Investing’s constant battle against temptation

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When markets are booming, there is an opportunity cost to holding high-quality stocks, but disciplined, long-term investors have nothing to fear.

Opting for high quality over low quality when it comes to things like friends, food and financial advice will always pay off.

With investing, depending on your time horizon, that’s not necessarily true.

While high-quality assets typically outperform low-quality assets over the long term, there are ups and downs along the way because markets are irrational, and booms (and busts) are largely random.

When markets are booming, quality investors are not rewarded for their conservatism and may be penalised for sticking to their investment philosophy, even if their philosophy is irrefutably sound.

This scenario is playing out right now, with some of the market’s lowest quality stocks, enjoying an extended rally.

Against a global backdrop of swirling economic stimulus and rising consumer sentiment, some low-quality stocks (defined generally as companies with questionable financials and low operating profit margins) are outperforming quality companies with higher, more reliable profits, lower debt and consistent dividends.

As a result, some investors are rotating out of high-quality stocks and into low-quality stocks, hoping to get some quick wins before jumping back into quality at the right time.

This strategy is not new, but it is incredibly dangerous because it exposes investors to significant risk, given the difficulties of accurately timing the market.

Even the most experienced, professional investors get it wrong, making it almost impossible for mum and dads investors to do.

The paradox of choice

Ultimately, investing is about making choices, hence the moniker stockpicker.

While the investment process involves research, analysis and portfolio construction, at the end of the day, it’s fundamentally about choosing which assets to buy, sell and hold.

Smart investment decisions can’t be made on a whim or in the heat of the moment.

These must be the outcome of following a sound investment philosophy, robust investment and risk management processes and exercising integrity.

It is often said that integrity removes the decision-making process. While this expression isn't usually applied in an investment context, it is equally valid whether you're contemplating skipping the gym or deviating from your investment philosophy.

The decision should be a foregone conclusion.

However, with fundamental investing, where human beings and not computers are in charge, the temptation to chase higher, short-term returns is real, particularly for managers who are lagging the market and need to catch up.

Standing firm in one's convictions isn't about being unreasonably stubborn in the face of stellar growth opportunities.

It is about being true to label and effectively managing risk by applying a consistent, proven approach to identifying and valuing companies, stock selection and portfolio construction.

For some managers, their mandate is to invest in more speculative, high growth, low-quality stocks. Holding high-quality stocks would be a deviation from their strategy and style.

Whatever a manager's style, they should be steadfast in their beliefs. Their processes should not wax and wane, depending on current market conditions.

For the majority of conservative, long-term value investors, high-quality companies with a clear strategy, solid earnings and a strong balance sheet are always the place to be, irrespective of how markets are behaving. Long-term investors should focus on companies that offer value to consumers and have the ability to raise prices if they need to.

Over the long term, they will deliver solid returns with less volatility and a better night's sleep.

Rather than wrestle with tough decisions, investors should let their investment systems and processes do the heavy lifting.

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