What It Means to Be a Long-Term Investor

By the LNWM Investment Team

Investing in the 2020s has been especially challenging following a decade of relative calm in the markets. Inflation has necessitated an end to easy money policies, resulting in lower valuations in virtually all asset classes and concern that worst is yet to come. Amid much higher market volatility than in the recent past, investors have some tough decisions to make. It is these decisions, typically made during a down market, that distinguish a long-term investor from the speculators.

It is easy to say: "Of course I'm a long-term investor" when markets are relatively stable and losing maybe up to 10% here and there. But what really defines long-term investors is their behavior when the markets are down and the news is disconcerting. That is when we here at LNWM make extra efforts to keep in touch with clients, provide perspective, and counter the urge to sell out of fear. At the same time, as long-term investors, we look for new opportunities created by the panic.

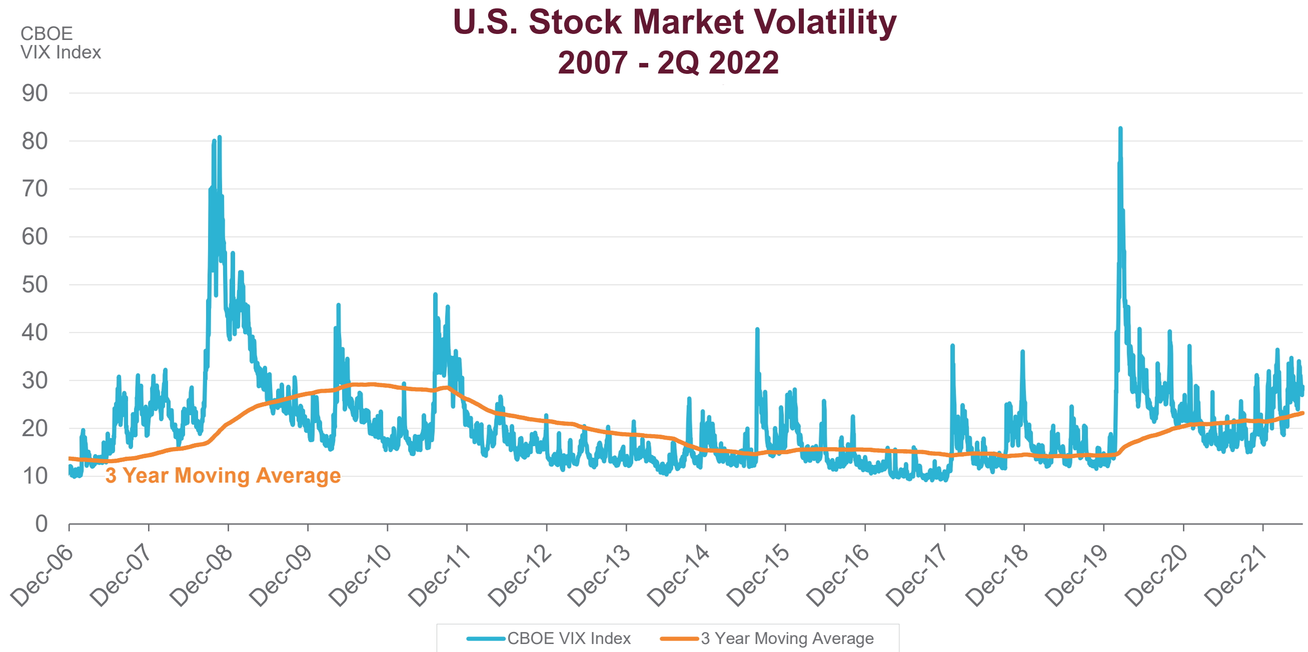
> "A long-term investor focuses on valuation, not timing."

By contrast, speculators are concerned with timing. Their main focus is: "What will the market do next?" Especially in the near term, no one really knows, regardless of the credentials and insights they may have. By contrast, a long-term investor does not spend a lot of time trying to figure out timing, especially during high uncertainty when the world is facing a resurgence of inflation and slowing economic growth. Instead, a long-term investor focuses on valuation, because when prices fall, stocks become cheaper as long as their business models and competitive advantages stay intact. That in itself – lower prices – is an advantage, not a threat.

The Danger of Getting Whipsawed

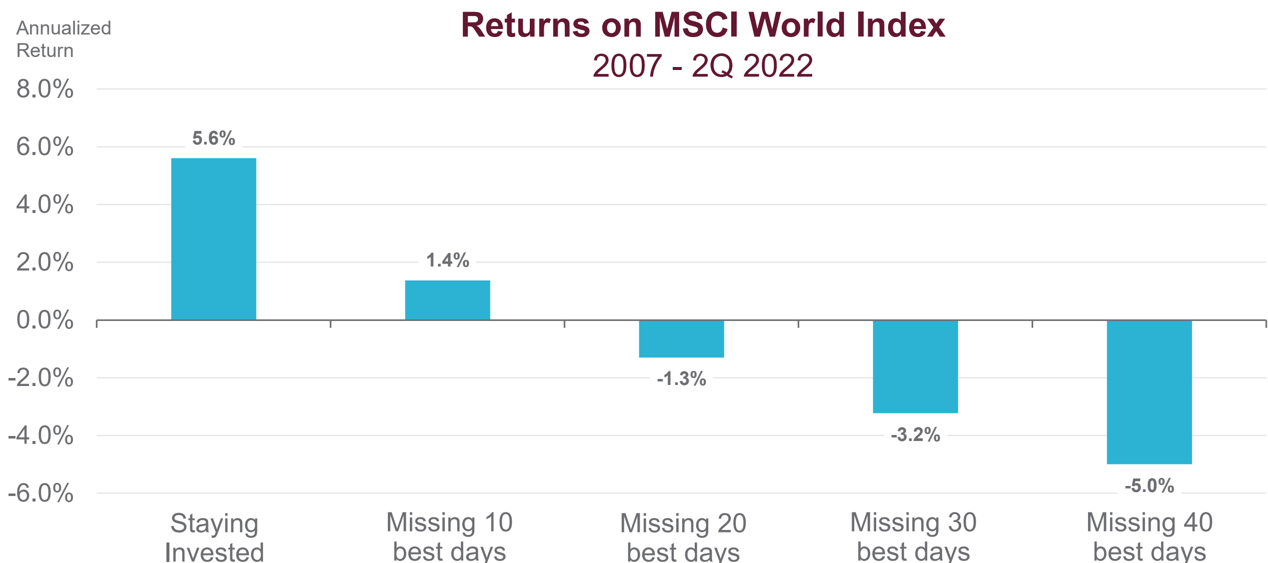
Day traders are professional speculators who try to profit from timing the market, and they routinely use stop-losses to limit the downside. That may sound like a great solution – say you place a stop-loss of 15% on your portfolio – and you sell most or all equity positions when that drop happens. The market then goes down another 10% and you are feeling vindicated. But then the market rebounds by 20%; you have then lost capital because of your trade and will likely continue to lose as you reestablish your position. The result is that you can get whipsawed. At times of higher market volatility, as experienced recently (see chart on next page), getting whipsawed is a big risk. This is why day traders are most profitable when the market is generally moving in one direction – either up or down – creating a trend for them to exploit.

Just as important, a speculator must decide not just when to sell but also when to buy back in. And that greatly increases the chances of missing days of major gains. Markets today have the potential to be extremely volatile relative to the past, with more than 5% daily losses as well as gains.



Source of Data: Bloomberg.

That's mainly because of these three factors: automated selling driven by algorithms – essentially computerized stop-loss orders on a massive scale; prevalence of ETFs (Exchange Traded Funds) whose individual holdings may not be able to be sold as fast as the ETF itself; and leveraged hedge funds and other investment vehicles that need to sell or buy assets to cover their exposures. All these factors can reverse very quickly from selling to buying and vice versa. If you are on the sidelines, this can mean missing some of the best days in the market. As the chart below shows, missing the best days in the market can have dramatic long-term results.



Source of Data: MSCI, FactSet, Wellington Investment Management.

Taking the Long View

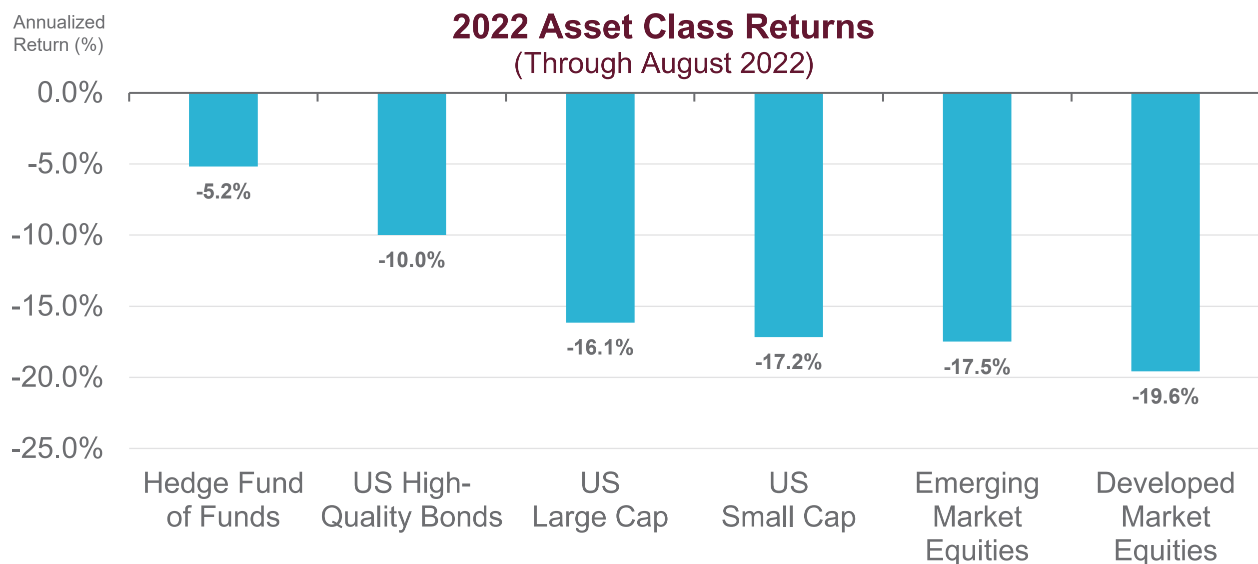
Here at LNWM, we remain long-term investors through bull and bear markets. That does not mean we stand still. It means these three things: (1) Understanding how portfolio risk is changing, and if risk is rising, making adjustments to bring it down to levels that are manageable, including raising a certain amount of cash to have available to invest as the market shows signs of long-term recovery; (2) Accepting that stock markets can move significantly down and stay down for quite a while; and (3) Evaluating each client's financial situation to make sure they have enough cash outside their investment portfolios to feel comfortable through a downturn.

While it is impossible to tell when the selling pressure will ultimately subside, market drops create valuation discrepancies. This is not surprising, considering that indiscriminate selling tends to happen across all asset classes as investors raise cash. If the economy might is heading into a recession, long-term investors are at an advantage. Recessions can present very significant investment opportunities due to lower equity valuations but also from shifts in the economy and the marketplace, as there are changes in consumer preference/habits, business strategies, and government policies/regulations.

As long-term investors, we take comfort in the following characteristics of our portfolios:

Diversification

During the down market in 2022, diversification across asset classes proved its merit, as our allocation to real assets (commodities, infrastructure) and alternatives (hedge funds, private market investments) held up relatively well relative to our public equity and fixed-income holdings.



Source of Data: MSCI, Bloomberg.

High Quality

We make it a priority to invest with asset managers that focus on high-quality stocks and bonds. In equities, this means our managers tend to prefer companies with strong competitive advantages or "moats," strong management teams, good balance sheets (lower debt levels), and relatively high free cash flow. Companies in hard-hit industries can actually grow during economic downturns as weaker competitors suffer and give up market share. And companies that were once high-flyers may find that the market dynamics have changed, making their operations less profitable than before.

Active Investing

Investing via actively managed funds in markets that are the most inefficient — such as U.S. small stocks and foreign equities — is more important than ever. During the past decade, the stock market has essentially been a tide that lifted all ships; everything seemed to go up in value. The fight against inflation will create market winners and losers and significant marketplace shifts. We believe this will magnify the importance of in-depth analysis and active management (as opposed to index investing) in assessing which companies are worth investing in based on operational measures, such as supply chain strength, management capabilities, labor and government relations, competition, and new technology.

Several of the equity managers we use in our portfolios were quick to get defensive, raise cash, and sell shares of companies hurt by changing supply/demand dynamics across the world. Subsequently, they have started upgrading their portfolios to stocks that are rarely cheap but have been indiscriminately sold as investors rush for safety. While none of them will be able to call the bottom, and we don't expect them to, this reshuffling sets up their portfolios for strong performance on the other side of the pandemic as investors again reward the best companies.

The Way Forward

Famous value investor Benjamin Graham provides guidance that is hard to listen to at the moment but has proven prescient: "Price fluctuations have only one significant meaning…an opportunity to buy wisely when prices fall sharply and to sell wisely when they advance a great deal." Further:

> "The investor who permits himself to be stampeded or unduly worried by unjustified market declines in his holdings is perversely transforming his basic advantage into a basic disadvantage… [He] would be better off if his stocks had no market quotation at all, for he would then be spared the mental anguish caused him by other persons' mistakes of judgment."

Here at LNWM, we have helped our clients navigate through many market declines since 1967. It is especially during times of great uncertainty that keeping emotions out of investment decisions is imperative. That is possible for our clients because we create for each a long-term business plan for investing that is geared to withstand market turbulence so they can achieve their long-term goals. During turbulent times, we are here to address client needs and concerns as they arise, while also looking for new opportunitiies to add value to their portfolios.

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