

Buy Low, Sell High
(Acronym Code: BL/SH)

Have you ever heard that one? Everybody knows that you need to buy low and sell high (BL/SH). By following this simple rule, you can always make money. To be a successful investor, you only need two things: (1) a long-term mindset and (2) the conscious decision to buy low and sell high. Yet, most investors do not have either of these. They are not willing to commit to the long term, and they always follow a different rule—buy high and hope to sell higher! The much greater popularity of this alternative rule is a reality in the marketplace, and we believe that the evidence of this is clear.

Past Proof

In a recent *Fortune* article, Warren Buffett pointed out the extreme lack of correlation between the growth of our country over the last 100 years and the returns of the stock market. While the stock market makes many dramatic moves, both up and down, the economy as measured by GNP (gross national product), grows at a relatively steady pace. During the last century, there were three huge bull markets spanning 44 years, and there were three periods of stagnation covering 56 years when stocks were actually down (excluding dividends).

Why do we experience so many quick, extreme moves in the market when the changes taking place in the underlying economy are not that quick or that extreme? We have two reasons. First, consider the significant changes that have taken place in interest rates. As we have noted in the past, a company's intrinsic value is always the net present value of the future cash flows that the company is able to generate. If long-term interest rates are high, the present value is much lower than at a time when interest rates are low. So, when rates were much higher in the early 1980s, a company's intrinsic value was significantly less than it is now, a time when long-term rates are relatively low.

The second reason for having these wild stock market swings is less quantitative but just as real, the predictable behavior of the average investor is to buy high and “hope” to sell higher. Stock market investors always seem to assume that whatever happened in the recent past will continue, getting even better (greed) or even worse (fear). This behavior results in accelerated buying at market tops—buying high—and accelerated selling at market bottoms—selling low, further amplifying the irrational highs (2000) and lows (1982). The catchword for this behavior is overreaction.

Professional Proof

The market masses cannot figure out how to BL/SH, but certainly the professionals in charge of the largest pension funds in the world should understand and follow this simple rule. These pension fund managers also have time on their side. These funds have long-time horizons, so their fund managers could be very patient with their investment decisions and wait for the opportunities to come to them. Plus, there is no need to panic since it is not their money being invested. Our experience over the last 25 years suggests that even these professionals do not come close to following the simple BL/SH rule, no more so than the man on the street.

We were the in-house advisers at RJR Nabisco, and we knew many of the professionals who were responsible for the largest corporate pension funds in the country. If there were a single contra-indicator

that we would use, it would be to do exactly the opposite of whatever is currently being done by the consensus of all institutional funds.

In the late 1970s and early 1980s, pension fund managers were abandoning stocks and investing in tangible assets, like real estate, oil, and gas. These years were at the peak of inflation, and tangible assets were way up. Clearly, pension fund managers were buying tangible assets at a time when these professionals thought the assets would go higher. Stocks were very cheap, having gone nowhere since 1966. The market was being priced extremely low, less than ten times earnings, and these corporate pension fund managers were assuming that the market would go even lower. They had observed what had happened in the recent past, and they assumed that the markets would continue to do the same in the future.

With any market extremes—the oil bubble, portfolio insurance, the international/Japan bubble, the technology bubble, etc.—you will find a certain behavior with professionals. Even today, we see it with their poor timing in flocking to venture capital investments and their latest rage, hedge funds that have not yet imploded. Not only are these professionals unable to avoid the herd mentality, but they are the herd. Again, BL/SH is a behavior often preached but seldom practiced, even by professionals.

Present-day Proof

What does it take to BL/SH? The correct BL/SH behavior is perfectly clear, in hindsight. Not only is history clear, it is somewhat repetitive. Each repetition is sufficiently different to allow for a “this time it is different” theme to emerge. But, the characteristics of those repeating cycles are generally the same. Then, why do investors not learn?

Quite simply, to BL/SH consistently requires an abnormal, counterintuitive, discomfoting behavior. You must be a contrarian. The world is fortunate that most people are not contrarian by nature. People are more comfortable doing whatever others are doing. The more other people come to your same decision, the more this confirms your decision. The thought process is that people would not make a decision if they did not think they would win, and if they lose, it is much more comforting to lose among friends and respected peers than by themselves.

So it should be easy to identify the “present-day proof” correctly for our theory that investors as a group do not follow the BL/SH rule. We will show this by identifying the stocks that investors are most comfortable buying today, and you can assess for yourself whether those securities are “low.”

- **Index Funds** – Any good investment idea can be destroyed by over popularity. Portfolio insurance in 1987 was a good example. As with most examples, the star quickly rises and falls within a few years (e.g., nifty-fifty, oil bubble, technology bubble). However, with index investing, the cycle from infancy to a market extreme has spanned two decades rather than a few years. The popularity of indexing began to build slowly in the early 1980s, and it has risen steadily over the last two decades. It has grown from almost nothing to over 40% of the assets invested in the S&P 500 Index. Once again, similarly to the portfolio insurance problem, the popularity of capitalization-weighted, index investing among the investment professionals is one of the principal causes for today’s market valuation problem. However, over the last three years, the S&P 500 has declined 2.5% per year. As we have noted in many of our quarterly commentaries over the last few years, we believe that this particular cycle peaked in 1999 and that the downside of this cycle will create a problem for the larger capitalization stocks for years to come (see below).
- **Mega-Cap Stocks** – The index-investing problem noted above has created a new nifty-fifty problem. When you make an investment, you are making an asset allocation

decision. Investors and markets are better served when assets are allocated to the most productive businesses. With index investing, assets are allocated to the largest businesses, not the most productive. The larger businesses get even larger, and, as they receive this “easy money,” the companies probably become even less productive. The price/earnings ratio for the S&P 500 Index is now at 26, excluding negative earnings. If negative earnings were included, the P/E ratio would be 57. Historically, the ratio has averaged in the mid to high teens. Even with the recent market declines, investors’ comfort in buying very large, high multiple companies—Wal-Mart, Home Depot, General Electric, Microsoft, etc.—may be misplaced.

- **A Technology Recovery** – Investors still appear somewhat comfortable buying technology stocks. The prevailing belief is that the original concept for buying tech stocks was good, and because they have dropped so far, now must be a good time to buy. While we like stocks that have been beaten down, we do not share that level of comfort with this sector. At their peak in 1980, oil stocks were 35% of the S&P 500. They are now around 6%. It took over a decade for total belief in the original concept to fully dissipate. At their peak in early 2000, technology and telecommunications were over 40% of the S&P 500. They are now around 22%. Those stocks continue to have little or no earnings, so their price/earnings ratios are still in the triple-digit range. Any comfort with investing in this sector probably continues to be misplaced.

After years of practice and training, we have found that some of us can be successful contrarian investors while still finding a way to fit in with society. This is the only way we know of to buy low and sell high consistently for our clients. Since the principals at CornerCap invest their own money in the same securities as their clients, they intend to continue following the simple rule of buying low and selling high, even though this contrarian behavior may seem counterintuitive and discomforting at times.