The small, big and bigger picture

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Most market participants implicitly believe that the job of an investor is to focus on the "big picture", i.e., the macro-fundamentals—growth in gross domestic product (GDP), inflation rates, interest rates, exchange rates, commodity prices, unemployment rates, real estate prices, and more. They would attempt to anticipate these, and position their portfolio to benefit from these. If the reality turns out to be different, they would like to react quickly to minimize the damage to the portfolio. This is a reasonable description of the job of a securities trader.

But an investor would work in a manner where she is not trying to be extra smart by trying to predict macro-fundamentals—which have been proven to be unpredictable. Nor is she trying to benefit by positioning the portfolio to take advantage of these based on an anticipated value or direction. Rather, an investor tries to design her portfolio to be reasonably robust against the various directions that the macro-fundamentals could take and also to have flexibility and liquidity to take possible advantage of the market reactions to the macro-fundamental surprises, if she has the time and inclination to do so and if these are worth the transaction costs and taxes.

When small is better

An investor is better able to ride any turbulence caused by macro-fundamentals by looking at the "small picture" rather than the "big picture". The "small picture" is the bottom-up focus of stock picking—focusing on companies that have a robust business model, strong balance sheets and cash flows, proven track record of allocating shareholder capital in growth opportunities, and which are available at a discount to intrinsic value.

The portfolio should be diversified in terms of number of holdings, exposure to a reasonable number of sectors or industries, and sufficient liquidity.

With such a portfolio, when the market participants, primarily traders, are surprised by macro-fundamentals and react in panic, thus causing potential large mis-pricings in some securities, the investor can realign the portfolio to an even higher quality relative to the price or even cheaper relative to quality.

The investor can focus on the "small picture" since she is aware of the "bigger picture". She reminds herself of this whenever there is a lot of talk about the "sky falling", "end of the world", or "this time it is different" and "game changers".

The "bigger picture" shows that in a reasonably free economy, in a relatively stable political system, individual participants in the economy work towards maximising their gains by innovating and providing value to the rest of the economy.

This causes a virtuous cycle causing the economy to grow over the long term.

This is likely to be accompanied by the turbulence over the short-term when trends might be over-extended beyond their requirements. Because of the individual participants in the economy and their basic consumption patterns, there is stable growth rate in an economy as long as it is managed in a reasonably balanced manner. Any excesses can be corrected within a few years.

The "bigger picture" of the stability of basic economic needs and the resulting consumption patterns of individuals and their ability to control their political system is what anchors them to focus on the "small picture" of bottom-up stock picking. That is why it works.

Striking a balance

The macro-fundamentals in a stable economy are mean-reverting. Excesses correct back giving a long-term GDP growth rate, and long-term base inflation and interest rate. People will need to eat food, wear clothes and need shelter. They will need certain infrastructure and services. Companies providing these will continue seeing demand through the ups and downs of the economy, even though demand

distortions can happen for shorter periods. The intelligent investor picks companies that are likely to see persistent demand for their products and services, for which consumers are willing to pay prices with sufficient margins and which are available at a discount to intrinsic value or, at worst, fair prices.

As long as the companies have stable businesses and strong balance sheets, they are not vulnerable to a large extent to “big picture” macro-fundamentals changing unfavourably. Yes, their share prices could fluctuate, they could face temporary fluctuations in revenues and margins, but over the long run, they would come back to normal. The main caution when buying such companies has to be that they should not be overvalued. A company bought at a large overvaluation is likely to result in low returns or even losses.

Sometimes, in search of the best quality companies, investors end up overpaying for the stability of a business model and large growth opportunities. Investors feel pressured to buy these, especially when the economy is not doing that well. That is precisely the time when these should be avoided and other companies focused on which have strong balance sheets and relatively less stable business models that may currently be facing some short-term upheavals. These companies, which are stable under the “bigger picture” analysis, are the ones likely to be undervalued when the economy is going through a down cycle.

The time to buy stable companies is when the economy is doing extremely well and the herd is chasing the next “innovation” at extreme valuations and also willing to pay much higher prices for the companies that were facing lower demand during the down cycle but are now faced with huge demand and high margins. This is the time to switch out of these companies and into stable companies that are relatively unwanted and are available cheaper. Bought at fair prices, they provide strength to the investor’s portfolio in a down cycle. The investor can then switch during the subsequent down cycle if the market is willing to pay an overvalued price for these companies’ stable business models. At that time, the investor can switch to the relatively less stable but extremely undervalued companies which are stable over a business cycle.

Thus, the “bigger picture” analysis supports the “small picture” focus and makes the “big picture” something not to anticipate or react to but rather to benefit from or ignore.

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