Dangerous Thinking: This Time Is Different

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Sir John Templeton famously warned in the eleventh of his "16 Rules for Investment Success" that the investor who says *this time is different* has uttered "the four most costly words in the annals of investing."[1] The legendary growth fund manager was making the point that one needs to be careful of rationalizing why the current environment will end better than a similar one did previously.

Why do we bring up Templeton's quote from more than 25 years ago? Today, the pace of innovation is changing our lives so dramatically that it can be tempting to think that surely the *business* landscape is no longer what it once was. And in the past, investors have falsely believed that sharp advances in security prices would continue because of some new development. Even Templeton reportedly conceded that the investor who says this time is different has a 20% chance of being correct.[2]

Disruptive technologies have indeed threatened a variety of industries, causing some investors to question the idea of *mean reversion* and whether certain companies or entire sectors can return to prior levels of growth.

We consider it our job as an active value manager to differentiate between those industries whose fundamentals are being disrupted from those who are only experiencing stock price disruption. Opportunities can arise if the market overreacts to the threat of disruption and underappreciates a seemingly threatened company's moat or durability.

Indeed, we think active value management is the most logical approach to investing when disruptive technologies roil the market. Obviously, passive or index strategies pay little heed to secular changes, and smart-beta factors that rely on price-to-book or price-to-earnings multiples to drive stock selection may miss company- or industry-specific nuances.

Cheap vs. Undervalued

Our approach to value investing seeks to determine whether a company is simply "cheap" or whether it is undervalued. With a cheap company, the price has fallen but is unlikely to recover because the company is vulnerable to structural issues. On the other hand, an *undervalued* company has mean-reverting capabilities, meaning its price has fallen for reasons that may not be long-lasting.

A key tenet of the value approach is to develop a solid understanding of not only the company but its industry and main competitors. This naturally leads us to investigate the specific role technology plays in the company as well as the industry. In each case we ask, is this company and/or industry vulnerable to disruption? Or is there a widespread misperception that may be creating an asymmetric opportunity?

For example, our research teams are wary of the competitive threat that online retailers pose to traditional brick-and-mortar retailers, and we have limited our exposure accordingly. However, not all industries may be exposed to these threats equally. We have found opportunities in a few grocers, especially in the United Kingdom, because online and home delivery companies have not been able to easily disrupt these established businesses.

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Likewise, we are overweight financials, especially in the United States, despite threats from financial technology (fintech) firms. Fintechs largely affect personal loans, money exchange and payments, while we've found value in some of the larger money center banks that also derive a large portion of their value from the more defensible areas of trade finance, foreign exchange and payments. In addition, many of these institutions not only have the resources to compete with the fintechs, but should also benefit from their technology investments that improve efficiencies and fundamentals. We believe such fundamental improvements will eventually be reflected in higher share prices.

For oil-related companies, secular competition—e.g., from electric cars and solar energy—appears to be growing. But these innovations might not have a truly major effect for years to come. While some investors may look at oil as a dying industry, global oil demand and production are each expected to continue growing, (thanks in part to emerging markets), although they may be volatile in the shorter term due to cyclical, economic and political factors.[3] Our company-specific analysis has led us to opportunities in integrated oil companies (with operations in nearly all facets of energy production and distribution) with strong balance sheets and diverse exposure to the value chain, rather than the more levered companies focusing only on exploration and production.

Disruption from technological innovation has been part of investing at least since the appearance of the automobile threatened the so-called "buggy whip" companies in the late 19th century. Today, the pace of disruption might appear more amplified than ever before. But our task has been the same since Brandes began operating 45 years ago. We strive to determine if a business that has fallen out of favor has the ability to adapt and survive, or will go the way of the buggy whip makers.

Technologies May Change: Investing Fundamentals *Don't*

Today *is* different from the past in many ways. But the *principles* guiding our active value investing approach haven't changed. And the disruption we've witnessed recently only strengthens our belief in the need for investors to distinguish potentially undervalued businesses from cheap companies that may only get cheaper.

[1] "16 Rules for Investment Success" by Sir John Templeton, Franklin Templeton Investments, 2017. Reprinted from *World Monitor: The Christian Science Monitor Monthly,* 1993.

[2] Memo to Oaktree Clients, Howard Marks, Oaktree Capital Management, June 12, 2019

[3] U.S. Energy Information Administration, July 2019

Price/Book: Price per share divided by book value per share.

Price/Earnings: Price per share divided by earnings per share.

Smart Beta: An investment strategy that is based on a passive approach but seeks to adjust portfolio weights to manage risk variables such as volatility, quality, liquidity, etc.