

The Importance of Price Discipline

This article is excerpted from a letter by Luis Sanchez and John Pelly, co-founders and managing partners of Overlook Rock Asset Management, based in New York.

“At some price, every company is a buy; at some price, every company is a hold; and at a still higher price, every company is a sell.” –Seth Klarman

We agree with fellow value investor Seth Klarman, price discipline is extremely important, if not the most important factor for good investment results. Experienced stock market investors recognize that the market is fickle. Stocks that are dear in the first quarter can quickly become despised by the third quarter and prices can swing on the turn of a dime. This is true for large blue chip stocks that frequently make headlines. This is especially true for lesser-known small capitalization stocks that can trade wildly on sentiment or rumors.

Let’s use the last four years of Walmart’s stock price as an example. If four different investors bought Walmart at four different points in 2015 and sold the stock at the end of the last quarter, they could have had widely different investment returns. The table below shows the average dividend adjusted stock price Walmart traded at during each quarter in 2015. The range of possible returns is over 40%! Keep in mind that Walmart is one of the largest and most-followed stocks in the entire world.

Period	Walmart’s Average Stock Price	Total Return If Sold on 6/29/18
Q1 2015	\$77.60	10.4%
Q2 2015	\$70.33	21.8%
Q3 2015	\$63.70	34.5%
Q4 2015	\$56.01	52.9%

As active managers, we take advantage of the volatility in the stock market to buy and sell at opportunistic prices. However, we are presented with a problem when new clients become partners at Overlook Rock and when existing clients provide us with more capital to invest. The problem is that over the course of time the opportunity set of what is trading for an attractive price changes. In other words the stocks we bought for clients in the first quarter may no longer be the best stocks for new money in the second or third quarter.

We have decided the best way to maximize investment returns for all clients is to invest fresh capital in the best opportunities at the time capital is deployed. For most active managers, this approach is out of the question because it would be impractical to conduct research on a new set of companies while maintaining research coverage on existing investments. However, we have leveraged our combined technical and analytical proficiencies (something we believe is quite unique in the investment industry) in a way that allows us to effectively maintain multiple portfolios which represent the best opportunities according to our process at the time of formation.

Our software and human analysts evaluate the top investment ideas on a daily basis. Because we are always on top of the best investment ideas at any given time, we have the ability to fully invest a new portfolio with little notice. In addition, our software monitors each investment idea and provides the human analysts with the determination on when to sell. As a result, our software plus human oversight investment process is highly scalable. Not only does our technology enable us to better pick stocks but it enables us to better manage money.

While there may be a day in the not so distant future when we allow clients to send us money to be invested with little to no advanced warning, for now we have decided to gate inflows to just once or twice a year in “vintages”. Each vintage will be invested in the top ideas at the time capital is deployed. Our first vintage was deployed in January 2018 and we are currently collecting investor interest for our second vintage which will be established in the second half of 2018.

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