The Optimistic Investor

FOCUS ON WHAT REALLY MATTERS

Overview

Welcome Back!

Thank you for coming back for the second edition of The Optimistic Investor. We're glad so many of you enjoyed the inaugural edition and hope you continue to find value in these memos. Please continue to share your feedback as we move forward!

Last time we focused on innovation and the compounding of knowledge that occurs over time, and we talked about how that process supports a healthy optimism about the future. In this edition, we want to build on those concepts to discuss how we, as investors, can benefit from innovation and some of the challenges associated with doing so.

Investing In Innovation

We all benefit from innovation in a general sense. It gives us new medicines and treatments for disease, increased computing power and capabilities, new gadgets that make our lives easier, and safer methods of transportation, just to name a few. As we noted last time, however, there is also tremendous value created as innovation and advancement occur.

So how do we share in those financial gains as investors? For starters, we must understand that the economic benefits of innovation typically flow to the innovators. And, because the large-scale innovations we're talking about generally require some combination of in-depth expertise and considerable sums of capital, the innovators are often large, well-financed businesses. Fortunately, there is a mechanism through which we can easily invest in such businesses and reap the rewards of the innovations they produce. It's called the stock market.

The stock market may seem mysterious, but the core concept is simple. It provides a platform where: (1) companies of sufficient size can raise capital from investors by issuing stock; and (2) people looking to purchase and sell stock can come together to accomplish those transactions.

That brings us to the topic we want to focus on this quarter, which is the distinction between "stocks" and "companies." What's the difference? A share of ***stock*** is a legal convention that represents an ownership interest in a company. It is not the thing you're investing ***in*** (or at least it shouldn't be); it's the vehicle you're investing ***through***. Your actual investment is in the ***company*** that issued the stock.

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Establishing a strategy

This subtle distinction matters because it's much easier to see how investing allows us to share in the economic benefits of innovation when we're talking about companies rather than stocks. As noted earlier, the financial benefits of innovation flow to the innovator. And, simply put, ***stocks*** don't innovate. In fact, they don't actually ***do*** anything.

Companies, on the other hand, do a great deal. They manufacture goods and render services for the purpose of making profits, and those profits ultimately flow to the companies' owners through some combination of increasing valuations and dividends.

This is one of those aspects of investing that often gets glazed over. When you're a shareholder in a public company, you're literally an owner of that business with a claim on a portion of the company's net cash flows and assets. Your portion is very small, so you can't just call up the company and demand it, but your ownership claim is nevertheless a very real thing.

That's important because public companies ultimately exist and are operated for the benefit of their owners (shareholders). Each one is run by a team of experienced, professional managers with a legal responsibility to do what's in the best interest of the company and its shareholders.

As you would expect, managing a publicly traded company worth billions of dollars is a tremendously complex process. It involves the constant balancing of short- and long-term tradeoffs as the managers try to steer the enterprise towards opportunity and away from risks. And making decisions around innovation is an important part of that exercise. Every company must decide how much it can and wants to grow, when to improve or evolve its products and services, and whether to develop new offerings as consumer preferences and demands change over time. As those decisions are made, a company must also determine whether to reinvest its profits in the business or distribute them to owners via dividends and share buybacks.

Some management teams are better than others, and different companies experience varying degrees of success as they balance these considerations. Apple and Microsoft are examples of companies that successfully reinvented themselves as technology and consumer needs changed. Many others have been unable to do so. Think of Kodak; once the largest film manufacturer in the world and a respected brand (remember Kodak Moments?), it was never able to embrace the shift to digital photos for fear of eroding its core film business. Blockbuster Video is another great example; it was a wildly popular business, but ultimately misjudged consumer preferences and went bankrupt because of it.

> ***"[E]very company is trying to evolve and improve for the future, but many will be unsuccessful."***

The point of these examples is that virtually every company is trying to evolve and improve for the future, but many will be unsuccessful. Some businesses are bound to make poor decisions, fail to anticipate trends, or be displaced by better and more innovative companies (think Netflix replacing Blockbuster). It's extraordinarily difficult and very risky to try to predict what companies will succeed (or fail) at innovating. Fortunately, we don't need to do that because the capital markets do the work for us. Over time, markets are incredibly efficient at directing capital to companies that are succeeding and taking it away from those that aren't.

So, to capture the economic benefits of innovation, we simply need to set ourselves up as owners of well-diversified portfolios and let the markets do their thing.

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Maintaining focus when prices and values diverge

The difficult part of capturing the economic benefit of innovation is not implementing this strategy. Mutual funds and ETFs enable us to create diversified portfolios of thousands of companies at very low cost. The hard part is the same thing that makes it difficult to be a successful investor in the first place: sticking with the strategy through the ups and downs of the economic and market cycles.

This is where understanding that we invest in companies (not stocks) really matters. If you truly understand the difference, it will increase your comfort level when the stock market inevitably goes through corrections and bear markets (*i.e.*, temporarily goes down). Before we get into that, however, let's briefly review some stock market basics.

As noted earlier, the "stock market" is a platform where people looking to buy or sell shares can come together to accomplish those transactions. We call the price they transact at the "market" price, because it's set based on the current bids (offers to buy) and asks (offers to sell) in the marketplace.

The market price for a company's stock is generally the best indicator we have of that company's value at any given point in time. It reflects the aggregate view of millions of market participants based on all available information. And most of the time, the market price of a stock and the enduring value of the company that issued it are well-aligned. That is certainly the case over long periods of time, because market participants (as a group) are very good at digesting new information and making reasonable adjustments to their bids and offers. At some points, however, market prices and enduring values can diverge.

These situations most typically arise when there is a major shock to the economic system or so-called "black swan" event. It could be a financial crisis, the outbreak of war, or any number of other things. The essential feature is that the shock must be severe enough to create tremendous uncertainty and a fevered state in which people believe the resulting crisis might not be solvable.

When fear that a crisis may be "unsolvable" takes hold, there's a general expectation that corporate profits will decrease, and uncertainty over how and when the crisis will end causes people to project those reduced profits far into the future. This can cause stock prices to decline significantly. In a typical market “correction” the decline is 10-15%, but with events that trigger “bear markets” the decline exceeds 20% and often 30%.[1]

At such times, thinking about our investments as stocks can drag us into a short-term mindset that promotes bad decisions. We see share prices falling and no immediate reason why that will change. That’s a scary thing, and it can make us feel like we need to make “protective” changes to our portfolios, even though we know that letting current events drive our investment strategy is a recipe for failure.

Happily, the picture is more encouraging when viewed through the lens of the companies we own. Unlike stock prices, the enduring values of companies are not driven by fear and panic. They are determined by how companies manage resources in balancing the short- and long-term strategic considerations discussed earlier.

> ***"Unlike stock prices, the enduring values of companies are not driven by fear and panic."***

[1] Think of the fear that gripped the world as COVID-19 spread before we had vaccines or established treatment protocols. As the number of cases and deaths climbed rapidly, mass closures caused a severe reduction in economic activity, and uncertainty over how we would slow the virus and when the world would re-open drove the S&P 500 down 34% in 33 trading days.

When a black swan event hits, corporate managers quickly recalibrate their decision-making frameworks. Faced with large-scale uncertainty and significant reductions in demand and revenues, managers take measures to preserve corporate resources into the future. Among other things, they can decide to cut costs, lay off workers, sell inventory at a discount, decrease or defer capital investment, and reduce or suspend dividends. Those choices may bring pain in the short-term, but they’re made to steer companies away from the immediate risks of the black swan and position them to take advantage of opportunities that will arise in the future when things (eventually) return to normal.

This explains why it’s almost unavoidable that stock prices and the enduring values of companies diverge in times of distress. Stock prices are driven down by fear of uncertainty and the resulting projection of short-term disruptions into the future. In contrast, while stock prices are falling, the managers who run companies are actively working to minimize the disruption's impact. They're striving to maintain enduring values into the future through prudent decision making and risk management. In other words, the managers of ***companies*** are taking steps to avoid the fearful scenarios reflected in the market prices of ***stocks***. And those efforts are the reason there has never been an event that stopped public companies (as a whole) from innovating and increasing shareholder value in the long run.

Perspective is everything when it comes to successful investing. And remembering that we invest in companies can help us maintain that perspective and make sound decisions when markets are down. We don't need to adjust our investments in response to black swans and other current events, because the managers of the companies we own are reacting to those events for us. They are positioning the companies for future success after the storm clouds pass, and our willingness to bear the uncertainty of waiting for that to happen is ultimately what allows us to capture the long-term premium returns that flow from owning great companies and the innovations they produce.

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Innovation & Good News

1) Last quarter we highlighted the achievement and confirmation of fusion ignition, noting it could transform the energy sector and provide our cleanest and most efficient source of electricity generation. Building on that development, last month a private company announced that it expects to provide Microsoft with electricity from a fusion power plant within the next five years!

2) Researchers think they can use the world's oceans to remove carbon dioxide from the atmosphere. This would be a major breakthrough in efforts to slow or reduce global warming, and research efforts are underway using both self-powered electricity and microbes.

3) Developments in artificial intelligence (AI) are showing huge potential in the world of medicine. Researchers have trained an AI algorithm to predict the occurrence of pancreatic cancer up to three years in advance. This is important because pancreatic cancer is one of the deadliest forms of cancer, in large part because early diagnosis is very rare. Similar efforts are showing potential in diagnosing lung cancer.

4) In another example of the potential impact of AI, Pharmaceutical companies are leveraging it to expedite the early stages of drug development and bring drugs to later stage trials sooner.

5) A new drug reduced the progression of Alzheimer's disease by 35% in a final-stage trial and is expected to be approved by the FDA.

Financial Planning News & Updates

At the end of last year Congress passed the Secure 2.0 Act, which made several changes to the laws that govern retirement accounts. There are two we want to highlight here:

RMD age – the Act increased the age at which required minimum distributions (RMDs) must be taken from IRAs, 401(k) accounts, and other retirement plans. Account holders must now begin RMDs in the year they turn 73.

529 plans – 529 plans provide a tax-advantaged way to save for college and other types of education. However, current law provides that when leftover funds are withdrawn from a 529 plan, the earnings are subject to tax and a 10% penalty. Under the Act, beginning next year, leftover 529 assets can be used to fund Roth IRA contributions for the named beneficiary. The 529 account must be at least 15 years old before such contributions are permitted, annual 529-to-Roth transfers are capped at the maximum IRA contribution for that year (currently $6,500), and there is an aggregate limit of $35,000 on such transfers. This new rule may impact how we utilize 529 plans, but it's too soon to determine that because the IRS has yet to issue guidance. Stay tuned!

Happy Fourth of July and enjoy the summer!

Keep us in the loop!

Please contact us if there are changes in your personal or financial situation, so we can update our previous recommendations as needed and make any necessary changes to your plan.

KOOMAN & ASSOCIATES

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- If there are any changes in your personal/financial situation or investment objectives, so we can review, evaluate and/or revise our previous recommendations as needed.
- If you would like to impose, add or modify any reasonable restrictions on our investment advisory services.

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