This is How Cash is Supposed to Work

TANDEM INVESTMENT ADVISORS®

COMMENTARY – JANUARY 2019

Few would argue with the premise that the most basic principal of successful investing is buying low and selling high. Yet the actual execution of this most basic principal is far more challenging than many realize.

The concept seems obvious, doesn't it? Buy low. Sell high. To most, that means buy when prices are their least expensive and sell when prices are at their peak, just before they fall. The problem with this notion of what it means to buy low and to sell high is that, absent a crystal ball, a bit of guesswork is required.

How low is low? If prices are falling, are they likely to keep falling? And how high is high? If you sell today and prices go higher tomorrow, did you sell too soon? Timing, reading tea leaves and on-the-fly market analysis can enter into the decision-making process. More often than not, human emotion plays a role as well.

Too frequently, the average investor actually ends up buying high and selling low – the exact opposite of the obvious goal. When prices are falling, it can be very scary. Most aren't thinking about the opportunity that is unfolding. Instead, they are thinking about the money they are losing. They decide they can't afford to lose any more and so they sell – when prices are low.

It can be very exciting when prices are rising. Investors are making money, and they want to make even more. So they continue to buy stocks (or at least hold on to them) as prices rise. This strategy may work for awhile, but ultimately buying stocks as they get more expensive results in.....you guessed it – buying high. So you see, buying high and selling low is actually very easy. It is practically second nature for the average investor. Buying low and selling high is more complicated.

Judgement can be unduly influenced by recent experience. If prices are falling, aren't they likely to continue falling? And if prices are rising, surely they will continue to do so. In fact, buying low and selling high requires the discipline to look forward, not backward. To do so successfully, one must remove sentiment from the process and focus on what is knowable. Tandem's investment discipline does precisely that.

> Buying low should *not* mean buying at the absolute low. Similarly, selling high doesn't require knowing the absolute high. High is high. Even if prices go higher.

Buying low should not mean buying at the absolute low. Similarly, selling high doesn't require knowing the absolute high. High is high. Even if prices go higher.

There are many acceptable tools for valuation analysis. The most common is PE, or Price/Earnings ratio. Tandem utilizes its own proprietary ratio. It really doesn't matter what metric is used as long as discipline is exercised.

From Tandem's perspective, when a company is trading at an historically low valuation, and the fundamentals of the company remain appealing, the stock is cheap and should be bought. Can it get cheaper? Of course it can. Undervalued things often become even more undervalued until order is restored. Buying low does not require buying lowest. Low is okay. Paying a reasonable price increases the likelihood of a profitable return as the market cycle turns higher.

While buying low requires discipline, selling high might actually be harder. It certainly requires discipline. It can also require patience. For clients that were with us throughout 2017, patience was indeed required. The stock market continued to hit all-time highs month after month while our cash levels remained historically high. But our cash levels were high with good reason – most stocks were expensive. There were more opportunities to take profit (sell high) than there were to put money to work (buy low). As a result, cash levels rose. With so much cash in a market making all-time highs, we underperformed in 2017.

We were not concerned by this. We do not invest your money simply for the sake of being invested. We take seriously our commitment to buy low and sell high, and to have the patience and discipline in between. The best opportunities to buy and sell do not occur simultaneously. When there are more things to sell than buy, cash levels in client portfolios rise. Conversely, when there are more things to buy than sell, cash levels will decline. To us, this is the way it is supposed to be.

The patience of those with us in 2017 was rewarded in 2018. The market peaked in January and then corrected. We had plenty of cash to take advantage of the situation and we were able to buy some stocks at compellingly low valuations. We put some of our clients' cash to work. The market recovered to new highs, and then sold off nearly 20% in the 4th quarter. Cash ended up being beneficial to our portfolios two ways. As stock prices were declining, the value of our cash was not! And by still having cash on hand, we were able to take advantage of the market's

a. 145 King Street, Suite 400, Charleston, SC 29401 *p.* 843-720-3413

opportunities once again. Tandem enjoyed a solid 2018 and patience was rewarded.

We can chart the meanderings of the S&P 500 through the bear markets and bull markets following the bursting of the tech bubble in March 2000. And with that we can illustrate the ebbs and flows of cash levels in Tandem's portfolios. While the correlation of cash to the price of the S&P is not perfect, Tandem's cash levels are generally declining coming out of market bottoms and rising as the market approaches tops. In other words, Tandem is putting money to work when prices are cheap (buying low) and taking money off the table when prices are high (selling high).

Most of our peers tend to believe that their job is to remain fully invested at all times, leaving the decision of when stocks are cheap and when they are expensive to others. We simply cannot operate this way. It is not in our DNA to hold without taking some profit, or even worse buy, overvalued securities. We work hard to make profitable investments on behalf of our clients. It is our responsibility to protect those profits when appropriate. For those of you that have now been with us through market ups and subsequent market downs, hopefully you see that we do what we told you we would do.

It is not in our DNA to hold without taking some profit, or even worse buy, overvalued securities. We *work hard* to make profitable investments on behalf of our clients.

a. 145 King Street, Suite 400, Charleston, SC 29401 *p.* 843-720-3413