

Colin Nicholson: Newsletter 90

21 July 2009

Hear Me Speak on the Gold Coast and in Sydney

Gold Coast

Wednesday 29 July 2009

Australian Investors Association Conference

10.30 to 11.30

Share selection 1 - What to look for and why

Before starting out on our investment journey, we must know where we are intending to go. I will explain my models for finding stocks with high potential, but with an all-important margin of safety. Once I have sketched the map, I will show where the journey leads. Even more important, I will show the guideposts to look for when beginning the journey.

11.30 to 12.30

Share selection 2 - How to find and assess good stocks

Once we know what to look for, good stocks do not just fall into our laps. I will demonstrate how to search for good candidates using charts and fundamentals. Having found a list of prospects, I will show how to sort the gems from the rubbish. I will conclude with an assessment of the current stock market landscape for stock selection.

Further information on the conference: <http://www.investors.asn.au/G700GoldConf.asp>

Sydney

Monday 17 August 2009

5.15 – 7.15pm

Australian Technical Analysts Association Meeting

I will be repeating the presentation given at the AIA Conference (details above)

Further Information: www.ataa.com.au

Further Speaking Engagements

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

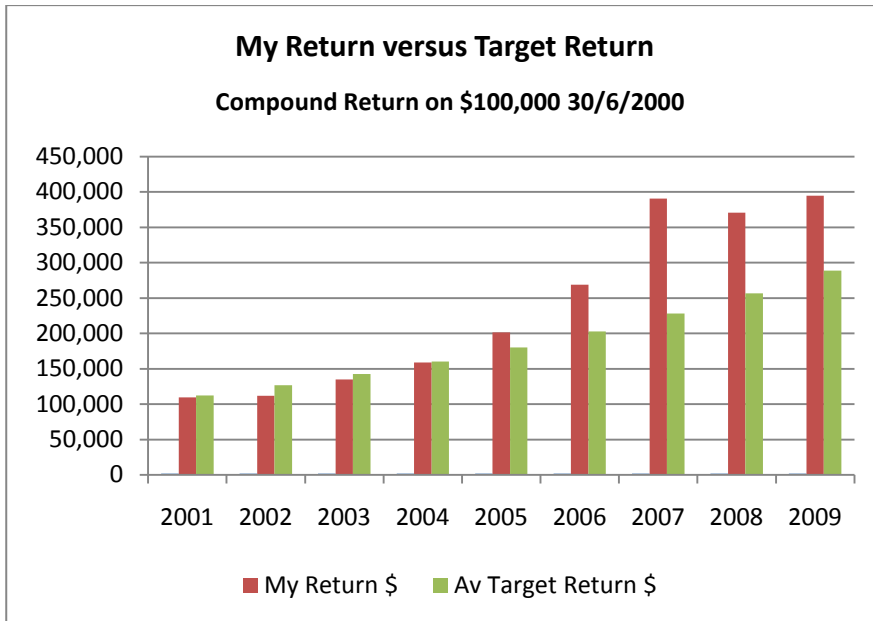
Tax Invoices

I am often asked for tax invoices. I email a tax invoice to **every** purchaser of my books, or to members of my website who are joining or renewing, even when the amount involved is less than \$82.50.

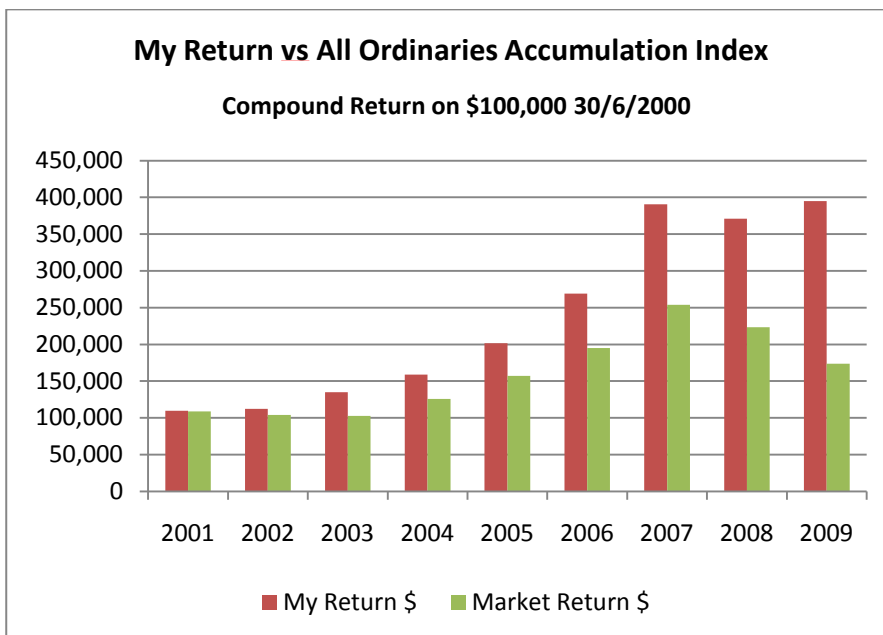
I am also sometimes asked to show the name of the entity making the purchase on the tax invoice. There is no requirement to do this under the tax law, unless the tax invoice is for \$1,000 or more. I have automated the way I issue tax invoices and to include the name of the entity purchasing the goods takes time, which I can better spend in other ways. My policy is not unusual. If you buy something in a retail shop, the shop will not show your name on the tax invoice. You may add your name or the name of your SMSF to the tax invoice later if you wish. The key thing is to be able to show that the cash for the purchase came from the SMSF. The easiest way for a SMSF to do this is to buy a debit card and use that for purchases.

My Investment Track Record

I have added a new page to my website www.bwts.com.au. This page provides access to a document which analyses my investment track record since 2000. There are several ways to assess investment returns. One is against the target return. My target return is to average 12.5%pa over the cycles. The following chart shows the compound return I have achieved assuming \$100,000 capital on 30 June 2000 compared to my target return:



The other way to assess investment returns is to compare them to the market return. Since I am an investor, I compare my returns to the ASX All Ordinaries Accumulation index, which assumes the reinvestment of dividends. My investment plan should beat the market over the cycles. The following chart shows the compound return I have achieved assuming \$100,000 capital on 1 July 2000 compared to the market index:



To access my complete investment track record document, which shows tables and charts, please click on <http://www.bwts.com.au/text.cfm?59>

The Snowball by Alice Schroeder

I read this book over the Christmas - New Year period. It is by far the best book I have read about Warren Buffett. It is a very well researched, but also easy to read, biography of the greatest investor of our time.

I was interested to read the book as a way of learning about the person. However, on the way through, I marked a number of sections which threw light on what has made Warren Buffett as good as he is as an investor.

His first investment was in a stock that had for years been recommended to clients by his father. He admits this was the only reason he chose it and that "I didn't understand the stock very well when I bought it", which should echo in all of us as where we also started on our investment journey. The stock went down, then rallied and he grabbed a small profit. Who has not also done that when they started out? He sold it at \$40 per share, but the price subsequently rose to a high of \$202. How many times has that happened to readers?

Buffett drew some lessons from this episode, which he would call the most important of his life:

1. "...not to overly fixate on what he paid for the stock."
2. "...not to rush unthinkingly to grab a small profit."
3. "...which was about investing other people's money (his sister was in the deal with him). If he had made a mistake, it might get somebody upset with him. So he didn't want to have responsibility for anyone else's money unless he was sure he could succeed."

This last point echoes with me. I am comfortable investing my own money, but feel a greater responsibility for other people's money which I manage.

The most important thing for me here is that he started where we all started. The difference between Buffett and most private investors is that he progressed beyond that to an unusually high level of excellence as an investor. As you will see, it was all about the way he thinks about investing, which is different to most private investors.

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One of Buffett's earliest business ventures was to save some money and invest it in the purchase of pinball machines. This led to another early lesson: "Warren had discovered the miracle of capital: money that works for its owner, as if it had a job of its own."

What is underlying this is something of even greater importance. To have investment capital, we have to spend less than we earn. This is called saving. Buffett began this process at school and carried it on through his entire life.

Buffett became very interested in handicapping as a kid. He read everything he could get hold of through his congressman father on the subject. Not one book. Every book he could get. Isn't this the same as the way we learn investing and finetune our skills?

“The art of handicapping is based on information. The key was having *more information than the other guy* – then analysing it right and using it rationally. ... Handicapping horses combined two things he was very good at: collecting information and math.” Here we see the key to what Buffett was later to study with Benjamin Graham as he learned the craft of investing. It is worth spending more time examining Buffett’s education in this key area.

Buffett: “I would go through [old racing forms], using my handicapping techniques to handicap one day and see the next day how it worked out. I ran tests of my handicapping ability day after day, all these different systems I had in my mind.”

This really resonated with me. For almost thirty years I had done just that with investing, mainly using technical analysis, but later adding the missing link of fundamental analysis. It was slow work then, because we did not have computers and did everything by hand from newspaper pages. Testing, testing, testing and testing again. This is the real key for me in the development of a sound method in which I had unshakeable faith under pressure. If readers have not undergone this process, they are not yet even at first base in the investment journey. Remembering some rules is never going to be enough. We must totally understand them and how they work in practice. Computers allow the drudgery to be done more quickly and easily, but our minds must still be engaged in detail until we develop understanding. This is a level well above knowledge, which is far more easily attained, but is only a prerequisite.

Buffett: “There are two kinds of handicappers. There are speed handicappers and class handicappers. (see page 107 of *The Snowball* for a fuller description). ... In horse racing it pays to understand both types of handicapping. But back then I was basically a speed guy. I was a quantitative guy to start with.”

For investing, it is a good analogy to the two main styles, value and growth.

“As he tested, thought, and observed, Warren discovered the Rules of the Racetrack:

1. Nobody ever goes home after the first race.
2. You don’t have to make it back the way you lost it.

The racetrack counts on people to keep betting until they lose. Couldn’t a good handicapper turn those rules around and win?”

Buffett: “The market is a racetrack too. But I was not developing elaborate theories in those days, I was just a kid.”

Yes, but he was already learning very important precepts that would stand him in good stead as a great investor. This was his process:

Buffett: “I’d get the *Daily Racing Form* ahead of time and figure out the probability of each horse winning the race. Then I would compare those percentages to the odds. But I wouldn’t look at the odds first, to avoid prejudicing myself. Sometimes you would find a horse where the odds were way, way off from the actual probability. ... And the trick, of course, is to be in a group where practically no one is analytical and you have a lot of data.”

There you have it. This would later morph into the techniques of the great value investor. Read it again and tick off the key similarities.

However, at first, Buffett was to learn a great lesson, when he broke his own rules and lost heavily (for him).

Buffett: “You’re not supposed to bet every race. I’d committed the worst sin, which is that you get behind and you think you’ve got to break even that day. The first rule is that nobody goes home after the first race, and the second rule is that you don’t have to make it back the way you lost it. That is so fundamental, you know.”

Schroeder: “Did he realise that he’d made an emotional decision?”

Buffett: “Oh yeah. Oh, I was sick. It was the last time I ever did anything like that.”

This is interesting. We will all make wrong moves as we learn to be good investors. The best investors learn quickly and permanently from their bad judgements. They learn quickly and learn lasting lessons because they examine what they did. They think about it in depth. Then they draw lessons that are embedded in their psyche because they *understand* what they did, which did not work out, and why.

The first step in this learning process for investors is to keep good records. Not just details of the transactions, but a diary of what they knew at each point and what they were thinking. This enables us to avoid the hindsight bias (thinking we knew more at the time than we did). If there was information available, which we could have accessed, then that is a very valuable lesson to research in depth before committing money (see Jim Rogers in the previous newsletter).

Additions to my members’ website

My website: www.bwts.com.au is in two parts:

There is a great deal of material on my **free website**: Ask Colin, Newsletters some resources for investors and real time disclosure of stocks which I personally hold.

On the **members’ website**, there is all my published work except my books and what is on the free website. There are over 700 articles and columns there and I add to them as I write for newsletters or publications.

I have now begun to build a new resource on the members’ website, which is aimed at adding value to my book *Building Wealth in the Stock Market*. These additions are:

- **Presentations**: The slides of all presentations I give.
- **Market Scan Examples**: I analyse the stocks which come up on market scans using the methods in my book.
- **Market Case Studies**: Analysis of the Australian stock market in terms of the market exposure strategy in my book.
- **Stock Case Studies**: Analysis of investments which I make and other stocks which I may not decide to buy, explaining why. For my current investments, I will not be disclosing sell stops in real time, to avoid readers front-running my stops. These case studies are teaching tools, not real time investment advice.

The members’ website costs \$44 to join and \$55 per year (\$99 in the first year). Members may access, print out or download anything on the members’ website.

The influence of Benjamin Graham

Early in his investing career, Buffett sold many of his holdings and focussed on one stock, which was not a true “value” investment. This was totally at odds with his teacher and mentor Benjamin Graham: “Graham’s idea was to buy stocks trading for less than the value of their assets, and he did not believe in concentrating in just a few stocks.”

Clearly, this was a precursor to where Buffett’s style would take him much later, after he and the market changed away from a total focus on the value approach of Graham.

I also found this of great interest:

“Graham’s 1920’s bubble and Depression experiences had made him suspicious of earnings projections, so suspicious that while he paid lip service to this method of valuation in his teaching, he never used it himself in valuing stocks to buy for his firm.”

This is something I speak and write about often. Prediction is a black art that all of us are very bad at. Just think back to 2007 and the wild predictions of “stronger for longer” and much more.

To understand Buffett, we must understand Graham’s method, which was where Buffett began in his education as an investor. Schroeder provides a good summary of Graham’s method:

“If someone could buy a stock at a price which valued the company cheaper than its net worth, Graham said, eventually – a tricky word *eventually* – the stock’s price would rise to reflect this *intrinsic value*. (there is more description of what is involved in *The Snowball* on page 146) ... Complicating matters, however, was the issue of *eventually*. Stocks often traded at odds with their *intrinsic value* for long periods of time. ... That was why, as well as being a detective, you had to build in what Graham and Dodd called a *Margin of safety* – that is, plenty of room for error.”

“Graham used to talk about Class 1 and Class 2 truths. Class 1 truths were absolutes. Class 2 truths became truths by conviction. If enough people thought a company’s stock was worth X, it became worth X until enough people thought otherwise. Yet that did not affect the stock’s intrinsic value – which was a Class 1 truth. Thus, Graham’s investing method was not simply about buying stocks cheap. As much as anything it was rooted in an understanding of psychology, enabling its followers to keep their emotions from influencing their decision-making.”

“From Graham’s class, Warren took away three main principles that required nothing more than the stern discipline of mental independence:

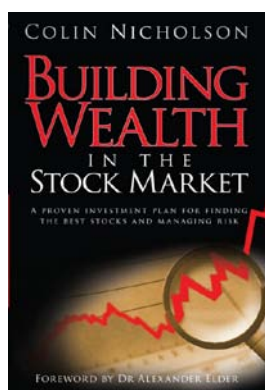
- *A stock is the right to own a little piece of a business.* A stock is worth a certain fraction of what you would be willing to pay for the whole business.
- *Use a margin of safety.* Investing is built on estimates and uncertainty. A wide margin of safety ensures that the effects of good decisions are not wiped out by errors. The way to advance, above all, is by not retreating.
- *Mr. Market is your servant, not your master.* Graham postulated a moody character called Mr. Market, who offers to buy and sell stocks every day, often at prices that

don't make sense. Mr. Market's moods should not influence *your* view of price. However, from time to time he does offer the chance to buy low and sell high."

"... the margin of safety was most important. ... Graham built his margin of safety in various ways. As well as buying things for considerably less than he thought they were worth, he never forgot the danger of using debt. ...his early experiences had scarred him and given him the habit of assuming the worst. ... He kept his firm small in part because he was so risk-averse. And he rarely bought more than a tiny position in any company's stock, no matter how sound the business. ... Warren ... disagreed with his teacher about the need to buy so many stocks."

Building Wealth in the Stock Market

My new book *Building Wealth in the Stock Market*, presented handsomely in a hardback format, is available for purchase directly from me postage free to Australian addresses.



Building Wealth in the Stock Market replaces *The Aggressive Investor*. Most of my basic method has not changed over many years. However, since I wrote *The Aggressive Investor*, I have refined a few things, notably how I view charts in the right time frame, my maximum risk per stock and my focus on an additional financial ratio. While these things are minor in some respects, they have improved what I do. In addition, I revised the way ideas were presented throughout the book. Of most significance, there are completely new and later case studies, plus examples that were not printed in the original book.

For a complete description of the book see <http://www.bwts.com.au/text.cfm?55>

I sign all copies of the book which are purchased directly from me.

Price: A\$65.00 including GST (Australia only). **Postage free to Australian addresses.** This price applies only to online orders and mail orders on a credit or debit card. Telephone orders and mail orders paid by cheque or money order attract a surcharge of \$5.00 for handling. On-line ordering on my secure website is perfectly safe and the cheapest way to buy the book from me.

Buffett at large in the markets

By 1962, Buffett's investment partnership had grown to \$7.2 million. By 1966 he was spelling out his investment philosophy for his partners:

Buffett: "We diversify substantially less than most investment operations. We might invest up to forty percent of our net worth in a single security under conditions coupling an extremely high probability that our facts and our reasoning are correct with a very low probability that anything could drastically change the underlying value of the investment."

"Warren had ventured far from the worldview of his mentor, Ben Graham. The hard-nosed "quantitative" approach espoused by Graham was the world of the speed handicapper, of the cigar-butt stooper who worked from pure statistics."

Now, Schroeder puts her finger on the reason that Buffett had departed from the pure Graham approach:

"As Buffett said of this, his favourite approach, *the more sure money tends to be made on the obvious quantitative decisions*. But the method had a couple of drawbacks. The number of statistical bargains had shrunk to virtually nil, and since cigar butts tended to be small companies, it did not work when large sums of money were involved."

So, here we have something important. Graham was a child of his time. Buffett began in his time, but the world changed after the stupendous post-war expansion. Added to this, Buffett had grown his partnership so much that Graham's world was now too small for his scale.

"Buffett had had what he would later call a "high-probability insight" about American Express [the company his partnership was then heavily exposed to] that confounded Ben Graham's core idea. Unlike companies whose value came from cash, equipment, real estate and other assets that could be calculated and if necessary liquidated, American Express had little more than its customers' goodwill. ...the competitive advantage that Charlie Munger had been talking about when he spoke of the *great businesses*. This was the method of the class handicapper, of Phil Fisher, and it involved qualitative, as opposed to quantitative, assessments."

Buffett: ... buying "the right company (with the right prospects, inherent industry conditions, management, etc.)" means "the price will take care of itself ... this is what causes the cash register to really sing. However, it is an infrequent occurrence, as insights usually are, and of course, no insight is required on the qualitative side – the figures should hit you over the head with a baseball bat. So the big money tends to be made by investors who are right on qualitative decisions."

Clearly, Buffett was no longer truly a value investor. He had embraced the ideas of the growth investment approach best described by Philip Fisher in *Common Stocks and Uncommon Profits*, which is a classic investment book still being reprinted today.

In doing this, Buffett had developed skills which are not shared by many investors. He totally understood what makes businesses work. He had joined and was to surpass the expert stock pickers that we would all wish to become.

Becoming an expert stock picker is not an easy thing to do. It requires enormous work and a great deal of thinking about the whole process. Most beginners in their first ten years complain that everything is so confusing. This is because they are just starting out and have not yet reached the point of consolidating in their minds a new and different way of looking at the world. It will take many years of consistent work, study and contemplation before breaking through to a view of the investment process that makes consistent sense and which they can apply with confidence. Nobody can just teach it to us, we have to actively learn. We remember what we are taught, but we do not understand it until we can operate with mastery – when we are so confident about what we need to do that we know it instinctively. As well, we can teach it – Buffett started out teaching his methods. Graham taught his methods most of his life. It is a wonderful discipline that requires a level of understanding far above simply knowing something.

Continuing themes

The first theme was that by 1966 Buffett experienced some turbulence in his investing which emerged because the market had changed since Buffett started out:

"But Hochschild-Kohn [department store] was the beginning of a pattern that would recur more than once in frothy markets: Buffett had lowered his standards to justify an investment. That he had done it at a time when he was having more and more trouble finding what he considered to be good investments in the stock market was no coincidence."

Munger: "We were enough influenced by the Graham ethos ... that we thought if you just got enough assets for your dollars, somehow you could make it work out. ...we didn't weigh heavily enough the intense competition between four different department stores in Baltimore at a time when department stores no longer had an automatic edge."

If this idea of falling for the temptation to relax standards of stock selection and risk management does not resonate strongly with readers, then they were not awake during the 2003-2007 bull market. I saw all around me people buying unsound businesses and totally overlooking the danger in debt at all levels. Buying poor businesses, that can only succeed on high levels of debt, with the investor also leveraged to the hilt, is always an accident waiting in the wings.

Of perhaps greater long term significance was the second theme of considering the strength of the business model as more important than the value of assets purchased. In time this became the prime way in which Buffett and Munger departed from the Graham model. This theme in Buffett's investing originated primarily for Munger, though we should see them as a like-minded pair which makes up one investing team.

A third theme, which comes along over and over again in the Buffett story, is that when he bought businesses, he looked to bring great managers with them. One of the first was Ben Rosner who ran Associated Retail Stores. This was the man who famously left a black tie function to count the sheets in a toilet roll because he suspected from a conversation that he was being cheated on his purchases. "Buffett felt as one with the Ben Rosners of the world – he saw in their relentlessness the spirit of success. ... He and Rosner shared a mutual obsession. As Buffett liked to put it, *Intensity is the price of excellence.*"

Another two themes that have had an enduring effect on the Buffett investment method also emerged at this time:

"...he laid out two new restrictions that would make it even harder for him to invest. ...

1. We will not go into businesses where technology which is way over my head is crucial to the investment decision. ...
2. [W]e will not seek out activity in investment operations, even if offering splendid profit expectations, where major human problems appear to have a substantial chance of developing."

"By *major human problems* he meant layoffs, plant closings – and union businesses that couldn't take a strike. This also meant he would think once, twice, three times, before smoking any more cigar butts."

The Buffett avoidance of technology was to become a major theme in the information technology and internet bubble of the 1990s to the extent where some pundits began suggesting that Buffett had lost his touch. Of course, Buffett had the last word on this subject in his long term investment record.

The focus on human problems came from several early investments in businesses that required what is euphemistically called *restructuring*. Buffett's focus on this is akin to the present focus of many people on ethical issues in investing and on a green bias in the climate debate.

Change of objective

In the late 1960s Buffett also had to deal with the way the market had changed and his investment capital had grown way larger. He made an important declaration to the members of his partnership:

“My own personal interests dictate a less compulsive approach to superior investment results than when I was younger and leaner... I am out of step with present market conditions. On one point, however, I am clear. I will not abandon a previous approach whose logic I understand (although I find it difficult to apply) even though it may mean forgoing large, and apparently easy, profits to embrace an approach which I don't fully understand, have not practiced successfully, and which, possibly, could lead to substantial and permanent loss of capital.”

In other words, he was easing back from the frenetic activity that had led to his superb returns in the past when he was younger, had less capital to invest and a great deal to prove to himself and the world.

However, at the same time, he was dedicated to sticking to what he knew and had proven worked well for him. He would not adapt to the wild conditions of the end of a long bull market by taking on riskier methods in which he did not believe. In this he was avoiding a mistake most new investors make in their first bull market. “Financial genius is a rising market” is a quotation from Kenneth Galbraith that is used at this point in the book to emphasise this issue that is pertinent to all first-time investors in a bull market.

“Buffett then stunned his partners by dropping his stated goal of beating the market by *ten* points a year to beating it by just *five* points a year – or earning nine percent, whichever was *less*.”

Here, Schroeder comments that “Beating the market by five points a year, compounded over any long-term period, would produce stupendous wealth. Even Ben Graham had beaten the market by just 2.5 percent a year. Buffett's revised goal of nine percent put a floor on their results that was still two percent or more better than owning an average bond. That consistency, year after year, *and not losing* money, would lead to a stunning result. Sticking with him, an average investor who took only a modicum of risk, could achieve these extraordinary returns, and do so *safely*.”

A little later, Schroeder again sums up what this change was all about:

“While he lowered his investing standards in difficult environments – and would do so again – one compromise he would never make was to give up his margin of safety. This particular quality – to pass up possible riches if he couldn't limit his risk – was what made him Warren Buffett.”

This is something which new and even experienced investors should read and re-read through the next bull market. Making great gains is of no account if much of it is yielded back to the market when the bull is replaced by the bear.

An important insight

“... since Buffett thought of a dollar today as the fifty or hundred dollars that it would become someday, it was as if he had lost many millions on Hochschild-Kohn because of the forgone opportunity to use the money more effectively. He drew a conclusion that he would later state as:

Time is the friend of the wonderful business, the enemy of the mediocre. You might think this principle is obvious, but I had to learn it the hard way... It's far better to buy a wonderful company at a fair price than a fair company at a wonderful price. Charlie [Munger] understood this early; I was a slow learner. But now, when buying companies or common stocks, we look for first-class businesses accompanied by first-class managements. That leads right into a related lesson: Good jockeys will do well on good horses but not on broken-down nags."

Some wisdom

Here are a few gems which are dropped along the way in *Snowball*:

"He helped her understand that it was always a mistake to pay too much for something you wanted. Impatience was the enemy."

I must remember that the next time a new investor remarks to me that psychology is not a factor in investing. It is, just as it is in the whole of life.

"He was always interested in what made sense rather than what had been done in the past."

This is very powerful the more we think about it. How often have you queried something and been told simply that it is what has always been done? Knowing that this is the wrong answer is a vital step to becoming a good investor. Yes, examine the past and understand it, but the key question is always to ask whether it is still a sensible approach to a problem.

"He taught me to think of a business as a whole..."

This comes straight out of Buffett's idea that when you buy a stock, you become a part owner of the company. We must not become so enmeshed in the different parts of the company that we lose sight of the whole. An owner is looking for a return based on the end result of the way all the parts have played their part. When looking at any part of the business, always relate it back to its relevance to the reason the whole company exists. Never, ever fall in love with some warm and cuddly part of a business that makes us feel good, but is so costly that the profit of the business is reduced. We may still want to see that aspect of the business continue, but it can only make sense if it makes a positive contribution to the whole. If the whole company fails, we lose that aspect of the business anyway.

This review and discussion of *The Snowball* will be continued and concluded in the next newsletter (No 91).

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