April, 2016

Tune Out the Noise

"You will never reach your destination if you stop and throw stones at every dog that barks."
— Winston S. Churchill

When I'm driving and I hear a honk, I automatically tense up and wonder if I'm the intended recipient of it. Is the honking a gentle alert, an assessment of my driving or is it simply just noise? If the honking continues, it can be really unsettling; so in a panic, I might react by making a poor driving decision. Even if the honking was harmless, the noise becomes what behavioural psychologists refer to as "negative feedback", which (when there's an abundance of it) is a recipe for making bad decisions.

Recent volatile markets and accompanying daily negative news headlines are a constant reminder of just how much noise exists. Not all negative news is noise though. When there's a fundamental change in an industry or a specific company, we need to listen and update our views accordingly. The challenge is to distinguish potential distractions from relevant information. Noise is information that does not meaningfully impact the long-term fundamentals of a business. As investors, it is important to guard against noise because it can lead to bad decisions. But can we completely tune it out?

Being rational and unemotional when investing is easier said than done – we all have built-in psychological shortcomings. For example, psychologists have long shown that losses are felt much more deeply than gains; approximately twice the amount of pain is felt with a loss, than the satisfaction received from a gain of equal size. This asymmetry works against investors. In Michael Mauboussin's book "More Than You Know", he demonstrated that the more often you check your portfolio's performance, the more likely it is that you will feel an overall emotion of pain. The explanation lies in the asymmetric level of emotions triggered by gains and losses. If the above two-to-one ratio is applied, you must experience twice the number of up-market days than down-market days just to feel neutral! The more frequently you check the market's performance, the more likely you'll feel an overall negative emotion. As a result, you may react impulsively and make a bad decision such as selling a stock at a low point, despite the company's favourable long-term prospects.

Empirical studies support the suggestion that the average investor is unable to cope with noise. A classic example involves comparing the return of an index fund with the actual return of individual investors participating in the same fund. According to Morningstar, Vanguard's S&P 500 Index Fund averaged an annual return of 7.4% over the past 10 years, measured in U.S. dollars. However, the average investor in the fund personally gained just 5.1% over the same period. This differential suggests that investors are buying and selling at the wrong times, likely because the human mind is ill-equipped to defend against noise in the market, potentially leading to bad decisions.

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Even prominent investors are not immune to market noise. In his book, "The Education of a Value Investor", Guy Spier explained that he moved from New York to Zurich because he believed that he would be a better investor if he distanced himself from all the noise. Interestingly, he also changed the colour scheme of the stock tickers on his computer screen to be dull and muted. The flashing greens and reds served as distractions that urged unnecessary action that could lead to bad decisions. Sionna's not moving to Zurich, no matter how much better its transit system is. However, there are a number of safeguards in our investment process to help tune out the noise, a few of which we highlight below:

1. Look at each investment with a long-term lens.

   This approach allows us to look beyond a cyclical downturn or a temporary operational issue; provided that it does not fundamentally change our long-term investment thesis. As Warren Buffett said, "your goal as an investor should simply be to purchase…. a business whose earnings are virtually certain to be materially higher five, ten, and twenty years from now". Nobody knows what will happen in the next quarter or even the next year or two, but we do have conviction that our long-term focus helps us to cope with, and take advantage of, noise that causes short-term gyrations in the market.

2. Calculate the intrinsic value of each business.

   A combination of quantitative and qualitative analysis, calculating an intrinsic value also involves some amount of "art". The result is our best estimate of what the entire business is worth; it also serves as a guide for us. Regardless of the volume of noise in the market, if the fundamentals of the business, and our investment thesis, have remained the same, the intrinsic value won't change. This is not to say that we're inflexible; when the facts change, and our investment thesis no longer holds, we act accordingly – but only if there are new facts, not just in response to noise. Calculating an intrinsic value imposes a discipline that reduces the impact of noise, no matter how loud and incessant.

3. Conduct comprehensive and independent research.

   Our team doesn't rely on sell-side research to assess the quality and value of a company. Brokerages are incentivized to increase trading activity; so sometimes their interests may not fully align with investors – resulting in subjective research reports and investment recommendations. Conducting our own in-depth research helps to independently identify the key drivers of a business from a perspective which may differ from the market's view. Understanding these drivers help form a differentiated investment thesis. New information may subsequently move a stock's price, but if it doesn't affect our investment thesis, then we simply consider it noise.

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A constant stream of negative news headlines can be unnerving for anyone, but it's important to ignore the "honking". Built-in psychological shortcomings can lead an individual to give undue attention to noise and cause a reaction that ends up being a bad decision. At Sionna, we protect ourselves by taking a long-term view, calculating an intrinsic value and conducting independent research. Our disciplined process enables us to tune out the noise and take advantage of mispriced stocks to generate solid returns for our clients over the long term.

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