In for the Long Haul

With our five-year anniversary behind us, I would like to discuss our commitment to long-term investing. Although it is fairly common to raise the banner of long-term investing, it is still important for investors to understand why they're doing what they're doing. Why, indeed, is a long-term horizon so critical for investing? There are a number of factors at play here, so let's discuss them one by one.

Markets trend up

Stocks go up. That is to say, stock markets go up. Individual stocks may go in all sorts of directions, but stock markets as a whole trend upwards. This has been true for more than a hundred years. Even before stocks and stock markets existed, this has been true, albeit in different form. On average, stocks gain about 10% a year. A long-only fund benefits from this most basic of tailwinds day in and day out. (Conversely, those attempting to short stocks, even if only hedging their long positions to be "market neutral", are fighting against a strong headwind. Betting on stocks going down when on average they go up about 10% a year leaves them fighting an uphill battle.)

But the average gain of about 10% is just that – an average. Any given year can have returns higher or lower – often, much lower. The steady upwards march of stock markets is only evident over the long term. If you only invest over a short time period, you are in no way guaranteed satisfactory returns. If, on the other hand, you stay invested for a long time period, you will generally benefit greatly from the long-term market trend.

It is true, if one were to have perfect foresight (otherwise known as hindsight), one could join the market for its uptrends and neatly sidestep the downtrends. But no one has such foresight. No reliable method of timing markets has yet been found, and in all likelihood there is none. By staying invested in the market for the long-term, committed through thick and thin, in good times and bad, one reaps the benefit of the market's long-term upwards march. If you try to avoid the bad times, you usually end up missing out on enough of the bull market to more than counterbalance your having sidestepped some of the bear market. The lesson of history is clear: Do not try to time markets; just stay invested for the long term.

Emotional investing

The second reason to invest with a long term horizon is to avoid emotional investing. This is a constant theme of our writings – the need to avoid emotional thought patterns, the need to be utterly rational. When people try to respond to the moment, to deftly swerve in and out with the short term price swings, they almost inevitably fall prey to emotional investing. They *think* they are thinking, but really they are just emoting. Taking the long term view naturally puts you in a more impartial frame of mind, where thought and cool analysis rule, which is absolutely crucial for any successful investment plan.

Value Investing

The third reason to take the long term view is because there is almost no reliable way to invest other than value investing. The surest, most successfully implemented method of investment is deep, fundamental analysis of the company, its industry, its competitors, the competitive landscape, and everything else impacting the company's prospects. This is the method championed by the vast majority of the investment greats, the investors who have stood the test of time – Ben Graham, Phillip Fisher, Walter Schloss, Charlie Munger, Warren Buffet, John Neff, Bill Ruane, Peter Lynch, Bill Miller, Seth Klarman, and many others.

And for the price of a stock to come back in line with its true value, with its true prospects, *simply takes time*. There are exceptions, such as investing around major binary events (e.g. drug approval for small biotechs), but these tend to be riskier strategies. In general, when you find a deeply undervalued company that the market is mispricing, it takes time for events to unfold, earnings to rise, and your thesis to be vindicated.

Volatility and liquidity – both a blessing and a curse

The fourth reason to invest with a long-term view is to tame the effects of volatility. There is a common misconception that risk can be measured by volatility. To this end, various measures have been created to capture the precise exposure to volatility – standard deviation, beta, Sharpe ratio, Sortino ratio, etc. But precise measures are not really useful if they precisely measure the wrong thing, and volatility is the wrong thing to measure when assessing risk. Volatility is only really a risk for someone who may need the money on an immediate or short-term basis. Here is a secret – *there is no safe place in the stock market for money that is needed on a short term basis*. If you anticipate the need for the money within the next few years, then the money should be in a bank, CDs, or ultra-high-quality short-term debt (e.g. treasuries) held to maturity. Definitely, absolutely definitely, *not* in the stock market. Because of the inherent volatility of equities, you should only be investing in the stock market if you are investing for the long term – a minimum of five years, or even better, ten years.

What causes volatility? The answer is counterintuitive to many. The root cause of volatility in the markets is constant liquidity. With trades happening constantly, the prices rise and fall with the push and pull of buyers and sellers, supply and demand. Private businesses and real estate, which do not suffer from being constantly priced-to-market, exhibit less price volatility. Not because their fortunes and circumstances are more static than publicly traded companies, but because there is no one constantly offering a bid and an ask, changing the "price" on the minute. Private businesses and real estate do not have the insane Mr. Market. Not nearly as much as stock markets do.

Liquidity is both a blessing and a curse. The blessing is not that you can sell whenever you want; on the contrary, *that is the curse*. The blessing of constant liquidity is that you can *buy* whenever you want. Whenever Mr. Market is running a fire sale, selling good companies at absurdly low valuations, you can step in and buy. On the flip-side, the curse of daily liquidity is that you can sell whenever you want. All too many people fall prey to the fear of the fire sale and sell out of the market or specific investments at the lows.

The solution is to embrace the long term. This too shall pass. Take advantage of the blessing of constant liquidity to scoop up shares on the cheap, but do not fall prey to the temptation of the curse of liquidity. Ride out the storm, it will inevitably pass.

The true risk for a person with time is not volatility, the temporary loss of capital as the market ebbs and flows. The true risk is the permanent loss of capital, caused by poorly conceived or mistaken investments that become permanently impaired. The way to deal with risk is to stay focused on the long term, and deeply research, analyze, and understand what you're investing in, so as to avoid permanent loss of capital as much as possible.

Walking the Walk

It is relatively easy to *say* that you invest for the long term; it is rather harder to actually do so. Many professional managers talk the talk; fewer walk the walk. However much a manager would like to focus on

the long term, the realities of the business force him to focus on the month and the quarter. If his fund stumbles sharply, he will see a rise in redemptions. If the underperformance (or a market crash, for that matter) lasts half a year or a year, the outflows start gushing. Managers are only human, and humans respond to incentives. Incentives are behavior. If focus on long term investing will hit the manager in the pocketbook, then the manager will simply not be able to truly focus on long term investing, however much he would like to do so and however much he professes to do so.

That is why we at Focus Capital Management believe it is of utmost importance to *align our incentives with best investment practices*. That is why we believe firmly in having multi-year, renewing lock-ups at Focus Capital Management. This gives us the mindset and the runway needed for true long term investing. We are quite aware that this insistence undoubtedly pushes some investors away, but we believe this is the price to pay for continued long-term outperformance. We firmly believe that our lock-up policy is an essential ingredient in the secret sauce that powers the Fund's success.

As we often like to say, by being willing to endure some short-term volatility, we thereby enable steady long-term gains.