Three grumpy thoughts from a jet lagged investor

First, happy new year. I got back yesterday from my honeymoon; we went to Tokyo and all across Vietnam. It was a blast. I highly recommend Vietnam in particular and would be happy to give recommendations offline.

I wanted to mention the honeymoon for a specific reason: I'm jetlagged. So while I'm thrilled to be back at work, I am a bit grumpy from jetlag (and lack of constant beach time... and tropical weather... and ignoring everything and eating a vacation diet!). So if this post is a bit more "an old man yelling at a cloud" than usual, you know why!

Anyway, there have been a few things that have been really popular over in fintwit world recently that I think are relatively harmless in themselves but I think can push other investors into a somewhat scary place. They are:

1. Posting annual returns
2. Posting portfolio snapshots
3. Blind valuation games

Again, none of them are particularly dangerous individually (and this post is not meant to call out anyone for doing any of them), but I do think they can put other investors seeing those tweets into a somewhat dangerous spot.

Let's start with the first point: posting annual returns.

Look, the whole name of the investing game is to put up good numbers, and it's normal to want to brag about a particularly good year. I have noticed that I've seen a lot more people posting their 2019 numbers than I did in 2018 (when I'm guessing everyone's results were much worse!), but let's ignore that for now. My real concern about posting annual returns on twitter is not for the person who is posting the numbers; I'm more worried about what it does to everyone who sees those numbers posted. Let's say you were up 50% last year. That's great! But if you flip through twitter and see 15 people post they were up 100%, that's going to put you in a very dangerous spot. It'll be human nature to feel jealousy (I've talked about how dangerous jealousy is before). Or to start questioning yourself: Why was "everyone" up so much more than you? Are they smarter than you? None of those thoughts are going to put you in a good place. You're likely to either get more aggressive than you should be or start "coattail" following ("I don't really know this company, but person X owns a ton and they were up way more than me last year, so I might as well buy it"). Plus, you may feel behind because 15 people posted +100% returns, but that's a really small sample set. Anyone who had bad returns (probably) isn't going to put that out there publicly!!!! So you're biasing yourself to be more aggressive just because you think everyone is doing way better than you even though you're doing just fine (more than fine actually!)! My bottom line here: investing is a long term game. Don't get jealous because it seems everyone is doing better than you. Stick to your process and ignore other people's annual return tweets.

PS- one other note while I'm here: it's really easy to get influenced by everyone posting good numbers on twitter, but you don't know how they got those returns. Maybe they took on way more risk than you're comfortable with (huge leverage, or lots of options, or taking on a bunch of risk in some other way). Maybe they just got lucky. Heck, maybe they're just lying about returns to get some props on twitter.

Ok, moving to point number two: posting portfolio snapshots (i.e. here's my portfolio: 5% stock Y, 4% stock z, etc.). Again, I have no problem with people who do that, but I think they can lead to a lot of group think. It's interesting how every portfolio snapshot I've seen on twitter seems to have the same stocks in roughly the same weighting. Maybe that's because everyone's done all the work on these names and has equal conviction, but it's also possible that everyone wants to be part of the cool crowd and own the same names as each other. My worry with this is that posting these things makes you more likely to manage a portfolio by consensus. Let me just pull one example out: a popular fintwit name to be long is something like MSFT. If you currently own MSFT and post about it every quarter, but then decide to sell, when you make your next portfolio post all of your friends are going to question why and might be somewhat critical of you. At a minimum, when you post your new ex-MSFT portfolio going forward, you're going to get a lot less likes and engagement. An even worse possible outcome: what if you have some really insightful thought about something that most people who like MSFT hate. As a hypothetical, let's say most MSFT longs make fun of IBM as being a dying dinosaur. If you suddenly have an insight and do a bunch of work on IBM and think it's a long, but you're also in the habit of posting your portfolio to get praise from other people who have similar portfolios.... I don't think you'd be able to pull the trigger and actually go long IBM. All of your friends who give you kudos for owning similar stuff every quarter are going to dump on you when they see you bought IBM. Bottom line here: I worry that if you're constantly posting portfolio snapshots, your portfolio is more likely to turn into a popularity contest than a portfolio where you're actually running to be differentiated / generate alpha. There's a lot of potential to let popularity / bias influence your investing here.

Again, I mean no ill will towards anyone by posting this (particularly not you, MSFT shareholders. You're the best! IBM shareholders on the other hand....). I've been very public with my long cable / IAC / sports team thesis, and each one of those are very popular in the fintwit portfolio popularity game. So I very much post this out of concern that the popularity contest has affected me in the past or will do so in the future. For example, if I got more bearish on cable (either because I thought the sector's outlook got worse, or because I thought the valuation was too far ahead of the fundamentals), it's entirely possible that my thinking on the position might be subtly influenced by the fact that if I sold, I wouldn't get as much online love as I do currently. I think and hope I can act rationally, but wanting to be loved can create huge blind spots in people's perceptions. People will do insane things to be liked; is it really so crazy to think that wanting to be liked online could encourage to hold on to a popular stock a bit too long (or subconsciously convince yourself it's still a good value even though all the evidence suggests otherwise)? One of the dangers of publicly writing things up is that you can bias yourself to holding on to the company / position no matter what new news comes along; publicly posting portfolios seems susceptible to very similar issues.

The last thing I worry about is the "blind valuation" games. A blind valuation generally looks something like this: I post a year or three of basic financials (simplified income statement, balance sheet, and cash flow statement) for a company and then ask the reader to come up with a valuation of the stock. Often I'll divide or multiple the financials by a number so no one can guess the company easily. Again, I don't think it's an awful practice, but I do worry about the mindset it leads to. It's basically asking you "can you do a DCF?" I worry it puts people in the habit of thinking a simple excel model is how to perform a valuation, and that the way to practice investing is to simply do a lot of excel models. That's not investing to me: I think investing is about deeply learning a company and spending time thinking about them, and a blind valuation encourages none of that. Plus, I think many of the opportunities in investing comes from complex things that can't be captured in the simple financials, or things that actively distort the financials. The most frequent example I use is "pulling an adobe"; basically murdering your current income statement by switching from selling software to selling a subscription. If you did the same "guess the valuation" game with a company in the middle of that process, you would think the business was going to zero at exactly the same time it was getting dramatically more profitable.

If "blind valuations" aren't great, what's the way to practice? A good one (that I probably don't do enough) is to pull out a 10-K, read it, and then try to value the company based only on the 10-K (maybe add an earnings call transcript too). Do all that without looking at the share price. Compare your valuation to the current market price (I believe the Snowball mentions Buffett used to do that). Do that for ten companies in an industry and see how many of the companies are within range of what you came up with. If your blind valuation is within range of the current market price, you're probably doing something right. If it's not, that should cause you to do some soul searching. Are you systematically ignoring risks, so you're being more aggressive than the market? Or is the market ignoring risks that you see? Or is there opportunity in that sector of the market (i.e. if you think all the companies you look at are worth $20/share and they're all priced at $10/share, maybe you found an opportunity! I get that seems pretty simple; it's how most of us probably look at most companies for the first time (maybe we already know their stock price though!). But I think it's a most better practice than the guess the stock price on blind financials game; it actually encourages you to think about the business and understand what's happening on the income statement.

Another variation of the blind valuation game that I think is far more useful? Look at the "blind" financials and then try to think about what type of business you think the company is in. Often opportunity presents itself when a business calls itself one thing but its financials resemble something completely different. I get that probably sounded like a bunch of gibberish, so let me give a hypothetical example to illustrate. Most grocers run with very low margins; I'm just glancing looking at Kroger's (KR) 2018 10-K, and in each of the past three years their operating margins have been in the 2-3% range. I've reviewed plenty of grocers and most of them are in that ballpark on margin... and that margin makes sense! Grocery is a very competitive business with basically no switching costs or customers loyalty; if you try to raise prices, it's super easy for your customers to walk across the street and go to a competitor's store, and grocers turn their inventory over pretty quickly, so they can take a lower margin and make it up on volume. So if you looked at a grocer and saw they had 15% operating margins, that would raise some eyebrows. To me, I'd be wondering what I was missing: is this business actually a grocer, or do they have some other business hidden in there that's driving all of the margin boost (and that the market might not have picked up on yet)? Are the financials trustworthy (when one company's financials are way out of whack with the rest of the industry, sometimes it's because it's a fantastic business, and sometimes it's because it's a fraud!)? When the financials of a company are massively different than what the rest of the industry and your industry knowledge suggest, often time that's where opportunity lies. For example, if I showed you the income statement for only the broadband portion of a cable business, you might think I was showing you the income statement of a subscription SAAS business, not a cable company. The broadband piece of the business has generally been masked in cable's income statements by the consolidation of their TV business (which is extremely low margin); historically, that presented an opportunity for people willing to think about the different parts of cable and not just accept the headline numbers at their face. There are plenty of other examples out there; a historical one that loosely fits the bill here (but had a huge impact on my evolution as an investor so I'll mention it anyway!) was Bob Evans (BOBE). BOBE was historically a restaurant company, but they had CPG business that had massively grown in value. All the analysts who covered it were restaurant analysts, and that's how the market always valued the company. But if you pulled apart their financials, you could see most of their value was coming from their CPG business and their owned real estate, not the actual restaurant business. That was a big opportunity, but you had to do some digging and understand the different components of the company to see. Blindly valuing the whole company would never let you see that (heck, owned real estate at historical cost would never get captured by a blind valuation since its value is in the footnotes!), but some industry knowledge and valuing each of the parts would.