"Invest at the Point of Maximum Pessimism"

Some thoughts on the maxim of Sir John Templeton

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Sir John Templeton is considered one of the great investors of the 20th century. He studied economics at Yale and law at Oxford. He began investing in 1937 and retired in 1992 at the age of 80, to devote his time to philanthropy by making donations totaling USD $1B. His *Templeton Growth Fund* returned 16% annualized from 1954 to 1992.

His value contrarian investment philosophy is characterized by finding excellent companies that are neglected by the market, and therefore purchasable at a discount. He was a pioneer in foreign company investing, which in his days, was not widely followed.

Here are some observations on the approach, and what I believe it takes to succeed with it.

We need to have the courage of our convictions and control our emotions

For some, this philosophy may seem obvious, but for others, going against the tide can be frightening. One thing that is certain, is that it addresses a fundamental notion of the psychology of investing: when investing, it is crucial that we do not require constant validation by our peers; we need to accept feeling alone at times and being in the minority. For example, prior to the burst of the technology bubble in the year 2000, it was extremely difficult to resist the dot-com siren call when friends and colleagues were making windfall returns. The greatest difficulty in investing is the ability to control our emotions. Money holds a very powerful sway over our emotions; therefore, when it comes to investing, it is crucial to learn to control tendencies towards fear and greed.

We must choose our battles

Stock prices are a result of supply and demand. The more an investment attracts investor demand, the more its price increases. The more an investment is popular and publicized, the more exciting or comforting it is, the brighter its perceived outlook, and the higher the price paid per unit of earnings will be. A good example of this today is **Netflix**, which is trading at around 154 times past earnings. Conversely, the more a stock is neglected, either because it looks dull and uninteresting, it is negatively portrayed in the media, or because it is obscure or too small, the lower the price paid for the same unit of earnings will be. The key to winning in any competitive activity, is to face little or weak competition. We must therefore choose our battles. *Look for investments that attract fewer investors/competitors, or competitors that we believe to be impatient, panicked, forced to sell, or blinded by an external event, the latest investment fad, or flawed logic.* Investing at the point of maximum pessimism is thus only one of the ways to have fewer competitors at the time of purchase, but it should only be viewed as a good starting point for further thorough research, because pessimism can be justified and last for a long time.

Do our homework, assess the risks, and remain patient

All of this may seem obvious but is difficult to achieve, because it isn't simple to judge the quality of a business, its outlook, and an adequate price to pay; it requires a lot of experience, a lot of reading, and good judgment. In addition, a contrarian investment can take time to bear fruit and can test our patience. Having a minimum 3- to 5-year investment horizon is necessary. Also, we must not get discouraged if an investment remains in negative territory for a certain while, provided that our investment thesis is periodically revalidated. This requires having identified a positive catalyst for recovery in the stock's price (e.g. sustained recovery of earnings and renewed investor interest). I view hitting the point of maximum pessimism as a theoretical goal, but in practice we can be satisfied if our average cost for a security is sufficiently low to give us a good margin of safety. *It is capital preservation, meaning, the downside risk mitigation, which is at the core of contrarian value investing.* Paying a low enough price, that does not discount exaggerated hope or very high expectations, helps to reduce our risk and increase our average returns.

Continuous learning and intellectual honesty

Whatever our investment philosophy may be, investing involves a continuous learning process. It requires us to systematically review each of our investments; analyze our successes, but most importantly analyze our mistakes. A written record of our mistakes embedded in a checklist is necessary. One must accept with humility that investing, which essentially consists of predicting the future, should be the pursuit of a good long-term average, and in this pursuit, we will make our share of mistakes.

"Groupthink"and crowd psychology

Finally, an important notion to understand in the stock market: group thinking is at times superficial and distorted; misinformation and exaggeration sometimes becomes contagious. For example, think of the collective illusion that preceded the 2000 technology bubble, the 2008 real estate bubble, or even the collective hysteria in the United States preceding the war in Iraq in 2003. The "groupthink" effect, this comforting need to feel that we all hold the same idea and therefore it must be true, is extremely powerful. The stock market is often manic depressive and falls prey to this same phenomenon; we must strive to profit from this attribute and not fall victim to it, by developing our own convictions through in-depth research, all the while maintaining sound skepticism.

In conclusion

Let us finally add to the maxim of Sir John Templeton:

"*Invest at the point of maximum pessimism****, in companies of high quality, where you detect future earning power is patiently being built but is not yet recognized by the market".***

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