



Worth Noting

Volume III, Issue XXVI, 17 December 2003

Worth Noting is the fortnightly management journal of research and conferences company L21. It is focused on management strategy issues of relevance to senior executives.

World stock markets seem to be finally on an uptrend. Data from the U.S. is increasingly positive, Western Europe appears to have stabilised and the Australian market edges from strength to strength. Moreover, there is nothing like the capture of Saddam to give the market a shot in the arm. (Imagine what would happen if they caught Bin Laden before Christmas!)

In *Worth Noting, Volume III, Issue X* (30 April, 2003), we gave some anecdotes about how spectacularly wrong pack mentality can be from the book *Memoirs of Extraordinary Popular Delusions and the Madness of Crowds* by Charles Mackay – a favourite book among investors such as Warren Buffet and Bernard Baruch.

In this final edition of *Worth Noting* for 2003, we look at common pieces of wisdom from some of the most successful stock market investors over the past century: Bernard Baruch, John Maynard Keynes, Benjamin Graham, George Soros, Warren Buffet and Jacob Rothschild. There are many books written on how to achieve success in the stock market. Our intention here is not to add yet another one to the pile. What we intend to do here is simply look at the common simple axioms these investors propounded. We think this is worthwhile because in doing so, it is a useful reminder that there are several axioms that never change over time.

Of course, some of the axioms below will seem so obvious as to be banal. Remember, however, that as obvious as they are, the vast, vast majority of investors – both amateur and professional – ignore them most of the time. The distinguishing factor between the average investor and the truly successful investor is that the latter systematically and with unwavering discipline implement these axioms when they invest. They are therefore worth noting and worth remembering.

Stock markets indices will increase over time because they represent the trend of increase economic production and wealth over the long term.

However, whilst stock markets have gone up, the vast majority of investors have under-perform the relevant indices average. Moreover, the great investors have far outperform the indices average over a sustained period of time. This proves that investing in stock markets cannot just be about luck. Indeed, believing that investing success is a matter of luck is probably one of the worse attitudes we can have according to the master investors.

Some investors have particular methods and techniques they use. However, we are more concerned with the general axioms that are common to ALL of them.

Principle 1: Don't Listen to the Crowd

The crowd is generally right in the short-term because they define what happens in the short-term. But that is usually the only time they are right.

Seemingly logical behaviour is almost certain to be wrong behaviour in the long term. If this sounds unnecessarily contrary or cynical, consider the fact that the vast majority of 'experts' consistently perform below the average. Bear in mind also that top fund managers who outperform the market average by 2-4% are seen as outstanding yet hardly any sustain the 2-4% record more than two years running.

The overwhelming majority of tips never come true. If they do come true, it is likely to be for unrelated reasons or that the information behind the tip was illegally offered.

As a matter of historical fact, common bullish perceptions of a stock are at its most optimistic when the stock has already reached what is to be its highest price.

When opinion on a stock seems unanimous, this is the danger time and almost certainly the time to do the opposite.

In particular, do not listen to analysts that engage excessively in the latest market speak and are overly aware of the latest trends and exciting companies. Appearing as the market intelligentsia, these are the people most susceptible to crowd behaviour. (A common remark made by the best investors is that they try to avoid conversations with 'Wall Street' analysts before buying or selling a stock.)

Principle 2: Practice Sound Buying and Selling Strategies

Fear and greed are the two major motivating factors behind buying and selling in the stock market – the influence of both exacerbated by the inherent uncertainty in markets. Try not to exhibit either one.

If you ever plan to buy a stock, always know at what price you will sell it beforehand. If you're not sure, it is always better not to buy in the first place.

It is psychologically easier to buy a stock than to sell a stock. Do not fall into this mentality - it is irrational and almost certainly leads to losses.

After a stock has gone through a long period of price accumulation, then suddenly becomes stronger on dramatically heavier volume, it is almost certainly time to sell.

Never buy stocks with money you need to live or maintain a lifestyle. You cannot possibly make the right decisions under those conditions.

Never, ever be sentimental about a stock or the company.

Avoid holding post-mortem examinations on the 'might have beens' in your portfolio. This is a waste of energy, time and is likely to contribute to an unhelpful mentality.

Retreat from the chatter of the marketplace periodically to make your own judgments and decisions based on facts you can gleam.

Analyse your mistakes and relate them to a general principle of investing. Do not dwell on them beyond that.

Do not sell what you believe to be a good stock in order to free up money to buy what you believe to be a better one.

If you do not understand the business of a company, do not buy the stock.

Try not to be too concerned with stock market fluctuations. Concentrate on the inherent strengths and weaknesses of the business you bought stock in.

Principle 3: Stick to a Firm Portfolio Strategy

Diversification is one thing but it is generally better to have stock in a smaller number of companies that you monitor than a large, diversified number of them that makes monitoring difficult. (All the best investors make it a deliberate policy to never own stocks in dozens of companies at the one time.)

Never invest all your funds. Always have cash as part of your portfolio to jump in when opportunities arise.

Do not be a hyperactive investor. Constantly fiddling with a portfolio or being overstimulated by dozens of ideas and companies is a bad strategy. (For example, in the last two decade, 90% of Buffett's gains have come from 10 stocks he took a strong position in and held for a long time.)

The key in a successful portfolio is not to make substantial losses. (For example, five good years can be wiped out by one bad one.)

In building a portfolio, think conceptually about the world: what society needs materially, where the world is heading etc. Then build a portfolio with companies heading in the same direction.

Principle 4: Take Investing Seriously

Successful investing takes time and effort. The ones who lose most of the time are the intellectual dilettantes. These are generally intelligent, well educated people who dabble in the market and are the most susceptible to the latest trend or fad. They are also the first ones to panic.

These principles and axioms sound obvious don't they? Even so, we would challenge you to think about the last time you lost a significant amount of money on the stock market and consider whether one or several of these axioms could be applied.