TOCQUEVILLE

On Optimism

BY KENNETH E. LEE ON *OCTOBER 2, 2017*

"The man who isn't a pessimist is a damned fool." – Mark Twain

Is the grizzled, cynical investor the more successful one? Are his cynicism and negativity a sign of intelligence and experience? Do we perceive the pessimistic person as more intelligent than the optimistic one, and if so what relevance does this have to investing?

Expressions of optimism are fraught with pitfalls for the money manager. Optimism is fine while stocks are going up, but woe be to the optimistic money manager during a bear market *even if the optimistic manager performs better than the outwardly pessimistic money manager in the same down market.*

There is some academic evidence to suggest that optimistic capital allocators who maintain resource availability produce the best results.[1] My anecdotal observations of the best long-oriented equity investors suggest this is true, if you think about Warren Buffett, or perhaps Peter Lynch.[2] *My take is that skepticism, combined with maintenance of resource availability, or "dry powder", is key to the success of the optimist.*

Nurture the Skepticism

It seems to me that expressions of optimism by a professional investor or pundit are dangerous to his reputation because such expressions are often conflated with naiveté or an overly trusting nature, or, perhaps, a lack of skepticism or experience. I had just such an encounter with an investor during the market slump of Q1, 2016, when I penned the original (unpublished) draft of this note. The investor and I were speaking on the phone during market hours as the market was falling dramatically; and he could not understand how I could be optimistic about buying anything when everything was going down. I was optimistic because prices of the stocks that I was interested in buying were lower than the value of the long-run income stream I believed those stocks would produce for my clients; *and I had "dry power."*

In his classic 1981 work on stock prices versus variations in earnings, Robert Shiller[3] argues that markets are likely to trend too far (both the up and down) to be rational. He posits that prices oscillate relatively widely around their fair value defined by their actual dividend streams. Later papers written by Shiller and others refine and deepen the conclusion that markets overshoot, sometimes persistently. Yet, the long-term owner of stocks ultimately receives the expected value through dividends and/or price appreciation.

Research further suggests that our own recent experiences influence our interpretation of facts[4] and that we over-value possible negative financial outcomes in our decision-making.[5] Today, the tendency to overshoot on the down-side is compounded by retention of the "dot.com" bust (2000-2002) and the 2008-2009 financial crisis in our collective recent memory; just as, in my opinion, fear of owning bonds bred by runaway inflation of the late 1970's and early 1980's allowed bond prices to grind higher for 30 years instead of prices and yields adjusting more quickly. In the two decades after the Crash of 1929, stocks only very slowly recovered to long-run valuations despite dawning growth opportunities,[6] arguably because of the harrowing experiences many market participants (and family members of market participants) had in the Great Crash of 1929 and subsequent Depression. This may be why stocks have been slowly grinding higher for so long since the 2009 lows. The old adage, "a bull market climbs a wall of worry" appears to apply to the post 2009 period in which fundamentals had been ahead of assets prices until (perhaps) late 2016. Lots of people worried, so they did not invest, yet public companies have executed well, and their stocks have now belatedly responded.

The experiences of bear markets, including the ones through which I have managed, suggest that valuation, liquidity and leverage drive outcomes; that is, at a high level, the structure of the type of equity investments we make matters. High valuations reduce future expected returns overall; liquidity in our own portfolios and on the balance sheets of those we invest in allow for rational capital allocation decisions; and low or manageable leverage at our portfolio companies allows management to make rational decisions, rather than narrowly-focused bankers making decisions for them. The corollary is that I am skeptical of high valuations, high leverage and poorly financed companies above all.

In Defense of Optimism

Jeremy J. Siegel argues in his now classic book, *Stocks for the Long Run* (1994), that, over virtually every twenty year holding period, being fully invested in equities produces higher real returns than bonds, stocks, cash or gold; and that this is also true over most ten year holding periods.[7] The clear implication is that *not* being invested is the more risky course. Pessimists may win the public relations game because they appeal to our instinctual fears, but they risk missing opportunity. Patient long-term investing demonstrably preserves and creates real returns, and the results of Tocqueville's longstanding clients support this claim with clarity.

The risk I run in writing a piece like this is that the reader may assume that because we are optimists, we are not skeptical or risk averse. Far from it: we are cautious, skeptical and risk-averse to the core. However, negativity creates opportunity for the long-term investor, so let's embrace it.

Kenneth E. Lee
October 2, 2017
Originally Penned February 11, 2016

[1] The idea here is that CEOs who are either pessimistic or, conversely, overly optimistic tend to underperform CEOs that are optimistic within a frame of strong capital resource management: "Will managerial optimism affect the investment efficiency of a firm?" I-Ju Chen,*, Shin-Hung Lin. Procedia Economics and Finance, Volume 2, 2012, pages 73-80.

[2] Any number of credible sources contend that optimistic people experience less stress and live longer including: Scheier, M. F.; Carver, C. S. (1987). “Dispositional optimism and physical well-being: the influence of generalized outcome expectancies on health”. Journal of Personality.

[3] Robert J. Shiller. Do stock prices move too much to be justified by subsequent changes in dividends? *American Economic Review*, 71:421—436 (1981).

[4] Ross, L., Lepper, M. R., & Hubbard, M. (1975). Perseverance in self-perception and social perception: Biased attributional processes in the debriefing paradigm. *Journal of Personality and Social Psychology*, 32,880–892.

[5] D. Kahneman, A. Tversky, Prospect theory: An analysis of decision under risk, *Econometrica* 47 (1979) 263–291.

[6] J.J. Siegel, *Stocks for the Long Run* (1994) pp. 28: “The crash of 1929 affected the public’s investing habits for at least a generation”, and pp. 37-39.

[7] Ibid. Page 31.