Warning lights lead to change

Money Matters

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This week's article is an extract from a reply to a client's question on whether he should reduce his share exposure or move to a balanced portfolio strategy given several "warning lights" on the horizon.

"The easiest way to address your fears and I use this word specifically to emphasise that your question is coming from an emotional point of view rather than a rational thought process, is to ask the following question: Do you think Berkshire Hathaway is selling their interest in great businesses like Coca-Cola, Apple and/or Wrigley's chewing gum simply because Warren Buffett is worried about the Coronavirus or an inverted yield curve?

"What is important is valuation and differentiating between temporary and permanent losses. Temporary losses as a result of the Coronavirus and/or similar triggers should simply be ignored and ridden-out in the knowledge that prices will recover after the panic subsides. Market timing does not work, which has been proven time and time again, moving into cash in the hope of avoiding a crash to buy back in at the bottom is a myth and if anyone gets it right then it is pure luck. There are numerous studies to back this statement up.

"The only way long-term investors lose money on shares other than bankruptcy is through overpaying for a share and this is why valuation is so important. Portfolio managers applying a valuation discipline will actively rotate out of shares once they reach fair value in favour of companies trading below their intrinsic value, which is referred to as a margin of safety. The value philosophy differs to the other management styles, which include momentum, growth and quality where a manager will be prepared to pay a higher price based on growth expectations.

"The last decade has seen value investing materially underperform growth, momentum and quality as financial repression and the resultant cheap money flowed mostly to a narrow basket of shares bought at any price. The proliferation and growth of passive investments is testimony to this wall of money chasing the crowded trade into quality, growth and momentum at any price. Ironically the Coronavirus is now pushing these quality (defensive) company prices even higher… Temporarily!

"What fixes high prices? High prices fix high prices because they always come down and vice versa with low prices. If you agree the definition of risk is permanent loss of capital, then what you should be asking your portfolio manager is the value vs. price of the portfolio using the following valuation metrics:

- Price to book (p/b)
- Price to earnings (p/e)
- Price to Free cashflow (p/fc)
- Active share (indicates how different the portfolio looks versus the broad market index)."

"A buy and hold philosophy is appropriate for an actively managed strategy with a valuation underpin and a longer-term focus." – *www.mwwealth.co.za*