

A Conversation with Chris Davis on Successful Investing



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Chris Davis on Successful Investing

What should investors bear in mind navigating today's market and beyond?

If the brain is the most important organ for successful investing, the stomach may well be the second as reason and judgment can easily be distorted by fear and other emotions. Over 65 years and three generations of investing, our family has seen this occur again and again. While common sense would dictate that buying stocks when prices are low is better than buying when prices are high, investors often do the opposite. Falling prices make investors fearful and soaring prices make them greedy. In essence, healthy investor behavior means being disciplined, patient and unemotional. This requires having the temperament and discipline to invest *especially* when prices are low. In contrast, unhealthy investor behavior typically leads to selling during periods of great pessimism (most recently in the depths of the financial crisis) and leaping in at the top of bubbles (for example, into tech stocks during the Internet boom or into real estate during the housing bubble). Such emotional decisions can wipe out years of gains achieved through compounding.

Here are three specific lessons to keep in mind.

First, disregard short-term market and economic forecasts.

Amazingly investors often rely on interest rate forecasts and stock market predictions despite overwhelming evidence that these have little or no value in predicting stock price moves.

For example, we tracked the average interest rate forecast from *The Wall Street Journal's* surveys of economists from December 1982 to today. This average forecast was then compared to the actual direction of interest rates. The result? Overall, the economists' forecasts were wrong in 47 of the 74 time periods—64% of the time!¹ To build long-term wealth, investors must disregard such forecasts.

Second, do not chase the latest hot-performing investment category or asset class and do not try to time the market.

Again and again we see investors flock to managers and strategies that have recently done the best, only to be disappointed when those same managers go through the periods of underperformance that so often follow such hot streaks. For example, over the last few years, passive, index-oriented investment strategies have delivered strong returns as the correlations within the stock market between individual stocks and their sectors have been quite high. As a result, investors have poured money into these passive strategies. We believe the investment landscape may be changing, however, and we may once again be entering a stock picker's market where success will depend on a professional portfolio manager using discipline and judgment to separate good businesses from the bad. Even though active management may not be in fashion at the moment, we do not intend to change an investment strategy that has served us well for decades or give up the ability to use judgment rather than formulas in managing our clients' savings.

Third, invest systematically. Investors who want the growth potential of equities but may be too concerned about a market correction to begin investing should consider a systematic investment plan.² Systematic investing involves investing money in equal amounts at regular intervals, regardless of the market environment. For example, an investor with \$10,000 to invest in

1. This is a semi-annual survey by *The Wall Street Journal* last updated 6/30/19. **Past performance is not a guarantee of future results.** 2. Systematic investing does not assure a profit nor protect against losses in declining markets. Systematic investing involves continuous investment regardless of fluctuating prices. You should consider your financial ability to continue purchases through periods of high or low price levels.

stocks may choose to invest \$1,250 every three months over a two year stretch. A systematic investment strategy has three key benefits:

- It removes the emotion that can adversely affect the timing of investment decisions.
- It means investors automatically purchase more shares during periods of uncertainty when prices are low and fewer shares during periods of euphoria when prices are high.
- It capitalizes on market volatility because more shares are automatically purchased at lower prices when the market drops.

This sort of systematic approach is an excellent feature of many 401(k) plans where employees make regular investments based on pay periods. But we believe many other types of investment accounts could benefit from this same approach.

What are the biggest contributors to your success as an investor?

We believe the three biggest drivers of our long-term outperformance are perspective, discipline and alignment with our investors.

In terms of perspective, we never forget stocks represent ownership interests in real underlying businesses. As a result, we focus steadfastly on the durability and long-term growth of the *businesses* we own rather than their fluctuating stock prices. If we are right about the business fundamentals, then time and the power of compounding will work to our advantage in building wealth over the long term.

Regarding discipline, we recognize the growth of the underlying business can be amplified if the business is bought at a bargain price. As a result, a strong valuation discipline is a central tenet of our investment philosophy. This discipline also serves to reduce risk by providing a “margin of safety” in our purchase price as a buffer against inherent uncertainties and gives us the staying power to weather occasional but inevitable economic storms.³

3. While Davis Advisors attempts to manage risk there is no guarantee that an investor will not lose money. Equity markets are volatile and the investment return and principal value of an investment will vary.

In terms of alignment, we have always believed in eating our own cooking. Our firm's employees, board of directors and their families have more than \$2 billion invested side by side with our clients.⁴ This alignment means that in addition to thinking about the upside potential of any investment, we also think about the downside. As fellow investors, we are also motivated to maintain a relentless focus on research and results while avoiding the conflicts that can arise when portfolio managers invest their own money differently than their clients' money.

What is the key mistake investors make?

The most common reason investors fail to achieve satisfactory results over the long term has more to do with temperament than ability. Quite simply, people often want to do today what they wish they had done five years ago. Time and again investors choose to buy *after* prices have gone up and to sell *after* prices have gone down. What is true for individual stocks is also true for funds and even asset classes. Investors often want to purchase funds and asset classes that have strong performance in recent periods and sell funds and asset classes that have lagged. Such behavior reflects emotion rather than rationality. Investors should not be optimistic or pessimistic but realistic, taking into account the key important and knowable factors, both positive and negative, that can affect their returns over time. In our view, durable businesses run by able and honest managers with strong competitive moats, reasonably attainable growth prospects and high returns on capital are the best vehicles for compounding wealth, provided they are purchased in a disciplined fashion and held for the long term. Moving in and out of stocks, funds, investment styles, or asset classes based on what has already gone up or down generally results in unsatisfactory long-term returns.

4. Includes Davis Advisors, Davis family and Foundation, our employees, and Fund directors. As of 6/30/19.

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