Sometimes Analogies are Just Easier to Understand

TANDEM INVESTMENT ADVISORS®

COMMENTARY – JULY 2021

Imagine that I have successfully persuaded you to manage my money. Specifically, I have convinced you to construct a portfolio for me of residential real estate located exclusively within your home town. You no doubt have a decent understanding of residential real estate, and likely some pretty strong opinions about the local market as well. No matter. You have agreed, and so you proceed.

There is no way for you to easily or immediately replicate the "market". There is no ETF or fund you can put my money into in order to satisfy my demands. Instead, you must construct this portfolio thoughtfully, one property at a time.

You will employ your own criteria to identify properties worth owning, and you will seek out those that meet your criteria at a price you think reasonable to pay. The day I hand you the money is certainly not the same day all properties will be identified and purchased. This will take time.

If your local real estate market is a buyer's market, your task might be easier. There will likely be plenty of opportunities to choose among. If, instead, your market favors the seller, you must search more deliberately to find properties for my portfolio. There are always bargains available. Sometimes, it simply requires greater effort and patience to identify them.

The process takes however long it takes. It may even be the case that you don't spend (invest) all the money, because there just aren't enough opportunities to use every dollar. And that is okay, because you continue to search for opportunities for the uninvested cash. Maybe you will find an unexpected bargain, and having the extra cash will be a blessing.

After initial construction of the portfolio is complete, the process of actually managing this real estate portfolio begins. Suppose someone offers you 3 times what you just paid for a property. This is obviously more than you consider the property's fair value. You have been given a gift by an anxious purchaser. Since this is my money (remember), I beg you to accept this gift and sell the property!

> When it comes to stocks, the notion of diligence with *patience* seems less readily understood or accepted.

Are you selling because you have some other property you want to buy? Or because you have a particular view of the market that informs you to sell? Not at all! You are selling this property because it is the right thing to do.

And now you have more cash. You continue to search for properties that meet your criteria, whatever they may be, at prices you think are reasonable to pay. Suppose that while you are searching, zoning regulations for one of your properties changes and a highway is to be constructed through the back yard. Understandably, this property needs to be sold as well.

Again, are you selling because you have some other property you want to buy, or because you have a particular view of the market that informs you to sell? No. You are selling this property because it is the right thing to do.

With the sale of the second property complete, you have even more cash than before. That is because there have been more properties to sell than there have been to buy. This will eventually change, and when it does, you will be well-positioned to take advantage of opportunities. You avoided the temptation to buy simply because you had cash, so now you have the ability to make the appropriate buys when they present themselves. This is sound management on your part. Congratulations, and thank you for treating my money this way.

For whatever reason, most of us understand real estate and can relate to this analogy. When it comes to stocks, the notion of diligence with patience seems less readily understood or accepted.

Among the investing public, media and other observers, there seems to be some sort of mystique around "the market". There is great excitement when "the market" goes up, and much handwringing when it goes down. And bizarrely, the more the market goes up, the less risk the public perceives. Similarly, during market declines, risk is perceived to be rising.

At Tandem, we take a very different view. We will never invest your money simply for the sake of being invested. Your money is

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not invested in “the market”. Much like the real estate analogy, we try to identify those businesses (instead of properties) that meet our criteria at prices we think are reasonable to pay. We are not attempting to replicate “the market”. We are attempting to make sound investments, one at a time, on your behalf.

Unlike with real estate, we can sell some of what we own in a company without having to sell all of it. So when a company we own is trading at a price we think is unreasonably and unsustainably high, we take advantage of this gift and sell a piece of our holding, not all of it. Recall in the real estate portfolio someone offered 3 times what we paid for a property, so the property was sold. In your Tandem portfolio, we can use the same philosophy, yet still own that company, just in a smaller amount.

We do not liquidate overvalued companies, but we do reduce our exposure to the risk of an overpriced security. And we do this not because we have another company to buy, or because we have a negative view of the market and want to hold more cash. We do this because it was the right thing to do for a particular company at a particular price.

If a particular company ceases to meet our criteria, we will sell all of our holdings in that company. Whether we have something else to buy is not part of the decision-making process. We sell the company because it is the right thing to do, and we will redeploy the cash when opportunities present themselves, but not before.

When real estate prices rise unrelentingly, most would-be buyers rightly become skeptical. However, when stock prices rise unrelentingly, most want to participate more. If you doubt this, please check the data. Purchases of mutual funds and ETFs historically are greatest at or near market tops. Conversely, sales of mutual funds and ETFs are greatest at or near market bottoms. But in real estate this would be called a buyer’s market!

Why do so many perceive less risk when stock prices are higher and greater risk as prices fall? I can’t say. But at Tandem, we believe that lower prices and higher prices both present opportunities.

Lower prices, in our view, make for more compelling investments than do higher prices. Higher prices are often gifts to be taken advantage of by selling a partial stake, while lower prices are a chance to put that money back to work. This is how to buy low and sell high. Too often investors actually do the reverse – buy when prices are high and sell when prices are low.

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Most investors tend to be trend aware. They try to identify the next big thing, or jump into whatever seems to be working now. But eventually trends reverse, and the investor must know when to move on.

Tandem prefers to try to be opportunistic when the market misprices companies. We call this mean-reversion investing. Mean-reversion is about math, not anticipation or guesswork. Rather than hoping to identify the next trend, we rely upon a simple statistical concept based on the notion that most of the time, stocks are fairly valued. And whenever they are not, there is a very high statistical probability that they will revert back to fair value eventually.

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