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THOUGHTS FROM HOME

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The Business of Investing

““The stock market is a giant distraction from the business of investing.”

- John C. Bogle, Founder, The Vanguard Group

Month after month, the 24 hour news cycle provides an endless flow of output that the market is forever inputting into stock prices. This constant flood of fact, opinion and general sentiment causes both positive and negative market movements but often does little to inform us on how the companies we own are actually doing. The business of investing is about selecting, owning and occasionally selling quality companies, based on their individual merits. This month, we will highlight some current investment headlines to determine how they affect our business.

Inflation has been much in the headlines in recent months. Is it permanent? Is it transitory? During September, fear of permanent inflation led to a tightening of the U.S. yield curve and a general market sell off. In October, inflation worries eased and the market rallied. The true answer to the above questions is as long as companies can maintain profit margins and pass the higher costs on to the consumer, inflation has no real effect. When sales begin to slow and margins begin to compress because the consumer has less purchasing power, then we have to re-evaluate our holdings. As of this quarter, consumer demand remains robust and profit margins strong, despite the concern that inflation would dampen the future growth prospects of the market.

So why does the market react the way it does to inflation news? The answer lies in the structure of the investment landscape. Institutional investors, pensions and mutual funds make up the majority of most daily trading. They are not concerned about taxes or capital gains. Their sole focus is to outperform their benchmarks and their competitors quarter by quarter. Because of their short term time horizon, they jump in and out of stocks with much greater frequency, which can lead to market volatility and needless worry. However, this volatility can also be our friend. Take the third quarter U.S. earnings reporting season that is currently under way for example. Once again, most companies have beaten expectations and generally guided earnings forecasts higher which lead to institutional investors jumping back in to the market and sending stocks higher.

Corporate earnings are at the core of the business of investing. The numbers never lie but at times stocks don't react immediately and that creates opportunity. Let's use MasterCard as an example. The company has grown earnings 20% this year and bought back $1.5 billion in stock. Currently, there are approximately 2.9 billion cards outstanding that are accepted by 80 million merchants and yet the stock is only up by 2% year to date based on the vague fear that consumer spending could slow down. MasterCard is a more profitable company with fewer shares outstanding than last year and it is our firm conviction that this will be reflected in the stock price in the future as travel spending continues to increase. We continue to hold and will selectively add to the position if it becomes underweight in your portfolio.

Another key to the business of investing is corporate management. The best management teams continually grow earnings and successfully manage through hard times. There are many fine examples but we would highlight Disney's reaction to the Covid crisis. During Covid, all their businesses were essentially closed. A weak management team would have thrown up their hands and waited the crisis out, taking punishing losses along the way. Instead, the Disney team created Disney+, an online subscription streaming service. In a matter of months, they went from zero to 118 million subscribers each paying $7 per month. This has created about $10 billion in annual cash flow and added incredible value for shareholders. Disney+ alone has about half the number of subscribers as Netflix and it is our belief that the market is significantly undervaluing the value of Disney's other businesses. Once travel starts to pick up, we see strong potential for the stock.

Changing business circumstances also play a crucial role. A fine example of this is Thomson Corp. Years ago, they were the leading newspaper company in Canada and proud owners of the prestigious Globe and Mail. However, Thomson management saw the growth potential of the internet and sold all their newspapers to focus on providing market and legal data online. Investors initially hated the move but management was exactly right and now newspaper companies are worth a fraction of their previous value. For perspective, the Toronto Star was sold for $52 million, even though it was once valued at well over $1 billion.

At other times, even companies in a strong sector can stumble and must be sold. Activision is a leading online gaming company and benefitted greatly during Covid. However, when employees filed a lawsuit citing a toxic work environment and harassment, we exited the stock at a profit and then watched it drop 30%. Environmental, Social and Governance (ESG) criteria have been widely adopted by institutions and if a management team loses investor confidence, the sell off is usually heavy and the stock is avoided until matters are resolved.

Any good business has a diverse inventory to meet customers' demand. In the business of investing, diversification is a key to success. When the market is running well, everything tends to move higher. The real key to diversification is when the markets weakens. September was a prime month to illustrate the point. Though the S&P 500 was down 4.8% for the month, the leading growth sector, technology, was down over 10%. In fact, Ark Investments, the leading U.S. technology fund, is actually down for the year despite strong markets and a large investment in Tesla. Chasing a hot trend always seems like a good idea at the time but is only rarely sustainable and the damage can be heavy if you find yourself on the wrong side with all your investments.

Another major distraction is U.S. government policy. The short term traders worry about debt ceilings, monetary stimulus and infrastructure projects. While all these debates make interesting headlines, strong companies are making their own way. They may get knocked down temporarily in a market sell off but are the ones that are most resilient.

One final thought is how the markets react to an external crisis. Hurricane Katrina, 9/11, Covid and the 2008 financial crisis are all examples. During these times, we analyze the long term impact on our specific portfolio of companies and the economy as a whole. In most cases, there is no long term impact on the market and it becomes a time to selectively buy stocks, not sell them. The one notable exception was 2008, when there was a true risk of companies failing. However, the business of investing remained unchanged and careful research, analysis, and diversification won the day.

This month, we have highlighted some of our thoughts on the business of investing, focusing on some of the key elements we look for in our portfolio stocks. Overall, despite lingering inflation worries, the market direction is remaining positive and we look forward to another strong year ahead as supply chain issues begin to resolve and hopefully we finally see the end of Covid. Until next month, stay healthy!

As always, questions, comments, concerns and general discussion are always welcome.

Yours truly,
Trevor, Walter and the Cooper Wealth Management team