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Waiting for a catalyst

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In the realm of investing, timing is everything. The ability to make the right move at the right moment can be the difference between reaping substantial gains or suffering significant losses. As investors navigate the complex landscape of the stock market, there is considerable value in exercising patience and awaiting a catalyst within the investment case. Being early by rushing into a position without a catalyst can be akin to being wrong, potentially leading to extended periods of underperformance. By waiting for a spark of change, investors can increase the probability of positive price movement and reduce the risk of mistimed or premature investments.

A catalyst can manifest in various forms, such as a significant technological change, a reorganization of management, regulatory modifications, or a shift in the underlying fundamentals of a business. Among these catalysts, I would like to underscore the importance of fundamental changes.

Momentum investors may lose out due to lack of conviction

We are not believers in price momentum investing, which means investing in companies that have recently done well and selling them as soon as that price rally loses steam. Chasing stocks higher might lead investors to buying overvalued stocks at peak prices, and to turf them when valuations adjust to more reasonable levels because they lack conviction in the underlying fundamentals.

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The roots of positive change need to take hold

We do, however, advocate for fundamental momentum. This approach involves investing in companies where positive change is beginning to take hold and this is demonstrated over at least two consecutive periods. At least two consecutive periods are required to ensure that the change is “real” rather than “perceived”. Typically, a change of this nature is accompanied by strategic efforts by management to enhance efficiency or refocus on core business segments.

Meta’s fortunes turned when it became more disciplined about the “metaverse”

We can recall two noteworthy examples of the importance of awaiting a catalyst before entering a position. The first one is Meta (previously known as Facebook). With Meta, investors were concerned by the substantial amount of money being spent on the “metaverse”, a futuristic concept that, despite a cumulative expenditure of $36 billion since 2019[1], still appears to be a distant reality. In 2022, Meta’s loss of more than $13.7 billion in its “Reality Labs” (metaverse) unit contributed to a significant decline in its share price as it seemed that management was chasing a dream, with ever more vigour, despite negative feedback from investors.

However, in their fourth quarter 2022 results, Meta dramatically reversed tack and announced a decline in the amount it was spending on the metaverse together with a reorientation of its focus toward efficiency. This move has been very positively received by the market and its share price has risen a notable 105% year to date. In Meta’s case, even if you were a believer in the strength of its core business, it would have spared you considerable downside as well as stress to wait for management to heed investors’ concerns prior to making an investment.

[1] According to an Insider analysis of the firm’s filings done by Business Insider. https://www.businessinsider.com/meta-lost-30-billion-on-metaverse-rivals-spent-far-less-2022-10

It has taken a while for Rakuten's mobile business to turn around

The second example is Rakuten. Unfortunately, this is one where we, at Flagship, got our timing wrong. Rakuten is the largest ecommerce player in Japan and over time it had expanded into several other verticals with enviable success. Unfortunately, in 2019, they decided to build a mobile network operator (MNO) from scratch, and their share price collapsed due to the market correctly anticipating that the billions of dollars they would spend on this would not generate an economic return. You only need to look at the example set by Cell C to see how hard it is for another MNO to enter a market that has already settled into a cosy oligopoly.

Today, historical capital destruction notwithstanding, the discount Rakuten trades on relative to the sum of its parts justifies an investment, but we should have waited until its path to narrowing operating losses and reduced capex spend was clearer before we made our initial investment.

Its moment to shine is finally imminent. Its operating losses are set to contract due to new subscriber additions as well as increases in average revenue per user (ARPUs), leading to better fixed cost absorption. It has also guided analysts towards its capex spend in fiscal 2024 (its year end is December) being a quarter of what it was in fiscal 2022, which should ease concerns investors have over its balance sheet.

Avoid jumping in too soon

While the prospect of potential gains can be enticing, it is important to wait for a catalyst that aligns with your investment case, especially if it is a turnaround story. This gives the investor insight into what moves the company's share price and what it would take for market sentiment and company fundamentals to turn around.

It also allows an investor to assess the probability of a recovery or a positive shift in momentum with a clear, cool head and not to jump in too soon.

Glacier Research thanks Gerhard Janse van Vuuren for his contribution to this week's *Funds on Friday*

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