April 19, 2022

Fellow Investors:

In my Q1 2022 letter, I spoke about investment risk. In this letter, I'd like to share some general thoughts on managing economic developments and on managing our emotions. But first, a note on why stock prices move.

Stock Prices

One of the biggest mistakes made by inexperienced investors is thinking that the markets respond directly to developments in the world. This is only partially true. A more correct statement is that markets respond to changing expectations of market participants regarding future developments in the world. Three important differences between these statements should be highlighted:

- First, the market responds to *expectations* of events, not to events themselves. If, for example, investors generally expect a company will report $1/share of earnings, then that expectation will already be reflected in the stock price prior to the earnings announcement. When the earnings of $1/share are actually released, the stock will have no significant change in value, positive or negative, because the outcome was consistent with expectations and was already embedded in the trading price of the stock. This is true even when outcomes are more extreme; for example, when a company is expected to have massive earnings growth, and then does in fact report massive earnings growth consistent with expectations, the stock price will not change. Of course, earnings announcements frequently do cause stock prices to change, but it is usually because of the new information in the reports that causes investors to reassess their future expectations for the company.
- Second, it is only the expectations of market participants that move prices, not the expectations of non-market participants. The expectations and opinions of analysts, journalists, or anyone else who is not actively trading stocks will never move the price

of a stock, except to the degree that their opinions influence the opinions and expectations of market participants.

- Third, is it only expectations of future events that matter for stock prices. Current or historic events are not relevant on their own, only to the degree to which they may inform future expectations.

These three points may seem obvious to some, but they are so frequently ignored that all investors would do well to remember them. It is the job of the professional investor to understand not only the probable future performance and health of the underlying business in which he/she is investing but also to understand the expectations of market participants currently embedded in the stock price. Neither of these can be observed directly, but judgement and experience can be developed over time with practice and effort.

Economic Developments

In light the previous discussion, I want to address some the many highly visible concerns in the news today. Many worry about inflation and commodity shortages, corporate profit margins and earnings growth, actions of the Federal Reserve, government budget deficits and debt levels, European war prospects, Chinese government interventions, shortages in the labor market, immigration, and the still on-going COVID-19 pandemic, to name some of the most prominent.

While these are all serious issues with uncertain outcomes, I would argue that by the time these events are being blared by new reporters and talk show hosts, their implications for stock prices (if any) have largely already been embedded in stock prices. In other words, you shouldn't make investment decisions by listening to the news. Merely observing these events, or even anticipating them is not sufficient. One must also assess the market's current embedded expectations of these events. If investors generally expect high inflation, or declining corporate profits, or Federal Reserve action, etc., then the actual occurrence of these events will not materially affect stock prices. To be above average in investing, one must find risks or opportunities that are not apparent or generally understood by most investors before they become so. This is a far more difficult task, but can be done by careful study and observation, albeit imperfectly.

Managing Emotions

Finally, I want to discuss emotions. For many, the apparent problems of the world are too much. They are so overcome with fear and worry that they are unable remain invested. Money is an emotional topic. That's a fact of life. Money represents one's life savings, the fruits of one's labors. It represents power to act, or transact, and obtain that which we need or want in life. Almost universally people want more money, and they view anything that increases their wealth as good and anything that threatens it as bad. We could talk at length about whether these attitudes are healthy for individuals or for society in general, but they nevertheless represent a reality of the world we live in.

In general, emotion is not the investor's friend. Emotion frequently leads to taking either too much or too little risk as the investor's mood swings like a pendulum from greed to fear and back again. This dynamic is a large part of what drives market cycles. The best investors are able to separate analysis from emotion and even use emotions to their advantage by selling when others are eager to buy and buying with others are anxious to sell.

A well-known story from the Bible illustrates this idea. In Matthew 25, we read the parable of the talents. While its often interpreted as though the talents represent gifts or abilities, following our usage of the word today, it's instructive to remember that the parable is literally talking about money and investing. A talent was a Hebrew monetary unit equal to 3,000 shekels. In the parable, the first servant was given five talents. He traded and gained five more. The second servant was given two talents and similarly gained another two. Both were equally commended. But the third servant who was given only one talent made no effort to multiply it, for which he was condemned. The master said the talent would have been better given to the exchangers that he might earn usury, or interest. Why had the slothful servant not done so? His excuse: "I was afraid."

Likewise fear and greed rob many investors of success. This does not mean we should be pollyannaish, naively assuming everything will work out fine. There is plenty to be genuinely concerned about in the world. But markets, by their very design and function, are mechanisms for pricing risk. Investing is the craft of carefully evaluating risks and allocating capital accordingly. This is what I strive to do for you each day.

I've gathered a few quotes from other investors about managing emotions. Perhaps you'll find they express the idea better than I have.

"The greatest enemies of the equity investor are expenses and emotions."
Warren Buffett

"The investor's chief problem—and his worst enemy—is likely to be himself. In the end, how your investments behave is much less important than how you behave."
Benjamin Graham

"A lot of people with high IQs are terrible investors because they've got terrible temperaments. You need to keep raw, irrational emotion under control."
Charlie Munger

Thank you for your ongoing support. As always, please contact me with any questions. I enjoy catching up with each of you.

Kind regards,
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