20 lessons over 20 years

1. Value, not momentum

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One of the most basic economic concepts that I'm sure you're all familiar with is the relationship between the demand for a product and its price: as prices go up, demand goes down, and as prices go down, demand increases. So if 'widgets' are generally sold for $10 and then go on sale for $5, people will generally stock up at $5.

However, here's an interesting peculiarity when it comes to how investors in the sharemarket behave compared to how they behave in everyday life - when prices of shares are going down, people want to sell and when share prices are going up everyone wants to be a buyer.

Why is this?

This is momentum investing, following the herd, buying when the market gets caught up in the hype of the latest fad, theme or boom. And when prices are down momentum investors tend to allow fear to take hold and they sell out.

On the other hand, value investing, which is what we do at IML, is carefully calculating fair value for a company's shares and buying at the right price. So when the markets are overvalued, it can be a great time to sell and take profits for our investors, and when markets drop it's often a great time to buy quality companies that are undervalued.

We have managed our clients' money through various market cycles since our inception 20 years ago – a period that included several booms and busts, and times when momentum investing was prevalent and fundamental valuations were ignored.

The 1990's tech boom

In the late 1990s and the early days of mainstream internet usage, investors around the world were caught up in the excitement of the 'new economy'. Instead of traditional metrics such as profit and earnings, internet companies were valued on jargon such as eyeballs, clicks, page impressions, traffic and burn rates which seemed to overexcite many investors with their potential. The rise and rise of the 'dot.com' stocks, saw companies run by inexperienced management with no genuine business plans, and in some cases losing millions of dollars every month, valued by the share market at billions of dollars.

This boom was followed by the inevitable correction when from March 2000 reality caught up with the irrational valuations as the Nasdaq (US tech stock index) Composite Index plunged by over 50% in the following twelve months. The share prices of most of 'new economy' stocks fell to fractions of their boom-time valuations. News Corp which led the dot.com bubble in Australia and represented 18% of the S&P/ASX 300 Index at the height of the boom, dropped by over 50% while other boom time favourites like Solution 6, Voicenet and OneTel ended virtually worthless.

These tech stocks were classic momentum stories, market darlings one day, and of little or no value the next.

Early noughties China led Aussie mining boom

Increased demand for commodities like iron ore and coal, primarily from China, drove sharp and very swift rises in commodity prices from late 2003. Iron ore which had been averaging $20-$30 per tonne for many years peaked around $170/tonne in late 2007.

During this period, many smaller iron ore producers such as BC Iron and Atlas Iron reached valuations of many billions of dollars - well above their fundamental value - purely based on the expectation of continued upward momentum in commodity prices, only to crash to fractions of this value as the iron price fell to more normal levels of US $50-60 a tonne.

While buying companies which represent fundamental value does not protect investors from market corrections, these companies tend to recover better over the long-term.

So, the lesson for investors is to **focus on the fundamental value of a quality company you are investing in, not just the momentum of a company's share price** because history has shown, with these examples and many more over the years, that buying quality companies which represent fundamental value provides resilience in a market correction and these companies tend to recover faster and deliver better returns over the long-term.

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