Shunning the fads and investing for long-term growth

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KLINGENSTEIN FIELDS
WEALTH ADVISORS

Introduction

It's all too easy to get excited about the "next big idea." We have all heard stories about investors who bought Apple (or Microsoft or another company) when it was unknown and trading at a very low price and now the same stock position is worth millions of dollars. Of course, few investors talk about the stock(s) they bought at absurdly low prices that went down instead of up! So, what is the secret? How do you find the future winners to achieve investment success?

Klingenstein Fields Wealth Advisors believes the answer lies in following a disciplined approach to asset allocation, proper diversification and investment selection, with a focus on investing for the long term. We shun fads that are not supported by underlying fundamentals. And, while we pay close attention to what's going on in the world, we conduct proprietary research to seek to weed out the "noise of near-term sentiment" so we can uncover true long-term opportunities.

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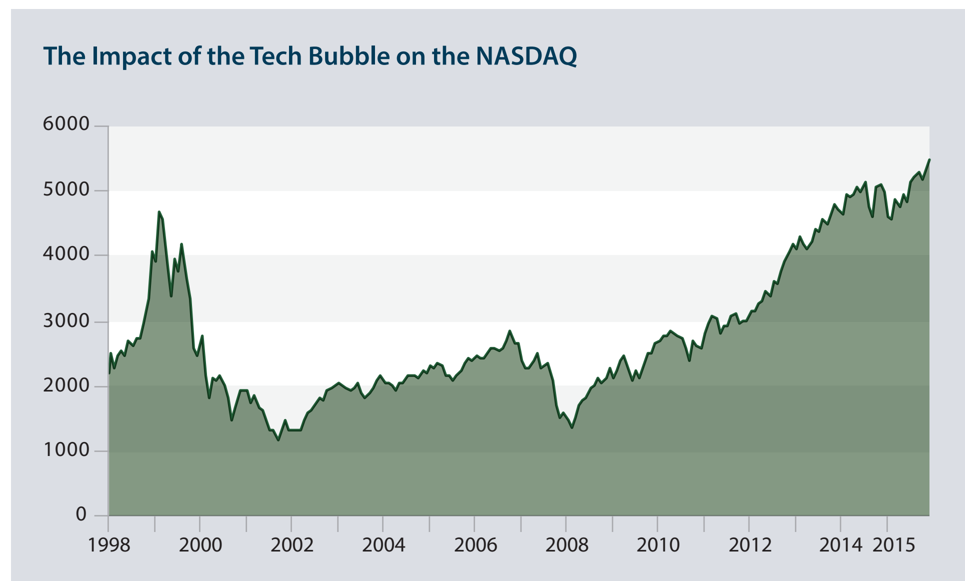
Difficult to Resist

Think back to the tech bubble of the late 1990s. Tech companies were all the rage and valuations were in the stratosphere, despite the fact that some of these companies had no real assets or prospects of earning profits. Yet many investors, amateurs and professionals alike, kept pouring money into tech companies, without discriminating between those that had solid long-term underlying fundamentals and those that did not. Unfortunately, the rising tide that lifted all tech stocks also brought them all down when the tide rapidly receded. While companies such as Cisco Systems, Microsoft and Amazon, remained fundamentally strong and eventually recovered, it was a long process. Microsoft's stock price, for example, as well as the NASDAQ 2000 Index (NASDAQ) have only in the past 12 months approached their 1999/2000 level. Other darlings of the ".com era," such as Pets.com and Webvan, disappeared without a trace.



Source: NASDAQ

History: Doomed to Repeat Itself?

Busted fads are not a recent phenomena; the Tulip Bulb Mania bloom and bust, deemed by many to be the first recorded example of a market bubble, occurred in the first part of the 17th century! Tulip bulbs began to sell at extraordinary prices, far beyond any rational value, until prices collapsed in a sudden panic. The shock and damage to the Dutch economy is believed to have lasted for many years.

3D printing is a more recent example of the market hyping potential over reality. Consumers' fascination with 3D printing and its potential to let anyone make almost anything in their own home, along with media coverage of commercial applications, promised future high demand and led to sharply elevated stock prices for companies related to 3D printing.

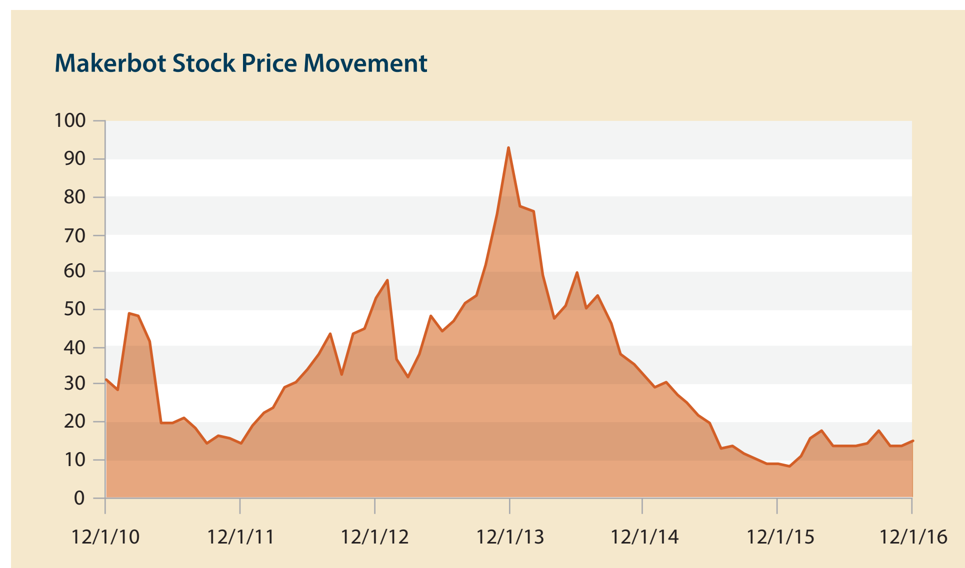
The Rise and Fall of Retail 3D Printing

The Hype: *With demand just "starting to ramp up," 3D printers would be the laptop of the 2000s and everyone would soon own one.*

The Reality: *3D printers have expanding applications in manufacturing and other commercial uses, but the "cool" factor didn't translate to practical mass-market use and adoption.*

The Aftermath: *After a significant run up in 3D printing related stocks and valuations way ahead of fundamentals, reality hit, and stocks retreated to pre-hype levels.*

Companies such as Makerbot opened storefront locations to tap into the strong perceived retail demand, developing a series of smaller, lower-priced household use printers. 3D Systems, a leading 3D printer manufacturer, witnessed a 904% increase in its stock price from December 2011 to December 2013. However, the hype far exceeded the market potential (Makerbot has since closed its storefronts and is focusing on the education and professional markets) and prices have since fallen to well below pre-hype levels. Despite the S&P 500 Index rising over 80% since 2011, 3D Systems' (DDD) stock price plunged after peaking in 2013, and is now trading in the $13-$15 a share range, achieving barely half of the S&P 500 return over the last five years.

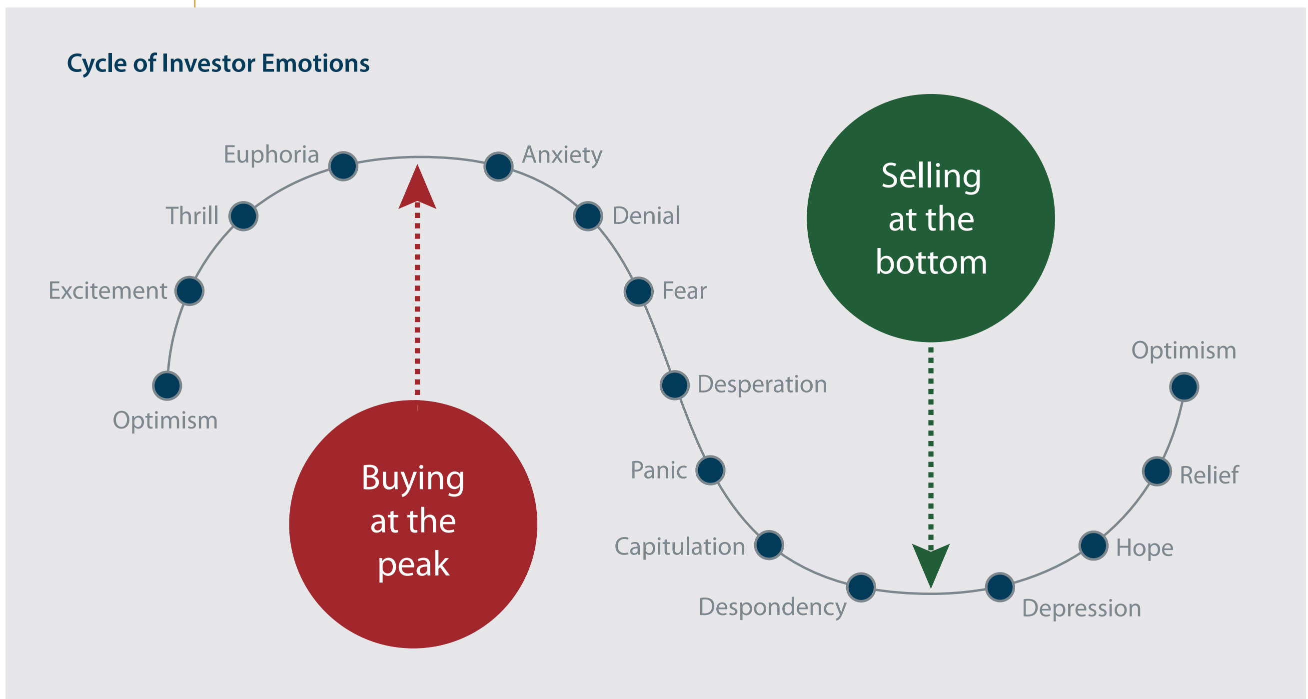


Source: NASDAQ

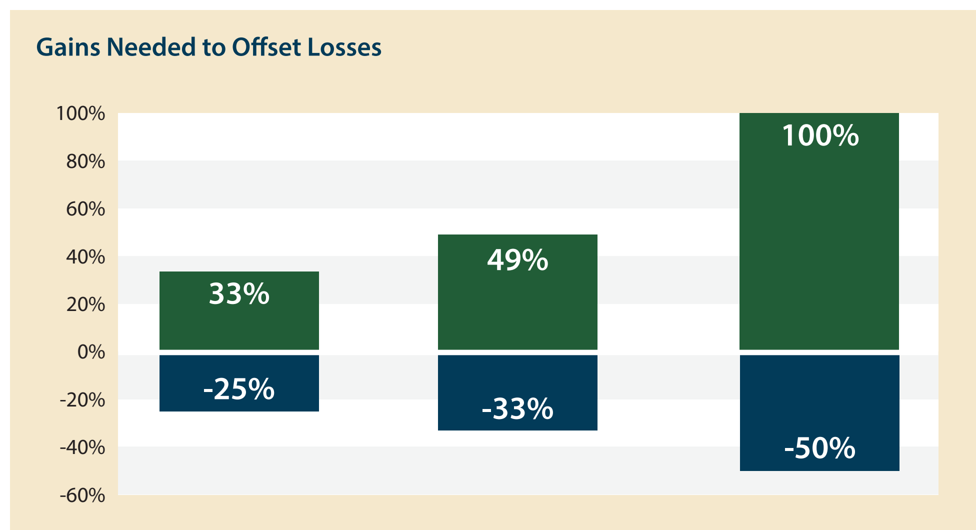
The rise and fall in the prices of rare earth metals and related mining and processing companies is another example. These metals are used in a variety of high tech and manufacturing functions. In the late 2000s, China attempted to limit exports, causing prices to rise and triggering a panic over potential shortages. Prices of rare earth metals such as Neodymium, Dysprosium and Cerium, as well as companies such as Molycorp, the only U.S. rare earth mining and processing company, rose astronomically between 2009 and 2011 as a result of export restrictions by China, which controls the lion's share of the world's rare earth metal supply. The increase in prices and scarcity motivated companies such as Ford to find alternatives and Molycorp to increase its mining efforts. At one point, Molycorp's share price rose to close near $80, a 4-fold increase in the share price in one year. When China relaxed its export restrictions prices plummeted. Molycorp has since filed for bankruptcy and its shares are now worthless.

Bad for Investment Health

Another issue that arises is that investors may invest emotionally and retrospectively, with the conviction that extraordinary recent results will continue. The average investor, buying at the height of hype and selling after the story has peaked, often suffers permanent loss of capital. In other words, investors often buy just when a stock is reaching its peak and sell only after it has fallen sufficiently to shake their faith in the story.



Hot investment ideas come along all the time, regardless of market conditions and where we are in the investment cycle, from bull to bear markets. Some investment newsletters push and promote stories around stock fads. Those promoting the hot ideas may even have a monetary interest in seeing those ideas catch investment attention. Hot ideas rarely get broad recognition until after the stock prices have already run up significantly. If anticipation of "sure" growth is baked into the price, even a moderate miss compared to expectations can have a devastating impact on the stock value. Playing the fads, large and small, can often be devastating to long-term investment health. If an investor buys at the most expensive point, and then experiences a large drop, the loss is very difficult to make up. For example, if a portfolio value drops 33%, it takes a gain of almost 50% (excluding compounding) to return to the original principal value.



Source: Klingenstein Fields Wealth Advisors

Passive Investing Doesn't Protect

So why not invest in passive strategies to prevent just the sort of emotional investing that can end so disastrously? Passive investing does not solve the problem and can, in fact, by its intrinsic structure, have the opposite result. In traditional passive investments, all stocks in an index are represented. The bigger the market weighting of the company, the larger the proportion within the passive strategy. As a result, an overvalued stock or industry sector can comprise a disproportionately large part of a passive strategy, exposing investors to unwanted risk. Harking back to the tech bubble, at their height, tech stocks made up a huge proportion of the NASDAQ, well over 60% (for reference, they currently make up approximately 43%, still a large proportion, but much less than in 2000). So when the tech bubble burst, so did the NASDAQ. When tech stocks hit the skids, so did the NASDAQ, falling more than 75% from its peak in March 2000 to its bottom in 2002.

A Thoughtful Long-Term Approach

Our approach to investing begins with developing a customized plan based on a deep understanding of client needs, goals and personal circumstances. Our Wealth Advisors and Wealth Planners meet with our clients and their outside accounting and legal advisors to coordinate and integrate their plan with their tax situation, estate planning and philanthropic needs and other objectives. Each client's wealth plan is the basis for developing a personalized asset allocation and portfolio strategy based on their goals, spending needs and risk profile. Investments are selected that reflect our long-term strategic thinking. We believe that portfolios should be well-diversified in terms of:

- Style
- Capitalization
- Asset classes, including the use of alternative classes when appropriate
- Geography
- Industry

Once we develop a plan, asset allocation and portfolio, each client's investment positions are regularly reviewed for adjustment to reflect any changes in a client's life and to remain aligned with the firm's investment views.

Finding the Winners

As long-term investors, we believe in using a thematic approach to take advantage of secular trends we identify in the markets. We differentiate, however, between themes or fads that we feel do not represent long-term shifts in the markets. Few, if any, would argue that the technology revolution was not a game changer that engendered a permanent shift in the way that the world operates. However, that does not mean that every tech-related company is destined for success, as seen from the earlier examples cited. Once we have identified a theme, we look for specific characteristics in selecting potential investments.

1. Solid **fundamentals**
2. Stable, strong **management**
3. Attractive **valuations**
4. Identifiable growth **catalysts**
5. Comfort level with potential systemic and idiosyncratic **risks**

The “flashy,” obvious investment is not necessarily the one poised to benefit most from a trend. An example of a less apparent opportunity can be found in a subsector of the communications industry that provides wireless infrastructure solutions around the world, including towers for communications antennas. It may not be the first (or even the second or third) type of company when you think of the tech revolution. However, we believed this small group of companies had strong long-term investment potential for several reasons:

- Good fundamentals and stable business model (existing tower infrastructure and long-term contracts)
- Experienced, strong management
- Growth industry, particularly in high potential developing countries with limited existing infrastructure
- Strong profit margins generating high free cash flows
- Attractive valuations levels
- Limited competition, with capital investment requirements serving as a barrier to entry
- Low level of assessed exposure to idiosyncratic and/or systemic risk factors

And sometimes, fundamental analysis can apply to both an entire sector of the economy, as well as identifying potential investments within the sector. For instance, we believe that healthcare as a sector possesses strong long-term potential, given demographics, competitive environment and other characteristics and trends. As a result, we may overweight our investments in healthcare stocks versus the broad market index. However, within the healthcare sector, we perform extensive fundamental analysis to identify those companies that are likely to exhibit attractive long-term growth.

Conclusion

There will always be themes that occur in investing, with the powerful temptation to try to jump on the band wagon. Differentiating between fads and long-term trends is crucial to investment success. We believe that thoughtful diversification through disciplined asset allocation based on client risk and return parameters and adherence to stringent fundamental research in selecting investments can help investors avoid falling prey to emotional decision making. KFWA invests for the long-term, while maintaining the flexibility to make short-term tactical adjustments to react appropriately to emerging opportunities or risks. Our Wealth Advisors and Wealth Planner work together with our Investment Committee to customize portfolios to client needs, while incorporating the best investment ideas of the firm. We welcome the opportunity to meet with you and further discuss our approach to managing money.

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