LightHouse Investment Services

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Investment Psychology

It is hard not to feel somewhat buoyed when the value of your share portfolio rises. The tendency is to feel both materially and morally advantaged. (Materially because your portfolio is deemed to be worth more and morally because you are able to say to yourself, “I was right.”) This is a fundamentally irrational impulse and one that we should make a very conscious effort to avoid. After all the market’s assessment of the value of a parcel of securities that we own is really no more relevant than the market’s assessment of the value of the home that we live in. Its market value only has any significance at two points in time – when we buy it and when we sell it.

What is meaningful is their utility. In the case of the home it is its ability to provide a dwelling that matches our needs and desires. In the case of a portfolio of investments it is the income stream that it will pay us over time.

An equally irrational impulse is to feel despondent when the value of your share portfolio declines – as it has so dramatically in recent times.

You may be familiar with Ben Graham’s tale of Mr Market which Warren Buffett retold in his 1987 letter to shareholders. For those of you who have not, I think it is timely to repeat it:

> Ben Graham, my friend and teacher, long ago described the mental attitude toward market fluctuations that I believe to be most conducive to investment success. He said that you should imagine market quotations as coming from a remarkably accommodating fellow named Mr. Market who is your partner in a private business. Without fail, Mr. Market appears daily and names a price at which he will either buy your interest or sell you his.
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> Even though the business that the two of you own may have economic characteristics that are stable, Mr. Market's quotations will be anything but. For, sad to say, the poor fellow has incurable emotional problems. At times he feels euphoric and can see only the favorable factors affecting the business. When in that mood, he names a very high buy-sell price because he fears that you will snap up his interest and rob him of imminent gains. At other times he is depressed and can see nothing but trouble ahead for both the business and the world. On these occasions he will name a very low price, since he is terrified that you will unload your interest on him.
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> Mr. Market has another endearing characteristic: He doesn't mind being ignored. If his quotation is uninteresting to you today, he will be back with a new one tomorrow. Transactions are strictly at your option. Under these conditions, the more manic-depressive his behavior, the better for you.

> But, like Cinderella at the ball, you must heed one warning or everything will turn into pumpkins and mice: Mr. Market is there to serve you, not to guide you. It is his pocketbook, not his wisdom, that you will find useful. If he shows up some day in a particularly foolish mood, you are free to either ignore him or to take advantage of him, but it will be disastrous if you fall under his influence. Indeed, if you aren't certain that you understand and can value your business far better than Mr. Market, you don't belong in the game. As they say in poker, "If you've been in the game 30 minutes and you don't know who the patsy is, *you're* the patsy."

Our aim is to invest in businesses that will continue to provide a growing income stream and in which you will be proud to be part-owners. The best way we see of doing this is by only investing in businesses because we understand them inside out, and not simply because the fashion of the day is to buy shares in particular types of companies. If we can get this right (at least most of the time) we believe we will continue to do well with your savings.

Debt

In the wake of the US sub-prime fallout, and the tighter credit environment that has accompanied it, there is a great deal of talk about the level of debt that businesses have. Over the past half dozen years, with easy credit and steadily rising asset prices, it was tempting for businesses to gear up their operations and boost their returns to shareholders. This was often accompanied by less than transparent financial structures so that the company's actual level of debt might be significantly higher than its reported level. Institutional investors could be scathing on businesses that had "lazy" balance sheets. With the dramatically changed environment they have changed their tune and fleeing businesses that they perceive to have too much debt (particularly any that needs to be rolled over in the short term).

We find this a rather odd approach. Debt has always been an initial filter we apply to any business that we are considering investing in. Unless there is a clear reason why a higher level of debt is acceptable (such as particularly secure contracted future revenue) our rule of thumb is that we would like the business to own at least twice as much as it owes. So we would want a business with $100 million of debt to have $200 million of net tangible assets and $300 million of total tangible assets. To now begin filtering on the basis of debt looks a bit like locking the front door after the burglar has ransacked the house.

Many of our absolutely favourite businesses have **no** debt. Companies such as Flight Centre, Blackmores, Microsoft, Platinum Asset Management, Hunter Hall International, and Treasury Group, as well as the listed invested companies that we recommend and even Sirtex and Infomedia, have no debt and in some cases substantial sums of cash in the bank. This luxury, which may have had a dampening effect on their earnings during the recent "go go" years, also gives them a remarkable degree of resilience in the face of tougher economic conditions, which helps us to sleep a lot more soundly.