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The Best Way Out is Always Through
Robert Frost

The question I am asked most often is: “What do you think the market is going to do?” There is something about the stock market that fuels an insatiable desire for predictions. On the surface it seems sensible. After all, investing is essentially about the future. We invest today for a better tomorrow. It seems logical that investing should be driven by predictions about the future.

There are two problems with this “What’s the market going to do?” mindset. The first is that it is focused solely on the future. Energy is better invested in working to understand what is going on now rather than trying to figure out what will happen next month or next year. Understanding the present is challenging enough, accurately forecasting the future is impossible.

My first investment was all about the future. The year was 1986 and I was 19 years old. I got up in the morning, used my Crest toothpaste from Procter & Gamble, put on my Nikes, and headed off to McDonald’s with friends just in time for breakfast. Later that day I invested pretty much my entire savings in a newly public hovercraft company. Proctor & Gamble, Nike and McDonald's were profitable businesses funding growth with cash flow, making products that I knew well but none of that impressed me. The hovercraft company touted exciting new products that would be featured on an upcoming episode of Miami Vice and a huge military contract just around the corner. The fact that the company was funding operations with investors’ money did not concern me. I lost half my investment in a few months and learned a valuable lesson.

I realize investing in a hovercraft company sounds ridiculous. An easy mistake to avoid, but I often see otherwise reasonable people “investing” large amounts of money in all sorts of things they know little about. There always seems to be something new capturing the imagination (and money) of the investing public. One thing after another. Not long after the dotcom bubble burst, BRIC (Brazil, Russia, India and China) funds exploded in popularity. The hot new thing cycle typically goes like this: enthusiasm grows as prices rise, attracting more and more “investors,” pushing up prices further in a self-reinforcing feedback loop. This process continues until it doesn’t. The only thing more stunning than the rise is the fall.

Today, artificial Intelligence (AI) appears to be replacing cryptocurrencies atop the “next big thing” list. I do not doubt AI’s potential, I just do not think it is possible to determine who the winners will be. The future is less predictable than people like to think. Over the past 12 months we have seen the highest inflation in 40 years as well as the first ground war in Europe in 70 years. Neither were predicted. Before that it was a pandemic. That was not predicted either. The future is uncertain; investments based on a particular vision of how the future will unfold are especially dangerous.

At the Madison Group, we are not interested in funding ventures that are losing money, hoping that profits are around the corner. We invest in companies that are funding growth with profits, not new investor money. We pay close attention to results and do not get excited about projections. It is easy to make projections, making money is hard.

The second problem with the “What do you think the market is going to do?” question is that it is *market* focused rather than *asset* focused. The market is for buying and selling. It is an auction. Investment success is more likely achieved through buying assets you want to hold onto rather than sell. It is better to ask, “what do I want to own?” Buying an asset that you want to own makes more sense than buying an asset you want to sell. Wealth is built through ownership of assets. There’s an old saying “you don’t make money until you sell.” Brokers like to say that. Think about the wealthy people you know. Did they make their money owning or selling? Their wealth was most likely created through long-term ownership. Wealth is created by owning, liquidity is created by selling. It makes sense to sell when you think there are better investment options available or when you need the money. It makes sense to hold when you are confident in what you own. An enormously successful investor I worked under years ago was fond of saying “holding is a decision, just like buying and selling.” Warren Buffett says his preferred holding period is forever.

I recently bumped into the wife of an old friend. Her husband built a great business and was a generous mentor to me. He sold the company a couple of years ago. When I asked how he was doing a worried look crossed her face. “Not great” she said, “he’s been bored since they sold the company. He’s watching CNBC, trading online, and going to the casino after the market closes.” It made me sad to think someone who had been so amazingly productive had fallen into spending time that way. Boredom can be a dangerous enemy.

Her husband built his wealth through equity ownership in a company he helped build. For thirty-plus years he focused on delivering a better product and service than his competitors. He created an environment where talented go-getters loved to work. He would tell me: "We have the best customers because we have the best employees." He acquired a large competitor during the financial crisis when the seller needed liquidity. Over thirty-plus years he built tremendous value for his employees, customers, shareholders and community. He turned a sleepy little company into an innovative leader that he took public in the 1990s.

At the Madison Group, we work to invest in companies like my mentor built. We pay close attention to management decisions as well as employee and customer happiness. We believe that doing the humble work of today is the surest path to a better tomorrow. That's how we built our business, and it's what we look for when investing.

The future is unpredictable, and markets are volatile. This has always been the case but as the pace of change accelerates the danger intensifies. Our approach to dealing with this reality is to invest in companies that are durable, profitable, growing, and managed in a way that reflects a healthy respect for uncertainty. We think that trying to be quicker than the market is risky and naïve. We believe that maintaining an in-depth understanding of individual businesses and closely monitoring operating results and capital allocation decisions leads to better decision making. Market volatility will eventually test everyone. Investors who simply follow price trends and the latest market news are vulnerable to getting sucked in as prices approach new highs and spooked out as they approach new lows.

Today, despite sharply higher interest rates and a slowing economy, valuations reflect optimism about future profits. Since we do not know what the future will bring, we are not willing to pay a premium based on rosy expectations. As we grind ahead, we are not counting on a rising market or a strong economy. The massive monetary and fiscal stimulus that pushed asset prices to record highs are being reversed to combat inflation. Higher interest rates put real pressure on economic growth, corporate earnings, and valuations. Pressure that works slowly and is unlikely to be reversed soon. These same higher rates make fixed income investments more attractive. After a decade of paltry interest, investors can now earn reasonable rates on fixed income.

So, based on the current situation, what are we doing now in our managed accounts? Good question- thanks for asking ☺. We are sticking to what we know, investing in industry-leading companies with the management and financial capacity to capitalize on challenging conditions. While the future is unpredictable, careful study of the present reveals some businesses are in a much better position than others. We are holding companies that we think are well positioned to weather a recession (if that's what happens) and grow longer term. While the markets are volatile, they also provide access to equity ownership in many of the best companies in the world. We are adding to holdings where we think valuations offer reward potential worth the risk. The liquidity that can lead to severe price swings also allows us to build positions incrementally, reducing the risk of unlucky timing. We are investing reserve funds and fixed income allocations in short-term, high-quality securities where we can earn 4 to 5% and maintain liquidity to capitalize on opportunities that may come as we move forward. While the easy money policies of the past favored borrowers and speculators, we think today's tighter monetary conditions favor our disciplined approach to investing.

Let us know if you would like to discuss your personal portfolio, we would enjoy hearing from you. Thank you for your trust and confidence.

Phil McCauley III
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