

January 2021

Focusing on the Long Game Under Stress

I looked up from my desk and found the market down more than 10%. The next day, it was up 10%. The day after, down 10% again. That violent yo-yo-ing was the reality this past spring. At one point, the S&P/TSX Composite Index lost a quarter of its value in about a week.

Reflecting on 2020, the most memorable (or rather, forgettable?) part of the year was the market freefall during the spring. Amid the chaos, our team triple-checked every holding's balance sheet and the discounts on offer and acted decisively. During such a stressful period, how were we comfortable that we were making good decisions?

A Stress Debrief

Stress is notoriously connected to sub-optimal decision-making. And this past spring was no doubt stressful. Yet, our professional task is to protect our portfolios and take advantage of these situations. So the saying goes, "never let a crisis go to waste" right? But how did we make sure that our decisions were sound when both investors and markets were stressed?

Let us step back and discuss what triggers stress and how it affects decision-making. According to Michael Mauboussin, a prominent investment strategist and the chairman of the renowned Santa Fe Institute, stress can be triggered by:

1. The lack of predictability and control,
2. The absence of "outlets to let off steam", and
3. The perception that things are getting worse.

The onset of the pandemic checked all three boxes. Yikes. It is no wonder stress was so prevalent. Yet these rare events, accompanied by sharp market movements, is precisely when we need to be levelheaded and act rationally and decisively.

One phenomenon is that stress causes people to shorten their time horizon. When a zebra is being chased by a lion, the zebra is more concerned with surviving the moment than what it will do later in the day. In the presence of a physical stressor, amongst other reactions, blood pressure rises and short-term memory improves, all at the expense of long-term functions.

What is fascinating is that *mental* stressors elicit the same physiological response as *physical* stressors. And in the modern world, mental stressors are much more common and relentless; physical and mental time horizons are then under constant pressure to compress shorter. The tendency to focus on the here and now makes sense for survival, but less so if your goal is to achieve long-term returns.

Trust the Process

The bad news is that our response to stress is hardwired in us. Even prominent researchers in behavioural psychology confess they fall prey to biases despite being experts themselves. The good news is that we can structure processes to focus our attention on the long term.

Central to our approach at Sionna is a reliance on cold hard data and analysis. When market movements are extreme, we use calculators to combat the temptation to shorten our time horizon.

For example, we look a few years out when we calculate the intrinsic value of companies. Considering a company's prospect further into the future forces us to ask important questions. Is the current setback permanent or transient? When a "normal" environment returns, what is the company's prospect? Will it survive today to reap the rewards tomorrow?

Before a long-term horizon is considered, it is the last question that we must answer first. After all, there is no long term if you cannot survive the short term. Once this item is satisfied, we move on to focus our attention on the years ahead rather than the months ahead.

The reality is that short-term events are unpredictable. However, overreactions occur from time to time. These situations present opportunities for long-term investors who have done their homework on company fundamentals beforehand. Armed with a deep knowledge of companies, a calculator and an unemotional adherence to our process, we were able to act decisively in 2020.

Going Long

Robert Sapolsky, an expert on stress and the author of *Why Zebras Don't Get Ulcers*, noted that people's reactions under stress are "generally short-sighted, inefficient, and penny-wise and dollar-foolish." We want to avoid this trap. Stress is inevitable, but our actions need not be. Shocks such as the pandemic tempt us to look down at our feet instead of farther out into the horizon. Combating this temptation is our investment process that lifts our heads, to see not the short-term penny but rather the long-term dollar.

Gary Chow, CFA, MBA
Portfolio Manager
Sionna Investment Managers



Sionna Investment Managers 8 King Street East, Suite 1600 Toronto, Ontario M5C 1B5
For further information, please email clientrelations@sionna.ca.

The contents of this document are not intended to serve as advice, recommendations or an offer to sell any product or service. This communication is for information only and should not be regarded as a sales communication. Readers should seek qualified professional advice before acting on any information provided in or through this document.