Accounting for Choice in Investing

Stock markets are called exchanges because they facilitate trades between buyers and sellers. Buyers offer cash in hopes of exchanging it for a seller's shares of stock. The current stock price represents a recent buyer's appetite for holding cash, versus trading their cash for shares of a particular stock.

In any trade, what you give up is just as important as what you get. An investor who trades cash for shares of stock, *gives up* a safe low yielding asset to *receive* a higher potential return accompanied by risk. The value of cash is not adequately measured by the current risk-free interest rate. Its true value resides within the choice cash provides to the holder, allowing them to exploit unknown opportunities that come about. Investors improperly account for the choice value of cash because it's difficult to measure.

Microsoft Corporation provides an interesting case to illustrate this point. In 1999, Microsoft was the world's largest software company with $20 billion in sales, 29% revenue growth, and a market capitalization above $500 billion. There was no question Microsoft had a bright future and wonderfully profitable business.

If you traded cash for shares of Microsoft in 1999, you had to wait until 2015 to have a **total investment return above 0%** without accounting for inflation. Try to estimate the choice value surrendered by holding Microsoft shares over cash during that volatile period.

Choice value tends to increase at an exponential rate during periods of high uncertainty or market stress. When a seller needs to exchange shares of stock for cash, investors who possess cash dictate the stock price.

Cash provides an investor with the opportunity to be greedy when others are fearful. It represents an opportunity cost often overlooked or unaccounted for entirely until it's too late. The saying, "It's better to have it and not need it, than need it and not have it", applies to such things as fire extinguishers, insurance, bear spray, and cash.

The price you pay for an investment drives your future return. Microsoft investors in the late 1990's correctly assumed the software company would be a winner in the coming decades. They failed to account for the level of future success embedded in the purchase price. This oversight was the primary factor in producing a total return on investment of 0% for more than 15 years. They mistook a business with a high likelihood of success for a guaranteed investment return.

> *"The issue is not which horse in the race is the most likely winner, but which horse or horses are offering odds that exceed their actual chances of victory… There is no such thing as "liking" a horse to win a race, only an attractive discrepancy between his chances and his price."*
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> *-Steven Crist*

Investing involves odds, not certainties or narratives. “All you have to do is buy quality businesses” is a severe distortion of the classic Charlie Munger philosophy – “a great business at a fair price is superior to a fair business at a great price.”

The interest rate on a risk-free investment helps determine the price you should pay today for a dollar received tomorrow. A higher risk-free rate makes expected future cash flows less valuable today, which *should* result in a lower current price. Interest rates are **simply a starting point** when trying to evaluate the price of an asset. They do not “justify” or “support” some recent or historical price a buyer was willing to pay.

Expanding on the Microsoft example, in 2001 the Federal Reserve cut interest rates from 6.50% to 1.75%. Interest rate **cuts of 4.75% in a single year** failed to help Microsoft recapture its $500 billion price tag from 1999. Instead, the rate cuts gave rise to the housing bubble and subsequent global financial crisis - a high-water mark moment for the choice value of cash.

A relevant saying attributed to Albert Einstein is, “Not everything that can be counted counts, and not everything that counts can be counted.”

The psychological effect interest rates have on investors represents something that counts but can’t be counted. Recent history has shown that earning 0% on cash is painful for investors to endure. It drives them to trade cash for higher risk assets in the hope of generating a return. Investors turn into speculators, speculators become gamblers, and prices distort beyond any rational level.

A large shift of investor appetite for the same asset drives prices up. Ironically, the allure of rising prices makes the asset more attractive, despite risk rising with price. It’s one of the many reasons why asset bubbles occur. Potential gains consume all thinking, and the risk portion of the return equation is happily forgotten.

> *“The chance of gain is by every man more or less overvalued, and the chance of loss is by most men undervalued.”*
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> *-Adam Smith*

Short-term rates have remained **at or near 0% for 11 out of the last 14 years**. Additionally, the Federal Reserve’s asset purchase programs suppressed long-term interest rates from - 2008 – 2014 and 2020 – 2022 through their Quantitative Easing process.

> *“Nothing sedates rationality like large doses of effortless money.”*
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> *-Warren Buffett*

The return gap between cash and stocks became more palatable last year. Cash measured as a 3-month treasury bill, outperformed the S&P 500 by 20% in 2022. The historical yearly return of the S&P 500 is just above 10% since 1926. Cash adjusting from 0% to earning 4%, versus stocks *historically* earning 10%, can lead to a shift in investor psychology. Speculators can turn into savers, buyers can become sellers, and large changes in market capitalization can occur.

Current market participants face an environment that offers a **risk-free return** on cash for the first time in decades. The minds of investors may require a grace period, to purge the psychological detritus leftover from prolonged 0% interest rates.

Investors squander their time on questions such as, “When will a rate hike/cut occur?” or “How large will the rate hike/cut be?” or “When will we have a recession?” Remember, we are technically always heading towards the next recession when we aren’t in a recession. Further, none of these questions are answerable with an adequate level of certainty to be useful.

Filter the noise and think independently. Spend more time thinking about a broad range of outcomes, rather than focusing on specific outcomes. Ensure that you are appropriately rewarded for risk when surrendering a risk-free asset with the embedded choice value cash possesses.

Investors who held Microsoft from 1999 to 2015 incurred tremendous costs in the form of lost opportunities. In hindsight, those costs were far more painful than the 0% investment return over 15 years reflects. Investors must never forget, in any trade what you give up is just as important as what you get.

Remember that cash provides choice, and choice always has value.

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