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## TEN LESSONS FOR INVESTORS

While the investment stories examined in this book reflect very different investment philosophies and are designed for a wide range of investors, there are some lessons that can be drawn by looking across the stories. In this chapter, you will see a number of propositions about investing that apply across investment strategies. Hopefully, these broad propositions about investing will stand you in good stead when you are subjected to the next big investment story by an over eager sales person.

### **Lesson 1: The more things change, the more they stay the same**

Each of the investment stories listed in this book has been around for as long as there have been financial markets. Notwithstanding this reality, investment advisors rediscover these stories at regular intervals and present them as their own. To provide a façade of novelty, they often give these stories new and fancy names (preferably Greek). Calling a strategy of buying low PE stocks the Omega or the Alpha strategy seems to do wonders for its curb appeal to investors. In addition, as more and more data on stocks becomes available to investors, some have become more creative in how they use this data to find stocks. In fact, the ease with which you can screen stocks for multiple criteria – low PE, high growth and momentum – has allowed some to create composite screens that they can then label as unique.

*Proposition 1: Be wary of complex investment strategies with fancy names that claim to be new and different.*

### **Lesson 2: If you want guarantees, don't invest in stocks**

No matter what the proponents of an investment strategy tell you, there are no stock strategies that can offer guaranteed success. Stocks are volatile and are driven by hundreds of different variables, some related to the overall economy and some arising as a result of information that has come out about the firm. Even the most elaborate and best planned strategies for making money in stocks can be derailed by unexpected events.

*Proposition 2: The only predictable thing about stocks is their unpredictability.*

### **Lesson 3: No pain, no gain**

It is perhaps the oldest lesson in investments that you cannot expect to earn high returns without taking risk, but it is a lesson that is often ignored. Every investment strategy exposes you to risk, and a high return strategy cannot be low risk. If you are an investor

who is uncomfortable with large risk exposures, you should avoid any high risk strategy, no matter how promising it looks on paper. Why are some investors so willing to delude themselves into thinking that they can earn high returns without taking much risk? One reason may be that the risk in some strategies is hidden and shows up sporadically. These strategies succeed most of the time and deliver solid and modest returns when they do, but create large losses when they fail.

*Proposition 3: If you cannot see the risk in a high returns strategy, you just have not looked hard enough.*

#### **Lesson 4: Remember the fundamentals**

The value of a business has always been a function of its capacity to generate cashflows from its assets, to grow these cashflow over time and the uncertainty associated with these cashflows. In every bull market, investors forget the fundamentals that determine value – cashflows, expected growth and risk – and look for new paradigms to explain why stocks are priced they way they are. This was the case in the technology boom of the late 1990s. Faced with stratospheric prices for new economy companies that could not be explained by conventional approaches, investors turned to dubious models, where growth in revenues substituted for earnings and cashflows did not matter. In the aftermath of every bull market, investors discover the truth that the fundamentals do matter and that companies have to earn money and grow these earnings to be valuable.

*Proposition 4: Ignore fundamentals at your own peril.*

#### **Lesson 5: Most stocks that look cheap are cheap for a reason**

In every investment story in this book, there is a group of companies that are identified as cheap. Early in this book, for instance, companies were categorized as cheap because they traded at low multiples of earnings or below book value. At the risk of sounding like professional naysayers, it should be noted that most of these companies only looked cheap. There was generally at least one good reason, and in many cases more than one, why these stocks traded at low prices. You saw, for instance, that many stocks that traded at below book value did so because of their poor earning power and high risk and that stocks that traded at low PE ratios did so because of anemic growth prospects.

*Proposition 5: Cheap companies are not always good bargains.*

#### **Lesson 6: Everything has a price**

Investors are constantly on the look out for characteristics that they believe make the companies they invest in special – superior management, brand name, high earnings growth

and a great product all come to mind. Without contesting the fact that these are good characteristics for a firm to possess, you have to still recognize that markets generally do a good job of pricing in these advantages. Companies with powerful brand names trade at high multiples of earnings, as do companies with higher expected growth. Thus, the question that you have to answer as an investor is not whether having a strong brand name makes your company more valuable, but whether the price attached to the brand name by the market is too high or too low.

*Proposition 6: Good companies may not be good investments.*

### **Lesson 7: Numbers can be deceptive**

For those investors who are tired of anecdotal evidence and investment stories, numbers offer comfort because they provide the illusion of objectivity. A study that shows that stocks with high dividends would have earned you 4% more than the market over the last five years is given more weight than a story about how much money you could have made investing in one stock five years ago. While it is sensible to test strategies using large amounts of data over long periods, a couple of caveats are in order:

- Studies, no matter how detailed and long term, generate probabilistic rather than certain conclusions. For instance, you may conclude after looking at high dividend paying stocks over the last five years that there is a 90% probability that high dividend stocks generate higher returns than low dividend stocks, but you will not be able to guarantee this outcome.
- Every study also suffers from the problem that markets change over time. No two periods are exactly identical and it is possible that the next period may deliver surprises that you have never seen before and that these surprises can cause time-tested strategies to fall apart.

*Proposition 7: Numbers can lie.*

### **Lesson 8: Respect the market**

Every investment strategy is a bet against the market. You are not only making a wager that you are right and the market is wrong but that the market will see the error of its ways and come around to your way of thinking. Consider, for instance, a strategy of buying stocks that trade at less than book value. You believe that these stocks are undervalued and that the market is making a mistake in pricing these stocks. To make money, not only do you have to be right about this underlying belief but markets have to see and correct their mistakes. In the process, the prices of these stocks will be pushed up and you as an investor will make money.

While you may be justified in your views about market mistakes, it is prudent to begin with a healthy respect for markets. While markets do make large mistakes in pricing stocks and these mistakes draw attention (usually after the fact), they do an extraordinary job for the most part in bringing together investors with diverse views and information about stocks and arriving at consensus prices. When you do uncover what looks like a market mispricing and an investment opportunity, you should begin with the presumption that the market price is right and that you have missed some critical component in your analysis. It is only after you have rejected all of the possible alternative explanations for the mispricing that you should consider trying to take advantage of the mispricing.

*Proposition 8: Markets are more often right than wrong.*

### **Lesson 9: Know yourself**

No investment strategy, no matter how well thought out and designed it is, will work for you as an investor, if it is not match your preferences and characteristics. A strategy of buying stocks that pay high and sustainable dividends may be a wonderful strategy for risk averse investors with long time horizons who do not pay much in taxes but not for investors with shorter time horizons who pay high taxes. Before you decide to adopt any investment strategy, you should consider whether it is the right strategy for you. Once you adopt it, you should pass it through two tests:

- a. *The acid test:* If you constantly worry about your portfolio and its movements keep you awake at nights, you should consider it a signal that the strategy that you just adopted is too risky for you.
- b. *The patience test:* Many investment strategies are marketed as long term strategies. If you adopt one of these strategies but you find yourself frequently second guessing yourself and fine tuning your portfolio, your just may be too impatient to carry this strategy to fruition.

In the long term, not much that is good –either physically or financially – comes out of these mismatches.

*Proposition 9: There is no one best investment strategy that fits all investors.*

### **Lesson 10: Luck overwhelms skill (at least in the short term)**

The most depressing lesson of financial markets is that virtues such as hard work, patience and preparation do not always get rewarded. In the final analysis, whether you make money or not on your portfolio is only partially under your control and luck can play a dominant role. The most successful portfolio managers of last year, all too often, are not the ones with the best investment strategies but those who (by chance) happened to be at the

right place at the right time. It is true that the longer you invest, the more likely it is that luck will start to even out and that your true skills will show through; the most successful portfolio managers of the last 10 years are less likely to get there because they were lucky.

As an investor, you should take both success and failure with a grain of salt. Neither is a reflection of your prowess or lack thereof as an investor or the quality of your underlying investment strategy. While you may not be able to manufacture good luck, you should be ready to take advantage of it when it presents itself.

*Proposition 10: It pays to be lucky.*

## **Conclusion**

Beating the market is neither easy nor painless. In financial markets, human beings, with all their frailties, collect and process information and make their best judgments on what assets are worth. Not surprisingly, they make mistakes and even those who believe that markets are efficient will concede this reality. The open question, though, is whether you can take advantage of these mistakes and do better than the average investor. You can but only if you do your homework, assess the weaknesses of your investment strategies and attempt to protect yourself against them. If you have a short time horizon, you will also need luck as an ally.