galileocapital
Challenging Conventional Wisdom

NEWSLETTER

Monthly Newsletter – June 2014

Note from Theo and Warren

We realise that you've received quite a bit of correspondence from us recently, but hope you have found it interesting. We promise to return to our normal monthly cycle for the rest of the year.

We are excited to announce the launch of a new service from the start of June: Galileo Asset Managers will provide share advice and portfolio management services to those of our clients who want to own individual shares on the South African stock market. This is something our clients have been asking about since we started Galileo and nine years later, we are ready to deliver on your request.

We have spent the last two years deciding how to offer this service and more importantly, finding the right person to lead this new business in the form of Warwick Lucas, who joins us at the start of June.

We will be providing more information about our share advisory service in the near future, but you are welcome to speak to your financial planner in the meantime if you'd like to know more.

And by way of introduction, Warwick has written us a short article for the newsletter below.

-- Theo and Warren

Bull market blues

By Warwick Lucas, CIO of Galileo Asset Managers

In 1999, I had emerged feeling thoroughly battered from trying to treat the aftermath of the 1998 crash as a mid-cycle correction. Feeling somewhat sulky, I went off to spend a week doing farm work on a friend's cattle and sheep ranch out Kokstad way.

Doing rounds in a bakkie, we stopped very briefly to look at some nondescript item in a field. A few sheep trundled over, thinking some tasty treat was being dished out. More followed. By the time we had driven to the top of the field, a seething mass of several hundred sheep were thundering down the hillside, looking for a tasty treat that wasn't there, and had already left. This, of course, was the most penetrating insight into a roaring bull market that I could possibly have hoped for.

The trouble with bull markets is that they are not investment fests – they are more like social events. Tales of derring-do and 'hot tips' abound. Morons become geniuses.

Worst of all, is the welcoming of dips as another opportunity to join the party. "All it takes is nerves of steel," the geniuses cry, "to double up into dips, and go big or go home!" Like Pavlov's dog, they are conditioned to start drooling every time the bell rings. Like Pavlov's dog they would also do well in the end to go home.

While I'm against the practice of market timing, strong bull markets have some emphatic defining characteristics that are well worth examining. Seasoned fund managers tend to doubt its existence: they've already had it so good they can't believe it will carry on. But mean reversion is hardwired to a greater or lesser degree into humans – it's a survival strategy. What goes up must surely come down, right? Often the great fund managers get out too soon – way too soon, often to the short-term detriment of their business. In a bull market, a fund manager who is under-invested in shares will lose clients faster than a cat loses its winter coat.

'Long-term' becomes a month. Nobody wants to hear about value, they want to hear about action and growth! In 1998, for several months, I recall signing up a minimum of three new accounts per day, with no effort. The trouble with so many newbies, is that they swamp the market's 'memory'. They also have no appropriate fear of risk. And risk is deceptively high in a bull market. The trend tends to disguise a portion of it. Second-rate brokers, lacking in quality, slash transaction costs to secure volumes, so debasing the industry.

Because of the sociable nature of the bulls, 'tipping' and it's nefarious cousin, insider trading, tend to pick up. Markets also tend to be more efficient when there are more participants. Remember, efficiency and investment merit, have nothing to do with each other.

And at the end, when the pack folds, what then? After 1998, I didn't have any bankruptcies or suicides amongst my clients, but make no mistake, they happened to others. There were, however, one or two divorces, as well as confessions that people had overstated their financial position, so that they wouldn't be turned away. Insane.

At the end of the day, there are always reasons to be bullish or bearish on a market. People will always cherry pick logic to validate their own conduct. All that is required for irrational exuberance or pessimism is a spot of sustained behavioural error.

Does this mean that one simply shouldn't invest in a bull market? No. The board is set and the pieces will play. Mostly it's a case of picking the right sectors, and then nearly outstaying your welcome!

In 2014, we are now 5½ years on from the lows formed after the most murderous bear market in real terms since 1980, and before that 1929. The strongest performers from that low base were in many ways the most defensive; namely booze, tobacco and retailers and globally in social media (with massive revenue growth, but as yet unproven profit sustainability). Our own Naspers was a beneficiary of that. To buy SAB now on a PE of 27x or Naspers on 65x, you would have to be betting on massive profit growth or further upward re-rating. That is not impossible, but in my judgement it is most certainly imprudent.

Given these circumstances, and traction coming through in global recovery, it is in some other areas of industrials where you can find value, but more particularly in financial companies. Financials benefit the most from asset price inflation, yet very little comparatively has flowed through to their share prices. Resources stocks also offer value, but given the lack of clarity in the supply-demand equation for them (think Chinese stock-piling and new mine supply coming online) we are happy to watch developments from the sidelines.

Conservative investors could also consider bank preference shares – they offer tax-friendly yields of 7.5%, they are at discounts to face values, and best of all no more will be issued because new Basle rules disallow banks from including Pref shares in their Tier One capital.

I have found that the market treats you as you treat it. Treat it like a casino and it will most likely spit you out like a punter. Treat it as a prudent tactical investor and it rewards in kind – over time. There is always opportunity in the market.

Warwick is the Chief Investment Officer of Galileo Asset Managers. He graduated from Wits University as an Industrial Engineer and worked as an engineer before entering the investment industry 18 years ago. He has worked as a research analyst and portfolio manager at BoE and ImaraSPReid. His creative and critical thinking, combined with a large dose of pragmatism has made him a popular market commentator on TV and in the press. In addition to his engineering background, he has completed the exams pursuant to the CFA designation and extensively follows contemporary finance literature.

Seven secrets of outstanding achievers

Charles Garfield, Associate-Professor at the University of California's Medical College in San Francisco and head of his own Research Institute – the Peak Performance Centre in Berkeley, has studied 1 500 outstanding achievers in nearly every walk of life. He finds they all have certain traits that are not innate but which can be learnt by anyone. Including you:

1. **Lead a well-rounded life.** Garfield says top performers know how to relax, are able to leave their work at the office, prize close friends and family life, and spend a healthy amount of time with their children and friends.
2. **Select a career you care about.** Garfield's data shows that when high performers choose work they like, their work is better and their rewards higher.
3. **Rehearse each challenging task mentally.** Before any difficult or important situation – a board of directors meeting, a public appearance, a key tennis match – most peak performers run through their desired actions in their minds over and over.
4. **Seek results, not perfection.** High performers are almost always free of the compulsion to be perfect. They don't think of their mistakes as failures. Instead they learn from them so that they can do better the next time.
5. **Be willing to take risk.** High performers are able to take risks because they carefully consider exactly how they would adjust – how they would salvage the situation – if they failed.
6. **Don't underestimate your potential.** Most of us think we know our own limits. But much of what we know is not knowledge at all but belief – erroneous, self-limiting belief, the biggest obstacle to high-level performance. High performers, on the other hand, concentrate on themselves – on their feelings, on their functioning, on the momentum of their effort and are therefore freer to achieve at peak levels.
7. **Compete with yourself, not with others.** High performers focus more intently on bettering their own previous efforts than on beating competitors. Because they are interested in doing the best possible job by their own standards, they tend to be "team players" rather than loners. They recognise that groups can solve certain complicated problems better than individuals and are therefore eager to let other people do part of the work.

The most important meeting of your week

A Harvard economist, Sendhil Mullainathan, has found that there are psychological connections between the bad financial planning of many poor people and the poor time management of busy professionals. In both cases, the experience of scarcity causes biases in the mind that exacerbate problems.

So, for example, he says, each year he has to renew his car licence disc. And each year, he does the same thing. He's really busy, so on each day leading up to the expiration of the licence, he tells himself he'll attend to it the next day. We've all done this – before you know it you're driving around with an expired licence disc, and so you turn down a different road to avoid a traffic cop, and you're late for a meeting, and it throws your whole day out of whack. And now you have even less time to attend to your licence.

In the end, if you'd just gone and renewed the licence, you'd have saved yourself a whole lot of time.

Mullainathan applied this to the economics of poverty. Lots of studies show that poor people tend to make bad financial decisions, the kind that land them in ever deeper cycles of debt. And Mullainathan realised there was an unexpected connection between his behaviour and the behaviour of the people he studied.

Not having enough money and not having enough time might not seem like similar things but psychologically, they are similar. You're running low on something you desperately need, so you feel the pinch of scarcity. Mullainathan turned to a colleague at Princeton, psychologist Eldar Shafir, and that conversation led to the book Scarcity, which they wrote together.

Their research led them to conclude that when you don't have something you desperately need, the feeling of scarcity works like a trap. In a study looking at poor farmers in India, for example, the researchers found that farmers tended to be better planners and thinkers when they were flush with cash. But right before harvest, when they were strapped for cash their brains focused only on short-term goals.

Poor farmers, for example, tend to weed their fields less often than wealthy farmers. It's the same with being super busy. The busier Mullainathan got, the harder it became for him to make time to get his car licence. In fact, there was a short-term reward for not getting it, because each time he delayed, he saved a little time to devote to other pressing demands.

But each delay made things worse the next day. People in the grip of scarcity are tightly focused on meeting their urgent needs, but that focus comes at a price. Important things on the periphery get ignored.

Mullainathan and Shafir think we ought to change how we think about poverty, and how we think about time. The poor farmers, for example, might need more frequent reminders to weed. Busy people might need to pencil in a block of time in their schedule so that long-term things have a chance to bubble up and be dealt with.

That means, if you have a busy day ahead, you need to schedule half-hour breaks that are just yours, where you have time to regroup, to catch up, to do those things you need to do. And if people try to make an appointment with you, just say you have a meeting. They don't need to know it's with yourself.