Analysis Methods – An Introduction

I would like to start with a key question. That question is "what is it that makes a great investor?" Now, in seeking an answer to this question, whom should we ask?

> *If I wanted to become a tramp I would seek information and advice from the most successful tramp I could find. If I wanted to become a failure I would seek advice from men who have never succeeded. If I wanted to succeed in all things, I would look around me for those who are succeeding and do as they have done. (Joseph Marshall Wade)*

So, if we are interested to know what it is that makes a great investor, who better to ask than the greatest investor of our time – Warren Buffett. For those who do not know, his record is roughly, a 20 - 25% compound return over 50 - odd years.

In the Preface to *The Intelligent Investor*, Buffett said this about his mentor Benjamin Graham's book:

> *To invest successfully over a lifetime does not require a stratospheric IQ, unusual business insights, or wide information. What's needed is a sound intellectual framework for making decisions and the ability to keep emotions from corroding that framework. This book precisely and clearly prescribes the proper framework. You must supply the emotional discipline.*

Whether you are an investor or a trader, I believe that, in this paragraph, Buffett has put his finger on the nub of the investment problem. However, what he leaves open at the end of it is where we find the all-important emotional discipline. Buffett himself returned to this subject at the 1993 Annual Meeting of Berkshire Hathaway:

> *Investing is not that complicated. …… You should read* The Intelligent Investor*. You need the right mindset, the right temperament. ……….. but don't do equations with Greek letters in them.*

The longer I am involved in investing for myself and in teaching others to invest, the more certain I am that Buffett is right here. It is the way we think about investing that determines our results, not how intricate and complicated we try to make it. In fact it is the simple "big ideas" that make the real difference. Buffett is widely quoted as saying this in his inimitable way:

> There are two kinds of information: *Those things you can know and those things important to know. Those things you can know that are important constitute an extremely small percentage of the total known.*

Many people I come across seem to think that if only they learn a bit more they will master the art of investing. They think it must be more complicated – don't experts and gurus always know complicated things that we do not understand? Well, the real nature of investing is the exact opposite to this. It is not how much we know, it is getting the simple things right, consistently. Buffett is typical of those who realise this and talk about simple ideas. Yet so many of his listeners just think he is hiding what he really does. He put it this way in an article in *New York Times Magazine*, April 1990, when talking about his beloved "value investing":

> *The fact that it (value investing) is so simple makes people reluctant to teach it. If you've gotten a Ph.D. and spent years learning how to do all kinds of tough things mathematically, to have to come back to this is like studying for the priesthood and finding out that the Ten Commandments were all you needed.*

As a teacher of technical and fundamental analysis, I know a lot of things. I can teach them all to you, if you have enough time. However, I only use a few of them myself. Slowly, over time, I have worked out what I need and what is just another way of doing the same thing, or does not add any value to the basic things.

The same applies to investment and trading. I have read and learned so many things over the years. Most of them make very little difference to my results. However, there are a few things that make all the difference. If I get them wrong, it does not matter how much peripheral stuff I get right, I will not achieve my goals.

In this series of thee articles, I am going to take you through some of the really important ideas. There are a lot of things we will not discuss. Most of them are intensely interesting, but do not make much difference to results. What I will take you through is the framework that I use to make investment decisions in three areas:

- Selecting stocks
- When to buy them
- When to sell them

Now, there is more to investing than this, mostly to do with the way we manage risk, but this is outside what I have chosen to talk about.

Where Do Profits Come From?

If we are going to be successful investors, we must have a very clear idea of how we can make money from investing. Another way of saying this is that we must have some “edge” or advantage over other investors, or at least most of them.

Warren Buffett is a keen card player. He uses an analogy from poker to make this point. Suppose you join a poker game. Buffett says that if, after playing for half an hour, you do not know who is the “patsy” (the player who loses to all the other players), then it is you.

So, if you do not understand how you are going to make money from investing, then it is very likely that you will be one of those who line the pockets of brokers and other investors who know what they are about.

The first important thing to know is that profits are made from investing by assuming, or taking on, risk. Profits are the result of successfully assuming risk. Losses are the result of unsuccessfully assuming risk. If we do not understand the risks, or if we assume too much risk, then losses are more likely to result than profits.

The idea that profits come from the assumption of risk is very basic. There is no such thing as a good investment that does not involve risk. If an investment is a certainty, then unless you know something nobody else knows, which is highly unlikely, then the investment will already be priced correctly in the market and there is no opportunity for profit.

Flowing from this idea, that profits come from assuming risk, is the important point that all investment involves both profits and losses at different times. Nobody has ever been able to only make winning investments. Everyone makes some judgements that are wrong. To expect that you will, or even could have, a perfect record is only setting yourself up to fail through unreal expectations.

The implication from this is that the only realistic expectation is that our results will vary over time and will be the sum of many investments, some of which were successful and some of which were not. The only way to measure investment performance is to take the net result of all investments in a period in total. The number of good investments relative to the number of bad investments in a period is totally irrelevant. The good investor will have made more profits from the total of successful investments than from the total of bad investments.

The second important thing to know is that it is impossible to predict the future consistently. Actually, very few people really believe that it is impossible to predict the future consistently. Most have at least a sneaking suspicion that there are some experts or gurus out there who can predict the future most of the time. However, most successful investors do not rely on the ability to predict what is going to happen.

Indeed, the value approach, pioneered by Benjamin Graham and practiced by Warren Buffett and many others, specifically starts from the idea that it is not possible to consistently predict the future for any company or for the economy as a whole. Despite this limitation, it remains one of the most successful ways to invest.

The third important thing to know is that there are only two broad investment philosophies within which we can classify almost all successful investors. These are generally called the "value" method and the "growth" method. There are endless arguments in the investment community over which is the best method. I try to avoid what is surely a futile argument and one that will never be resolved absolutely.

The truth is that both are successful over time for those who are expert in their use. One might give better results for a time, but the balance inevitably swings to the other for another period. My advice is to use the one that suits your inherent temperament and stick with it consistently. Either that, or use both, perhaps with greater emphasis on whichever one seems to best suit the current market conditions.

The Value Method

The value method derives from the ideas of Benjamin Graham. His most accessible book is *The Intelligent Investor*. The reasoning on which this rests is that, since we cannot hope to predict the future consistently, our best course is to seek out companies that have shown consistently sound results over a significant period and which can be purchased cheaply in the market.

This idea that they should only be purchased when they are relatively cheap rests on Graham's key investment idea – the "margin of safety". What this means essentially is that even if we are wrong about the company by a large factor, or it runs into trouble for a while, the odds are strongly in our favour.

The Growth Method

The growth method is probably best exemplified in the ideas of Philip Fisher in his book *Common Stocks and Uncommon Profits*. The reasoning on which it rests is that there are some truly outstanding companies. These outstanding companies will do far better than the market will do on average. In order to achieve outstanding results, we should seek out these companies and concentrate our investments on them.

Fisher's method was based on extensive research to find and monitor these outstanding companies. He identified industries where he would be likely to find these companies, often related broadly to what we now call "technology". He then searched out the best companies in those industries.

It should be stressed that Graham was not against buying outstanding companies. Buffett has also made his name buying some of them. However, where the value crowd differ is that they will only buy such companies on the rare occasions when they may be purchased cheaply in the market.

The Common Elements in Both Methods

The interesting thing is just how much there is in common between the two methods. Indeed, they are best seen as the two extremes of a continuum. There is considerable middle ground, where both approaches might lead their adherents to buy the same companies at around the same time. After all, both might readily agree that the ideal is to buy outstanding companies cheaply.

Where they diverge is that the value adherents will not pay too much even for an outstanding company. Thus they aim always to buy low and sell high. The growth adherents, on the other hand, are ready to buy outstanding companies at anything short of ridiculous prices. They aim to buy high and sell higher.

What I have found is that both methods require attention to basic fundamental analysis. We must know what it is we are buying. While it is possible to rely only on fundamental analysis, I have found that, while it is strong on which stocks to buy, it is weak on timing and suffers from reliance on information.

So, I have learned from experience that both methods are enhanced by also employing technical analysis. Technical analysis tells us little about what we are buying, but it does tell us a lot about timing and can alert us when the market knows something that is not yet generally known or is taking a view about available information that differs from our own.

What I am going to show you in this and the next two articles is how both methods are stronger when used together than reliance on only one of them, as most people do. If you come here primarily as a fundamental analyst, I hope to show you how technical analysis can add value to your primary method. If you come here primarily as a technical analyst, I also hope to show you how fundamental analysis can add value to your primary method.