George Mateyo, Chief Investment Officer

During these unique times, first investing principles come first.

I want to introduce you to my long-time friend Pete. Pete is a good guy and knows a lot about a lot of things, which makes him a great conversationalist and a fun person to be around. Professionally, Pete earned his engineering degree from a leading university and has enjoyed a successful career in the healthcare sector.

Every summer for the past 20+ years, my family and Pete’s family meet for a week to recharge and relax. Over the week, conversations span a broad gamut; sports, history, and politics are some of the many topics we discuss, and spirited debates are a natural occurrence.

Given my chosen vocation, our conversations invariably lead us to discuss the financial markets. Over the years, I’ve always been interested to hear the types of investments that Pete is drawn to.

In 2000, he was euphoric over a company called Gadzoox. That year when we met, the company had just come public. The stock was offered at $21 per share but soared to nearly $90 per share on the first day of trading. Soon after our vacation that year, the CEO and CFO of Gadzoox abruptly resigned after financial irregularities had been detected. Two years later, the company filed for bankruptcy.

Several years after that, I recall Pete expressing newfound enthusiasm for a company that, in his eyes, had reinvented itself from a modest mortgage lending company to a diversified financial services juggernaut. The company – Countrywide Financial – had been experiencing exceptional growth and landed on the list of Forbes “Most Admired Companies.” Sadly for Pete, however, several months after our 2007 get-together, the company was sold in a fire sale at a fraction of what it was worth at its peak.

Our vacation has been put on hold this year, but Pete and I caught up last week. During our conversation, Pete exuberantly shared his latest investment idea, one he thought carried little/no downside and enormous upside. The company’s stock price was around $3 per share, but it had already gained over 300% — ostensibly a central tenet of Pete’s investment thesis.

Interestingly, a lot of investors have been captivated by the same stock, as I soon realized. In the first few days of June, on average, nearly 200 million shares of Pete’s stock traded hands per day, more than 60 times its daily average last year. This unusually high trading activity of a low-price stock was reflective of a broader trend: A recent report found that in the first few days of June, stocks trading below $1 per share gained, on average, nearly 80%. Conversely, those stocks with the most substantial price per share rose “just” 4% in the same period. Authors of this report cited commission-free trading and the lack of sports and sports betting as reasons behind some of these surging share prices.

Pete is convinced that he’s found a winner. But from my perspective, this is not investing but speculating, and it led me to reflect on our approach to stock selection, portfolio construction, and risk management.
We believe that owning a low-turnover portfolio of quality common stocks is the best way to outperform the market over a full cycle. There are few good reasons to focus on high-risk, low-quality, speculative securities that typically only outperform when coming out of a cycle trough. While the prospect of high possible returns from such securities can be intoxicating in the short run, we have largely found them to be ephemeral and not worth chasing.

There is no single agreed-upon definition of quality. As a rule, however, we focus on companies that are industry leaders, consistently profitable, possess strong balance sheets, and are led by proven management teams with a demonstrated track record of successfully allocating capital.

When it comes to portfolio construction, our most considerable edge is our long-time horizon. Unlike my friend Pete, we are often willing to look ahead a few quarters, perhaps even more than a year, to find positive inflection points in temporarily underappreciated businesses.

Sometimes, this may make us feel like we are missing out when Mr. Market is throwing a party. However, if the goal is outperformance over a full market cycle, we still find it preferable to stick to our knitting and not chase the “hot dot” with the “in crowd.”

Finally, given the unique times in which we are living, risk management takes on new meaning. To us, it means protecting against the permanent impairment of capital and eschewing stocks of bankrupt and near-bankrupt companies, for example — the very profile of Pete’s stock du jour. He may prove to be correct, and he will always remain a close friend. But to me, the first principles I’ve listed above come first when it comes to investing.

For more information, please contact your Key Private Bank Advisor.