Some Thoughts on Roller Coaster Investing

Take a look at this roller coaster stock price chart.

The stock crashed by 63% in just 118 days between late 2008 and early 2009. Then, after a rise over the next few months, it dropped 31% in just 15 days.

Now look at the stock price chart of a different company which too looks like a roller coaster.

The stock price fell by 20% in just 58 days.

Now look at another roller coaster chart of a different company.

The stock price of this company fell by 24% on 44 days, then shot up and then fell by 20% in 44 days. What a roller coaster!

Now look at the stock price chart of another company. A roller coaster again.

The stock price fell by 31% in 127 days!

You just saw *four* charts of *four* different companies.

Did you? Actually, no. I lied.

What you just saw were four charts (covering different periods) of the *same* company over the last five years and that company is called Wabco.

I never owned shares in it, but I wish I had. That's because it's a great, scalable, highly-profitable business run by a great team of managers. And boy, has it made money for it's long term investors. An 18-bagger in five years.

And lest you think that those returns are influenced by the choice of start and end dates (of they are), here are 3 year rolling period returns of the stock over the last 5 years.

Wabco			
		3 year Rolling Period Return	
Date	**Price**	**Stock**	**Nifty**
23-Jul-09	242		
23-Jul-10	863		
22-Jul-11	1,182		
23-Jul-12	1,455	82%	6%
23-Jul-13	1,689	25%	4%
23-Jul-14	3,586	45%	11%
23-Jul-15	5,380	55%	19%

Those, by the way, are average *annual* returns. Wabco beat the shit out of Nifty *consistently.*

But what about those stock price declines? Where the bleep are they in the chart? Can’t spot them?

Turn the page then.

Here they are, those "big," "ugly," "horrible," "gut-wrenching" stock price crashes.

Those little red rectangles? Yes those ones. Those little *blips* represent those big, ugly, horrible, gut-wrenching stock price crashes. The "roller coaster" journey of Wabco's stock is barely visible if you look at its 5 year chart.

For investors who bought Wabco stock five years ago and have held it till now, those major declines didn't matter. For those who got in *after* those declines, they were a boon. And for my friend Ian, who understands the process of long term wealth creation, such declines are a wonderful opportunity to *average up* which is so contrary to popular wisdom amongst value investors.

Anecdotal evidence? Not representative? Wrong!

Take the stock price performance of almost any great business over a fairly long time period and you'll see the same roller coaster pattern play out. There will several instances where the stock will drop a lot. Sometimes it will drop by 50% or even more. If you owned it *before* the crash, it will feel horrible afterwards. But if you owned a great business — and that *is* a big if, and if the valuation was not crazy expensive relative to its long-term potential earning power, then selling out would almost certainly be a bad idea. It would be a bad idea even if you could correctly anticipate that a significant stock price decline was imminent.

Philip Fisher came to the same conclusion. (I am merely substantiating what he wrote in his books). For instance, in "Common Stocks and Uncommon Profits," he wrote this.

STAY OR SELL IN ANTICIPATION OF POSSIBLE MARKET DOWNTURNS

"Should an investor sell a good stock in the face of a potentially bad market? On this subject, I fear hold a minority view, given the investment psychology prevalent today. Now more than ever, the actions of those who control the vast bulk of equity investments in this country appear to reflect the belief that when an investor has achieved a good profit in a stock and fears the stock might well go down, he should grab his profit and get out. My view is rather different. Even if the stock of a particular company seems at or near a temporary peak and that a sizeable decline may strike in the future, I will not sell the firms's shares provided I believe that its longer term future is sufficiently attractive. When I estimate that the price of these shares will rise to a peak quite considerably higher than the current levels in a few years time, I prefer to hold. My belief stems from some rather fundamental considerations about the nature of the investment process. Companies with truly unusual prospects for appreciation are quite hard to find for there are not too many of them. However, for someone who understands and applies sound fundamentals, I believe that a truly outstanding company can be differentiated from a run-of-the-mill company with perhaps 90 percent precision.

It is vastly more difficult to forecast what a particular stock is going to do in the next six months. Estimates of short-term performance start with economic estimates of the coming level of general business. Yet the forecasting record of seers predicting changes in the business cycle has generally been abysmal. They can seriously misjudge if and when recessions may occur, and are worse in predicting their severity and duration. Furthermore, neither the stock market as a whole nor the course of any particular stock tends to move in close parallel with the business climate. Changes in mass psychology and in how the financial community as a whole decided to appraise the outlook either for business in general or for a particular stock can have overriding importance and can vary almost unpredictably. For these reasons, I believe that it is hard to be correct in forecasting the short-term movement of stocks more than 60 percent of the time no matter how diligently the skill is cultivated. This may well be too optimistic an estimate. On the face of it, it doesn't make good sense to step out of a position where you have a 90 percent probability of being right because of an influence about which you might at best have a 60 percent chance of being right.

Moreover, for those seeking major gains through long-term investments, the odds of winning are not the only consideration. It the investment is in a well-run company with sufficient financial strength, even the greatest bear market will not erase the value of holding. In contrast, time after time, truly unusual stocks have subsequent peaks many hundreds of percent above their previous peaks. Thus, risk/reward considerations favor long-term investment.

So, putting it in the simplest mathematical terms, both the odds and the risk/reward considerations favor holding. There is a much greater chance of being wrong in estimating adverse short-term changes for a good stock than in projecting its strong, long-term price appreciation potential. If you stay with the right stocks through even a major temporary market drop, you are at most going to be temporarily behind 40 percent of the former peak at the very worst point and will ultimately he ahead; whereas if you sell and don't buy back you will have missed long-terns profits many times the short-term gains from having sold the stock in anticipation at a short-terns reversal. It has been my observation that it is so difficult to time correctly the near-term price

movements of an attractive stock that the profits made in the few instances when this stock is sold and subsequently replaced at significantly lower prices are dwarfed by the profits lost when timing is wrong. Many have sold too soon and have either never gotten back in or have postponed reinvestment too long to recapture the profits possible."

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IN AND OUT MAY BE OUT OF THE MONEY

"There is more to learn from the Texas Instruments and Central California Electronics situations. When I originally acquired these Texas Instruments shares in the summer of 1955, they were bought for the longest type of long-range investment. It seemed to me that the company fully warranted this degree of confidence. About a year later, the stock had doubled. With one exception, the various owners of the funds I managed, familiar as they were with my method of operations, showed no more interest in taking a profit than did I. However, at that time I had one relatively new account owned by people who, in their own business, were used to building tip inventory when markets were low and cutting it back sharply when they were high. Now that Texas Instruments had doubled, they brought strong pressure to sell, which for a time I was able to resist. When the stock rose an additional 25 percent to give them a profit of 125 percent of their cost, the pressure to sell became even stronger. They explained, "We agree with you. We like the company, but we can always buy it back at a better price on a decline." I finally compromised with them by persuading them to keep part of their holding and sell the rest. Yet when the big drop occurred several years later and the shares fell 80 percent from their peak, this new bottom was still almost 40 percent higher than the price at which this particular holder was so eager to sell!

After a very sharp advance, a stock nearly always looks too high to the financially untrained. This client demonstrated another risk to those who follow the practice of selling shares that still have unusual growth prospects simply because they have realized a good gain and the stock appears temporarily overpriced. These investors seldom buy back at higher prices when they are wrong and lose further gains of dramatic proportions.

At the risk of being repetitious, let me underscore my belief that the short-term price movements are so inherently tricky to predict that I do not believe it possible to play the in and out game and still make the enormous profits that have accrued again and again to the truly long-term holder of the right stocks."

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I couldn't agree more with Fisher. If you end up owning a fantastic business, then plan to hold it for a long time. And prepare yourself for a roller coster ride. If you have chosen the right business to own, the ride will be worth it.

Sanjay Bakshi
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P.S. This post makes two points: (1) Big money is in buying and holding great businesses. (Although not specifically mentioned, it is implied that those businesses were acquired at reasonable valuations.); and (2) Owning such businesses *will* produce gut-wrenching roller

coaster rides which the investor has to have the willingness to take. They can't avoid those rides by jumping out and trying to get back in, and attempts to do so are likely to be unsuccessful. So, the best strategy is to stay put and bear it.

This post also does not claim that those gut-wrenching declines occur only in stocks of great businesses. They don't. They occur in stocks of almost all businesses. However, in the case of great businesses, they don't matter in the long run. They look like tiny *blips* on a chart.

Finally, this post does not offer any advice on how to tell in advance if the business acquired is great or not so one can prepare oneself for enduring gut-wrenching rides in the expectation that it will all be worth it in the end.

PS-II: No position in Wabco. Nor am I recommending the purchase of its stock.