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How to Buy Fear

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Major equity indices around the world were down in the teens in the fourth quarter, with many stocks down 50% from their 52-week highs. That got our attention. When we see this type of correction, we ask ourselves:

- **Did the value of the business really fall 50%?**
- **Is the stock going to zero?**
- **Was the peak a proper level to anchor to or was that too high?**
- **Is the current price level a bargain?**

One of Wall Street's favorite clichés is: don't try to catch a falling knife. That has merit to it. After all, every stock that winds up at zero starts off by falling 50%. We know from experience that our first buy of a falling stock is very often not the low. We often expect the stock to go lower and size our initial buy accordingly. But if you think about it for a minute, unless the stock is going to zero, it is going to bottom at some point. You only know that point in hindsight, when of course it looks obvious. Very often when a stock eventually reaches that bottom it is up again very quickly, and if you haven't acted before that, you missed that gain. The broad-based equity market rebound in January 2019 highlights this point well. So yes, we will buy stocks on the way down, especially in market environments like the one we experienced in late 2018.

We certainly don't automatically buy any stock that's down 50%, but we look at them. Looking is free. We pass on the vast majority, but here's what we generally look for:

1. **What does the balance sheet look like? We look at the balance sheet first, and that is usually where we stop. It usually takes less than two minutes. If you want to lose all your money with some regularity, buy stocks in free fall that have lots of debt. Those are the ones we pass on.**
2. **Can we understand the business? There are businesses we are happy to leave for others who will understand them better than we do. There are plenty we can understand and we stick with those.**
3. **Can we value the business within a range? We can't value some businesses, but for the many we can, we do so through diligent financial analysis, and then we simply compare our appraisal to the stock price.**
4. **Does this type of industry have a blind side? Industries that are clearly being disrupted also often turn out far worse than anybody expects.**
5. **Do we believe we have a behavioral edge over another investor who is selling this security to us? We remain keenly aware of behavioral biases so we don't fall victim to them.**

Let's explore number five more closely. For everything we buy, somebody is selling it to us. One of us is wrong. How can we raise the odds that it isn't us?

We want to invest with people who are diligent and smart and motivated by intrinsic value analysis—but these are not the people we want to trade against. We much prefer to buy from an investor motivated by fear.

Since the stock market is anonymous, how do we find the panicky seller motivated by fear? In a bear market, they are quite easy to identify. The panicked investor is very often the one willing to sell a stock that is down 50% in six months even though the business has a strong balance sheet. We rarely see this creature in a bull market, but saw it very frequently in the fourth quarter of 2018.

The stock market is a very competitive game and we are very clearly not the only investors out there trying to buy stocks for less than the underlying business is worth. Everybody has access to the same financial

statements that we do. Many investors wait for a stock to stabilize before buying—they don't buy "falling knives." When a stock is in free fall, a lot of potential buyers are likely to be sitting on the sidelines. This is a rare chance for us to be a buyer when competition is thin. So while the stock market is pretty efficient, our favorite inefficiency is buying true fear. Fear versus rational analysis is not a fair fight, and this inefficiency never gets old.

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