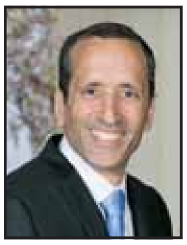
The Investment 'Theory of Relativity'



By Jonathan Caplan

Ask a random person on the street a question about the theory of relativity and she is likely to say something about $E=MC^2$ or perhaps tell you it has something to do with Albert Einstein. And that's about it.

I myself cannot tell you much about the theory of relativity. But in the world of investing, I would like to share with you my version of the "theory of relativity." I have found that measuring the attractiveness of a potential investment on a relative basis can cause investors to veer off a rigorous and disciplined approach. Moreover, it can cause investors to have a false sense of security about their investment strategy and may lead to poor decision making.

What Is Relativity In the Investment World?

In our dynamic and everchanging world, assessment of risk and reward in the realm of investments has become increasingly challenging. Valuations of stocks and bonds, particularly in the United States, is rather stretched from a historical perspective. But due to our excessive focus on near-term market dynamics, we tend to misjudge risks as well as potential rewards.

Our instincts tell us to rely on historical analogs to help assess the investment merits of an asset class or a particular security. That is a prudent practice. But when looking at historical analogs, one has to make sure that the measures are comparable given the current investment climate.

Relativity Generating a False Bearish Signal

A handful of clients call me when bull markets begin to appear extended and frothy. They will ask whether I believe the market is going to crash. I am not in the business of predicting crashes. I am in the business of deploying capital into investments with the best long-term risk-adjusted return prospects.

But even investment professionals can get caught up in the mistake of using historical relativism that perhaps leads them to the wrong conclusion. A prime example of this is that the stock market currently trades at a price-to-earnings ratio that is on the high end of its historical range. The last time the stock market was trading at such lofty levels for an extended period was in the late 1990s, just prior to the dot-com bust.

Now I will not argue that the stock market today is a screaming buy or that it is grossly undervalued. But I would caution that concluding that the stock market is overvalued due to the relative price-earnings ratio today versus in the late 1990s may be somewhat flawed. One of the main reasons is that interest rates, which are a key factor in determining equity value, are significantly lower today than they were in the late 1990s. If one makes an argument based on one relative factor (e.g., price-earnings ratio), one could be missing other important factors (e.g., interest rates) that are also critical determinants of valuation.

Relativity Generating a False Bullish Signal

At Caplan Capital Management we believe that valuation should not be conditioned on daily market volatility and/or price movements. When valuing an investment candidate, we look at those fundamental factors that drive an appropriate valuation. Once we conclude that our valuation of a stock is significantly below current market prices, we look to deploy fresh money into that investment. Our deployment is driven by the estimated valuation gap with little attention to short-term market dynamics.

While 2021 has witnessed some fairly healthy equity returns, earlier this year, there were a number of stocks whose price movements have defied logic and conventional valuation principles. We have seen individual stocks double or triple overnight based on little to no fundamental news. Some of these companies are in weak financial positions and have seen their businesses severely threatened by COVID-19 and/or technological disruption. Nevertheless, their stock prices skyrocketed. More recently, many of these companies have seen their share prices falling back to earth.

Now here's where investors are prone to make errors in judgment. If a stock is trading at $10 and surges to $100 without any fundamental improvements in the business, one should probably stay away. Moreover, if the price subsequently falls in half, and trades at $50, one should not draw an erroneous conclusion. To ignore the fundamental case and make a decision based on the relative near-term performance could be costly. While true that the stock has fallen sharply from the highs, it can still be grossly overvalued. The "theory of relativity" from a short-term standpoint would suggest that the stock is now "cheap," trading at 50% off. But in reality, the stock is still up five-fold on the year. Moreover, if the fundamentals of the company remain precarious, one could be putting one's entire investment at risk.

A Lesson From the Past

One of my first clients called me in a panic in the early 2000s. He had bought a technology stock that was once an investor darling. After it fell 50% in price, he bought more of the stock. The stock continued to fall and he called me in a panic, wanting to know whether he should be buying even more. I told him that I do not recommend buying based on the fact that the stock appeared relatively cheap. Rather, he needed to focus on the long-term prospects of the company and the stock's valuation. Many investors (or shall I say speculators) lost a lot of capital in the dot-com bust because of ill-advised strategies that focused more on price movements and relative valuation rather than absolute valuation.

A Word to the Wise

While I tend to shy away from making grand market prognostications, we are more vigilant these days with a market that has been supported by massive government spending and artificially manipulated interest rates. We continue to focus on absolute valuations rather than relative valuation. And surprisingly, we continue to find a healthy number of opportunities that we believe can provide some ballast to one's portfolio. This is especially important with so much uncertainty and potential economic speedbumps ahead. Preserving and growing capital in this environment will require a rigorous focus on valuation. Equally important, we believe investors need to determine what investments to avoid.

No, the sky is not falling. But the potential risks in the market should lead investors to seek a more disciplined approach for the coming year and beyond.

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Don't Give Up!

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over and I thought to myself: What a wasted opportunity!

And then it happened.

An older gentleman wearing a tweed hat, a torn and stained shirt, unlaced tennis shoes and an overcoat reminiscent of Detective Columbo, walked over to me at the end and said: "You know, everything he said sounded to me like '**Jabberwocky**,' but I am sold on this unitrust idea." He subsequently signed up for the $1.3 million unitrust and transformed that day into a huge success.

And that's how we got back to Lewis Carroll.

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