

More Versus Less is Better Than In Versus Out



COMMENTARY – OCTOBER 2020

Most Americans now get their news from social media, which is probably not the best straight news source. For the few of us left that don't, we most likely consume news from sources that speak to our own points of view. Most of us would rather see the world through a comfortable lens, rarely attempting to gain the perspective of a different point of view.

The tragic part of this information isolation is that we fail to even recognize the other half of our population. Red and blue rarely co-exist. And thus, we seem helplessly divided, with one side right and one side wrong. You decide which side is which.

The point of all this is to say that none of this is new. It is just easier than ever before to limit the perspectives we consume, and easier than ever before to criticize those with whom we disagree. But this division is not new, and our country is no more divided now than in the past.

We are simply victims of recency bias. Things happening now seem bigger, more important, and more consequential than those things that happened in the past. Our memories often lose perspective. But this is not new.

We regularly hear from investors in times of turmoil. They usually want to know how we are positioning our portfolios for the inevitable chaos or prosperity that awaits us. Many are concerned that the market has lost any connection to the economy and they can't figure out why prices fail to reflect a deeply flawed world. Others may be of the opinion that all is good, and a rising market would be more than justified. In times of persistently rising markets, neither believes the market is accurately reflecting our present circumstances and want to know how our portfolios will fare.

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It has long been said that the market climbs a wall of worry. That means that in spite of all the reasons that stocks shouldn't rise, they still do. Many wring their hands over the market's lofty valuation and say this cannot last. Yet the market continues higher. Until it doesn't. And guessing when that switch might get flipped is pure folly. No one can successfully time the market. Instead of trying to figure out when they should get in and when they should get out, investors would be better served if they did not succumb to this false binary choice.

Instead of thinking in terms of in or out of the market, investors are better served when they think in terms of degrees of risk. If the investor thinks the market is due for a major sell-off, the temptation to get out of the market should be avoided. If the market fails to meet the investor's expectation, getting back into the market can prove very problematic.

Similarly, if an investor believes the market is poised to go higher, the temptation is to invest more aggressively. If a dramatic move to the upside fails to materialize, the investor has bought high and is exposed to greater risk to the downside.

Volatile markets can produce a wild ride that whip-saw many investors. Those pursuing an all or nothing strategy most likely buy stocks when prices are high and rising, and sell them in the steep declines. They are buying high and selling low.

Doing nothing would likely net better results, but likely more anxiety as well. We believe the middle road is the best road. Minimizing the peaks and troughs can reduce anxiety and help fight the very human urges to buy when prices are high and sell when prices are low.

From Tandem's perspective, "the market" is not an investment. It is a measuring stick that we may want to compare ourselves to over time, but we do not seek to behave like "the market". We do not invest your money for the sake of being invested. You hire us to deploy your capital prudently and wisely. What we pay for securities matters a great deal.

A Tandem portfolio is a collection of individual companies, each of which has met a set of criteria that makes it, in our view, worth owning. These companies are added to the portfolio independently of one another. When we buy a security, we buy it because it meets our criteria and we can pay a price we think is reasonable to pay. When we eliminate a company from our portfolio, we do so because it no longer meets our criteria. And

when we take profit in a company, we do so because it meets our criteria and we want to keep it, but its valuation is too expensive and we wish to take some money off the table.

Tandem will only hold those securities that meet our criteria. When they are inexpensive we will add to them, and when they are expensive we will scale back. When they cease to meet our criteria, we liquidate them. We take very seriously the notion of buying low and selling high, and having the discipline and patience in between. Rarely do the best time to buy and the best time to sell co-exist. Most investors feel compelled to buy something whenever they sell something. We do not. That seems arbitrary and capricious to us.

We buy when valuation compels us to do so. We scale back when valuation seems to us to be unsustainably high. If there are more things to buy than sell, cash levels in your portfolio will naturally decline as a by-product of our process. Cash levels do not decline because we decided “the market” was cheap. Cash levels decline because we found more things to buy than to sell, and our decisions are based solely on math, not emotion, bias or interpretation. It’s just math.

Cash levels rise when the reverse is the case—there are more things to sell than buy. But these buy and sell decisions are not based on a view of the market, or the economy, or the election, or the Federal Reserve. They are made in isolation, one company at a time, void of anything other than our math.

This is a time-tested investment discipline, meant to limit the market’s extremes (both good and bad) and instead deliver a much smoother, more consistent experience. We believe that volatility is the enemy of the average investor. It makes us all want to do the wrong thing at the wrong time for the wrong reason. By limiting volatility in our portfolios, Tandem hopes to keep investors invested by controlling the risk within the portfolio. This middle ground of risk control avoids the in or out mentality.

Tandem thinks in terms of degrees of risk, not whether to get into or out of the market. When we proactively sell when prices are high, we are reducing our exposure to overvalued securities. When we remove securities from our portfolios that no longer meet our criteria, we are reducing risk by eliminating fundamentally flawed companies. When the market corrects, or worse, overvalued and flawed companies typically perform worse than reasonably priced, fundamentally sound securities. We have reduced risk, not tried to time the market.

In the short run, Tandem portfolios are left open to the possibility of underperforming a market that is high and rising. That, to us, is the proper risk to take. We are still invested, still making

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money (presumably) and still exposed to the market’s direction. We are simply exposed to a lesser degree. When prices ultimately fall and valuations become compelling again, we have cash to put to work when others are selling.

Extreme positions are likely to be unsustainable. Whether considering how we consume news, how divided we are as a nation, what a particular event might portend for the market or whether investors should be all in or all out, Tandem believes extremes are ultimately self-correcting. Avoiding binary outcomes, at least as an investor, produces less risk. Finding the middle ground helps us avoid the extremes, and it keeps our clients invested through any economy, much like the companies we hold – businesses that grow through any economic environment.