



Holland Views

Met Many Bears + The Most Important Thing

With markets having boomed in 2013 and most glossy New Year projections thankfully now behind us we take the liberty of reasserting the view on markets we distributed in November and how we suggest clients should feel towards them. We remain neither optimistic nor pessimistic on market levels but sceptics in our search for value and ideas. In other words, we are still looking to find companies we deem as high-enough quality with the right characteristics to make them exciting long-term investments but we continue to use a sceptical eye to make sure we are still given enough value at our purchase price to give us a margin of safety.

In addition to the views in the attached piece we make two further additional observations:

[Christmas Reading](#)

I have spent a little time of late with a new book: **The Most Important Thing** by Howard Marks. It gives Marks' view on approaches to investment and responses to those views by respected investors. Below is an extract from it:

"I'm firmly convinced that investment risk resides most where it is least perceived, and vice versa:

- *When everyone believes something is risky, their unwillingness to buy usually reduces its price to the point where it's not risky at all. Broadly negative opinion can make it the least risky thing, since all optimism has been driven out of its price*
- *And, of course, as demonstrated by the experience of Nifty Fifty investors, when everyone believes something embodies no risk, they usually bid it up to the point where it's enormously risky. No risk is feared, and thus no reward for risk bearing – no "risk premium" – is demanded or provided. That make the thing that's most esteemed, the riskiest.*

This paradox exists because most investors think quality, as opposed to price, is the determinant of whether something's risky." – Howard Marks, The Most Important Thing

In response:

"I agree – there are a number of dangers that come from using a term like 'quality'. First, investors tend to equate 'high-quality asset' with 'high-quality investment'. As a result, there's an incorrect presumption or implication of less risk when taking on 'quality' assets. As Marks rightly points out, quite often 'high-quality' companies sell for high prices, making them poor investments. Second 'high-quality' tends to be a phrase that incorporates a lot of hindsight bias or 'halo effect'. Usually, people referring to a 'high-quality' company are describing a company that has performed very well in the past. The future is often quite different. There is a long list of companies that were once described as 'high-quality' or 'built to last' that are no longer around! For this reason, investors should avoid using the word quality' – Christopher Davies, David Select Advisors

These views are very useful we suggest in framing risk and price in our minds better. They also shine a little light on the “Quality Stock” argument that many professional investors have with themselves. As a few of the world’s widely-accepted best ‘quality’ companies (e.g. Coke/Diageo/Berkshire) have underperformed recent market surges they may now likely outperform whether markets rise or fall from this point.

More important however we hope the above quotes explain why we are looking at companies like Coach, DirecTV, Wells Fargo or National Oilwell Varco rather than Coke or Diageo again. The reason is simply that their low share-price ratings imply more risk than we assess their business models and prospects as actually possessing. As a result they might not be the *highest quality* businesses in the world but they might be among the *best investments* available today.

[Surely it is time people stopped beating-up America - After all they are sitting on a gold mine](#)

The only other observation we might make is still how much scepticism we read on the US at a time when we assess its prospects as being extremely bright. Most of the negative views seem to centre on either looking at past mistakes (banking regulation etc.) or its political shortcomings (is this something new? ...really?). Little of it seems focused on its genuine economic prospects but for 2-3 years now we have assessed these prospects as being good, or even excellent.

Such prospects are a function of a starting point from the proper trough of a cycle which was reflected in all asset classes and thus had far-reaching consequences (i.e. genuinely higher unemployment rates and business bankruptcies). This realisation, and their low price vs. the quality of the business models, has largely been behind our bullishness on the US banking sector - a stance we retain and reiterate despite recent good performance.

Adding to this bullish outlook on US economic growth, we believe, is Shale Oil and Gas and the revolutionary impact (hardly an understatement) it is having. We have spent quite a bit of time recently looking at a couple of companies in this area and will distribute notes on them soon. During this process we gained more conviction on an idea we have realised for a year or so now. This idea being, the significant economic benefit that cheap US shale oil and gas brings and the extent of just how wide this advantage could yet prove. That this is down largely to nothing more than luck is maybe obvious but that does not make its ultimate effect any less dramatic. Like other bulls in this area we conclude that much of US heavy industry will continue to receive a huge ongoing boost due to this structurally lower input cost many years into the future.

Additionally, there may well be other second order effects that have yet to be fully appreciated. An example we recently read about was the record low 2013 Asian coal prices. One reason why this happened was more US coal was exported as US gas prices were so low (NB. Coal’s share of US electricity generation fell in a single year (2012) from 42.3% to 37.6% - that’s in a single year! These observations on Shale are not unique, neither were our views on the US financials sector of a few years ago, but sometimes we all need to think harder as to what the real ramifications of events can mean.

[Met any Bears Lately?](#)

Our comments below/attached (which we would ask you to read if you did not in November) hopefully show we are aware that markets now discount a chunk of good news. We have also now seen enough cycles to know that future equity returns will not be achieved from today’s starting point in a nice smooth path. That said we should see recent market optimism for what it is... the slow and late realisation by many that Equity prices were far too cheap both in absolute and vs. other assets classes, nothing more.

What investors should be careful of, we think - particularly the bearish ones - is to assume that there is some economic abyss lying underneath asset prices. Of course there are uncertainties both to markets and economies, but there is also much reason for economic optimism. We have been pretty upbeat on the prospects of the US economy due to its highly capitalist system and great capital allocation model that remain fully intact and arguably emerged stronger post the credit crunch. Additionally so due to the depressed economic starting point from which it rebounded.

Pessimists would be wise to remember the role that luck plays in life and investing. The US is indeed hugely lucky to have these discoveries, but that does not mean the effects of them will be any less pronounced. As one of our Ex-employers Merrill Lynch once famously boasted –
“Be Bullish - on America”

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