October 11, 2023

Dear Clients and Friends,

"Call me Ishmael," is the opening line of Melville's *Moby Dick* in which he introduces one of literature's most enduring characters. As the compelling story unfolds, we learn that Ishmael is a keen observer of the world. He absorbs and learns from experience; he questions his assumptions as he waits with patience for truth to emerge. Ishmael says, "I leave a white and turbid wake…The envious billows sidelong swell to whelm my track; let them; but first I pass." In contrast to Ishmael's measured approach to life's chaos, Ahab, Ishmael's captain on the whaling ship *Pequod*, is possessed by a consuming passion that causes him to behave self-destructively, sacrificing his safety and that of his crew. Spoiler alert! Those who have read the book know that Ishmael is the lone survivor of the *Pequod's* destruction by Moby Dick.

Investors would be wise to behave more like Ishmael and less like Ahab. In the first three quarters of 2023, the S&P 500 returned 13%, partially recovering from 2022's decline of 22%, at its lowest point.[1] The actual values of the businesses underlying the S&P 500 are unlikely to have experienced such wild gyrations in either period. In markets driven by current sentiment or the latest CNBC "breaking news," the pendulum can swing wildly, even when businesses continue to perform reasonably well. The stock market's strong performance in 2023 might be attributed to investors concluding that a 4.5% yield on the ten-year treasury note is not catastrophic; or the assumption that the Federal Reserve is likely near the end of its tightening cycle; or perhaps investors have convinced themselves that the widely anticipated 2023 recession has been delayed. Whatever their reasons, market behavior on any given day tends to reflect investor opinion of the prospects for the short-term horizon upon which they fixate.

"The stock market is a device for transferring money from the impatient to the patient." Attributed to Warren Buffett

This quotation aligns with the teachings of Buffett's mentor, Benjamin Graham, who introduced us to this highly emotional character, Mr. Market, in his seminal book, *The Intelligent Investor*. Mr. Graham writes: "Mr. Market is there to serve you, not to guide you. It is his pocketbook, not his wisdom, that you will find useful. If he shows up some day in a particularly foolish mood, you are free to either ignore him or to take advantage of him, but it will be disastrous if you fall under his influence." While looming large in the minds of investors in the short run, factors like election cycles, geopolitics, and Federal Reserve pronouncements, have limited impact on long-term stock performance. Investors hoping for immediate validation of their investment choices often overreact to unpredictable short-term stock price moves, further exacerbating market gyrations.

Value appreciation, which may take years to materialize in a company's stock price, most heavily depends on the underlying performance of the company. Douglass Winthrop focuses on the quality and durability of business models by investing in companies characterized by defensible competitive advantages, high returns on invested capital, large and growing markets, and capable management teams aligned with shareholders. We also scrutinize companies' balance sheets to ensure they have enough financial flexibility to navigate periods of financial stress.

"The big money is not in the buying or selling, but in the waiting." Attributed to Charlie Munger

Stock market participants are tempted to think that there is some secret sauce that will make them rich. The best investors possess more prosaic instruments in their toolbox: hard work and patience. While building an investment thesis around

[1] Bloomberg

a company involves hard work, it can be harder still for an investor to appreciate that patience might be their most valuable competitive advantage. When it comes to money, nobody *wants* to be patient. Plus, patience can be sorely tested. It often seems as if there are two main reasons why people sell investments: because they're up and because they're down! If true, the greatest challenge most investors face is their own disposition. Investors tend to be afraid that they will give up their unrealized profits, or that they will experience further unrealized losses once a position has declined. In fact, current share price movement often bears no relationship at all to a company's long-term prospects.

At least two (and probably many more) examples of company share price movements that tried our own patience can be found in Douglass Winthrop portfolios. We have owned **Google** and **Mastercard** in most client portfolios since 2010 and 2011, respectively. In the years since then, our conviction in these companies has been tested. On four occasions while we have owned Google, the stock has fallen over 20% and as much as 40%. Likewise, on six occasions during our ownership, Mastercard has fallen more than 20% and as much as 41%.[2] These are the moments when investors need to avoid knee jerk reactions to price movements by revisiting their analysis of a company's long-term prospects. If the investment thesis stands up to thoughtful scrutiny, selling because the price has fallen is likely a mistake.

By the same token, price appreciation alone is rarely a good reason to sell. Everyone wishes they had bought **Amazon** in the beginning of 1998 for a (split-adjusted) price of approximately $0.25 per share. (Douglass Winthrop did not add Amazon to its portfolios until 2020). In less than two years from early 1998 to December 10, 1999 Amazon stock rose 21-fold. Many an investor would have been tempted to sell, and they likely would have felt rather satisfied with that decision because shortly thereafter, between late September 2000 and 2001, Amazon shares plummeted 84%. While most investors won't tolerate that kind of volatility, those who stuck with Amazon through that decline until now have enjoyed a 500-fold return. Those who "wisely" took profits before the 2000 implosion, benefited from only a small fraction of the company's extraordinary appreciation.[3]

Investors may also be motivated to sell due to a pessimistic outlook for the market or the economy. While markets can pull back quickly and unpredictably, most pullbacks, including severe ones such as that which occurred in the 2008-2009 Financial Crisis, have recovered within a reasonable timeframe. If an investor has a thoroughly analyzed, positive, long-term outlook for a company, that holding should not be sold to prepare for a dip that is likely to be temporary. Selling gives an investor two opportunities to be wrong: the expected decline may or may not occur; and, whether it does decline or not, it will be tough to figure out when the time is right to get back in. Sadly, even the most successful investors are not in possession of a crystal ball!

When Should Investors Sell?

If after careful review and analysis another investment appears to offer a superior risk-adjusted prospective return, it's reasonable to reduce or eliminate an existing holding to make room for it. For taxable investors, the decision to sell should also consider the tax impact of realized gains. To be worthwhile, the return on a new investment will have to earn back the taxes paid on gains in addition to outperforming the company sold. This can be a high bar. We also will sell a holding if our ongoing analysis of current data reveals a weakness in our original investment thesis or the probability of its success diminishes significantly.

Another good reason to sell is the need for cash. As a general matter, we counsel clients not to hold equities with cash they anticipate needing for expected expenses. This is particularly true now that our Client Relations team and our Trading Desk have worked to ensure DWA clients have access to safe and liquid money market funds paying about 5%.

[2] FactSet
[3] Bloomberg

While a 5% return on cash is unlikely to achieve most families' long term investment goals after the impact of inflation, it does reduce the penalty investors have long suffered for holding needed cash temporarily.

Looking Ahead

As we enter the 4th Quarter, there is plenty to worry investors. At the time of this writing, the United States government looks incapable of performing its legislative responsibilities. Labor strife within important sectors of the economy rumbles on. Rising energy costs coupled with the expiry of pandemic-era fiscal support is hitting household budgets. Households in the bottom 80% of the income distribution now have lower savings in real terms than they had at the beginning of the pandemic.[4] These factors threaten to undermine consumers and businesses whose resilience shows signs of cracking under the weight of higher interest rates. The geopolitical situation is equally troubling with a continuing hot war in Europe, and China's efforts to militarize and exert hegemony over the South China Sea through which approximately a third of global shipping flows.

"But, spite of all this, I could see no compass before me to steer by…." Ishmael, *Moby Dick* by Herman Melville

Like Ishmael, investors could be pardoned for sensing their compasses are adrift amid the tumultuous sea of distressing headlines. Pause, however, and think back over the last 100 years or so, during which US equities have returned about 9-10% per year and ask, "Was there ever a period of time when investors had little to worry them?" Then Douglass Winthrop clients can remind themselves that their portfolios are made up of great businesses like Mastercard, Google and Amazon, as well as other long-term Douglass Winthrop holdings like **Canadian National Railroad**, **Berkshire Hathaway, Brown Forman** and **Nestlé**. These companies are characterized by high returns on invested capital, time tested business models resilient to challenges, and management teams aligned with shareholders.[5] According to a study by Reuters, the average holding period for US equities has shrunk from about eight years in the 1950s and 1960s, to about five and a half months in 2020.[6] Warren Buffett says: "Our favorite holding period is forever." We agree. In addition to rigorous analysis, patience can provide investors with a lasting advantage over those who lack conviction.

In closing, we thank our clients for entrusting us as their advisors during these troubling times. Your support strengthens our resolve to be patient with our convictions. We hope we will continue to earn your trust through the challenges ahead, and we wish you a healthy and happy Fall and Holiday Season. Please feel free to contact us or, better yet, stop by for a visit.

Sincerely,

Douglass Winthrop Advisors

[4] Bloomberg: "Only Richest 20% of Americans Still Have Excess Pandemic Savings," September 25, 2023
[5] Douglass Winthrop Advisors
[6] Reuters: "Buy, sell, repeat! No room for 'hold' in whipsawing markets," August 3, 2020