investment community should be doing more. Reputation is important. People who are known to have abused the spirit of the law (let alone the law itself) should not be employed in the industry. I have been appalled to see this obvious good practice ignored by members of the industry.
3. The investment community should self-regulate and set standards of practice of the highest order and expel those who do not meet the required standards.

The problem is a global investment industry problem, not one specific to any one country. Despite a deluge of regulation, abuses in the industry are escalating. For example, more and more opaque products are pedalled by the trading banks to unsuspecting “investors” who do not read the fine print because they trust their brokers. Their money will soon be parted from them. Note that tiered A-rated sub-prime debt is just one of many examples.

I have specific reservations about the role of trading banks in the global savings industry. An industry and a regulator that permit brokers to promote initial public offerings (IPO’s), offer research, perform portfolio management, trade for their own accounts and broke shares at privileged rates deserve what they get. And it has been so for over a hundred years in the United States. The vested interests have kept it that way, for they have too much easy money to lose.

If you are going to play this game, watch out for the 1000 kg gorilla with all the cards and access to the regulator when things turn against him and he needs to change the rules (LTCM<sup>1</sup> is just one example of many).

Expect more headlines.

Dave Foord

<sup>1</sup> The American company Long-Term Capital Management L.P. was a speculative hedge fund manager that used trading strategies combined with high leverage. LTCM’s primary hedge fund, Long-Term Capital Portfolio L.P., failed shortly after incurring billions of dollars in losses in 1998, leading to a bailout by other financial institutions under the supervision of the US Federal Reserve.



## ANNEXURE A – ACCOUNTING STANDARDS

We show below an example of how accounting can be manipulated. Chancer Incorporated, a newly listed company, is up to nothing in particular. It issues bonds at par to a set of high yield bond managers; they are apparently not that discerning. Let's say Chancer Incorporated spends the capital raised on an asset that depreciates by 30% p.a.

### Balance sheet:

Share capital	20
Bond capital	80
Asset	100
Net asset value (NAV) =	20

Now let's say interest rates rise and credit spreads widen, such that Chancer Incorporated debt trades at 50c on the rand. Presto:

### Balance sheet (one year later):

Share capital	20	
Bond capital	40	(80 marked to market)
Equity adjustments	10	(net mark to market gain of 40 less depreciation of 30)
Asset	70	(depreciated by 30%)
NAV =	30	(note that NAV has increased by 50%)

The company is insolvent (using historic cost accounting) and has been made to look great by the new accounting rules of mark to market. Which is correct? The answer will depend on the future cash flows that occur.

It is indeed a travesty of the accounting frameworks that corporate earnings numbers are not reliable. Yet it is this very fact that presents opportunity to the intelligent investor.

**Solution:** do your homework, understand the drivers of earnings, estimate the earnings beyond the market's time frame knowing that you will be wrong, but put in controls to protect against being too wrong. Use probabilities. Think outside the box. Use your judgement to guess better than the rest. Remember that very few market participants even try to guess.

Get to understand the difference in earnings quality. Volume increases in turnover are more valuable to bottom line earnings growth than cost savings.

This will improve your investment results, but it is not a guaranteed formula. You need to be aware and thinking.

## ANNEXURE B – COMPOUND INTEREST

Assume that there are identical twins, A and B. A commences saving for retirement at age 20 and ceases annual contributions at age 29 (after contributing for 10 years). B commences saving at age 30, without ceasing contributions. Both twins' contributions remain at R1 per year throughout the lengths of their contributions.

In **Scenario 1**, we assume a nominal rate of return of 11.35% per annum. Despite A's cessation of contributions after age 29, A's wealth will be double B's at age 60.

In **Scenario 2**, we introduce inflation and consequently the ability of each twin to contribute proportionately more each year assuming their salaries rise by inflation and their contribution rates remain the same. In this scenario we assume a real rate of return of 5% per annum. B's wealth only overtakes that of his twin A when they reach the end of their 49th year.

### SCENARIO 1

Age	A's wealth (Rands)	B's wealth (Rands)
20	1.0	
21	2.1	
22	3.4	
23	4.7	
24	6.3	
25	8.0	
26	9.9	
27	12.0	
28	14.4	
29	17.0	
30	18.9	1.0
31	21.1	2.1
32	23.5	3.4
33	26.1	4.7
34	29.1	6.3
35	32.4	8.0
36	36.1	9.9
37	40.2	12.0
38	44.8	14.4
39	49.8	17.0
40	55.5	19.9
41	61.8	23.3
42	68.8	26.8
43	76.6	30.9
44	85.3	35.4
45	95.0	40.4
46	105.8	46.0
47	117.8	52.2
48	131.1	59.1
49	146.0	66.8
50	162.6	75.4
51	181.1	85.0
52	201.6	95.6
53	224.5	107.5
54	250.0	120.7
55	278.3	135.4
56	309.9	151.8
57	345.1	170.0
58	384.3	190.3
59	427.9	212.9
60	476.4	238.0

### SCENARIO 2

Age	A's wealth (Rands)	B's wealth (Rands)
20	1.0	
21	2.2	
22	3.6	
23	5.2	
24	7.0	
25	9.2	
26	11.7	
27	14.5	
28	17.8	
29	21.6	
30	24.0	1.9
31	26.8	4.0
32	29.8	6.6
33	33.2	9.6
34	37.0	13.0
35	41.1	17.0
36	45.8	21.6
37	51.0	26.9
38	56.8	33.0
39	63.3	40.0
40	70.4	47.9
41	78.4	57.0
42	87.3	67.3
43	97.2	79.1
44	108.3	92.5
45	120.6	107.6
46	134.3	124.8
47	149.5	144.2
48	166.5	166.2
49	185.4	191.0
50	206.4	219.1
51	229.8	250.7
52	255.9	286.3
53	284.9	326.4
54	317.3	371.6
55	353.3	422.4
56	393.4	479.5
57	438.1	543.6
58	487.8	615.7
59	543.1	696.6
60	604.8	787.4

## RECOMMENDED READING

REMINISCENCES OF  
A STOCK OPERATOR,  
Edwin Lefèvre

BILL GROSS ON INVESTING,  
Bill Gross

CAPITAL, THE STORY OF LONG-TERM  
INVESTMENT EXCELLENCE,  
Charles Ellis

THE INTELLIGENT  
INVESTOR,  
Benjamin Graham

FOOLED BY RANDOMNESS,  
Nassim Nicholas Taleb

AGAINST THE GODS,  
Peter L. Bernstein

"THE REALIST'S CREED," an article by  
Howard Marks of Oaktree

CLASSICS, AN  
INVESTOR'S ANTHOLOGY,  
VOLUMES I & II,  
Charles Ellis &  
James Vertin

THE AGE OF  
TURBULENCE,  
Alan Greenspan

A TREATISE ON  
PROBABILITY,  
John Maynard Keynes

SECURITY ANALYSIS,  
Benjamin Graham & David  
Dodd

“EMPLOY YOUR TIME IN  
IMPROVING YOURSELF  
BY OTHER MEN'S WRITINGS,  
SO THAT YOU SHALL **GAIN EASILY**  
WHAT OTHERS HAVE  
**LABOURED HARD FOR.**”

Socrates (reputedly)

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