The money game

By Geoff MacDonald, portfolio manager

Flashback

We've decided to bring back Mr. B in this commentary. If you're not familiar with Mr. B, he was first introduced in our first quarter commentary in 2010. We've used Mr. B in the past to illustrate that most stock market participants don't act like rational business owners.

Mr. B has a refreshing view of the stock market and believes it exists to serve him.

At the time he was first introduced in 2010, the doom-and-gloom "bears" were all caught up in the macroeconomic noise and fear, missing out on something that a rational business owner could not ignore at that time: great businesses at stupidly attractive prices.

Oddly, these days, fear and worries about the stock market seem to be expressed through very high prices on a select basket of investments that supposedly offer some form of "certainty" for those who own them.

The rich

Think of the three or four richest people or families you know in your town. Do the same for your neighbouring town. Then think of the 10 or 20 richest people or families in the world that you've heard of.

And how they got rich

How did these people amass their wealth? I take little risk in speculating that they amassed their wealth by owning a quality business or two over many years, likely decades. There is no better way to build wealth over the long term than to own quality businesses that were initially purchased (or built) at a reasonable cost. This will never change unless capitalism, as we know it, ends.

Mr. B

For those newer to EdgePoint, Mr. B is the average business person, similar to those you thought about a few paragraphs ago. We like to call him or her a rational business owner.

As a rational business owner, Mr. B approaches the stock market as simply a meeting place where business people can buy or sell an ownership stake in a business. He loves the stock market because he's figured out that it's there to serve him.

He knows that stocks are not just quotes that move up and down, but instead represent ownership stakes in businesses.

And all those stock prices that go up and down each day in the "market" are simply other peoples' interpretation of what the businesses are worth … or maybe it's other peoples' interpretation of where the stock prices are going. It's truly useless information for Mr. B, unless, he has an interest in potentially buying or selling one of these businesses.

Again, the overall level of the stock market and the individual stock prices give him no useful information, other than that these are the prices that others arbitrarily set on the few businesses that he's interested in.

We believe Mr. B.'s view is how any rational business owner would view the stock market. And, if wealth has been amassed over time by owning good businesses, the stock market is a great place to find future wealth generators.

Monkey see...

There are far too many games being played in the stock market, but the only game anyone needs to play is "monkey see, monkey do" with Mr. B. If before we did anything in the stock market, we asked ourselves "What would Mr. B do?", we'd find serenity – and a larger stash of net worth in the future. I'll spend the rest of the commentary explaining the serenity that comes by simply acting like Mr. B.

The Money Game

Speaking of games, my second all-time favourite book on investing is *The Money Game* by Adam Smith. The author was not the Adam Smith in the photo, who has been memorialized with the statue in Edinburgh as the father of economics. Instead, "Adam Smith" was a pseudonym that was given to him when he was a young journalist for New York magazine in the 1960s, to hide his identity from sensitive Wall Street sources. The book is highly instructive and amusing, and an excellent book for those looking to become better investors.

The author of The Money Game, George Goodman was an American author and economics broadcast commentator. His personal style of presenting economic facts and data has been described as that of a witty, urbane dinner guest, a droll observer of human affairs. Goodman pioneered a style of financial writing that made the language and concepts of Wall Street more understandable and accessible to the typical investor.

His other works include: *Supermoney* **(1972),** *Powers of Mind* **(1975),** *Paper Money* **(1981),** *The Roaring '80s* **(1988).**

If I could summarize the key findings that I've taken with me for the past 20+ years since reading the book, it would be that successful investing is accompanied by serenity. And serenity can only be achieved by the avoidance of anxiety. And to avoid anxiety when investing in the stock market, you have to know who you are, what you're doing and why you're doing it. The author calls this your "identity".

Mr. B knows who he is – he's a rational business owner. Make your identity Mr. B and you'll have pleasing long-term results, you'll find serenity when investing and you'll likely have fewer grey hairs!

...Monkey do

Luckily for Mr. B, most investors ("professionals" included) can't emulate what he does and thus don't invest like rational business owners. That might sound like a harsh statement, but the next few paragraphs will back it up with just a few of the many examples we could use. It's Mr. B's fortunate reality because he gets to buy businesses from (and sell them to) those who can't or won't emulate a rational business owner.

Lucky Mr. B – example 1

The average investor holds a stock for approximately six months. Six freakin' months! Remember, a stock actually represents a stake in a business! Can you imagine Mr. B only owning his businesses for six months at a time? The Mr. B you know from your neighborhood didn't make his or her money doing that. Who could? Imagine if an investor:

- bought a hotel,
- but six months later sold the hotel so he could buy a railroad,
- and six months later sold the railroad so he could buy a plastic packaging company,
- and six months later sold the plastic packaging company so he could buy a vineyard,
- and six months later … and so on and so on.

I think that most people realize that this "investor" would have difficulty compounding wealth. So why do "investors" try to do this exact same thing with businesses in the stock market? If you ask me, it doesn't make any sense. It's certainly not how a rational business owner would approach things. But, Mr. B gets to buy businesses from (or sell them to) these irrational, short-sighted "investors." Lucky Mr. B.

Lucky Mr. B – example 2

Most professional investors are compensated and measured against a benchmark. The benchmark is an index of some sort (like the S&P 500 Index[i] for a U.S. equity manager). When a portfolio manager's compensation is based on beating a benchmark, the first question from that portfolio manager is "what's in the benchmark?". If the manager's portfolio is different from the benchmark, the manager will be at risk of underperforming it. That risk is called "benchmark risk."

If a manager is unsure about a sector or a company, he or she can simply market weight that sector or company, which means holding the same weight of the particular sector or company in your portfolio as the index does. This way the portfolio manager takes no risk with respect to how he or she is measured and compensated. In other words, they have put your money into something they are unsure of or have no opinion about, yet according to conventional wisdom, they have taken no risk.

You'll hear managers using words like "underweight." That means they don't like something so they own less of it than the benchmark holds. Why hold it at all? Imagine a rational business owner investing his money in a business he doesn't like, but rationalizing it by explaining that he owns less of it than others do. Clear absurdity, right? Look no further as to why so many managers have less than satisfactory long-term results.

Lucky for Mr. B, with so many closet-indexers, this allows him to look where no one else is looking.

Lucky Mr. B – example 3

The gargantuan flows that have been going into index funds have worked in Mr. B's favor. An index fund literally takes its investors' money and buys and sells businesses every day without asking (or caring) about the business' management team, prospects, accounting, competitors and/or valuation. For investors, the cost of being ignorant about their investments could far exceed the low cost of the index fund. If you put your rational business owner hat on, you see that it's truly an illogical way to buy businesses, but let's hope this trend continues because it creates opportunities for rational business owners like Mr. B.

Lucky Mr. B – example 4

Luckily for Mr. B, momentum investing has become vogue again over the past couple of years. The last time he remembers momentum investing being this popular was in 1999 and early 2000. For him it ended well, but not so much for those who were caught up in the momentum trade when it suddenly collapsed with scarcely a skid mark. Mr. B didn't think he'd ever see such a large group chasing momentum again, but time has a way of erasing bad memories.

Momentum investing aims to capitalize on the continuance of an existing market trend. The belief is that trends persist and that it's possible to profit by sticking with that trend until its conclusion, no matter how long that may be.

Say what you want about momentum investing, but you can't say it's how a rational business owner would buy a business. Imagine Mr. B buying a business because other people's interpretation of what the business is worth (its stock price) keeps going up, which must mean that they know what they're doing, which must mean the price will keep going up. But, the mere fact that the price is going up is the reason other people want to buy the business. Mr. B could look at the valuation and likely notice that the business is excessively expensive, but this information wouldn't be needed for momentum investing.

As you can see, this approach is beyond ridiculous and not for those looking for the serenity and pleasing long term results, like Mr. B.

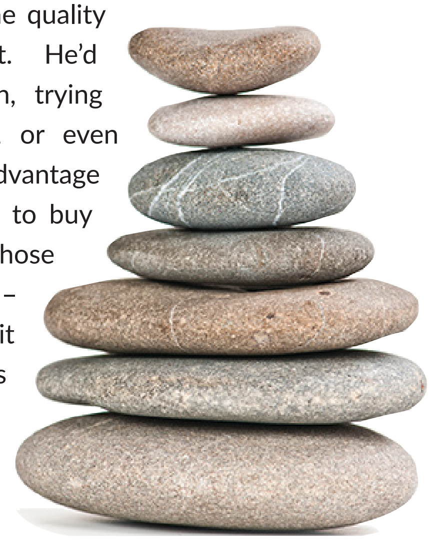
Taking candy from a kid

We could keep going. We have all seen examples of investments made in the stock market in very different ways from how a rational business person would approach investing. We've all likely done it too. And why would someone buy a business in the stock market differently from how they'd buy it outside of the stock market? We really don't know. We only know it's the main reason why most people don't get the results they could.

Serenity

You'll notice that I didn't fully explain Mr. B's approach to investing, except that he thinks and acts like a rational business owner and that he believes the stock market is there to serve him.

I suspect most of you already recognize what this means and how a rational business owner would invest. He'd view a stock as a business and not as a piece of paper. He'd take a long-term view. He'd form his own views on the prospects of the business and the quality of the management. He'd study the competition, trying to understand where, or even if a competitive advantage exists. He'd only want to buy the business if all those things checked out – and if he could buy it for less than he thinks the business is worth. It's a serene way of going about investing in a world where masses constantly buy businesses without treating them like businesses.



Time-tested

I'm sure you've guessed what the EdgePoint investment approach is all about – we try to invest like Mr. B each and every day. It's a time-tested approach that's worked very well for those who have partnered with EdgePoint and its principals for approximately 50 years.[ii] Nothing will ever change the fact that investing will be most successful if it is most business like. Just ask Mr. B.

[i] The S&P 500 Index is a broad-based, market-capitalization-weighted index of 500 of the largest and most widely held U.S. stocks.

[ii] We practice the same investment approach that was practiced by co-founder Robert Krembil since 1970s, which has resulted in pleasing long-term investment performance over various market cycles. The approach successfully built wealth for investors during Bob's tenure at Bolton Tremblay and Trimark Investment Management. Tye Bousada, Geoff MacDonald and Ted Chisholm have followed this approach after being hired and mentored by Bob during their investment careers at Trimark. EdgePoint Portfolios have also been managed according to this approach since their inception in 2008.

Published October 7, 2019.