The Power of Patience

Why Consistent Goodness Beats Occasional Greatness

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The beginning of every year is an opportunity to reflect on the year prior, heed lessons learned, and make tweaks for the next rotation around the sun.

As part of this exercise, I've been analyzing our own holdings and broader portfolio positioning, and of course reading widely.

From reading many 2021 market review or 2022 market preview pieces, one thing that's struck me is the old observation that investing is a discipline filled with conflicting maxims. Whether it's "The trend is your friend" vs. "Don't follow the herd," or "Only buy when there's blood in the streets" vs. "Use positive price momentum as a signal to buy more," or "It's important to sell losers early" vs. "Give time for the thesis to play out," there is no shortage of pithy one-liners that seemingly stand in direct contradiction to one another.

It's what makes investing such a challenge—and it's also what I love about it.

The fact is, there is no one set method for being a successful investor. I fully subscribe to the notion that investing is both a science and an art—and that by definition, it is impossible for everyone to outperform the market.

Investing is risky, and there simply cannot be one approach that guarantees outperformance, because if there was then everyone would adopt said approach. And once that happens then everybody would have the same performance, thereby guaranteeing that nobody outperforms.

This is not to say, however, that there aren't best practices you can follow to improve your odds. And although it definitely will not guarantee outperformance, today we'd like to talk about the power of patience.

The S&P 500's Best

We recently analyzed the top-performing stocks within the S&P 500 over the past decade (January 2012-December 2021).

You may have intuited quite a few of the names in the top 20: Nvidia and Netflix were 1 and 2, while Amazon, Apple, and Microsoft all made the cut. (The third best-performer was Lam Research, which is less of a household name.)*

These stocks have certainly made waves for delivering gains to their shareholders, but given their significant outperformance over the market average from 2012 to 2021, you might assume that each of them would almost always be among the top performers in any given year. But that was far from being the case.

Nvidia, for instance, was the best-performing S&P 500 constituent of the past 10 years—and by a wide margin. Yet it was among the top 20 stocks in the index in any given year only half the time (five appearances).

According to my analysis of data pulled from Bloomberg, of the decade's 20 best S&P 500 performers:

- On average, fewer than 3 made it in the top 20 performers of any single year.
- Only 8 of the top 20 S&P 500 stocks of the past decade managed to make the list of even the top 100 performing stocks in the S&P 500 in at least six years out of the ten (all were a part of the index for the entire decade).
- To put it another way, 60% of the top 20 S&P 500 stocks with the highest cumulative returns over the past decade had, at best, a 50/50 shot of cracking the top 100 in any given year.

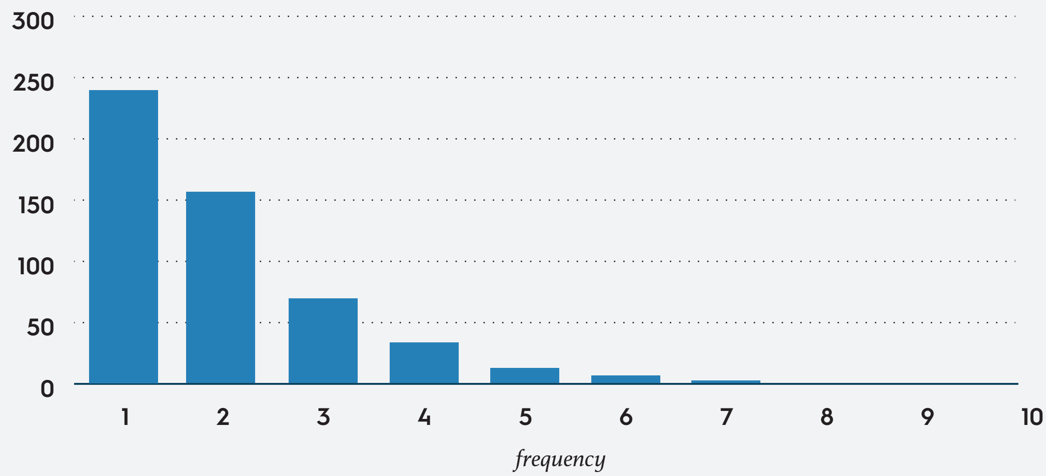
Top 20 Performing S&P 500 Stocks, 2012-2021
NVIDIA
Netflix
Lam Research
Adobe
Amazon.com
Applied Materials
Microsoft
Thermo Fisher Scientific
Micron Technology
Apple
KLA
Cintas
Intuit
Moody's
Constellation Brands
Sherwin-Williams
Trane Technologies
S&P Global
Broadcom
Home Depot

Source: Bloomberg.

Let that sink in. To be among the top 100 stocks of the S&P 500—the top 20%—isn't an overly stringent criteria, yet the top 20 constituents for the entire decade seemed to have struggled to consistently make this list each year.

On average, fewer than half of the top 20 made the list in a given year.

How often a ticker appeared on the annual list of top 100 performing stocks in the S&P 500, 2012-2021



Source: Bloomberg; 1623 Capital analysis.

What about the rest of the market? According to Bloomberg, there were almost 520 unique tickers that managed to finish in the top 100 at least once over the past decade (given that the S&P adds/removes around 20 stocks each year and there are a few companies with more than one ticker [e.g., Alphabet], it's not a mistake that there are more than 500). And given how the best of the best fared, it should come as no surprise that a large percentage of the stocks that made this list ended up being one-hit wonders.

Given these data, it seems logical to conclude that there appeared to be two ways to really try and maximize the returns of investing in these 20 stocks. You could either:

- Take a more active approach and attempt to buy when they were set to have bellwether years and sell when their performance was poised to be much more pedestrian.

Or

- You could invest at the beginning of the decade, monitor the fundamentals of the business to make sure your investment thesis wasn't broken, and ride through the manic ups and downs of the market.

The first approach requires impeccable timing. The latter approach requires extreme patience. Done correctly, both approaches could result in life-changing returns.

Of course, given the extreme difficulty of repeatedly accurately predicting the future, and that the former approach requires you to be correct with far more predictions (you not only needed to predict the top 20, but you also needed to both predict when they'll have their top years and what you'll invest in as an alternative when you sell), the latter appears to be a much more repeatable strategy.

Consider the case of Nvidia, which, again, was the index's best performer of the past decade. In the first year of this analysis (2012), Nvidia actually declined by more than 10%. It lost more than 30% in 2018.

The Key = Consistency

We believe the biggest takeaway here is that you don't need to be at the top year in and year out. What matters is consistency. Because consistency[1] is what can enable the magic of compounding to really take hold.

As a simplified example to illustrate this point, consider the following 4 stocks.

- Stock A delivers a modest, but consistent, annual return of 8%.
- Stock B is much more of a boom-and-bust situation: on odd years it gains 25%, but on even years it gives back half of that with a -12.5% return.
- In odd years, Stock C has an impressive 14% gain. And during even years, although it doesn't experience a large loss like Stock B, it doesn't have a positive return, either. It's flat.
- Lastly, Stock D delivers a 32% return on odd years, and gives back half of that (-16%) in even years. A 32% return would have meant that Stock

1 We recommend a wonderful 1990 Howard Marks memo on this topic, "The Route to Performance."

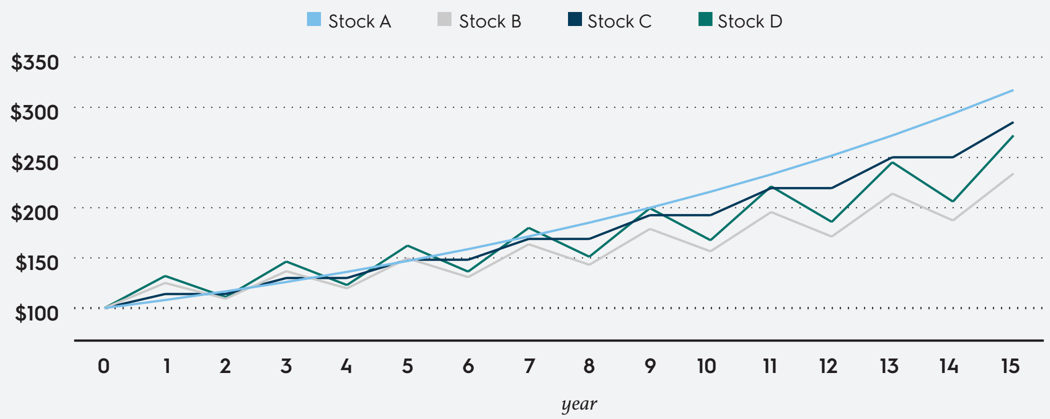
D would have landed in the top 100 of the S&P 500 five times in the past decade, which, if you remember back to the list of the top 20 stocks in the S&P 500 over the past decade, would be rarified air.

	Odd year performance	Even year performance
Stock A	8%	8%
Stock B	25%	-12.5%
Stock C	14%	0%
Stock D	32%	-16%

Hypothetical example using 1623 Capital's calculations/analysis.

The chart below tracks the cumulative performance of the four stocks over time. Early on, whenever it's an odd year (i.e., a good year for the more volatile stocks), Stocks B, C, and D all finish ahead of plodding Stock A, whose 8% annual return would prevent it from coming anywhere close to the top 100 in the S&P 500 during most years. But we only need to get halfway through the decade before things start to change, at which point Stock A's consistency starts paying off.

Change in value of the four hypothetical stocks



Hypothetical example using 1623 Capital's calculations/analysis.

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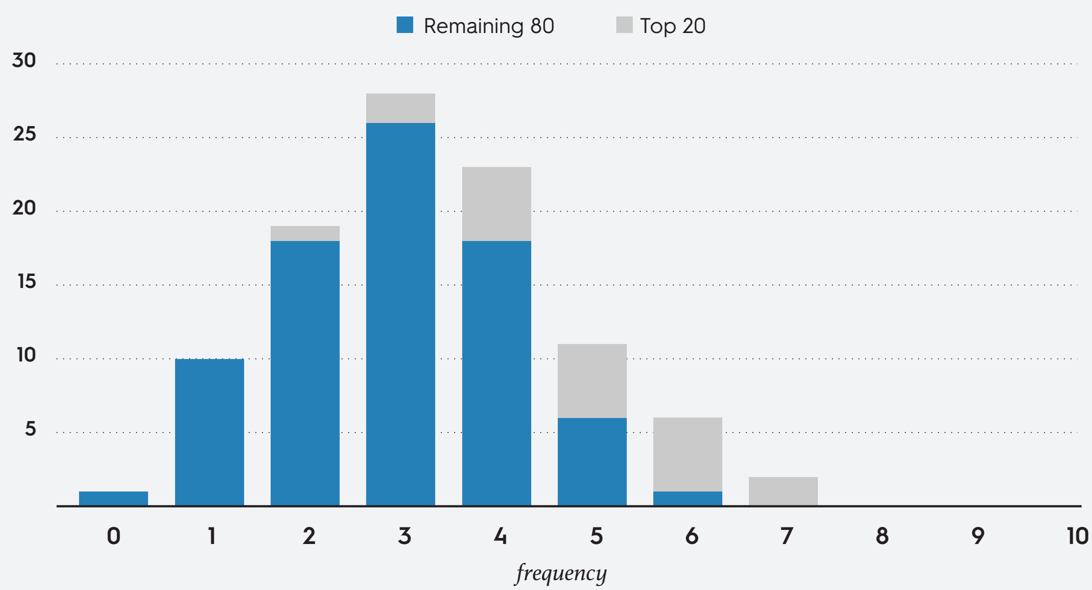
By year 5, Stock A has now pretty much caught up to Stocks B and C during their good (odd) years. And while it takes a little longer for it to catch Stock D, it has done so by year 9. As we move beyond year 10, the delta between Stock A and the other three only grows larger and the benefits of consistent compounding become even more apparent.

Don't mistake this for suggesting that we avoid young, fast-growing companies that can often be volatile. We don't. The key is that to benefit from consistent performance, you must practice patience—always amidst a chorus of noise, headlines, and frenzied short-term scares. Recall above that the No. 1 performer within the S&P 500 of the past decade, Nvidia, experienced a greater than 10% loss in the first year of this time frame.

Moving beyond the top 20 (since we discussed their returns earlier), looking at the Bloomberg data, we found that despite the impressive multiyear returns (the 100th best stock had a return that was more than 190 percentage points higher than the market), more often than not their single-year returns were merely pedestrian: 69% of the remaining 80 were unable to crack the list more than three times, with one stock failing to make an appearance even once!

How often a ticker appeared on the annual list of top performing stocks in the S&P 500, 2012-2021



Source: Bloomberg; 1623 Capital analysis.

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Not only did the remaining 80 struggle to frequently appear in the top 100, it was also far from certain that they would even beat the market—in seven out of ten years, less than 70% of this cohort managed to outperform the total return of the S&P 500.

However, despite their returns not being flashy, they were consistent—on average the cohort had positive returns in 8.6 out of 10 years. And they had returns of 8% or higher in 7.5 years this past decade.

The long view

Behavioral biases often lead investors to try to implement strategies that attempt to generate immediate outsized returns, including piling into recent top performers and chasing short-lived trends.

Although some stocks do make frequent appearances in the annual list of top-performing stocks, the overwhelming majority do not. Trying to find the biggest winners of any given year will be a Sisyphean task—difficult, and in our view, ultimately futile.

It's true that we aim to generate strong performance over all time frames, but ultimately it is the long-term time frame we're most concerned with.

As Morgan Housel has written[2], "If you understand the math behind compounding you realize the most important question is not 'How can I earn the highest returns?' It's, 'What are the best returns I can sustain for the longest period of time?'"

Because of this, we do not overreact to the performance of a single year. We choose to leverage the power of patience, and we remember that consistent goodness beats occasional greatness.

In a world full of investing axioms, that's one we hold dear.

2 Housel, Morgan. "Nature Shows How This All Works." Oct. 7, 2021.

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