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Don't Overreact to Cycles

The run-up to game seven of the NBA Finals teaches some important lessons for corporate executives managing their cash-- as well as a few basketball tips.

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As we await game seven of the NBA Finals tonight between the San Antonio Spurs and the Miami Heat it is interesting to reflect on the first six games and in particular the media reaction.

Each team has won three games of this best of seven series and they have alternated wins back and forth which makes it seem very close but in reality most of the games have been very unbalanced one way or the other. Games two through five were decided by an average of over 20 points per game.

The media reacted to each of these lopsided victories as if the result of each single game set a tone that would now dominate the series. When the Heat won game two by 19, many thought they appeared so dominant they would sweep the next three games to win the series in five.

The Spurs had other ideas when they shocked the basketball world with a win for the ages in game three. They dominated the game to win by an astronomical 36 points, which is the third highest margin of victory in NBA Finals history. This lopsided win inspired a media buzz suggesting the Spurs would surely win the series. Sports talking heads mocked Lebron James and his Miami comrades for saying they would win "not one, not two, not three…"

The series has continued to flip back and forth and each step of the way the experts overreacted to the outcome of a single game and extrapolated it forward.

OPINION

For those who evaluate company performance and capital market valuation, this sports story sounds all too familiar. Across economies, within industries and even at the level of specific companies we constantly witness overreactions to short term developments that seem completely unfounded when examined in the light of historical cyclical trends.

There are some very big examples of this that are hard to fully understand when we look back. Didn't we all "know" we were in a real estate bubble? Didn't we all "know" the meteoric stock market advances of the late 1990s were fueled by an unsustainable internet bubble?

And didn't we all "know" that when the stock market dropped over 50% through March 2009 that it had gone too far into a temporary trough and the market would generate very high returns over the next few years while it bounced back?

The reality is most of us didn't see these bubbles and troughs until after they were over or at least until they were past the peak. Just like the media covering the NBA, we all have a tendency to observe short term trends and extrapolate them forward. When business activity and employment are strong we tend to think and act as if it will last longer than it typically does. And when times are less favorable we also act like it will stay that way for an extended period.

We see this phenomenon at the company level too. When a company misses their expected earnings the share price often declines rapidly as if the lower earnings will be repeated indefinitely almost regardless of how extraordinary the cause of the earnings miss. And when companies launch a few successful new products they are often hailed as an ongoing fountain of innovation, which drives up the expected level of performance and their valuation soars.

The effect of these changing expectations on the volatility of stock prices is quite profound. Over the last year, the average company in the S&P 500 had a high share price that was 56% higher than their lowest share price. Across an entire business cycle the share price movements are even more significant.

This level of share price volatility can be stressful for management but here are some principles for managing through volatile and cyclical times:

1. Avoid the natural human tendency to extrapolate the present into the future. On a quarterly basis, examine company, industry and market trends to assess generally where you are in the cycle and to understand how your company and others are responding to it. Aim to be as fact-based as possible but also recognize you will not always see cyclical turns coming regardless of how well you prepare. After all, you are only human.

2. Be skeptical of any forecast that shows straight and steady improvements over time and conduct adequate thoughtful scenario testing to ensure strategies are robust if the path is less linear. Scenario testing should be based on realistic situations that could happen, not simple mathematical sensitivities.

3. Avoid falling into the capital and fixed cost versus variable cost efficiency trap. Capital and fixed costs can often be used to save variable costs and strong rates of return may seem attractive but the buildup of capital intensity and fixed costs could have very negative ramifications during the next downturn. Make sure worst case possibilities are considered before ever increasing fixed cost.

4. Avoid predicting the timing of peaks and troughs, but always recognize they will happen and prepare contingency plans. Create strategic options that allow flexibility so capacity and business activity can be increased or decreased when appropriate given the changing business climate. For example, use operating leases for a portion of assets with renewal options that can be exercised or not depending on capacity needs.

5. Try to practice "buy low and sell high". For example, aim to make capital investments when the equipment suppliers have overcapacity and might be more willing to settle for lower prices. Maintain adequate financing flexibility to be able to be opportunistic when others hunker down.

6. Track the performance and valuation of all possible strategic acquisition targets and seek to make acquisitions when prices are low. Often, more value is created when acquisitions are made during the time when share prices are generally low even if the percent acquisition premium ends up higher.

7. Be careful with the timing of stock buybacks as they have a greater chance of being effective for the shareholders that stay with the company if the buybacks are done when the price is generally low. Note that most companies get this wrong and buy back more stock when it is high than when it is low.

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