Investment Wisdom from *The Super Analysts*

While travelling overseas I have read the book *The Super Analysts* by Andrew Leeming. It is a series of interviews with some of highly rated sell side and buy side analysts around the world at the time (2000). While much of the content of the interviews concerned their specific jobs, Leeming also asked the analysts for their thoughts on investing in general and some of his questions elicited advice for private investors and what they do compared to professional investors. On the way through the book, I flagged some of these thoughts and have discussed them below.

Be a sceptic

This advice came from several analysts. Stuart Baker (Australian oil analyst) advised to "treat them all as liars and crooks until proven otherwise". In the context of a sell side analyst, this is sage advice, even if it is expressed in rather strong terms. However, my experience is that many private investors have a strong tendency to believe that everything the management of a company says is the whole truth of a situation, when that is unlikely to be the case.

The longer I spend in the markets, the more sceptical I have become about company announcements, especially of the negative variety. In particular, I have learned that the first advice of bad news is rarely the last. This may not be outright dishonesty as Baker suggests in the quotation. However, companies have a strong tendency to only disclose the minimum of bad news and to try to throw the best light on it that they can. They also tend to give the impression and perhaps believe that they have more control over a situation that they actually have. My natural reaction now is that more bad news is likely to follow rather than that all of the bad news has been announced initially.

This is where being a technical analyst is very useful. If there is more bad news coming, its shadow will tend to be cast on the share price. So, if the company says that there has been a problem, but that it is now all behind it, look at the direction in which the share price is moving. If the price is still falling, it is safe to assume there are more confessions to be made.

Mistakes

Many of the analysts talked about mistakes. Universally, they stressed that there was nothing wrong with making mistakes. Everyone makes mistakes. What they stressed was wrong about mistakes was not learning from them. In fact many of the analysts made the same point: that we tend to learn more from our mistakes than from our successes. Indeed, many pointed out that investors can frequently be wrong for the right reasons, if that makes sense. I think what they are saying is that it is very difficult to predict what will happen. Our analysis of the known information can be very good, yet what we expect does not come to pass, perhaps because the situation changes from that which prevailed when we made our analysis.

What also comes out of this is that it is the way we manage our mistakes that is important. We should expect that, at best, only about half of our investments will be successful and the key is not to lose too much by taking firm and early action when what we expect does not come to pass on an investment.

Talent

Many of the analysts put a great deal of stress on their view that much of their success as analysts and/or investors came from their hard work rather than any special talent they had.

That said, a view expressed by some analysts was that the great investors do tend to have a rare talent or at least a rare mindset that makes them great. However, this is a view about the great investors; the very few in any field that tend to have something special. One analyst said they were "hardwired" to be great investors.

Nevertheless, putting the greats aside, there are a large number of good investors who succeed because they work very hard at honing their skills and putting in prodigious hours over a long period to achieve their results. I guess the main point is that consistent investing success is not luck. Luck might give a scattering of big wins, but without consistent hard work, the losses will far outweigh the few lucky winners.

Management

One of the constants in the comments by analysts was the overriding importance of the quality of the management of the companies in which we invest. Most of the analysts put a very high priority on getting to know management and understanding their strengths and weaknesses. This is difficult for private investors, who do not have the same access to managements that is available to the best analysts.

However, the one important clue to the quality of management for private investors is their track record. Have they managed the business well over a long period? Critically, how well have they managed change in their industry and markets? Look beyond the leader to the strength and depth of their management team and the culture of the firm.

Of great importance is to look at the discipline of management in expanding the business by the acquisition of competitors. Are they building an empire at the expense of the return to investors?

A particular danger is ill-advised expansion into new activities that destroy shareholder wealth. Watch out also for over-reach into new markets dominated by entrenched competition.

Some key ideas are to invest in companies that are in businesses where the people can make a difference in terms of results and where the culture is conducive to the necessary teamwork. Above all, avoid companies and managements that have a reputation for arrogance because sooner or later they will blunder and not have the personality traits that can recognise the danger and take corrective action. Pride usually precedes a fall from grace in management.

Lise Buyer (US internet analyst) asks the four key questions in assessing a company:

1. How big is their market?
2. Does the company have a proprietary or sustainable advantage?
3. Why is this company the one to capitalise on it?
4. Who are the people running the company and can they make it happen?

Time frame

Time and again, analysts commented that private investors took a view that was far too short-term. Their advice was to focus on a five-year view unless the company strategy had clearly failed. The mindset required should be that of getting rich slowly. However, while buy-and-hold is a great strategy, no stock is a 'forever' stock.

In this respect, sell side analysts were more at fault than buy side analysts who tended to give managements time to allow their strategy to pay off. This may be in part because of the pressure to come up with deal-flow, which is where the money is for sell side analysts' firms.

The key that was emphasised repeatedly was to buy good companies with good managements in healthy industries when they were cheap and then hold with enough patience to allow their strategy to work or for the cycle to turn in their favour.

A key question is whether, if you had unlimited resources, would you be happy to buy the whole company? If not, why would you buy a part of it? In particular, ask whether the business is attractive in an absolute sense, rather than just being the best of a poor lot. There are many industries that we do not have to own a part.

In this regard, some of the buy side analysts stressed the importance of the size of the exposure to each investment being even more important than which investments they were. The two great sins were to have too large an exposure to a business that failed to perform and too small an exposure to a business that does really well. In other words, it is not so much which companies we buy, but whether the size of our exposure to them is well balanced.

Common sense, scepticism and cynicism

Again and again, analysts that were interviewed stressed the importance of common sense, which is of course not really that common in investing because of the stresses all investors are under. Scepticism is part of this. Question everything. However, while being a contrarian investor can be good some of the time in what are often special situations, being contrarian all the time is probably a recipe for failure because most of the time the crowd will generally be right. The main warning was against cynicism. A cynic knows the price of everything, but the value of nothing, which is another view of the idea that price is what you pay but value is what you get.

Trading verses investing

One of the more interesting definitions in the book was the difference between trading and investing. Lise Buyer saw trading as being all about reacting when you have no news, which is the opposite of investing that requires patience, commitment and courage.

Change

Change is both a challenge and an opportunity. Companies that fail to meet a challenge are to be avoided. However, when a company can manage change well, the opportunities for investment returns are very great. In this respect, Tim Jensen (US portfolio manager) highlighted that the perception of a company can change over time, often when new management is brought in or an existing management identifies change and takes great advantage of it.

However, it is important to recognise that change and/or growth have a cost in terms of debt or equity. Growth, where the cost of making it happen is too high, is not a good scenario for investors.

Tim Jensen, who had a focus on change situations, was often looking at out-of-favour stocks, seeking the big turnaround story. However, this is high risk. The way he manages this is to look to be able to identify three or four different potential factors in play that could work in the favour of the company concerned. He described these as catalysts that could move the share price in the favour of the investor. They may be internal to the business or external to it in the market or the economy.

Above all, when hunting for change situations, be flexible and keep an open mind. If the facts change, be prepared to reconsider the whole situation. Again, recognise that stock prices are driven by perceptions as much as by facts. If perceptions change and prices fall, facts may not save you and may in fact turn out not to be as solid as you thought. Against that, if perceptions become unrealistically negative, look for great opportunities if and when perceptions reverse from very strongly negative to strongly positive.

Information and certainty

Several of the analysts made mention of the idea that private investors tend to assume that the professionals have a great advantage because they have all the information. It is true that professionals tend to have a little more information and better access to management. However, regulators do try to keep the information playing field fair and technology has also acted to reduce the advantage to professionals in this regard.

The analysts in the book made great stress that they never have complete information. Nor does the market ever have complete or perfect information. This suggests that they are sceptical about the efficient market hypothesis, at least to extent that they can add value to the investing process by research and their insights.

This leads to their warning to be wary of brokers or advisers who are absolutely certain about the prospects of a company and who do not entertain alternative scenarios. The test suggested by one analyst in this situation was to ask such a broker or adviser if they can identify three key issues or events that could change or alter their judgement.

Beating the market

A number of analysts made the point that in order to beat the other professionals or to beat the market we must do something different. If we buy the same stocks as everyone else, our results will be the same, so to beat them, we must do something different. This may be different stocks, different weightings in our portfolio or different timing, to name just three strategy elements.

In particular, Murdoch Murchison (US global mining analyst) stressed the point that indices contain many companies that you would not want to own, so index investing was not the way to beat the market. In particular, he pointed out that many of the biggest stocks of today that dominate the index are likely to be the dinosaurs of tomorrow in investing terms.

Behavioural finance

I found the interview with Michael Mouboussin (US investment strategist) the most difficult to understand. Perhaps it is me that is way below the plane on which he thinks, but every other analyst was talking at my level. It was not until Andrew Leeming summarised some of his ideas at the end of the chapter (that did not seem to have been discussed much in the published interview) that I was at his level or on his wavelength. I have read Michael's work in one of his books and it was great, so perhaps this interview just did not work for me. Below are the five key investment points that Andrew Leeming drew out of it that are all based on behavioural finance ideas:

1. Don't irrationally escalate commitment to an initial course of action: As sunk costs are irrelevant, your reference point should be the present. Consider only future costs and benefits.
2. Don't anchor judgements on irrelevant information, including historical prices or multiples: The past is only a guide; change on the margin is critical.
3. Don't be overconfident: Try not to overestimate your abilities. Weigh all potential outcomes with probabilities. Carefully consider both sides of any investment case.
4. Don't be overly influenced by how information is presented: How a situation is framed can alter the choice. Be objective in weighing risk and reward.
5. Don't fall into the confirmation trap: Try not to seek confirming information at the expense of non-confirming evidence. Be honest and objective.

Trends

Understand that there are trends (bull and bear markets) in markets and the fortunes of companies. When investing in cyclical stocks timing is most important. Do not be afraid to buy when pessimism is at its worst or to sell when optimism is rampant.

This is something that I have explicitly incorporated into my investment plan for value model stocks. I do not plan to ever buy at the bottom or sell at the top. Instead, my aim is to take a large chunk out of the uptrend – hopefully 70 – 80%. The two hardest things I notice for most beginners to manage are:

1. Buying into a rising trend. They tend to think they are too late and fear buying at the top. Instead they buy the laggards and allow the strong stocks to soar upward without them.

2. Giving back significant paper gains after the top has been made. They typically wait for a retest of the top which never happens and they end up riding it down and down and down.

The sixteen rules

Twice in the book reference was made to Sir John Templeton's *Sixteen Rules of Investment Success*. For me to reproduce his whole paper here would be an abuse of copyright. These are his sixteen rules:

1. Invest for maximum total real return
2. Invest – don't trade or speculate
3. Remain flexible and open-minded about types of investment
4. Buy low
5. When buying stocks, search for bargains among quality stocks
6. Buy value, not market trends or the economic outlook
7. Diversify, in stock or bonds, as in much else, there is safety in numbers
8. Do your homework or hire wise experts to help you
9. Aggressively monitor your investments

10. Don’t panic
11. Learn from mistakes
12. Begin with a prayer
13. Outperforming the market is a difficult task
14. An investor who has all the answers does not even understand all the questions
15. There’s no free lunch
16. Do not be fearful or negative too often

This is just the list of his rules. The real value is in his explanations. His paper is available on the internet at https://www.franklintempleton.com/retail/pdf/home/splash_PUB/TL_R16_1207.pdf

I have downloaded the paper and made a recurring entry in my diary to read it again every month until I know it backwards. I suggest that readers do the same.

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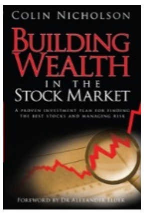

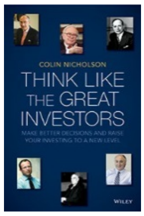

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