Written by Geoff MacDonald

28 Questions and a Night with the Bears

It was two years ago today on April 7th, 2009, when an event occurred that should remind us of the self-destructive nature of investor behaviour. To learn about how dangerous it was to the net worth of 1500 participants, you can read about it in the last year's commentary.

Why Do Investors Only Experience Volatility When Stocks Go Down?

From August 2010 to February 2011, global stock markets generally went straight up. The market continued to climb the “wall of worry” we’ve talked about many times over the past couple years. This run-up in stock prices reminded us of a curious fact about volatility. Specifically, investors only worry about volatility when stocks decline, but never when they go up in price. Are stocks only volatile if they move in one direction?

In my investment career, I’ve received approximately five questions when the market goes down for every one question when the market goes up. It’s unfortunate that the direction of the markets can set the tone of investors’ moods. And it’s often the wrong tone.

Why are there fewer questions when the market is going up? Do investors confuse a rising stock price with confirmation that the underlying business is doing well? Do investors actually believe that an increasing stock price means the company’s value has gone up by a similar amount? Do they believe that no action is required as prices increase?

However, when stock prices fall, why does the opposite happen? Falling stock prices tend to lead investors to believe there’s been a negative business development or a drop in the value of the business.

Why do investors take their lead from the direction of stocks? Does it mean you’ve made a good investment decision if a stock price increases right after your purchase? Do you believe the company is worth more? Whose judgment is more important, the market’s or your own?

And why is risk measured by stock price volatility? Isn’t risk the chance of losing money? Do investors really care about volatility or do they really just care about declining stock prices? In other words, why do stocks seem risky to “investors” when they are going down, but not risky when they are going up?

We have no idea what is in the mind of the average “investor”, but we’re glad we are legally allowed to take advantage of them … as is Mr. B.

What Do the Ups and Downs Mean to Mr. B?

You may remember Mr. B from the same commentary referenced above with regards to “A Night with the Bears”. Would Mr. B consider price fluctuations to be a significant risk?

Let’s assume Mr. B buys a business. We’ll also agree that he has a very good understanding of this business. After all, with the exception of some stock market participants, who’d ever buy a business without

knowing the management team, understanding the competitive dynamics of the business, and without a deep knowledge of the products and services the business offers?

Finally, we'll agree that Mr. B has a very good understanding of what the business is worth. He could tell you what it's worth under a variety of possible scenarios. After all, who'd buy a business without understanding this?

Does Mr. B view price fluctuations to be a significant business risk? For most "investors", a declining stock price indicates a risky investment regardless of the business fundamentals, however we suspect Mr. B would get excited about the opportunity to buy more of this business at a lower price, assuming the business is still progressing well on plan.

As it is impossible to invest in the stock market and avoid short-term price volatility, shouldn't this be expected? If so, why do "investors" allow that volatility to influence their decisions? Mr. B would welcome the opportunity to sell some of his business to an excited "investor" who feels increasingly smarter as the stock price rises. On the other hand, Mr. B would love to buy more of his business from an "investor" who gets increasingly depressed when the expected volatility that was known would happen actually does happen. Wouldn't you?

Why does this happen? Our only explanation is that "investors" don't know what they are buying. There is no other rational reason. If investors knew what they owned and what their investments were worth, they wouldn't be worried if they had a chance to buy more at a better price. The fact that many "investors" take their lead from the direction of stock prices has to mean they don't really know what or why they own what they do. It must be a very uncomfortable feeling. Wouldn't it be like someone who wasn't trained in brain surgery being asked to perform a brain operation? Or someone who has no knowledge of how to fly a plane being asked to be a pilot?

Price fluctuations do not equate to risk. They simply allow Mr. B to enhance his long-term returns.

Speaking of Price Fluctuations

During the first quarter of 2011, price fluctuations provided us with some wonderful opportunities to take some meaningful profits in companies such as EXFO Inc., Research in Motion Ltd., Hughes Communications Inc., and Tognum AG. The average selling price was approximately 115% above their average purchase prices.

Each of these companies was purchased at points of adversity. Investors who held these stocks without knowing why they owned them must have been forced to sell because the declining stock prices were signalling that something must have been wrong. Therein lies how volatility can be your friend.

Price fluctuations also gave us an opportunity to initiate new positions in three new companies during the quarter. We'll have more updates on these investments in future communications.

Sincerely,

Geoff

Commentary as at March 31, 2011. The above companies are selected for illustrative purposes and are not intended to provide investment advice. EdgePoint Investment Group Inc. may be buying or selling positions in the above securities.

Commissions, trailing commissions, management fees and expenses all may be associated with mutual fund investments. Please read the prospectus before investing. Copies are available from your financial advisor or from our website at www.edgepointwealth.com. Mutual funds are not guaranteed, their values change frequently and past performance may not be repeated. This is not an offer to purchase. Mutual funds can only be purchased through a registered Dealer and are available only in those jurisdictions where they may be lawfully offered for sale. This document is not intended to provide legal, accounting, tax or specific investment advice. Information contained in this document was obtained from sources believed to be reliable; however EdgePoint Wealth Management does not assume any responsibility for losses, whether direct, special or consequential, that arise out of the use of this information. Portfolio holdings are subject to change. EdgePoint mutual funds are managed by EdgePoint Investment Group Inc., a related party of EdgePoint Wealth Management Inc. EdgePoint® is a registered trademark of EdgePoint Investment Group Inc. Owned and Operated by Investors™ is a trademark of EdgePoint Investment Group Inc.

Published April 6, 2011