The Myopic Market: Why Investors Focus Too Much on the Short Term

November 2023

Dear Investors,

There was a time when access to information was a major competitive advantage for investors. In 1815, while England and France were fighting the Battle of Waterloo, the banker Nathan Rothschild had his own network of spies to follow the course of the war and learned before anyone else that England had won the battle.

With this exclusive information in hand, Nathan Rothschild began selling his assets on the London Stock Exchange. Since everyone knew about his network of informants, they deduced that the reason for the sales was that the war had been lost and began selling their shares too, triggering a wave of panic and a rapid fall in prices. At the same time, the banker instructed several of his agents to buy various assets at discounted prices. When the news that the battle had been won reached everyone, prices quickly recovered and Nathan suddenly multiplied his fortune.

Today, the maneuver would not be so viable. Major events are quickly reported across multiple media channels, and the time advantage professional investors gain in receiving such news is no longer sufficient to constitute a meaningful edge. Furthermore, access to non-public information through spy networks and the like would likely fall into the category of insider information, the use of which to trade in the market is illegal. Thus, it seems to us today that competitive advantage comes less from access to information and more from the ability, amid the infinite flood of news and data, to filter out what is relevant and not waste time on the rest of the daily noise. This filter requires having clarity about what truly matters for stock investment theses — the topic we will address in this letter.

What Drives the Value of a Stock

What determines the intrinsic value of a company is the expectation of the cash flow it will generate over the years, discounted by the rate of return an investor considers appropriate for the level of risk of the business. This is the discounted cash flow method, used as the basis for pricing virtually any asset.

One characteristic of applying this method is that cash flows generated in the distant future are worth less than those generated in the immediate future, under the logic that a dividend paid in the future must embed in its value an adequate return for the entire waiting period, while dividends paid immediately require no rate of return for the passage of time. That is, R$100 paid now is naturally worth R$100, while R$100 paid ten years from now is worth considerably less today — since, assuming a return rate of 15% per year, R$25 invested today would become R$100 after ten years.

However, even though near-term cash flows are worth more than those generated years into the future, the total value of a company still depends substantially on the results its business will produce over a very long time horizon. For example, a company that grows its earnings at 8% per year (roughly 3% above inflation in Brazil), when valued at a discount rate of 15% per year, has in its first year of results only ~6% of its total value. Over the first five years, ~27% of the total business value would be accounted for, and over the first ten years, 47% of the total value. The conclusion of this example is quite simple: next year's result matters little to a company's intrinsic value. Consequently, next quarter's result matters even less.

Despite this conclusion, it is common to see a stock's price move several percentage points because of a quarterly result above or below market expectations, or because of some news about politics or macroeconomics. What causes these price fluctuations is the market adjusting its projections for future results in light of new information. That is, the fact that a company reported poor results in a given quarter, for example, leads many investors to lower their expectations for the business over the coming years. Making the adjustment makes sense, since it is necessary to incorporate new information into investment analysis, but the impact is often exaggerated — and we are interested in understanding why.

Why So Much Attention to the Short Term

Behind the price volatility in the market lies an excessive focus on the short term, which in turn is the result of a coalition of factors pressuring investors and financial market participants to keep their attention on near-term events.

One of the main factors is the pressure from end clients (individual investors) on the agents responsible for managing their investments (wealth managers or fund managers) to produce quick returns and avoid volatility in the value of their portfolio. Although most professional managers understand that stock market investing is a long-term activity, when faced with the choice between following their true convictions and doing what their clients want to ensure they remain clients, the vast majority prefer the latter. As a result, correctly predicting stock price movements over the coming months becomes the objective of a large share of market professionals.

As a consequence of this dynamic, predicting the short term also becomes the goal that promises the most commercial success. For example, the *research* analyst who correctly predicts a company's result in the next quarter generally receives more praise from peers and clients than the one who correctly predicts the state of a company five years from now, since the time window is too broad for the forecast to still be remembered by observers. Furthermore, five years contain 20 quarters, which are 20 opportunities for the short-term analyst to develop and promote new theses, while maintaining the same thesis for five years generates far fewer topics for interesting conversations with clients.

Finally, the fact that the long term is far more uncertain also contributes to this excessive attention to the short term, since the human mind dislikes uncertainty and seeks devices to escape the need to admit its own ignorance (which also brings little commercial success). As a result, there is a strong bias toward spending most of the time analyzing recent events, projecting the near future with greater care, and simply assuming that the distant future will be an extrapolation of this brief recent past and short projection — a line of continuity that is intellectually comfortable to accept.

The problem with the practice of focusing excessively on the short term and projecting the long term through extrapolations is that it amplifies the weight of recent events too much. If a company has grown rapidly over a few quarters, for example, the simple act of assuming that last year's revenue is the best starting point for applying an average growth rate going forward can overestimate the value of the business. If the investor assumes that the pace of growth will remain elevated, the overvaluation may be even greater. The same dynamic applies to negative news, and as a consequence of the exaggeration in these adjustments based on recent events, prices become more volatile than they should be, given that projections for decades of results would not be expected to fluctuate so much from quarter to quarter.

Interestingly, a psychology study (McClure, Laibson, Loewenstein and Cohen, 2004) found that the human brain tends to place more value on immediate rewards (e.g., stocks rising in the very short term), processed by the limbic system, than on larger, deferred rewards (e.g., return expectations from long-term investments), processed by the frontoparietal system, because the limbic system has the ability to override the frontoparietal system, especially in stressful situations. In other words, the more stressed people are, the

more value they assign to the short term. This helps explain why investors tend to focus so heavily on the short term during periods of economic crisis.

What Is the Right Focus

Having settled the point that the short term has limited relevance for stock investment theses, the challenge remains of how to deal with the unpredictability of the distant future. A first step is to understand that not everything can be projected with sufficient confidence to serve as the basis for an investment thesis with a reasonable probability of success.

Among these difficult-to-predict factors, some are quite important for a business (for example, the price of oil for oil companies), but it is vital to keep in mind that the level of importance of something has no correlation with its predictability, and there are many factors in the world that remain unpredictable no matter how much effort is devoted to constructing intellectually elegant projections. The trap is believing that the complexity and elegance of forecasts increase their chances of being correct.

For example, a few years ago there was much talk of a prolonged drought super-cycle in Brazil that would affect the electricity sector and agribusiness. At the time, rainfall had been below normal levels for years, the reservoirs of power generators were low, and agribusiness was suffering from lack of rain. The projection was consistent with what had been happening and was supported by lengthy meteorological analyses. In the years that followed, a cycle of heavy rains began, filling reservoirs, generating record harvests, and erasing from memory the theses of prolonged droughts. This is just one example of the many elaborate forecasts we have seen prove diametrically wrong over time.

Accepting the fact that most of the future is irremediably unpredictable, the work of a good investor is to find the few points that are, at the same time, important to the success of a business and possible to predict with reasonable confidence. To do this, we typically begin by studying a long historical period. It is not enough to look at a business's results over the last two or three years. We want to assess how the company has behaved over the last ten to fifteen years and search its past for the points that have remained unchanged or have evolved according to a logic comprehensible enough to estimate how they will continue to evolve.

In Warren Buffett's famous investment in Coca-Cola, one relevant factor was the understanding that people develop strong habits of always consuming the same beverages. Curiously, we don't like eating the same things every day, but we tend to drink the same things for years and years on end. It is therefore reasonable to assume that demand for Coca-Cola's beverages is quite resilient and, consequently, so is its revenue level. This is an example of a factor stable enough to predict its continuation into the future.

No Forecast Is Precise

Note that, even in the Coca-Cola example, demand stability holds only over long time windows. That is, Coca-Cola's revenue is not completely stable quarter to quarter, or even year to year. Every business has its fluctuations over time. Predicting quarterly results is therefore not only a difficult goal, but also an unnecessary one. It is not what truly matters.

In fact, short-term stability is not even a condition for a business to be a good one. One example is our own investment case in Whirlpool, the company that owns the Brastemp and Consul brands and of which we have been shareholders for over ten years. Since home appliances have a long useful life, they are not recurring consumption items. Their demand is therefore cyclical, varying with macroeconomic conditions and real estate launch cycles (people buy appliances when they move). Despite the unstable demand, Whirlpool has not recorded a loss in over twenty years. Its profit margin fluctuates between high and low levels, but average profitability is quite attractive and stable over long periods, which has delivered excellent returns for us over the past decade, even amid the broad macroeconomic instability Brazil went through during that time.

Each variable has an appropriate time frame over which to make estimates with reasonable confidence — one that must be long enough to provide the sample space needed for the statistical tools used in forecasting to be applicable, following the logic that it is easier to predict the result of rolling 1,000 dice than the result of rolling 10, yet not so long as to introduce the risk that qualitative aspects may change so substantially over that period that the logic of the projections becomes inadequate. In our experience, the ideal period for business result projections tends to be a few years.

Why a Long Horizon Is the Right Approach

Since the very short term has low relevance for a business's value and the period of greatest accuracy for quantitative projections tends to span a few years, we believe that an appropriate time horizon for making explicit forecasts is five years. This period does not apply to all cases, as there are businesses that are predictable over a longer time frame (road concession companies, for example), but it is a good benchmark period that combines reasonable predictability with relevance to the intrinsic value of a company under analysis.

As a consequence, when we invest in a new company, we are typically prepared to hold its shares in our portfolio for several years. We may sell the position sooner if the price rises to a point that exceeds what we consider to be the intrinsic value of the business, or if our investment thesis collapses due to some event contrary to our expectations, but we consider it important to have expectations calibrated correctly: most theses take time to deliver the initially projected returns, and the exact moment when that happens is unpredictable.

In the meantime, between the initial investment and the decision to sell, it is important to remember that the price and the intrinsic value of a stock are distinct variables that do not always move together. We have spoken at length about this on other occasions, and we are in good company in the position of placing little importance on a stock's price when determining its real value. Benjamin Graham used the analogy of Mr. Market, a bipolar character who offered completely different prices for the same assets over time, depending on his momentary mood, and Warren Buffett echoes the same concept, saying that the market is there to serve us, not to instruct us. Both advocate that investors should make decisions based on an independent assessment of the intrinsic value of each business, and not based on price fluctuations and their actions in the market.

This is a simple concept that nearly everyone agrees with and very few actually practice, since daily price fluctuations affect the psychology of most people. The best way to deal with this is to buy stocks with the genuine intention of holding them in a portfolio for a long time. When we buy a car, for example, we rarely intend to sell it a few months later for a profit. The purchase decision is based on the expectation of using it over several years. So, if the market offers half the price you paid for the car the following month, you would hardly decide to sell it just because the price fell (the famous "*stop loss*") and would simply continue using your car, with some regret for not having bought it a month later at half the price. By analogy, we buy stocks with the expectation of receiving a certain cash flow over time (this is the intended "use"). As long as the business continues to be capable of generating the expected cash flow, the rationale for the purchase holds.

The Advantage of Focusing on the Long Term

As obvious as the approach we have described may seem to us, it is an investment style that faces little competition. While the majority of investors remain fixated on the short term and suffer through the mood swings caricatured by Mr. Market, we prefer to keep our attention on longer horizons and react with less intensity to the day-to-day developments that, in the vast majority of cases, prove to be nothing but noise, with no relevant effect over the long term.

Despite our position, we prefer that the market continue behaving in the same way, with its predominant focus on the short term and the exaggerated price swings it provokes, since it is precisely these swings that generate the investment opportunities we seek to take advantage of over time. Fortunately, the continuation of this behavior does not appear to be at any risk.

We do hope, however, to identify over time people who follow an investment philosophy similar to ours and who may become investment partners for the coming decades. So far, we have the privilege of having a group of investors who are very well aligned with our management style, having weathered turbulent periods alongside us with the patience required to reap good returns.

We remain optimistic about the coming years, given the quality of the businesses currently in our portfolio and the discount levels that the current price of our stocks contains when compared with our estimates of intrinsic value. Over our ten years of investing, there have been few moments when our portfolio's price has been as discounted as it is now.