Investing for the Long Run

Adam Smith said that in the long run there is a natural price for everything. It is an economic truth that if the forces involved in producing wealth in any country are allowed to play out freely without interference, the prices of goods and services tend towards a steady state, or equilibrium.

On any given day however, prices are random and can be above, below or equal to the equilibrium price, but the market is always moving to the long term natural price. Short term price volatility causes uncertainty to long term investors which they overcome through diversification. Ownership of capital is parcelled out to other long term investors through the issuance of equity shares and portfolios are constructed with diversity.

In today's well organised and efficient global stock exchanges, such shares are eagerly sought after and frequently traded by an entirely separate class of investor – the speculator. Speculation is always subsequent to investment because the speculator wants to take on risk and specialises in doing so. Speculators differ from gamblers who seek risks that do not exist.

Speculators maintain a short time horizon. Shorter time periods afford the measurement of uncertainty in terms of probabilities, which allows pricing of risk. Speculative investors create liquidity as they seek to share risk with long term investors. This balance between short term and long term investors is essential to a properly functioning market.

Problems arise when speculators all herd in the same direction, causing markets to blow up. Such bubbles can severely misallocate capital by distorting valuations of all assets and by increasing uncertainty. Consequently long term investment may stall, slowing growth in capital equipment to a rate below that sufficient to maintain full employment.

Just how seriously speculators can disrupt markets was evident in 1988 when Japan was 42% of the world stock market – one third larger than the US. Again in March 2000 the technology sector rose to almost a quarter of the world stock market and today stands at 9%. Now, China makes up almost 16% of the Emerging Markets, double what it was two years ago.

Our solution to this problem begins by making a distinction between market prices and market wealth. This distinction leads to our investment philosophy which is based on the maxim that market prices follow market wealth.

Our collective welfare or well-being requires the sustained production of all the necessities and conveniences of life. In aggregate, this perpetual flow of goods and services constitutes the wealth of any economic system. An unremitting lack of these things would lead to social break down.

Nothing can be produced however, without some sort of tool or machine or what is referred to collectively as capital equipment. The incentive to create machinery is the income or wealth earned from its output during its whole life.

The formation of capital equipment requires a long term perspective. It is another economic truth that in any free market all savings are transformed into machinery and equipment. And this is the social purpose of the stock market.

Companies produce wealth and earn income from their capital equipment. So it is possible to measure market wealth from company financial statements. By replacing company prices in any performance benchmark with company cash flow and net profit (two measures of income) and shareholders equity (the wealth that accumulates the income) we measure total market wealth.

Calculating each company's share of the total market wealth yields weights that are a proxy for the natural weights to which the market is always moving. These 'wealth weights' form a non-speculative, long term investment strategy. They provide a central limit around which prices move that is used to exploit market volatility by buying low and selling high through systematically re-balancing to the wealth weights every 90 days.

Diversifying core portfolios to include both market and wealth weighted index trackers is critical for the long-term investor who needs to avoid being exposed to the severe misallocation of capital caused by one-way speculation.