Rules of Thumb and A Big Investing Mistake

A common rule of thumb (or, in academic-speak, "heuristic") is leading investors to see too much promise in too many firms. This mistake has led to many opportunities for investors.

Because human beings have to make hundreds of decisions – both big and small – each day, our brains have come up with mental shortcuts that psychologists call heuristics. For example, if we're picking an entrée off a menu and thinking about which is healthiest for us, we could calculate the calories for each item, estimate the effect on our blood sugar, estimate the amount of exercise we expect to perform after the meal, etc. and select the optimal entree. Or we could simply use a rule of thumb, like "low fat" or "low carb," to make the decision. A person who crunched all the numbers every time he or she got hungry would probably starve to death before reaching the perfect decision. On the other hand, sometimes the "low fat" or "low carb" description is misleading, incomplete, or irrelevant. Heuristics are great because they save us lots of time, but because they're shortcuts, they can also lead us to biased decisions.

One type of heuristic that can lead to biased decisions is the representative heuristic. The representative heuristic says that we judge the likelihood that something belongs to a group based on its similarity to the stereotype of that group. For example, suppose I tell you that my aunt loves to read books and has glasses with a chain on them. Then I ask you, which is more likely: a) my aunt is a nurse or b) my aunt is a librarian? Most people will say "librarian" because my aunt sounds like the stereotype of a librarian, **but this answer ignores the fact that there are nearly 20 times as many nurses as there are librarians. By the numbers, my aunt is much more likely to be a nurse**. This is the predictable mistake humans make when using the representative heuristic: we ignore base rates, i.e. the unconditional probability that something belongs to a group. Instead, we focus too much on whether that something "sounds like" a member of the group.

At Counterpoint we believe there is a representative heuristic epidemic going on in today's markets. There are a handful of firms, like Amazon, which are true disrupters in their respective industries and have had enormous success. However, after the success of these rarities, many future firms have been dubbed "the Amazon of _____" because, in some dimensions, they fit the stereotype of disrupters like Amazon.

For example, they might sell a product online that is primarily sold offline, or they might have large revenue growth but no profitability. The danger of matching these type of firm qualities to the Amazon stereotype is that we forget how truly rare Amazon is, and by extension we overestimate the number of potential Amazons in the investing world. Since Amazon's IPO date, May 14, 1997, there have been 12,582 unique companies that have traded above $100 million in market cap the United States. Amazon is currently the third largest by market cap among this group. In other words, Amazon is a 3/12,582 = .02% probability event! More of a librarian than a nurse, you might say.

But this doesn't stop investors and managers from labeling many companies as the next Amazon. For example, Carvana (ticker CVNA) has been labeled the "Amazon of Used Cars" because it sells used cars online and ships them directly to customers. It has a price/sales ratio near four and has yet to report a profit. Similarly, Shopify (ticker SHOP) is called the "Amazon of Small Business" and has a valuation of 29 times sales despite no profitability. Zillow is frequently called the "Amazon of Housing" and Uber the "Amazon of Transportation"; both have valuations which are 4-5 times sales despite no positive earnings.

Our market neutral portfolio, which makes up Counterpoint's two equity funds, is designed to take advantage of investor mistakes, like those induced by the representative heuristic. The portfolio takes a mechanical multi-factor approach to investing, identifying stock characteristics like price/sales and earnings/price which are associated with mispricing. Stocks with high valuations and poor profitability are either kept out of the long side or sold short. If investors are finding too many Amazons, Counterpoint's portfolio is designed to profit from that mistake.

In the midst of the record bull market we've experienced over the past 11 years, it is as important as ever to remain sober when picking stocks. There are literally too many firms being labeled as the next major disrupter; investors are not sufficiently accounting for how rare this event is.

We saw a similar attachment to the "story of a business" rather than its fundamentals during the late 1990s. Although it is difficult to predict when this sentiment will end and more realistic expectations take hold, eventually each firm will have to realize expectations, report earnings, access capital markets and maintain the satisfaction of investors. When investors begin to demand these results, the Carvanas of the world may find themselves with much more conservative valuations.

Whatever your strategy or approach, don't fall prey to the representative heuristic.

Disclosure: As of the time of this writing, Counterpoint Long-Short Equity Fund and Counterpoint Tactical Equity Fund may have short positions in Carvana (CVNA) and Zillow (Z).

Important Risk Information

Mutual Funds involve risk including the possible loss of principal. Past performance is no guarantee of future results. There is no assurance the Funds will meet their stated objectives. In general, the price of a fixed income security falls when interest rates rise. The Fund may invest in high yield securities, also known as "junk bonds." High yield securities provide greater income and opportunity for gain, but entail greater risk of loss of principal.

Investors should carefully consider the investment objectives, risks, charges and expenses of the Counterpoint Funds. This and other important information about the Funds is contained in the prospectus, which can be obtained at counterpointmutualfunds.com or by calling 844-273- 8637. The prospectus should be read carefully before investing. The Counterpoint Funds are distributed by Northern Lights Distributors, LLC member FINRA/SIPC.

3819-NLD-10/28/2019