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What Can We Do Now? Part II

A list of ways to help us remain calm

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About four months ago, I wrote an article titled "What Can We Do Now?" Since then the market continued to rise undisrupted until this week. This headline from CNBC summarized what happened – "Dow Plummets 666 points, capping worst week in two years." I was just on CNBC's mobile website and the first 10 headlines are all about the Friday sell-off. The CBOE Volatility Index shot up 28.5% in one day. There's little doubt that there's wide spread mini panic in the market. The question of "what can we do now?" is again on investors' mind. But this time the seeking of an answer seems much more urgent and important than when I wrote the article in September last year.



In the opening paragraph of my aforementioned article, I wrote the following words: "We all know that in the U.S, valuation is elevated and the risk is high. But the question is what should we do now? This question is as easy as it gets and it is also as hard as it gets - depending on many factors such as whether an investor has figured out the purpose of investing, or whether he or she has well defined parameters (time horizon, circle of competency and etc.) in which he or she operates. Things become complicated quite easily." I also listed 5 ways to cope with the then-current environment. For reference purposes, I'll list them again below:

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1. If you are an individual investor, assuming you know your circle of competency and are investing for the long term, there's not too much difference in terms of how to invest in today's market level versus say the market level say two years ago, unless some of your holdings

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Performances of the stocks mentioned by Grahamites

Symbol	Company	Current Price	Change (%)
AAL	American Airlines Group Inc	\$ 48.60	-2.80 (-5.45%)
DAL	Della Air Lines Inc	\$ 51.23	-2.62 (-4.87%)
CSX	CSX Corp	\$ 50.47	-2.50 (-4.72%)
BRK.B	Berkshire Hathaway Inc	\$ 191.42	-8.95 (-4.47%)
BRK.A	Berkshire Hathaway Inc	\$ 288,000.00	-13,000.00 (-4.32%)
NSC	Norfolk Southern Corp	\$ 136.89	-5.79 (-4.06%)
LUV	Southwest Airlines Co	\$ 55.63	-2.26 (-3.90%)
UNP	Union Pacific Corp	\$ 124.86	-4.10 (-3.18%)
UAL	United Continental Holdings Inc	\$ 63.37	-1.99 (-3.04%)
CP	Canadian Pacific Railway Ltd	\$ 172.17	-3.72 (-2.11%)
Summary			-4.01%

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fundamentals dictate investment returns.

2. What you should do now depends on your opportunity cost. Your opportunity cost depends on your investment horizon and required rate of return, both of which need to be well thought out. Let's say your investment horizon is 3-5 years and your required rate of return is 15%, you will essentially be comparing what you have now with what the market is offering you now that may generate a 3-5 year CAGR of 15%. Because "3-5 years" are relatively short, multiple change plays a key role in expected return over this period of time and at today's valuation levels, there aren't many companies you can be confident that the valuation level 3-5 years from today will be higher than they are now.

3. Whether you should hold cash – again, this topic has been debated many times in the investment world. Holding cash implies that your opportunity set is worse than cash over a defined period of time, which may be true. But to simply hold cash because the market value seems high is almost equivalent to market-timing. In a previous article, I've argued that the market has appeared to be expensive since probably 2013 using either the Shiller P/E ratio or the Buffett Indicator (Total market cap/ GDP). You have to be almost exactly right on timing otherwise the opportunity cost is high. There are some "cash substitutes" stocks in the market – it was during last year's Daily Journal (NASDAQ:DJCO) meeting that [Charlie Munger \(Trades, Portfolio\)](#) said that [Warren Buffett \(Trades, Portfolio\)](#) bought Exxon Mobil (XOM) as a cash substitute.

4. Amateur investors with a shorter time horizon and professional investors have to struggle with what one should do now especially professional investors because clients pay money managers to generate returns in all type of market environment. For professional investors, I completely agree with [Howard Marks \(Trades, Portfolio\)](#) – it's time to be very cautious and defensive. In the equity market, there are a few ways to be cautious and defensive and not necessarily in a mutually exclusive way.

- First of all, we can study the past bear markets and see how different stocks behave differently both during the late bull stages leading up to the bear market and during the bear markets. This gives us some sense of what might happen but not what will happen because things are different now. For instance, discounters like Ross Store (ROST) and the dollar stores have done relatively well will during the past two bear markets. A while ago when Dollar General (DG), Dollar Tree (DLTR) and Ross Store (ROST) were all punished by the market due to the "Amazon Effect", that was a good time to scoop them up.
- Secondly, there should be a focus on quality, especially quality companies in defensive sectors such as healthcare and consumer stables. Of course valuation matters so you have to look for quality companies trading at reasonable multiples. For instance, Allergan (NYSE:AGN) and Kraft Heinz (NASDAQ:KHC) are both high quality companies in defensive sectors (healthcare and consumer stables) trading at reasonable multiples, in my judgment. But again, you should make sure the companies fall within your circle of competency.
- Thirdly, one can buy companies that fall under the "work-out" categories which include special situations, international stocks, and companies that have low correlation with the U.S market. For instance, if you can get comfortable with Fairfax, [Prem Watsa \(Trades, Portfolio\)](#) and Africa, Fairfax Africa (FFH.U) might be an interesting option – few people have heard about it; it selectively invests in Africa which most U.S professional investors don't care; and the capacity to reinvest is high as Africa's full of opportunities and volatilities.

5. Last but absolutely not least, as I've stated many times, what you should do also depends on your personality type (whatever makes you sleep better). Each one of us is different in

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I still think all of the above are applicable today even though we just had a sell-off. There's no need to explain again but I think the list is a good reminder in times like this.

A few friends have asked me what I think is the cause of the sell-off, both in the U.S and in China (especially the Chinese nifty-fifty names). If you go out and read the headlines, the most cited reason for the sell-off is the speedy rise in Treasury yields and the expected further rise in interest rates. But the rise in interest rate has been widely expected for a while – it can't be this week that everybody wakes up and finds out that interest rate is going to be higher. I think what happened can be explained very easily – when valuation is high and risk is elevated, it's only a matter of time before a sell-off happens. High valuation itself is a trigger that works like a time bomb except we don't know when it will explode. But as [Howard Marks \(Trades, Portfolio\)](#) said, "the pendulum will inevitably swing to the other direction." And that's what happened. It has little to do with interest rate although it's very easy for first level thinkers to blame interest rates.

In times like this, mental strength is absolutely key. There are a few things we can do to help us navigate.

1. We have to remind ourselves what Peter Lynch once said "People always ask me what the market will do. I tell them what the market does is that the market goes down sometime. And sometimes it goes down by a lot." Corrections and bear markets happen, regardless of whether we want them happen or not. This is key if we want to remain calm and poised. Here are some statistics that you may find useful.

- Since 1928, the S&P has had 51 corrections (defined as a drop from peak to trough of more than 10%). Of the 51 corrections, there has been 17 bear markets (defined as a drop from peak to trough of more than 25%). Of the 17 bear markets, 8 happened between 1928 and 1941 and only 9 after 1941.
- In the last 50 years (1968-2017), there has been 24 corrections and 6 bear markets for the S&P.
- On average, a correction happens every 2 years and a bear market happens every 5-9 years. These are the facts. We have to deal with it.

2. If the prices of some of your largest holdings go down dramatically, before you make any decision, check the fundamentals of the businesses first. It's human nature to panic and sell. In the panic mode, we always worry that if there's something that we don't know. If the sell-off continues, which I have no idea whether it will happen or not, knowing that the businesses you own will do well regardless of the stock price will help. This is especially true if you own great companies. For instance, in my personal portfolio I own Berkshire Hathaway ([NYSE:BRK.B](#)), Danaher ([NYSE:DHR](#)), Markel ([NYSE:MKL](#)) and Google ([NASDAQ:GOOGL](#)). The Friday sell off didn't bother me one iota.

3. Do a stress test for your portfolio and make your best guess at what your holdings might behave in a real bad market. If you don't know how to estimate the worst case, you may have stepped out your circle of competency and it's time to reevaluate whether you should own the business in the first place. Once you've stressed tested your portfolio, you should be ready for the ride whether it was going to be smooth or rough because you already know what the worst is likely to look like.

4. We also have to remind ourselves of [Seth Klarman \(Trades, Portfolio\)](#)'s advice:

"Of course, getting in too soon as the market falls involves great risk for all investors, including value investors. Certainly, when a few securities start to get cheap even as the bull market continues, a value-starved investor will step up and buy them. Soon enough, many of these prove to be no bargain at all as the flaws that caused them to be rejected by the bulls become more glaringly apparent when the world gets worse. "

5. Be prepared to buy if things get ugly and we have to buy on the way down. If you are fully invested, think about what companies you may want to cut in order to buy the cheaper ones and

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6. Last but certainly not least, meditation is a great way to help you remain calm in turbulent times. I've written about the benefits of meditation before so I won't repeat. Li Lu recommended a book called *Why Buddhism is True* by Robert Wright recently. It's a great read.

As always, I'm curious to hear your thoughts and feedback.

Disclosure: Long AGN,BRK,B,DHR,GOOGL,KHC,MKL.

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About the author:

Grahamites

A global value investor constantly seeking to acquire worldly wisdom. My investment philosophy has been inspired by Warren Buffett, Charlie Munger, Howard Marks, Chuck Akre, Li Lu, Zhang Lei, and Peter Lynch.

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