Katsenelson, Vitaliy N. – The Little Book Of Sideways Markets

John Wiley & Sons, 2011, [Equity Investing] Grade ★★★★★

In his second book, The Little Book of Sideways Markets one of the most successful young and upcoming value investors - Vitaliy Katsenelson - joins the many prominent writers in the "Little Book" format. The Russian born, US immigrant Katsenelson is the CIO of Investment Management Associates in Denver and he has previously written on their investment process in the 2007 publication Active Value Investing. The Little Book is in many ways a condense, better and clearer version of the previous book.

There are two main themes and they also make up the composition of the book. The first is to point out that just as the stock market historically has gone through long periods of 15 to 20 years where there were immense gains to be had, it has also gone through equally long periods where nothing much happened. The author also makes the point that we are now in one of these sideways markets since the year of 2000. The second theme is really about how you should act in one of these sideways markets and Katsenelson presents the value based "buy-and-sell" strategy they use at IMA.

Looking at multi decade trends Katsenelson draws the, perhaps obvious, conclusions that 1) the economies, and hence the corporate profits, have secular trends of growth or decline and 2) the price investors for these profits have secular trends of increases or decreases. Secular trends of declining economies and profits have really only occurred once, in the 1930's, and so it is often the trends in what investors are willing to pay that define the stock market environment. In an environment where profits grow and multiples increase, markets rise and the main risk is not being fully invested in stocks in general. However, if the profits grow and the multiples decrease they cancel each other out and the market trends sideways. The opportunity cost of being invested in cash is much lower and only the right equity strategy will give a meaningful return.

To the investors the sideways market is by no means a calm horizontal journey because this journey is hidden behind the rollercoaster rides of the shorter investment cycle. These wild swings are what Katsenelson's process tries to use to its advantage. IMA focuses on stocks that combine a) high quality in terms of good cash flows, high returns of capital, moderate debt and good management, b) growth of both profits and dividends and c) a margin of safety, i.e. a price discount to the intrinsic value of the stock. The point is that the volatility of the market sooner or later will eat away the margin of safety as the stock price goes up and then you sell. You then use the money to buy other undervalued stocks of good quality and with decent growth. If there are none, you simply park the money in cash until the opportunities arise again. Use the margin of safety as your market timer and cash for risk management.

All the "little books" are short, easily accessible, written in simple language and yet presents important topics told by authors with hands-on experience. This book is no exception, in fact it's probably my favourite second only to Joel Greenblat's Little Book that Beats the Market. Apart from the big topics, the book is full of useful hands-on advice - for example how to design your process and surroundings to minimize the hazardous noise of the stock market, how to structure the selling process etc.

Given its accessible form you might be fooled to think that this is a beginners' book. However, if all seasoned veteran investors learnt the lessons Katsenelson presents, the investment arena would be an even more intensely competitive place. Read it and get an advantage.

Mats Larsson, July 3, 2011