Colin Nicholson: Newsletter 86

13 March 2009

Hear me speak in Sydney

My next speaking engagement is:

Sunday 22 March 2009
Bulls and Bears Network Traders Club
10.00 to 12.00
Harbord Diggers Club Evans Street Harbord

How to buy a young bull

I will start by discussing how I saw and handled the end of the last bull market. Then I will outline my analysis method and strategy for getting into the next bull market at an early stage. There will be time for discussion and I will stay for lunch afterwards at the club for further informal discussion.
Further information: www.bullsandbearsnetwork.com.au

Further speaking engagements

I have now posted the dates for my 2009 speaking engagements on the *Hear Colin Speak* page on www.bwts.com.au.

Some thoughts for consideration

Each year Warren Buffett writes a long letter to his shareholders in Berkshire Hathaway Inc. These letters are published on the company's website and should in my opinion be mandatory reading for all thinking investors. I say that not just because I agree with many of his ideas. Rather it is because many of those ideas come from the most successful investor in our lifetime and they always make us think. They often expose us to insights which are often ahead of their time in the mainstream media. Here are some points from the 2008 letter, which I suggest are worth thinking about for what they may mean for our investment strategy in the years ahead.

Buffett: *This debilitating spiral has spurred our [US] government to take massive action... Economic medicine that was previously meted out by the cupful has recently been dispensed by the barrel. These once-unthinkable dosages will almost certainly bring on unwelcome after effects. Their precise nature is anyone's guess, though one consequence is an onslaught of inflation.*

My comments: This is a most disturbing thought. Inflation is one method that governments employ to repay debt. They borrow a dollar from the taxpayer and repay it later with dollars that are worth far less than the dollar which was loaned in the first place. Inflation is the biggest danger to private wealth, far more devastating than deflation. This is not for one moment to say that deflation is good; it is also disastrous, though the wealthy survive more easily than the unemployed. This highlights the difficult balancing act performed by governments and monetary authorities. They must find a path through two evils.

Buffett: *whatever the downsides may be, strong and immediate action by government was essential last year... like it or not* [we] *were all in the same boat.*

Amid this bad news, however, never forget that [the US] *has faced far worse travails in the past.*

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Without fail, however, we've overcome them... Though the past has not been smooth, our economic system has worked extraordinarily well... and it will continue to do so. America's best days lie ahead.

My comments: Buffett's confidence in the capitalist system sits at odds to most of the doom and gloom merchants in the media who assail us with nothing but sensational negativity. As many of you know, I never watch television and do not own a mobile phone or an ipod, all things which rob us of time to think, but are comforting for *people who are skimming along on the surface of life* (Joyce Carol Oates). I try in my research to focus all the time on facts, from which I try to draw my own conclusions. This is not easy. We have to make an effort to find the facts. Then comes the hard part: we have to think. It takes time and commitment to be a good investor in this sense. If you see me walking or going somewhere in a train, bus or plane, I am likely to be reading a book or thinking through the meaning and implications of what is happening in the economy.

In these selected excerpts from his letter, Buffett is trying to shake us into stepping away from the hype and pace of life to take a longer term perspective. He is reminding us of President Lincoln's reference to Solomon and the ring: *And this, too, shall pass away.* Nothing is permanent. We need to draw a line from the past into the future. Bad times are a time for preparation, so that we can be ready when the good times return, which they will.

Last chance to buy *Hot Stocks 2008*

I have only a few copies of my book *Hot Stocks 2008* left for sale. When they are finished, I will take the reference to them off the website and off the order forms which are on the website. Until then, you can assume I still have some left.

If you are interested in buying a copy, don't delay. Go to www.bwts.com.au and click on *Colin's Books* at the left of the home page.

Buffett: *...neither Charlie Munger, my partner in running Berkshire, nor I can predict the winning and losing years in advance. (In our usual opinionated way, we don't think anyone else can either).We're certain, for example, that the **economy will be in shambles** throughout 2009 – and, for that matter, probably well beyond – but that conclusion **does not tell us whether the stock market will rise or fall**.* (my emphasis)

My comments: I picked up two things in this excerpt. The first thing is that Buffett does not believe we are very good at forecasting or predicting. This is especially the case in the stock market. I know this will offend many technical analysis practitioners, but there is a growing volume of evidence that we are hugely overconfident about our ability to forecast and that we are not very good at it. There is no Holy Grail to be found in technical analysis or in fundamental analysis when it comes to forecasting. My personal approach to this issue is to never even try to forecast. There are too many problems in that occupation. Rather, I try to assess the condition of the market and the economy and devise a strategy to deal with the conditions I believe we are living through.

The second thing I picked up from the comment of Buffett's is that he has a view about the economy, but that does not translate into a view about the stock market. While I retain reservations about forecasting the economy as well, I could not agree more about the stock market. Both the economy and the stock market are subject to cycles. However, all my experience over 40 years of investing and my research of the past suggests that the cycles vary enormously in periodicity and amplitude. The result for me is that we must be cognizant

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of cycles, but not be fooled into thinking that we can make precise or even rough predictions as to their timing. What we can do is to follow an appropriate strategy for the part of the cycle we think we are in. Even more important is the insight that the stock market cycles tend to lead the real economy in time, so the most difficult times to execute our strategy is around the turning points.

Buffett: *In good years and bad, Charlie and I simply focus on four goals:*

(1) maintaining Berkshire's Gibraltar-like financial position, which features huge amounts of excess liquidity, near-term obligations that are modest and dozens of sources of earnings and cash;

My comments: This warrants long and careful consideration. How many of us can say we have a Gibraltar-like financial position in our own finances? I suspect very few. Otherwise, why is there so much in the news about people whose retirement savings and capital has been ripped up in the bear market? Why are investors having to sell good investments when prices are low if they have plenty of cash reserves? Moreover, why are there so many stories about stress from margin loans and huge mortgages if near-term obligations have been kept small? Ask how many sources of earnings you have in your financial plan.

(2) widening the "moats" around our operating businesses...;

My comments: Are you even thinking in terms of focussing your investments on companies and industries which are least affected by the vicissitudes of the bull-bear market cycle? Do the investments you have made have a margin of safety in terms of what you paid for the shares and also is the business one which will hold up well in a recession?

(3) Acquiring and developing new and varied streams of earnings;

My comments: This can be seen as not relevant to investors. That would be a mistake. I keep coming across investors with over 50% of their portfolio in one stock. Likewise, investors with six bank stocks making up their whole portfolio. Diversification is a sword with two edges. Buffett himself has said that diversification can lead to worse results than the concentrated portfolio of a great investor. However, most of us should recognise that we are not yet proven great investors, so some level of diversification is needed. In the above excerpt, Buffett is modifying his own previously extreme statements about "diworsification".

(4) Expanding and nurturing the cadre of outstanding operating managers...;

My comments: This made me stop and think. I need to try to do more about developing members of the next two generations of my family to be able to invest well. The question which has to be asked is whether the family can provide people with the necessary skills. If not, other solutions need to be thought about and investigated. It is easy to put this off and I am personally probably as guilty of this that any of my readers. Give it some high priority thought. Nobody lives forever. You should not try to manage from the grave, but you should invest in the managers who will carry on your investing processes.

Buffett: *Berkshire is always a buyer of both businesses and securities, and the disarray in markets gave us a tailwind in our purchases. When investing, pessimism is your friend, euphoria the enemy.*

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My comments: While Buffett's investment plan may differ from ours, this except contains a very important point. The easiest time to buy stocks is when we feel good about the market. This is often the worst time to buy. Whenever a decision to buy stocks seems to be really easy and not require much thought, be very cautious. It is often when an investing decision seems ill-timed because everything looks so black around us that the opportunities may be at their peak. However, be careful of the converse. Just because things are going badly may not mean that any stock might be a good buy. It is simply that prices are low and some real bargains may be available. Do not just buy anything that looks cheap. Instead, be alert for opportunities and do not relax your standards in assessing value and potential in selecting stocks.

I can not stress this enough. Just recently some friends expressed surprise that I had been very busy studying the company earnings reports announced in the recent profit reporting season and assessing potential purchases. My friends were concerned that they may be going stale because the bear market was dragging on and there was nothing to do. However, my view is that this is a time to be working hard on preparing for the opportunities that will emerge, probably in the darkest hours of the unfolding recession. For me, the time to relax and take it easy is not now, it is in the third phase of a bull market when the lemmings are running with the herd toward a cliff and I am pulling money out of the market.

Buffett: *During 2008 I did some dumb things in investments. Furthermore, I made some errors of omission, sucking my thumb when new facts came in that should have caused me to re-examine my thinking and promptly take action.*

My comments: Nobody is perfect. All investing decisions do not work out as we hoped they would. Those who seek perfection are looking for the impossible. Buffett is an excellent investor – possibly the best there is. However, what he is saying here is that he made a few bad moves. Even worse in a way, he took his eye off the ball at a critical time and acted too slowly. Bear in mind that this is from a person who absorbs more information in a short time than most of us absorb in a year. Yet, he felt he had not reacted to new information as he should have and missed taking action quickly. This relates closely to my friends, mentioned above, who were saying that they had stopped working hard on new information coming forward, because the market was falling.

When a market is falling, that is a good thing for investors because it brings us closer to really good opportunities. That is the time to be paying attention and doing the hard work on possible investment ideas. This is when price is falling lower than value.

On the other hand, when a market is rising, I am always a little disappointed that the great opportunities are behind us and as the market goes higher, there will be fewer and fewer stocks available at a good price relative to value.

Buffett has spoken about this many times before and often refers to the teaching of his mentor Benjamin Graham, which he does again in his latest letter. In his own words: *I like buying quality merchandise when it is marked down.*

Buffett: On page 7 of the letter, Buffett discusses "private equity". His comments are worth reading. In very simple terms he explains how private equity does not work very well.

Buffett: On page 11 and 12, Buffett discusses his view of what went wrong in the housing mortgage lending market. Again, he does this in very simple terms. If readers have struggled to understand just where and how the so-called sub-prime developed, then this is well worth

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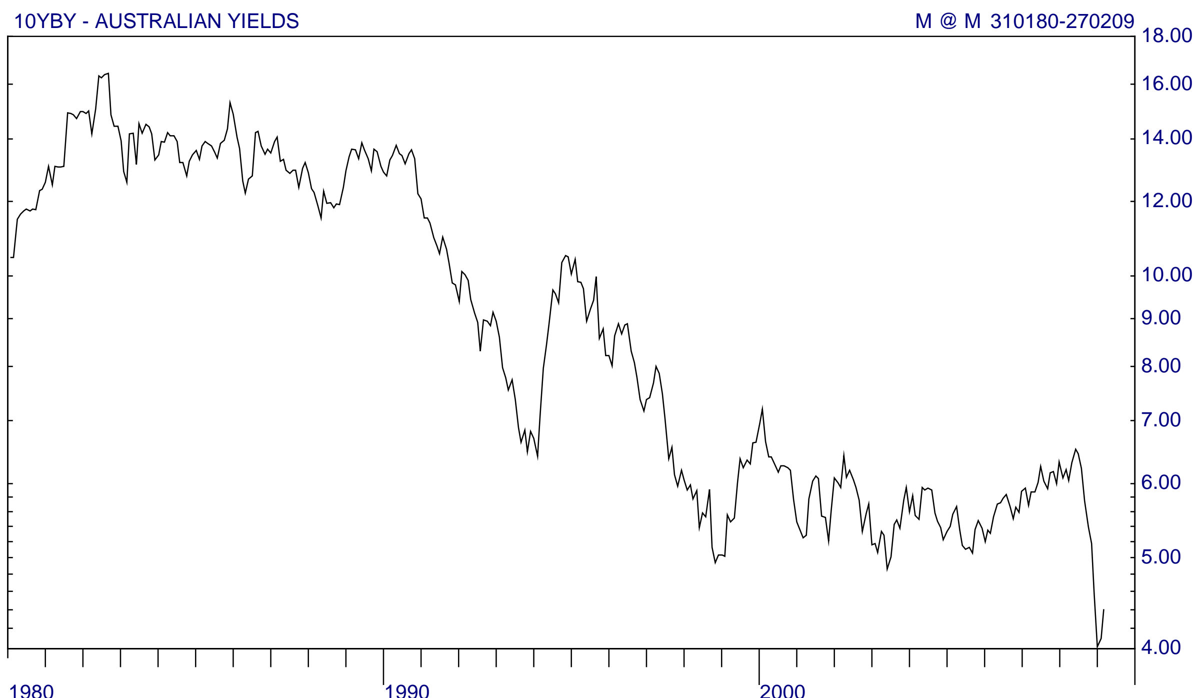
reading. His discussion begins with: *I described it as involving "borrowers who shouldn't have borrowed being financed by lenders who shouldn't have lent."* The first paragraph ends: *This chain of folly had to end badly, and it did.* The next paragraph includes: *...industry losses were staggering. And the hangover continues...*

Buffett goes on to discuss why the borrowers from the Berkshire subsidiary Clayton have very low delinquency rates. This is a model not just for the US, but for Australia and our own children and grandchildren:

Why are our borrowers – characteristically people with modest incomes and far-from-great credit scores – performing so well? The answer is elementary, going right back to Lending 101. Our borrowers simply looked at how full-bore mortgage payments would compare with their actual – not hoped for – income and then decided whether they could live with that commitment. Simply put, they took out a mortgage with the intention of paying it off, whatever the course of house prices.

Just as important is what our borrowers did NOT do. They did not count on making their loan repayments by means of refinancing. They did not sign up for "teaser" rates that upon reset were outsized relative to their income. And they did not assume that they could always sell their home at a profit if their mortgage payments became onerous.

My comments: Here Buffett is referring to an idea that I have often spoken about in many places. When considering any risk that we are about to take on, we need first to do some "what if?" calculations. Borrowing money involves risk. We need to define how the rate of repayment on the mortgage might change over time. Of course, one problem is that many people in our community and young people in particular, have no historical perspective on interest rates. Yet this is essential if, as is the case in Australia, mortgage rates are generally variable. I do not keep that data, but I do keep a good proxy in the form of the 90-day bill yield. Take a moment to examine the chart below:



This is a short-term look because my data only goes back to 1980, but it should be enough to scare the pants off a mortgage borrower. The scale on the right is the percentage yield. If you

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are about to take out a mortgage, you need to be sure you could handle payments when interest rates next range from 12 to 16 percent as they did in the 1980s. That sort of inflation can't happen again you say? Well, I hope not, but in view of the liquidity being pumped into the financial system around the world, I am not so sure. However, prediction is not the issue. The issue is whether a "what if" analysis shows a borrower could handle repayments of that magnitude, which is prudent and the only way to try to ensure a margin of safety. If you do not feel competent to do such a calculation, ask your mortgage broker to prepare a spreadsheet for you. If the broker will not or cannot do it, get another mortgage broker or financial adviser.

Then mortgage borrowers should look at the other side of this transaction. It is necessary to look at the ability of the borrower to meet the repayment schedule. Once you know the range of repayments that you think are possible (forget likely, that requires unheard of prediction skills), the borrower must consider what could happen to their earning ability. The borrower should assume that it is possible to lose their job. What cash reserve or insurance would be needed to cover for death or the longest conceivable period of unemployment? What other avenues might there be to meet repayments?

Then, we have both sides of the picture. If the worst can be covered on both sides of the risk, then the borrower can proceed with the risk of taking out a mortgage with a good margin of safety.

This basic approach is applicable to any investment or borrowing situation. We should always ask how well we could deal with the worst possible convergence of adverse events.

Buffett: *Commentary about the current housing crisis often ignores the crucial fact that most foreclosures do NOT occur because a house is worth less than its mortgage...Rather, foreclosures take place because borrowers can't pay the monthly repayment that they agreed to pay. Homeowners who have made a meaningful down-payment – derived from savings and not from borrowing – seldom walk away from a primary residence simply because its value today is less than the mortgage. Instead, they walk away when they can't make the monthly repayments...the home purchased ought to fit the income of the purchaser.*

My comments: Take careful note of the last part of that excerpt. One of the reasons why borrowers get into trouble is because their expectations exceed their ability to pay the price. So many people today start with what they would ideally like and borrow to the hilt to get it straight away. That is a recipe for disaster if interest rates rise or income streams are interrupted.

Buffett: After a long discussion of the risks in insuring bonds, we get this gem: *Investors should be sceptical of history-based models. Constructed by a nerdy-sounding priesthood using esoteric terms such as beta, gamma and the like, these models tend to look impressive. Too often, though, investors forget to examine the assumptions behind the symbols. Our advice: Beware of geeks bearing formulas.*

My comments: If readers do not fully understand what Buffett is saying here, go to http://www.berkshirehathaway.com/letters/2008ltr.pdf and read the explanation which preceded it.

Buffett: *...I have pledged ... to always run Berkshire with more than ample cash. We never want to count on the kindness of strangers in order to meet tomorrow's obligations. When forced to choose, I will not trade even a night's sleep for the chance of extra profits.*

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My comments: Read that again and take it in. It is another of the explanations of aspects of the margin of safety that drives all of Buffett's investing work. It is worth reflecting on the idea that Buffett is the best investor we have seen in a long time, yet he takes less risk and ensures he has a greater margin of safety than most investors.

Where this sticks out is now after more than a year into a bear market. The newspaper I read is full of ongoing stories of investors with all their capital tied up in stocks which have fallen substantially in value. Investors are crying out that they have to sell these stocks to get the money to live on. This is such a big issue in Australia that the government has relaxed temporarily the already magnificently generous rules applying to pensions from superannuation funds. Where are their cash reserves? Did they do a "what-if" analysis that was based on the worst that might happen? If they did, why did they not set aside an adequate cash reserve against this eventuality? The answer is either ignorance or greed and possibly both. Read Buffett's words above again and reflect upon what they suggest for your investment strategy going forward from now.

Buffett: *The world has gone from underpricing risk to overpricing it. This change has not been minor... When the financial history of this decade is written, it will surely speak of the Internet bubble of the late 1990s and the housing bubble of the early 2000s. But the Treasury bond bubble of late 2008 may be regarded as almost equally extraordinary.*

Clinging to cash equivalents or long-term government bonds at present yields is almost certainly a terrible policy if continued for long. Holders of these instruments, of course, have felt increasingly comfortable ... in following this policy as financial turmoil has mounted. They regard their judgment as confirmed when they hear commentators proclaim "cash is king", even though that wonderful cash is earning close to nothing and will find its purchasing power eroded over time.

Approval, though, is not the goal of investing. In fact approval is often counter-productive because it sedates the brain and makes it less receptive to new facts or a re-examination of conclusions formed earlier. Beware the investment activity that produces applause; the great moves are usually greeted by yawns.

My comments: Readers may wonder why I put this quotation in the newsletter. Although we can argue with semantics on this issue, Buffett is not a market timer. My approach is that of market timing. Am I not quoting something that is suggesting that my methods are wrong? I don't think so. In fact I agree with Buffett very strongly. Let me explain.

My policy is to be fully invested in bull markets and in cash in bear markets. Getting in is not a precise science and generally occurs over a year or more; likewise getting out. The key to what I try to do is to move in early and move out early. This is totally opposite to beginners who get in late and ride the market down the roller coaster of a bear market.

Therefore, I believe I am right to be in cash in what I think is the middle of the bear market. The danger, though, is to stay in cash for too long for the reasons which Buffett explained perfectly well. Market timing is not easy. It requires knowledge and many years of experience through at least one full cycle and preferably more. Investing has been my life for over 40 years, so I think I qualify to try to time the market. However, I would warn readers about thinking they can do it without the required knowledge or experience.

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What do the readers who lack the knowledge do? They start educating themselves and invest through professional managers for now.

What do readers who feel they have the knowledge, but lack the experience do? They start managing a small part (say 10%) of their money to gain the experience and invest the rest through professional managers for now.

My preferred method of investing through professional managers is that advocated by Buffett: use a low fee index fund or funds and dribble the money into it over the next few years on a type of dollar cost averaging approach. If readers do not understand what that is, they should see my next paragraph or get licensed professional help. This game of investing is serious and is played for keeps. You repent your mistakes in your retirement, which is getting to be a longer and longer period of time.

Of course, most investors are hugely overconfident and think they can do better than the professionals. Good luck to them. If readers in this category still insist on doing it all themselves, then start working hard at it. Design a portfolio of excellent companies. Calculate how many dollars you would ideally like to invest in each of the companies. Then divide those amounts into twelve and invest the same amount in each company each quarter for the next three years. If dividing by twelve is too small a parcel to buy, divide the total by six and act each half year. If that is still too small, divide the total by three and invest it yearly.

This is the dollar cost averaging approach in a nutshell, but readers should research it further before acting on this bare outline alone. Above all, if readers are not competent to assess the appropriateness of this method to their situation, they should seek licensed financial advisers to assist them in formulating an appropriate plan.

I repeat Buffett's warning: staying too long in cash is a terrible policy. There are bargains galore in the stock market. We just don't know when the ultimate low will come. I chose a three-year campaign to enter. If readers are even more pessimistic than that, they can adjust the method to a four or five year period. The key, though, is to start soon. I repeat, buy only good businesses. If you don't have the skills to devise such a portfolio, you should seek licensed financial advisers to help you. But before you do, please read my previous newsletter. You, not the adviser must state the objective. Your adviser may suggest changes to the objective, but if you do not have a starting point, how will you assess those suggestions? Then you must know what questions to ask. Start by utilising the earlier discussion on looking at the "what-ifs". It isn't all that hard, but you must be prepared to do some thinking.

Buffett: *Derivatives are dangerous. They have dramatically increased the leverage and risks in our financial system. They have made it almost impossible for investors to understand and analyse our* [US] *largest banks and investment banks.*

Indeed, recent events demonstrate that certain big-name CEOs... at major financial institutions were incapable of managing a business with a huge, complex book of derivatives. Include me and Charlie in this group [they sold out a big derivatives book at a loss over five years after they bought General Re].

Improved transparency... won't cure the problems that derivatives pose. I know of no reporting mechanism that would come close to describing and measuring the risks in a huge and complex portfolio of derivatives. Auditors can't audit these contracts and regulators can't regulate them. When I read the pages of "disclosure in [company reports] *all I end up*

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knowing is that I DON”T know what is going on in their portfolios (and then I reach for some aspirin).

The Bear Sterns collapse highlights the counterparty problem embedded in derivatives transactions...

A normal stock or bond trade is completed in a few days... Counterparty risk therefore quickly disappears.

Derivative contracts, in contrast, often go unsettled for years, or even decades, with counterparties building up huge claims against each other. “Paper” assets and liabilities – often hard to quantify – become important parts of financial statements though these items will not be validated for many years. Additionally, a frightening web of mutual dependence develops among huge financial institutions... Participants seeking to dodge troubles face the same problem as someone seeking to avoid venereal disease: It’s not whom YOU sleep with, but also whom THEY are sleeping with.

My comments: I included a substantial section of Buffett’s discussion here, but by no means all. If readers are interested in learning more about how Buffett manages derivatives in his business, his full letter is well worth reading.

Derivatives is an area of my own investment plan which has attracted its share of critical comment from readers over the years. My overall strategy is always to keep things simple. I also subscribe to Buffett’s philosophy of never investing in anything I do not fully understand. I have a luxury that Buffett does not enjoy (because his investments are big and widespread), I DO NOT EVER invest in derivatives. As soon as I say this or write it someone wants to argue the case for leverage through derivatives. There have been far fewer critical comments reaching my ears in the last twelve months.

Buffett: *We endorse mark-to-market accounting... however, ... I believe the Black-Scholes formula ... produces strange results when the long-term variety* [of derivative] *are being valued...*

... our derivative contracts, subject as they are to mark-to-market accounting, will produce wild swings in the earnings we report. The ups and downs neither cheer nor bother Charlie and me. Indeed, the “downs” can be helpful in that they give us an opportunity to expand a position on favourable terms...

My comments: This is all a bit esoteric for most readers, so I focussed on a few extracts that make interesting points. Readers who are interested in this fascinating issue might like to read the full discussion in Buffett’s letter. Buffet has a real gift in making complicated subjects clear in his letters.

This discussion should prompt one thought in readers’ minds. Before they buy a stock, one consideration that should be visited is whether the company behind the stock has any derivative exposure and how big it is. No shareholder or potential shareholder should be reticent about asking this question of companies they invest in. Of course, some companies may choose not to answer the question. In that case I would take the “Wall Street walk” and find another stock to invest in.

Buffett: *It’s often useful in testing a theory to push it to extremes.*

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My comments: This is out of context, but I thought to include it here because it raises an issue dear to my heart. We have already discussed it earlier in part in the “what-if” proposal.

I frequently employ this idea to clarify an argument. If we take one extreme of the possible situations the answer may be quite clear. If we then take the opposite extreme of the possible situations the answer then may also be quite clear. The problem frequently is that the muddy area is in the middle when there are elements of each extreme at play. However, by visiting the extremes we may often clarify things significantly. This is because in the “what-if” game, we become much clearer in our minds about what will most likely happen.

In his discussion, this is basically what Buffett does. He takes the extreme and shows the answer is silly. This is not to say that the model does not work in the short-term calculations for which it is most commonly employed. However, it does expose very clearly that the model is inappropriate for very long term derivatives.

I suggest that in future when confronted with a difficult issue or a theory you have trouble understanding, try testing its application at the extremes. It can be a very useful technique.

A similar idea that Buffett and Munger use is to invert. I will leave that for another time.

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The newsletter is intended to be a forum for discussion of interesting ideas about technical analysis, trading and investment. It is primarily educational in nature. I have taken reasonable care in its preparation. Nevertheless, everything in it should be read as my opinion, unless otherwise stated, and requires the reader to check the accuracy of facts and test the validity of my opinions before acting upon them. My opinions are not intended to be recommendations to trade or invest in any stock or financial security. Nor are they intended to be recommendations to use any particular trading or investment method. Readers who do not have the ability to assess the relevance to them of any matter discussed in the newsletter should consult acompetent and licensed adviser before acting upon them. I am not a licensed adviser.

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