Have Your Cake and Eat It Too Investing

Relative Strength at Work, Vol. 6: Lessons from Ludwig

July 31st, 2017

I first met Ludwig in 2003. He was a very likable client and at the time I was quite happy to be working with him. He had a sharp mind, good sense of humor, and was a hard working professional that valued both his work and his family. We had a lot in common… minus the sharp mind and sense of humor!

At the beginning of our working relationship, Ludwig was interested to hear my investment advice but he didn't always follow it. Like many investors he enjoyed doing his own research, which led to strongly held beliefs about how the future would unfold. When my advice clashed with his own viewpoints, he tended to stick with his convictions.

Keep in mind that back in 2003 I was still a novice with less than 4 years' industry experience – so Ludwig may have been well-served to not take all the 'fundamentally-driven' research advice I was giving. My advice back then was 'idea-driven' – buy this stock because we believe that 'this, this and this' will happen and if it does, we expect the stock to go up.

If you are a regular reader of our R/S series I would hope after this 6th edition you have grasped the concept that all our investment advice today is 'process-driven' – we don't give a rats ass what the stock or bond or ETF is that we're buying, as long as it matches our portfolio and relative strength investment criteria. The 'idea' we are buying into is that the price of the investment is showing strength relative to alternative qualified investments we could be buying. It is not based on profitability, commodity prices, product launches, dividends, etc. We are agnostic about the investments, passionate about the process.

Ludwig had a few distinguishing investment beliefs that at the time I thought were relatively harmless. Namely,

1. A Thematic Viewpoint. He liked to do his own research, reading up on different investment themes that he could understand and believe in. He was looking for under-appreciated opportunities not yet priced into the markets; ideas that would allow him to make great returns over the long run. In industry terms we might call him a Macro Investor, as in someone investing consistent with a long term Macroeconomic viewpoint.
2. The Long Term Perspective. He understood (correctly) that the really big money is made in investing by the compounding of growth over time. To truly be successful he needed to both identify the big opportunities and then stay with them for the long term (only partially true – he missed the part about the risk of overconfidence in an future outcome that may differ wildly from his expectations).
3. I Understand it. He repeated an oft-quoted catechism that he "only invested in things he understood".

These are admirable rules for an investor to follow… as long as they don't allow these beliefs to trump risk management along the way. I thought at the time they have probably served Ludwig well in the past, and that he would continue to do well if he stuck to these tenets going forward. Sometimes, however what *should* work is dramatically different from what *does* work. As Yogi Berra said, "In theory there is no difference between theory and practice. In practice there is."

Ludwig Chapter 1: The Growing Demand for Clean Power in China and India (2003)

The first experience I had in advising Ludwig contrary to his beliefs was related to Uranium stocks in the mid 2000's. Ludwig had spent an enormous amount of time researching the emergence of China and India as new economic superpowers. He read financial reports, newsletters, economic journals, and had come to believe (rightly so) that there was an enormous financial opportunity investing in uranium stocks that would benefit from the rising demand for nuclear power plants in China and India. It met all three of his investment criteria. It fit with his big picture view of the world (emergence of China as an economic super-power), it was long-term in scope (China was expected to outgrow developed markets for decades to come), and that it was simple to understand (limited uranium resources would be gobbled up by perpetual energy demand growth).

I remember a conversation Ludwig and I had at lunch one day in 2005.

"You know Jeff, as much as I hear your doubts about the long term view on the uranium market, the price keeps going up. Uranium prices have gone up (due to Chinese demand, in his view) every month for years. It just keeps going!"

"Ok Ludwig, I agree that's it's been a great investment for you. Congratulations. But when will you know to sell?"

"Oh I'm not selling anytime soon. Everything I read says that China is going to continue to grow for decades to come, and they are desperately short of clean power. This is a long-term core position for me."

Does any of this sound familiar? Have you ever heard a friend or even an industry expert proclaim their faith in a long term view (like Ted did here), only to deeply regret it later?

What he forgot was that sometimes the excitement around a story or a theme pushes prices far, far higher than is actually justified by current fundamentals. Ludwig was absolutely correct in his big picture, multi-decade view of growing Chinese prosperity. And for a time, that was reflected in some pretty sweet gains in his uranium stocks… until it didn't.

Thankfully Ludwig did not have all his money caught up in this uranium theme. As I said before, at his core Ludwig was a sharp guy with enough savvy to not put all his money in one basket. My best guess at the time, was that he put in about $50,000 originally, saw it grow to $500,000, then watched it slowly wither away to about $100,000 today. Just a rough guess as for reasons soon to come Ludwig, and I parted ways a few years ago. As the saying goes, "Making money is easy. Keeping it is hard."

On the topic of keeping it is hard… unfortunately Ludwig's second favorite investment theme after the China story was Peak Oil.

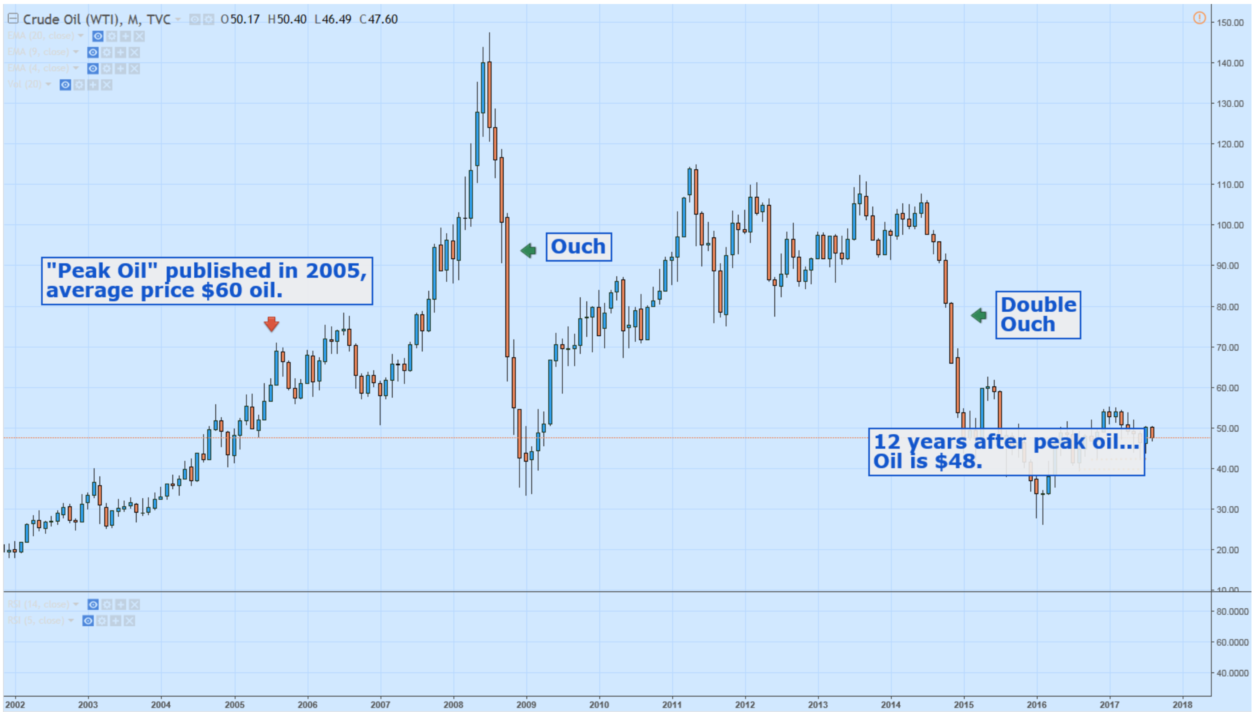
Ludwig Chapter 2: Peak Oil 2003-2017

I have a book on my shelf at work entitled "Twilight in the Desert – The coming Saudi oil shock and the world economy", by Matthew R. Simmons. It was published in 2005 when oil averaged around $60 a barrel. In the book, which of course my good client Ludwig had read and gave to me so I could 'understand the opportunity like he did', Mr. Simmons lays out the facts as to why the world is running out of cheap oil and how perpetually rising oil prices will affect the global economy. I confess I've never read it.

Ludwig's belief in Peak Oil confirmed his investment positions in oil and gas income trusts and dividend paying energy-focused mutual funds. Yet again, when I advised Ludwig in 2006 (oil fell from close to $80 to just above $50 in 2006) to put his beliefs aside and define a sell discipline (different from advising to sell, of course) his comments were the same as before.

1. I believe in the big picture view of Peak Oil.
2. I believe in the long term opportunity in oil and energy investments
3. I understand it. It makes sense to me. I am comfortable with my positions.

For a while (until mid '08), Ludwig's convictions seemed to work out. Until it didn't.



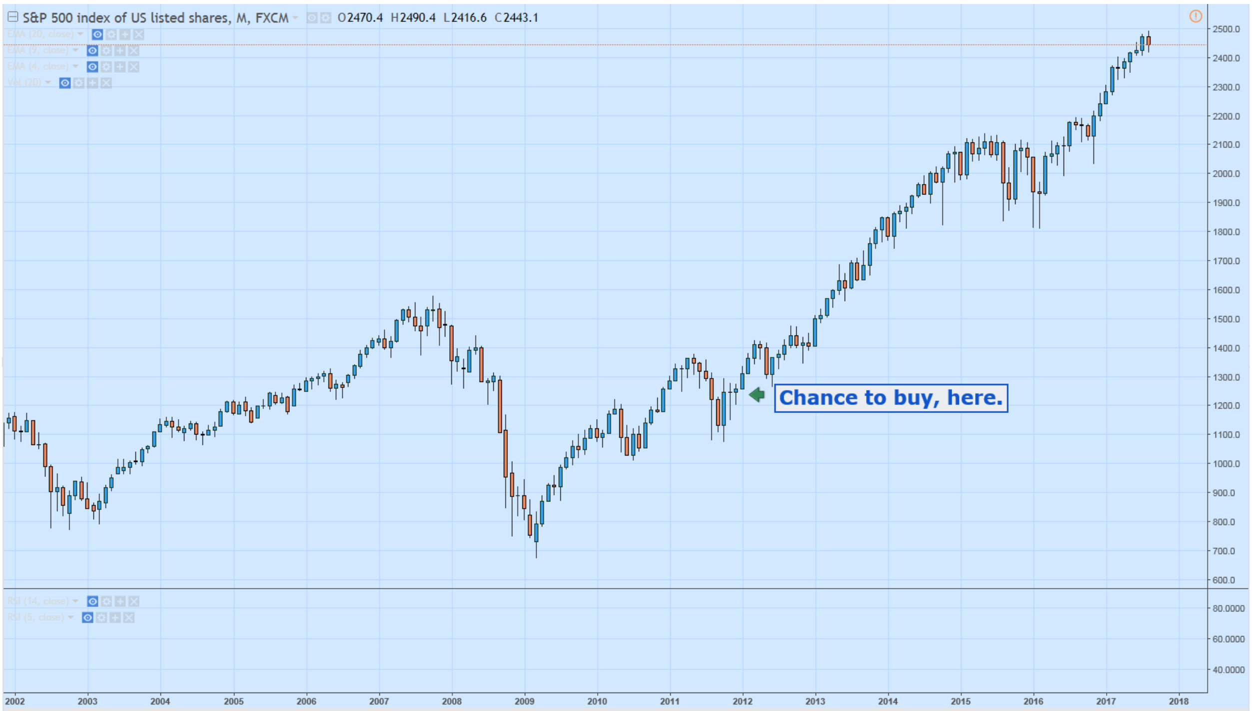
Despite how bad the collapse in energy stocks were in 2009, I believe the more recent collapse in 2014-2015 is the one that likely stung the most for Ludwig. Like many investors, Ludwig was drawn to the perceived safety of cash-flow. He had purposely been focusing his oil and gas investments into companies and funds that paid out a high level of dividend or distribution income and then reinvesting that cash to buy more shares. So instead of taking gains off the table (when he had them), he was continually plowing more money into these investments in the belief and faith in their long term success. The mathematics of loss can be devastating. For example, if you make 10% a year for 14 years on $10,000 you'll roughly have $40,000. If in the 15th year that investment suffers a catastrophic loss and loses more than 75% you just gave back those 14 years of growth. In other words, *past results do not guarantee future gains* but because of the success Ludwig had enjoyed in his energy investments, I could not get him to agree on a sell discipline until *after* he lost the money and it was too late.

Ludwig Chapter 3: The dangerous US Market, 2011 to present

As you might guess, Ludwig was feeling a little beaten up with his approach to investing. The last chapter in the Ludwig story began in mid-2011. If you remember, that was right at the time Greece and Spain were imploding under the weight of their debt obligations and the markets were tenuous at best. It was also the time when I had begun exploring the possibilities of running relative-strength based investment portfolios for clients and putting aside my past fundamentally driven (i.e. educated guessing) approach. I met with Ludwig and proposed a blue-chip portfolio of 20 stocks managed via my relative strength based process. At first, he was interested, until he discovered that I planned on picking only US stocks. The reason I told him that I wanted to go with a pure US stock portfolio at the time was because the US market was showing better relative strength than Canada, the CDN dollar was quite high at the time, but most importantly the S&P 500 is a fully diversified index compared to the TSX 60, which is mainly financials and cyclicals. When faced with this decision, what would you guess Ludwig would do? He fell back on his old biases for making investment decisions:

1. I don't understand the US markets, so that makes me nervous. The US has a lot of problems, too (i.e. I don't understand what the 'big' opportunity is.)
2. I don't see how the US will sustain its long term growth. That troubles me.
3. It just doesn't make sense to me. How can we make money in a market where everyone else is already invested in? Where is my unique opportunity?

Suffice it say that after many hours of discussion, Ludwig chose not to put a large part of his investment dollars into my US stock model (or even a small part). He remained largely in cash, while still praying for his uranium stocks to come back and still reinvesting dividends back into his energy mutual funds. That was the fall of 2011.



That would have been an easy win for Ludwig. In hindsight, I think I failed in my efforts to help him understand that he *didn't need to trust the US markets, or the stocks we were buying, because if things went south we had a sell discipline already in place to handle the worst case outcomes.*

Lessons from Ludwig:

1. It's beneficial to be knowledgeable about your investments. It's a detriment if you allow that knowledge or faith in a future outcome to prevent you from managing the risk of loss along the way.
2. Having a long-term investment outlook is a necessary ingredient to success, as long as you manage the short-term risk of getting blown up while you're waiting. If you are afraid to sell for fear of missing out on the move you are expecting to happen, you've already lost.
3. Just because you don't understand a potential investment idea does not mean you should ignore it. It's less about the idea, and more about the process around managing the risk should things turn ugly. Ideas come and go. Themes evolve and change. The process, however, should be the same each time. Understand the process and the ideas become secondary.

Epilogue:

You might be asking yourself, what does any of this have to do with relative strength?
The way we advocate using relative strength as an investment strategy is to use it to identify investments with the highest odds of making money. We buy what's working, and avoid what isn't. All the information we need to make a decision on whether to buy, hold or sell a security is based on the price of that security. Compared to Ludwig's beliefs about long term, thematic investing and a refusal to adopt any kind of sell discipline you can see why we were both best served to part ways.

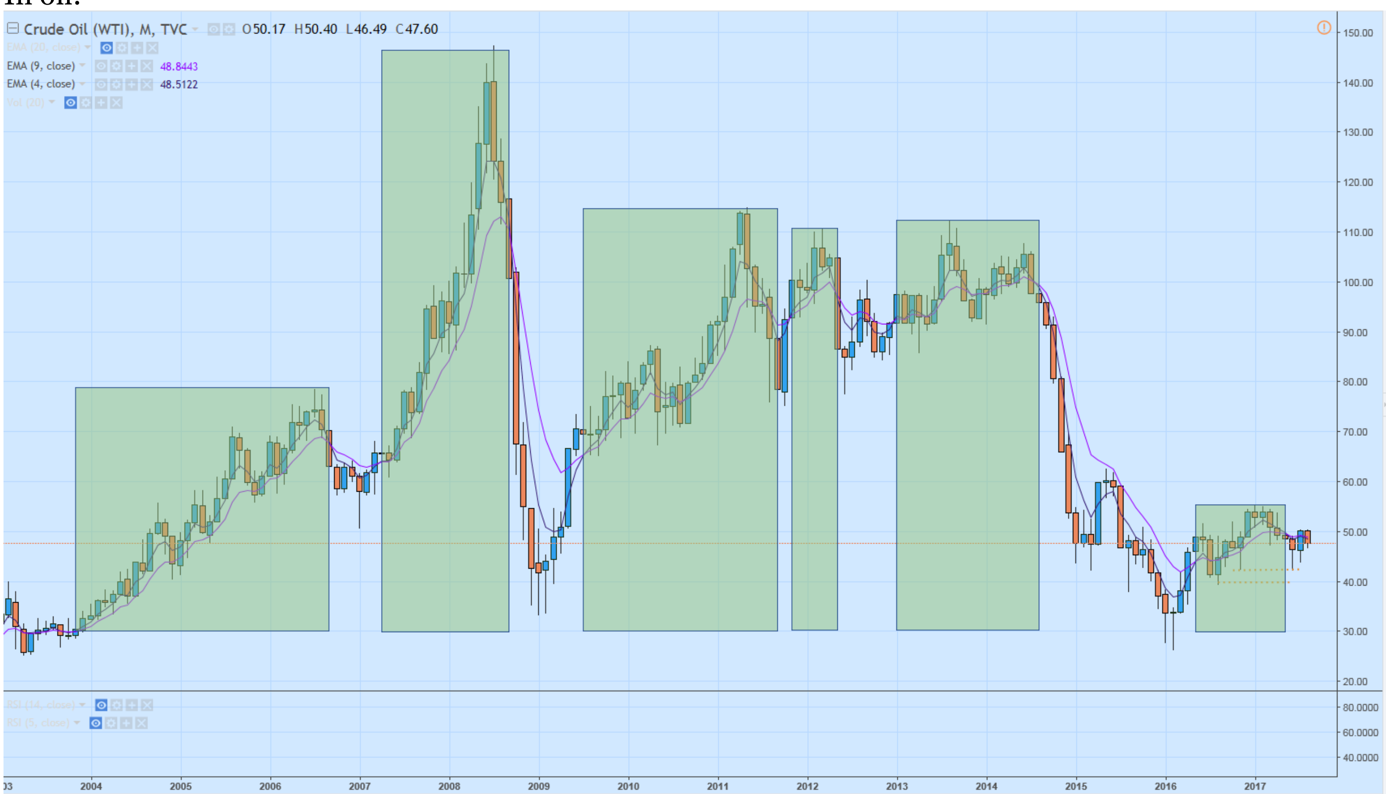
So through the lens of price and price alone, let's take a quick look back at what Ludwig *could have achieved* had he applied a simple relative strength based buy/sell discipline.

A very simple way to measure the relative strength of an investment of any kind is through moving averages. For instance, if we want to own investments that are rising in price over time, then the price today should be higher than the prices from a year ago. For this article we are going to use the average price over the last four months (recent price) and compare it to the average price over the last nine months (older price). As long as the recent price is higher than the older price then by definition that is an uptrend and something we would consider owning.

Now look at the difference. I put green rectangles on the charts to show the periods of time the recent price is higher than the older price (i.e. the 4 month avg. price is relatively stronger than the 9 month avg. price). *Pay special attention to how many times we avoid the big price collapse by following a price-based sell discipline.*

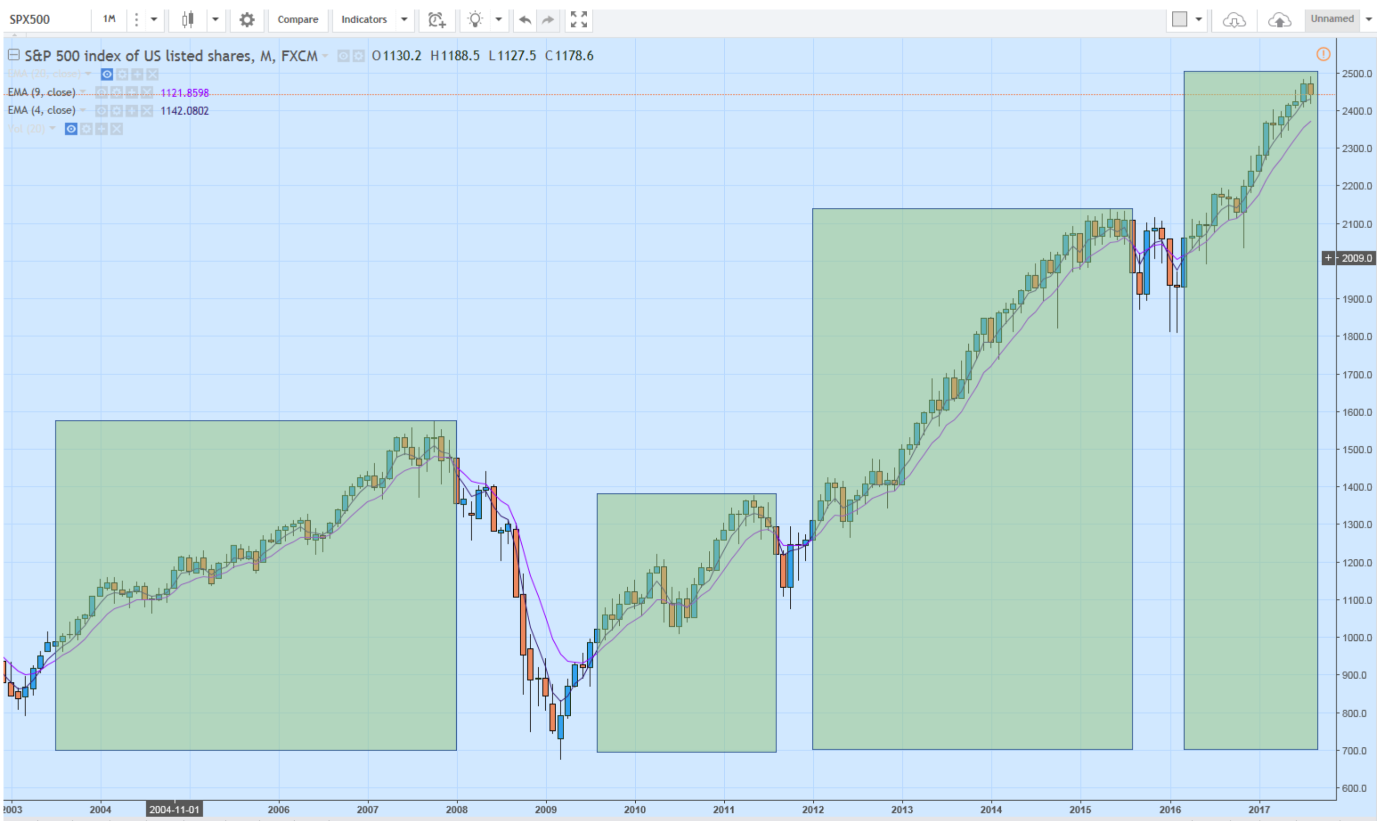
(Hint: All of them.)

In oil:



In Uranium:

In the S&P 500:



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Hey how about that!? Making money, and keeping it too.

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