

Investment Wisdom From Wall Street's Legends

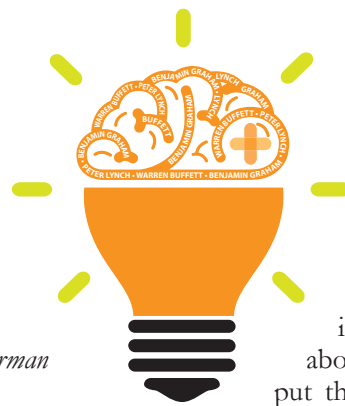
By Frederik Vanhaverbeke

Article Highlights

- Recommendations from successful investors on how to beat the market are eerily similar, but differ from how average investors manage their investments.
- Smart investors focus their efforts on stocks that have an above-average chance of being undervalued and conduct both quantitative and qualitative analysis.
- These investors look at stocks with negative sentiment, that reflect special situations, covered by very few analysts or that have insider buying.

"A country of security analysts would still overreact. In short, even the best-trained investors would make the same mistakes that investors have been making forever, and for the same immutable reason—that they cannot help it."

—Seth Klarman



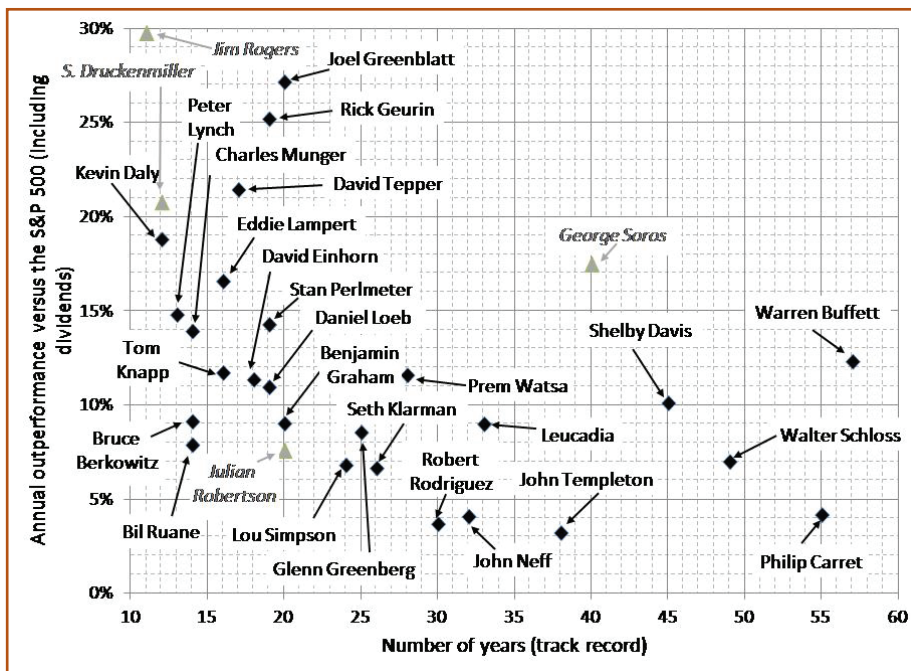
The vast majority of experienced investors will admit that beating the market is difficult. Many people try, but most fail even to keep up with the S&P 500 index. This observation has inspired academics to introduce the so-called efficient market hypothesis (EMH), which argues that people can only beat the market through luck. They argue that there are so many smart and rational people in the market that no single individual can have an edge. Hence, they recommend that investors pour their savings into the cheapest index funds or index trackers, which have a return that almost matches that of the market. In other words, they argue that investors should give up thinking and surrender to passive investment vehicles.

In my book "Excess Returns: A Comparative Study of the Methods of the World's Greatest Investors" (Harriman House, 2014), I firmly dismiss the efficient market hypothesis. Figure 1 speaks volumes. It shows the annual outperformance of a set of famous American investors over the S&P 500 index (with dividends reinvested) as a function of the length of the track record I could find information about. The heroic achievements of Warren Buffett and Shelby Davis,

who beat the market by more than 10% a year over periods of 45 and 57 years, respectively, cannot be explained by luck. To put this in perspective, people who invested \$1,000 with Buffett in 1957 would have about \$100 million by now, whereas investors who put the same amount in the S&P 500 would have \$250,000. And Shelby Davis managed to grow \$100,000 to a fortune of about \$900 million between the late 1940s and 1994. The track records of many other top investors in Figure 1 also measure up to those of Buffett and Davis. Joel Greenblatt, one of the most successful hedge fund managers ever, crushed the market between 1985 and 2005. Over that stretch of 20 years he turned \$1,000 into \$840,000, whereas someone who would have put that same amount in an index fund or tracker of the S&P 500 would have had only \$12,000.

In spite of these impressive track records, though, one must realize that beating the market is not easy. The investors in Figure 1 unanimously admit that the stock market is pretty efficient. They say that putting up their performance took hard work, unconventional thinking, discipline, patience and mental strength. The surprising thing is that their recommendations on how to beat the market are both eerily similar and pretty different from the way the average investor manages his or her investments. They look in the same uncommon places for bargains. They emphasize the same subtle qualitative factors in their due diligence, factors that are ignored by most other investors. They have similar buy and sell practices that fly in

Figure 1. Annual Outperformance Versus the S&P 500 of a Set of Famous American Investors



the face of conventional wisdom. And their risk management and portfolio construction run counter to academic theories on these subjects. Moreover, unlike the efficient market hypothesis, which assumes that most investors are rational, they stress that staying rational is a huge challenge that requires discipline and effective coping with psychological biases.

The Investment & Buying Process

“I have heard many men talk intelligently, even brilliantly, about something—only to see them proven powerless when it comes to acting on what they believe. Investors must act in time.”

—Bernard Baruch

Top investors point out that successful investors 1) have a superior process, 2) execute their investment method with discipline, and 3) successfully cope with psychological biases (i.e., psychological influences, which are researched in the academic discipline of behavioral finance and which tend to cause numerous investment mistakes). This is illustrated in Figure 2, where we can see

that the investment process consists of two major steps:

1. First, to manage their time effectively, smart investors focus their efforts on stocks that have an above-average probability of being undervalued. This also implies that they don’t waste their time on stocks that are unlikely to be bargains. A pitfall in this selection process is that numerous psychological biases steer us to exactly the wrong stocks, and away from the most attractive ones. For instance, people have the tendency to look at the market’s favorites (which are often overvalued) and typically show little interest in stocks that most people hate (which are regularly undervalued).
2. In a second step, intelligent investors perform due diligence of the selected stocks by examining the financial statements (i.e., a quantitative analysis); by evaluating the company, its industry and management (i.e., a qualitative analysis); and by trying to determine the fair value of the business. Note that psychological biases can render due diligence worthless. For example, it is common for investors to have

preconceptions about a company before performing due diligence (e.g., one can like a company’s products and therefore think that the company has investment merit). The consequence can be that one’s analysis of a company is colored by these preconceptions. Or one can look for only those elements that confirm one’s preconceptions and ignore the elements that negate them. Another example is that people often buy shares of the company at which they are employed because they think they are familiar with the business. In reality, though, they often don’t even know the basic financial data of the firm.

Finally, even after selecting the right stocks for analysis, and after unbiased and thorough due diligence, one still has to pull the trigger at the right moment. Intelligent investors buy attractive stocks at the right time. They regularly reassess the investment merits of every share they have, and decide whether it still belongs in their portfolio. And they sell those positions that no longer offer the return potential they aim for in their investments. Buying, holding and selling are difficult processes because numerous psychological biases interfere with acting on one’s ideas. For instance, many smart people are paralyzed when the market is in a tailspin. So they refuse to buy shares at rock-bottom prices, even though the analysis they may have done before the market downturn pointed out that these prices are absolute bargains.

In my book, I discuss all steps of the investment process in-depth and based on the recommendations of the set of top investors of Figure 1. In the following section, I briefly discuss where top investors tend to look for bargains. In the last section, I give some investment mistakes that top investors warn against. The average investor typically commits two types of investment errors: process errors, and buy and sell errors. Process errors are errors during due diligence (e.g., biased analysis due to preconceptions, as mentioned above) and when one is looking for an

attractive investment (e.g., focusing on the wrong types of stocks, see also above). In the last section, I focus only on buy and sell errors.

Where Top Investors Look for Bargains

“People are always asking me where the outlook is good, but that’s the wrong question. The right question is: Where is the outlook most miserable? The obvious application of this concept in practice is to avoid following the crowd.”

—John Templeton

In their search for market-beating returns, many investors resort to advice from analysts and brokers. They listen to the tips from their friends and family. They buy shares in hot initial public offerings (IPOs). Or they look for companies with a fascinating story that are

featured in the financial media. They can hardly be blamed, because it cannot be denied that finding interesting ideas in stock markets with thousands of publicly traded companies is a daunting task.

Unfortunately, the greatest investors in the world have repeatedly warned that it is not a good idea to invest in companies that look flashy or that enjoy a lot of popularity among market participants (including professional investors and analysts). So, where do these successful investors look for potential bargains? When examining the types of stocks that they tend to like, it is striking to see that they all seem to fish in the same ponds. And these ponds are not the ones that the average Joe is looking at.

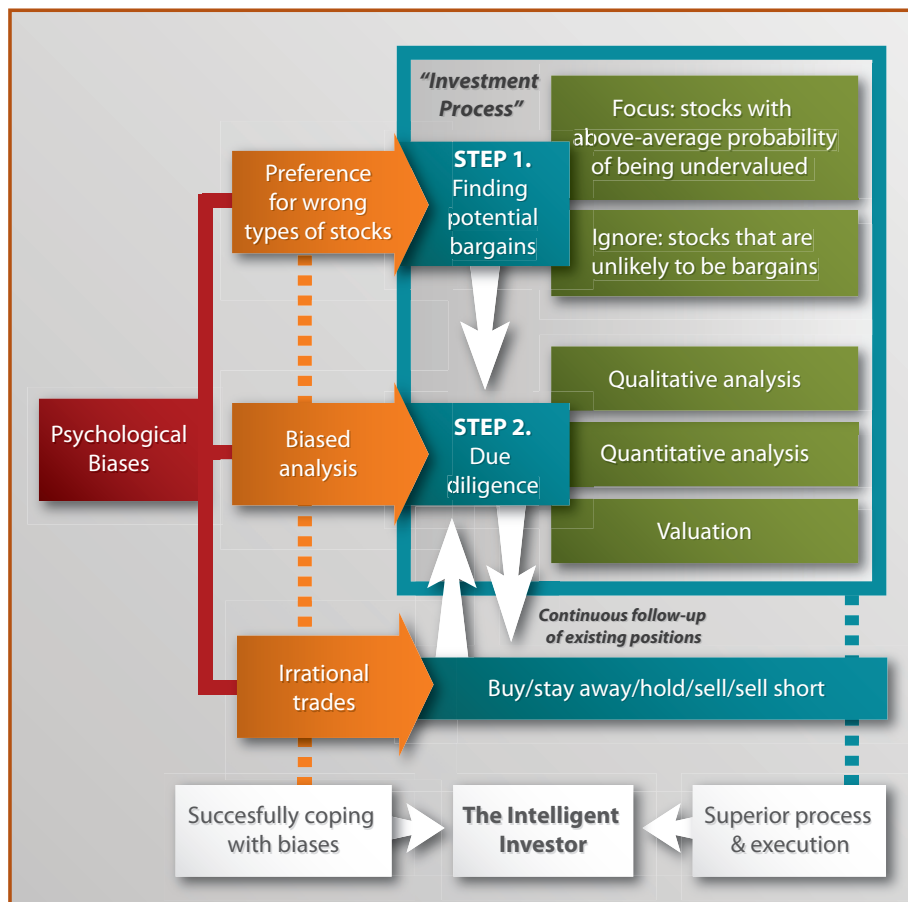
Investment legends like Benjamin Graham, John Templeton and Warren Buffet realized many decades before behavioral finance became a respected academic discipline that systematic

psychological errors tend to create market inefficiencies. They reasoned that herding behavior, the tendency of people to extrapolate past trends, the asymmetric nature of loss aversion (i.e., the fact that a loss hurts twice as much as a similar gain), and overreaction bias (i.e., the tendency of people to overreact to bad news) are strong forces in the market that can push unpopular stocks far below their fair value.

Based on this insight—and on the fact that this phenomenon is even further reinforced by the numerous momentum traders and short-term speculators that chase price trends—many of the world’s greatest investors look for interesting ideas among stocks that are beaten down by the market due to bad news [think BP plc (BP) after the Deepwater Horizon oil spill in 2010], that are despised in the corporate world, or that are even believed to be close to financial distress. For instance, Prem Watsa, an astute investor who is often called the Canadian Warren Buffett, recently invested heavily in the beaten-down tech company BlackBerry Limited (BBRY) when its survival was highly debated after massive market share losses in its smartphone business. In his latest letter to shareholders, Prem Watsa mentioned that at the moment Twitter Inc. (TWTR) went public, BlackBerry’s market capitalization was six times lower than that of Twitter, whereas it generated more than 10 times the sales of Twitter. Prem was convinced that the market vastly underestimated the potential of BlackBerry’s business.

In the same vein, the late father of value investing, Benjamin Graham, was always on the lookout for companies that once fetched sky-high valuations but that had crashed when they were unable to deliver on the market’s unrealistically high expectations. He reasoned that the vast underperformance of these companies’ stocks can be so frustrating that even the most hardened buy-and-hold investor is likely to throw in the towel. A good example of a class of stock that meets this criterion and is actively mined by top investors like Steven Romick and Paul Sonkin is busted

Figure 2. The Challenge for Investors in Following a Successful Investment Process



IPOs. These are companies that were once hot IPOs but that have turned cold since.

Other stock types that top investors (especially Joel Greenblatt and Seth Klarman) pay much attention to are the so-called special situation stocks. These are stocks that are distributed to stakeholders after a special corporate event. Examples are merger securities, preferred shares in going-private transactions, new shares of companies that emerge from bankruptcy and spin-offs. One of the reasons why special situation stocks offer high investment potential is that people who receive the new shares are inclined to get rid of them. Many do not understand what they are and the position is usually too small to justify a lot of research time. Others feel uncomfortable holding on to the shares because they never had the intention to own that stock in the first place. Professional investors may be forced to sell, as the new stock can violate their investment charters. Indiscriminate selling irrespective of price by all of these disinterested investors can push the stock price far below its fair value.

A second reason why special situation stocks tend to be interesting is that the underlying company is often more attractive than most people realize. Spin-offs, for example, are usually groomed by the corporate leaders of the parent so as to benefit the stakeholders. They are given or sold to the shareholders of the parent company, so managers who want to keep their job have a vested interest in the success of the spin-off. They have every incentive to pursue a low-to-reasonable transaction price to ensure that the shareholders of the parent company are happy with the price action after the transaction. Likewise, a company that emerges from bankruptcy usually has many of its issues (i.e., legal

claims, high debt load, etc.) sorted out such that the new business may be very different from the old one.

Apart from negative-sentiment and special situation stocks, many top investors also cherish companies that have low institutional ownership and that are covered by very few analysts. For example, Peter Lynch, one of the best mutual fund managers ever, was thrilled when he found a company that was not covered by a single analyst. The fact that little money is chasing these stocks and that few investors are looking at them implies that pricing can be far removed from these stocks' true value. Some types of stocks that are often ignored or shunned by the investment community are small companies, dull and unfashionable businesses, complex businesses and companies about which there exists little information. An example of an industry that many people ignore but that is often targeted by top investors is the burial industry. For instance, one of Peter Lynch's favorite all-time stock

picks was the burial service company Service Corporation International (SCI), which went up about 10-fold between 1980 and 1990.

Finally, while I said above that following the advice of brokers, analysts, tipsters, family and friends is seldom the road to riches, certain types of tip-offs can be very rewarding. Insider buying is a nice example. The massive and coincident buying of shares by well-informed insiders (especially the CEO and CFO) can be a strong sign that something good is about to happen to the stock. According to one of the U.K.'s greatest investors, Anthony Bolton, insider buying is even more significant when it happens after a sharp rise in the company's share price, as this signals that even more upside is in store. Another type of tip-off that may point to interesting stock ideas is ownership by an activist investor. Activist investors do their homework thoroughly because they have to commit a considerable amount of cash if they want to force

Table 1. Common Investing Buy and Sell Errors

Common Practices Among Investors	Top Investors' Comments
Constantly trying to anticipate the moves of the market	"Far more money has been lost by investors preparing for corrections or trying to anticipate corrections than has been lost in the corrections themselves." —Peter Lynch
Constantly trading in an attempt to take advantage of the market's movements	"Inactivity strikes us as intelligent behavior." —Warren Buffett
Believing that nobody has gone broke taking a profit	"Can you imagine a CEO using this phrase to urge his board to sell a star subsidiary?" —Warren Buffett
Selling winners and hanging on to losing stocks	"Selling winning stocks and hanging on to losing stocks is like cutting the flowers and watering the weeds." —Peter Lynch
Buying and selling based on emotion	"While enthusiasm may be necessary for great accomplishments elsewhere, on Wall Street it almost invariably leads to disaster." —Benjamin Graham
The economy as a first consideration	"The way you lose money in the stock market is to start off with an economic picture. All these great heavy-thinking deals kill you." —Peter Lynch

their will on the company they target. And they often create value through the changes they enforce. So companies that are targeted by activist investors with respectable track records (think Carl Icahn, Bill Ackman, and Daniel Loeb) can be excellent starting points for further scrutiny.

Studies confirm that the odds are in the investor's favor with the types of stocks discussed here. Spin-offs (in aggregate) appear to be excellent investments over the long term. Stocks that are held by activist investors tend to outperform the market. And it has also been known for quite some time that stocks in the doghouse are much better investments than popular and hot stocks. The above list of potential bargains is, however, by no means exhaustive.

Three Typical Buy and Sell Errors

Successful investing is all about buying at the bottom price and selling at the top price, right?

In a perfectly predictable world, this would indeed be true. But when even the brightest investors in the world admit that they can't time their trades with pinpoint precision, one has to think twice. Picking tops and bottoms is, according to the greatest investment minds, actually a serious investment error. Top investors don't try to pick tops and bottoms. Instead, they apply a high level of pragmatism in their buy and sell decisions. They feel comfortable buying before a stock touches bottom and selling before a top. Their buy and sell decisions are prompted by the fundamental

consideration: Is the stock price cheap or expensive versus its fair value? They realize that holding on to an overvalued stock in anticipation of a higher price is not investing but speculating, and so is postponing a purchase in a wild bet that a cheap stock will eventually become extremely cheap.

Let's move on to a flawed popular myth: Nobody has gone broke taking a profit. It all sounds logical: A stock that has done well must have "used up" its upside potential and therefore should be replaced with something of better value. Brokers take advantage of this myth to actively promote the sale of stocks that have risen 100% or 200% (as high turnover generates more transaction commissions for them). But once again, top investors totally disagree with this public wisdom. Peter Lynch even likened the common practice of selling one's winners and holding on to one's losers to "cutting the flowers and watering the weeds." The reason is simple. Many of the greatest investors in the world owe a large part of their exceptional track records to a limited number of stocks that they held for a long time. Exceptionally strong companies should perform extraordinarily strong in the stock market. Hence, many top investors recommend that investors hang on to winning stocks as long as they keep on performing and as long as the valuation is not out of whack with reality.

As an aside, and maybe to the surprise of many, the best traders in the world totally concur with the idea that one should not try to pick tops and bottoms, and that one should let one's winners ride. But this doesn't mean

that investors should integrate trading practices in their investment activities. This brings us to a third investment mistake: not realizing that trading and investing are two totally different market approaches. A nice example is the use of stop-loss orders (i.e., orders to sell automatically when a stock drops below a certain level). The typical trader doesn't care about a stock's fair value but tries to benefit from price momentum. He or she tries to buy stocks with strong price action and sell (short) stocks that behave poorly. Hence, the use of stop-loss orders makes perfect sense for traders as it limits the losses they may incur when a stock moves opposite to the trend that they expected. For investors, by contrast, stop-loss orders run counter to the fundamental philosophy that one should buy below fair value and sell at fair value. A drop in the stock price makes that stock even more attractive provided that its fair value has not declined. So, as stated by Warren Buffet, the use of a stop-loss order for an investor is as absurd as buying a house for \$1 million and instructing your broker to sell when he or she gets a bid for \$800,000.

A sampling of buy and sell errors are listed in Table 1 along with relevant comments from top investors. Sound practices in the purchase and sale of stocks require discipline, patience, and a mental setup that runs counter to conventional wisdom. Realizing that intelligent buying and selling are permanently hindered by the many psychological biases that constantly try to force the investor's hand is the first step to a sound buy and sell strategy. ▲

Frederik Vanhaverbeke is a portfolio manager at KBC Asset Management, Belgium. He is also the author of "Excess Returns: A Comparative Study of the Methods of the World's Greatest Investors" (Harriman House, 2014). Find out more at www.aaii.com/authors/frederik-vanhaverbeke.