Time and Chance

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For long-term value investors, risk is not defined by the level of volatility but by the likelihood of shareholder capital being permanently impaired. Though often vilified, share price volatility is actually opportunity masquerading as Warren Buffett's heavy-drinking manic depressive—"the crazier he is, the more money you're going to make."[1] In other words, volatility often proves a significant advantage to the long-term investor, since the result can be an increase in the frequency of mispriced securities (i.e., opportunities). Less sanguine types simply accept it as an inevitable and unpleasant part of the investment experience. That said, in the behavioral psychology context, the frustration that some investors feel when their portfolios exhibit volatility that exceeds expectations is certainly understandable, especially if such volatility is not associated with positive excess rates of return in the near term.

The challenge for investors—professional or otherwise—is to remain steadfast during periods of elevated volatility and the oft-associated underperformance. This is not to say that investors should stubbornly refuse to revisit their investment theses if the fundamentals have changed. Rather, it refers to the ability to tolerate short-term stock price fluctuations when the fundamentals have *not* changed and still appear favorable. This uncommon ability not only epitomizes the successful investor but the successful decision maker in any field where there is an element of chance.[2]

The temptation for many market participants is to draw inferences based on changes in share prices rather than based on underlying business fundamentals. As a result, many individuals tend to take assets out of the market when volatility is high and returns disappointing (and, of course, *vice versa*). Though many expect to come back into the markets in time to participate in the recovery, historical data show that identifying the peak or trough of a market cycle is extremely difficult, even for the most experienced professionals. And when the markets turn, they often do so quickly. To re-enter the markets once an upturn begins is, in most cases, to miss a significant portion of the return. In fact, studies such as DALBAR, Inc.'s annual *Quantitative Analysis of Investor Behavior*[3] provide evidence that staying invested during periods of elevated volatility is associated with strikingly better long-term investment results.

For further evidence of the benefits of staying invested and putting additional capital to work during periods of elevated volatility—or, in Baron Rothschild's words, buying when there's blood in the streets—one need only look at the actions of some of the most successful capital allocators operating today. In the wake of the financial crisis of 2008, many management teams, seeking to lower the risk profile of their businesses, made the common mistake of equating volatility with business risk and, as a result, accumulated idle cash on their balance sheets, refrained from acquisitions, and underinvested in their businesses. In contrast, companies in which insider equity ownership was significant exhibited a different behavioral pattern: these so-called owner-operators, individuals with significant amounts of personal wealth at risk, or "skin in the game," saw opportunities in depressed asset prices and deployed capital at

[1] Berkshire Hathaway 1997 Annual Meeting, May 1997.
[2] And since we've been advised by reputable sources that time and chance happen to us all, one would do well to consult Willy Feller's *An Introduction to Probability Theory and its Applications*, in particular the discussion on coin tossing in volume 1, chapter 3. For the more qualitatively inclined, consultation of the so-called wisdom literature is recommended (critic Harold Bloom proves a worthy guide down this right road of patience in *Where Shall Wisdom Be Found?*).
[3] http://www.qaib.com/public/default.aspx

attractive valuations in order to build shareholder value over the long run. That is, they used volatility to their advantage, recalling the adage to be greedy when others are fearful.[4]

While the more politically palatable decision to hoard cash—embraced seemingly *en masse* by the agent-operator cohort—combined with the inexorably increasing popularity of exchange-traded funds as the investment medium of choice, may have mitigated short-term share price variability and provided an effective floor to valuations, the long-term prospects for such companies now seem dimmer, as revenue growth has slowed following years of underinvestment. In contrast, we believe that the fundamentals for the owner-operated companies held in many Horizon Kinetics strategies appear bright. Owner-operators use their access to capital and informational advantage to make opportunistic investments that others cannot, not only because their experience allows them to see opportunities that others might not, but because their long-term investment horizons allow them to make investments that will not bear fruit for what are often unpredictably long periods of time. The management teams at these companies are invested in their business for the long term, and when outside investors experience stock price swings, it should prove comforting knowing that the personal wealth of the management team is at risk too.

Contrarian or value investors are, almost by definition, investing in areas of the market that are not in favor. Time must pass and volatility must often be experienced before intrinsic value is reflected in the share price. Regarding they who wait until the market price reflects a company's intrinsic value, we all know how that one ends.

[4] For an interesting take on this, see Nassim Taleb's *The Skin In The Game Heuristic for Protection Against Tail Events*.

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