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Easier Said Than Done

Common Stock Investing

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Potential investors may look at the long-term compound return of some 10% from common stocks and assume that earning those types of returns will be easy. This attitude belies the truth, and those who have tried it know for sure that it is just not that easy and that investing requires a lot of information and discipline. Most of all, to be successful at common stock investing over the longer term, one must have a deeply held philosophy or set of operating principles around which to invest.

It is common knowledge that there is a relationship between risk and return in investing. Investors require a higher return for taking on additional risk, which explains why stocks are perceived to be the higher-returning yet riskier asset class, and bonds are assumed to be the lower-returning but safer asset class. Many would be shocked to learn that the majority of common stocks have lifetime buy and hold returns that are less than that of one-month Treasury Bills. Said differently, the stock market overall generates attractive long-term returns, but most stocks fail to even match the returns of Treasury Bills.

The surprising fact of widespread common stock underperformance relative to Treasury Bills can be attributed to the positive skewness of the distribution of individual stock returns. Positive skewness means that while most stocks have modest or negative returns, a few stocks achieve extremely high returns, which significantly impacts overall market performance. Furthermore, it is also important to highlight the fact that the median lifetime of a common stock is only 7.5 years.

In fairness, it should be remembered that this return information includes the total universe of common stocks and includes many very small companies that have become public through initial public offerings, only to disappear quickly. Nevertheless, the outcome of many stocks is failure after a short period. Several assumptions can be made from this data. First, it confirms that stock selection is very important, and in fact, it is not that easy. Second, one had better stick with proven companies. Most of these are fairly large and have demonstrated over a reasonably long period of time that they have sustainability, that is, they can survive.

The statistical data presented above, which we find particularly illuminating, comes from the work of Professor Hendrik Bessembinder of Arizona State University. He has built a body of research exploring these very phenomena. Through studying returns from 1926 to 2019, he found that 58% of stocks failed to beat Treasury Bill returns over their lifespans, 38% of stocks beat Treasury Bill returns by just moderate amounts, and just over 4% of stocks are responsible for boosting the market's overall returns higher than that of Treasury Bills. Stocks altogether did create $47 trillion more in wealth than Treasury Bills over this period, but more than half of the excess wealth created came from just 83 companies whereas the remaining 25,584 stocks created the other half of the wealth. And what's more, just five firms account for 10% of the total wealth creation over this period. In analyzing the data, Bessembinder found only four stand-out factors to have statistical significance among the stocks that outperformed Treasury Bills. These factors included: strong cash accumulation, rapid asset growth (organic growth from output, product development, etc. rather than mergers and acquisitions), larger drawdowns in the prior decade, and higher research and development (R&D) spending. By looking at firms' outcomes decade by decade, Bessembinder provides patterns of evidence suggesting that over long-term horizons, returns follow fundamentals. We at Crawford heartily endorse the logic of returns following fundamentals.

How do these factors apply to our investment approach at Crawford? It all starts with the aforementioned need for an investment philosophy. We have one, and we have invested within its parameters since the founding of the firm. We believe quality is an essential characteristic, for it materially enhances the probability of sustainability in our companies. Furthermore, we believe the dividend provides the best window into quality. Companies that pay and increase their dividends on a consistent basis have not only proven their survivability but are demonstrating that they possess what Bessembinder has highlighted as successful characteristics in the market winners.

Practically, our philosophy gets implemented through our research process that begins with a focus on fundamentals. Our team of sector analysts perform fundamental, bottom-up research on each of the stocks considered for inclusion in our portfolios. In searching for high-quality companies, we look for free cash flow generation, organic growth, and R&D spending. These are generally considered to be growth characteristics. We appreciate growth as a characteristic, for it is essential to long-term investment success. However, we do not like to pay too much for growth and consider ourselves value investors. While we are not willing to hold companies with extreme downside potential, we are long-term, value-oriented investors who seek to own companies through the market cycle. We are also patient, willing to wait for short-term dislocations in investor sentiment to resolve or fundamentals to improve.

To take a step back further, if most individual common stocks provide buy-and-hold returns that fall short of Treasury Bills, most individual common stocks have short lives, and just five firms account for 10% of total wealth creation, we by no means seek to choose and invest in only the few stocks that account for the majority of wealth creation. Rather, we seek to build well-diversified portfolios to increase our chances of "getting it right" with stocks that become strong performers. Our first goal is to pick survivors, for out of survivors come winners. Bessembinder's study reinforces the principle of the asymmetry of investing and the importance of "winning with winners," which is what we aim to do at Crawford.

We hold the belief that successful gains from investments can far outweigh losses from failures over time, and our research process is geared toward maximizing the number of "winners" in each of our portfolios across various areas of the market and the market capitalization spectrum. While Bessembinder identified four statistically significant factors, we continue to believe that quality is the most durable factor that favorably influences common stock return generation and risk mitigation. If you stick with quality, you likely will not have to worry about survivability. Quality usually means durability, and it is where we will continue to devote our focus on behalf of our investors.