Reflecting On Experience

By Arthur Heinmaa, CFA, Chief Investment Officer

Over the past weekend, I spent time reflecting on the different market crises that I have experienced during my 32 years in the industry. From the crash of 1987 through the dotcom bubble to the financial crisis, the one common theme is that, at some point, these crises all resolved themselves and the market moved on. But, the journey through each crisis took a huge emotional toll on all market participants. Today we are, once again, doing emotional and financial penance for a future that we can't see.

There are a few differences between 2008 and today; the most striking is the overall expectations in the market. In 2008, most people knew there was some questionable lending to the US real estate industry. The big surprise was the extent of it. Every day, we would come to work and watch the problem getting bigger until the entire financial system was at a precipice. It took extraordinary measures by governments and central banks to keep the financial system functioning.

I think we are starting from the opposite point in today's market. All of us imagine how bad things might get, and it is that fear that is being expressed into markets in a remarkably short time. Maybe, just maybe, we are overestimating the long term implications of the outbreak just as we underestimated the problems in the financial system in 2008.

Could the stock market go to zero? The theoretical answer is yes, but that would mean that the entire productive capacity of a country is worthless. If you believe that a corporation has some value, then there is a number between zero and today's price where that corporation would make an attractive investment. In fact, that attractive price might be higher than its value today. But the question remains; how would you know?

The answer is, you have to have a framework within which to calculate what you think is an objective value for each investment. Not necessarily for the market as a whole but for each company individually. As you know, we believe that the value of any company's shares is the discounted sum of its cash flows. So, as a starting point, to determine value today, we must ask what impact this pandemic will have in reducing cash flow. The second step is to forecast when there will be a recovery and the size of the cash flows for the years to come. Right now, the only thing that the market can see is the reduction in this year's cash flow. If you can see beyond this year, you will find those investments that offer compelling value.

There is never an easy answer for when to buy in a panic, but if you continue to use a disciplined framework to value investments, you can eliminate as much of the emotion as possible and focus not only on today's news, but on future possibilities.

As of Wednesday, March 18th