Intelligent Investor's 20 Lessons from 20 Years

SPECIAL REPORT | MARCH 2018

Intelligent Investor's 20 Lessons from 20 Years

Twenty years ago, John Addis hung out his shingle and launched *Intelligent Investor*. It's been an amazing ride even if it hasn't turned out quite how he expected. Here are the top twenty lessons he's learned along the way.

JOHN ADDIS • FOUNDER, *INTELLIGENT INVESTOR*

Even after 35 years, recalling how Tracey Thorn and Ben Watt recorded ***Eden*** at the age of 21 makes me uncomfortable. After overdosing on punk and prog rock, Eden was my first introduction to minor chords and a jazz sensibility. It hit me square in the heart.

In their student years, Thorn and Watt got firsts in English and a hit album of languid, easy beauty. I got a 2:2 in Economics and a beer gut.

Modest redemption from the sense of falling short before life had really begun didn't arrive until 2013. Whilst reading a story on Thorn in the *London Review of Books*, she spoke of the 'apparent gap between the actual sound of the music we made and our intentions in making it'.

The last 20 years of *Intelligent Investor* have felt a bit like that. Finally, Thorn and I had something in common.

When the first hard copy issue – mmm, printed matter – arrived at the office it did not read or look as I had imagined. The third issue was worse. Somehow, the printer had mistakenly used pink ink rather than orange, making the newsletter look like something from Jane McGrath day at the Sydney Test.

At the office things were no better. Our staff numbered among them an office manager that wanted to raise her desk so she could look down on everyone, a coke fiend and a TV journalist that demanded a $50,000 'signing on fee', oddly mistaking us for Manchester United. We sacked him within his probation period but still he tried to sue us.

We make plans but end up wrestling with chaos, spinning dreams from barbed wire and fraying rope, holding on anywhere we can find a grip. That's what Robert Carey and I did anyway.

It is no exaggeration to say that I have spent much of the last two decades trying to bridge the gap between what we imagined *Intelligent Investor* would be and the reality of what it was.

We survived the chaos of those early years, just. Members past and present can judge for themselves whether we succeeded. It is certainly not Eden, but perhaps it is something. And we outlasted Enron.

Experience is the best kind of education. And so, to mark the 20th anniversary of setting out with the aim of writing interesting, profitable research on Australian listed stocks, I'm going to try and distil the last 20 years into 20 lessons.

Everyone starts life ignorant in almost every respect. Losing money is therefore an inherent part of growing up. In investing the growing never stops. No matter how long you've been doing it one thing is certain: if you're doing it right, you will lose money from time to time.

Our aim should be to reduce our losses, not eliminate them entirely. If you really want to do that, well, let me show you a term deposit and a yield half that of what you want. Or an index fund, where individual stocks losses will be buried in an average return.

If you want the far better long-term performances of shares over cash you simply have to invest. And that means making mistakes. As proof, let me offer up the history of *Intelligent Investor* and our most recent mistake, GBST.

Chart 1: Riding the GBST slide

Source: Intelligent Investor

We first recommended GBST in **March 2015** at a price of $5.75, recognising a loss of 67% two and a half years later in **August, 2017**. This harmed our portfolio performance – GBST featured in our **Equity Income** and **Equity Growth** portfolios – but we've so far managed to outperform the market in any case. All losses hurt; but in the end it's the averages that matter.

Remember, too, that you can only lose 100% of your investment (if you avoid leverage) but make many times that. This simple fact helps a lot. So, you will be wrong. Don't beat yourself up about it. **Learn the lessons** and move on.

Whilst it's fine to lose some money, it's never okay to lose all of it. Never take a bet big enough to take you out of the game. The reason is obvious: you can't recover from a mistake if you have nothing left to invest. In market parlance, this is called 'blowing yourself up'.

There's a whole host of advantages to simply hanging around, investing in stocks. First, the more time you spend investing the better you're likely to get at it (note the caveat at lesson five). Second, the more economic cycles you live through the more opportunities will come your way. And, finally, the longer you invest, the greater the impact of compounding on your portfolio. Making a mistake that takes you out of the game denies you these advantages.

The solution is to constantly address the possibility that you might be wrong. Humans are overconfident creatures, especially the male of the species. And once we've made a decision we become even more confident about its good sense. We need to control these risks.

The best way to fight overconfidence is to incorporate strategies that recognise you might be wrong. This means diversifying your wealth, not just around stocks but asset classes and geographies, sticking to sensible weighting limits for individual stocks, and being cautious in your use of debt.

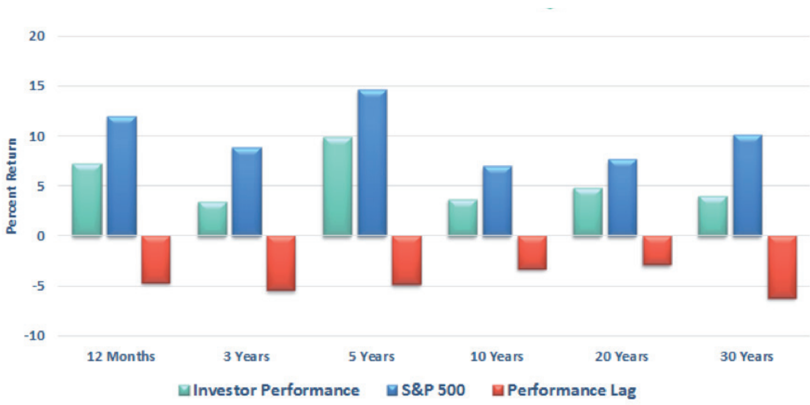
Leverage amplifies risk and can remove control over your investments. Margin loans can make you a forced seller at the worst possible time. If you must borrow to invest, a mortgage redraw facility means you control when you buy and sell, not the lender. It's an important distinction.

The most successful investment strategy is not necessarily the highest returning or the most conservative but the most sustainable. Be wary of debt, build a portfolio that lets you sleep and minimise risk by sensibile diversification. These simple rules won't eliminate losses but they will keep you in the game. And that is the game.

Most professional investors underperform the market. Small investors have some advantages over them (see lesson seven) but don't think beating the market is easy.

Even before taxes, fees and trading costs, beating the index is difficult. Research indicates most investors will do a lot worse than average.

Chart 2: Investor performance over time



Source: Dalbar Research, via Marketwatch.com

Dalbar's annual ***Quantitative Analysis of Investor Behaviour*** shows that over every period from 12 months to 30 years, investors significantly underperform the index:

You might believe this is down to the ineptitude and rapacious fees charged by money managers but Dalbar's research puts half the shortfall down to 'psychological factors'.

I'm surprised the figure is not higher. Over the past 20 years, I've spoken to hundreds of investors with excellent analytical skills that have struggled with the behavioural biases that lead to poor investment performance, particularly overtrading.

If you lack the analytical skills and psychological fortitude to go against the market, or the time needed to overcome these barriers, you probably aren't the best person to manage your money.

Getting all this stuff right – managing risk, picking stocks, minimising mistakes, reviewing and adjusting your portfolio – takes time.

Then there are the psychological traps that make beating the market difficult. Being herd animals, we're comfortable doing what everyone else is doing, which is why we panic sell when stocks are tumbling and greedily buy when they're rising. The fear of missing out is a powerful motivator when everyone around us is making money.

If this sounds like you there's a simple solution: accept an average return and take the low cost, easy option of index funds (correcting for the ASX's over-exposure to banks and resources). Just don't panic sell in the next crash.

There is no shame in this, so don't let your ego convince you that you can do what most investors can't. As Ben Graham said: 'To achieve satisfactory investment results is easier than most people realise; to achieve superior results is harder than it looks.'

If you make a realistic assessment of your skills, psychology and available time and conclude you shouldn't be managing your own money, settling for an average return from a low-cost index fund makes total sense.

What if you do want 'superior' returns? Well, you have to do something different to the market – but different and right, not different and wrong. This is the heart of what we try and do at *Intelligent Investor*: spotting market mispricings and acting on them to outperform the market over the long term.

Take Flight Centre as an example. We recommended this stock at a price of $3.00 on **27 Apr 98**, almost 20 years ago. We've recommended it regularly ever since, usually following substantial price falls. Chart 3 is from the last decade, the areas of green being Buy recommendations.

Chart 3: Ten years of Flight Centre

Source: Intelligent Investor

We last upgraded Flight Centre on **7 Nov 16** (Buy – $30.94), after which it remained on our Buy List for six months.

At the time, there was a general perception that the company was a sitting duck, vulnerable to Internet travel sites. So widespread was this view that the company was one of the most shorted stocks on the market.

The evidence, however, suggested that the weak international performance at the time was a cyclical rather than structural issue. That view has since been vindicated. Beyond these concerns was a booming corporate business.

In the 16 months since then the market has woken up to this reality, the result of which has been a near-doubling in the company's share price.

The business media and things like brokers' 12-month price targets are a reflection of the market. If everyone knows the same thing, copying it will get you the returns everyone else gets, give or take some costs and psychological blunders. You have to do something different to the market in order to get returns different from the market.

It's not enough, however, merely to be different. This is why value investing is not simply 'contrarian investing'. Contrarians see what most investors are doing and do the opposite. Value investors make decisions based on the difference between price and value. This often entails being contrarian, although contrarianism is not the reason for it.

You have to bet against the crowd to generate returns higher than the crowd. And you need a rationale for doing so. Neither is easy. And you will feel like a fool when you are wrong. But this is the only way to beat the market over the long term.

Remember the Brexit-inspired mini-crash? The Asian Crisis from 1998? Or the Dotcom bubble a few years later? These events created significant market instability. And yet here we are, years later, with far higher share prices.

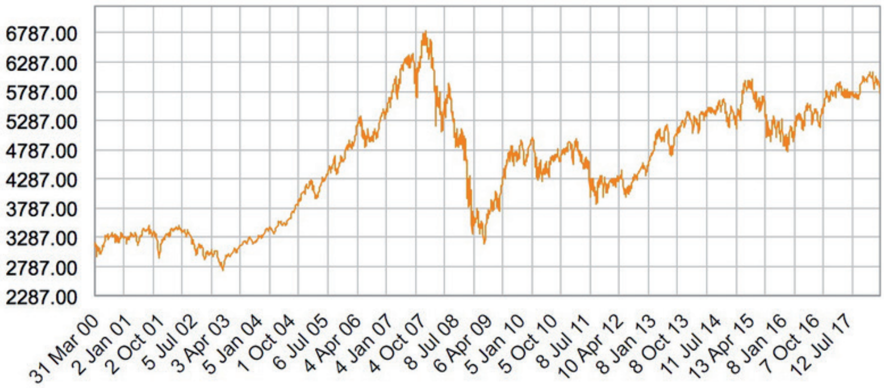
If you can ignore short-term shocks and the panics they create, you get the benefit of the long-term tendency for share prices to return more than bonds and cash. These events are visible on Chart 4, showing the ASX 200 over the past 20 years. As time goes by they become less significant. Current events won't matter anywhere near as much in the future as you think they do now.

How should you react to noteworthy events? In a word, opportunistically. We used Brexit to **upgrade NAB**. When Ansell announced a profit warning the stock immediately fell 20%. By the time of our upgrade on **4 Feb 16** (Buy – $15.49), it had fallen 36%. Since then, the share price has risen more than 60%.

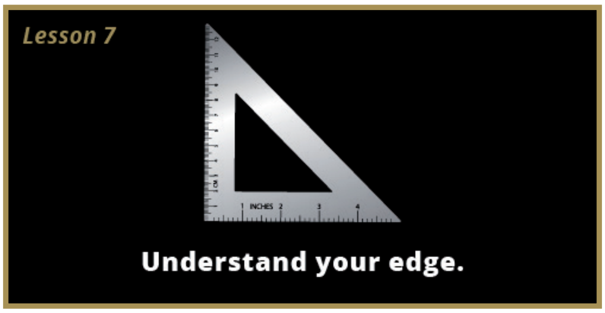
News is designed to excite our synapses, triggering fear and stoking ill-advised activity. If you're investing for the next 20 years, though, what happened today probably doesn't matter. Don't get sucked in.

Instead, turn it to your advantage. Some of our best recommendations have been made in the teeth of a crisis. Such times should be welcomed because crisis creates opportunity. And because crises don't last, neither do the opportunities.

Chart 4: ASX 200 Index over past 20 years



Source: S&P Capital IQ



It's weird when you think about it. Insider trading is rife; powerful computers get advance notification of trades coming down the pipe; regulators are weak; courts are soft on white collar crime; auditors are in the pockets of their clients; and some of the world's smartest people arrive at work each day to prey on the ignorance and gullibility of the small investor.

How can we possibly win? Everything appears to be stacked against us.

But being a professional investor is harder than it sounds. You get penalised for sitting on cash; you are judged on quarterly performance; you might lose your job after a bad year; clients monitor your performance daily and often withdraw their funds right at the time the best opportunities appear, and pile in when stocks are expensive.

Small investors, meanwhile, carry fewer burdens. As Joel Greenblatt wrote in ***The Big Secret for the Small Investor***:

'As individual investors, we have some major advantages over the large institutions. We don't have to answer to clients. We don't have to provide daily or monthly returns. We don't have to worry about staying in business. We just have to set up rules ahead of time that help us stay with our plan over the long term. We have to choose an allocation to stocks that is appropriate for our individual circumstances and then stick with it.'

This is our edge. We aren't running managed funds so we don't need to trade like we are. And we can sit on cash until a good opportunity comes along. A genuine, long-term perspective is the biggest advantage of all.

Value investing was the only approach that has ever made sense to me. As soon as I read about the difference between price and value ('price is what you pay; value is what you get') and the importance of thinking about investing as a business-like activity, the penny dropped and I was hooked.

It helped that successful investors like Warren Buffett, Ray Dalio, Seth Klarman and Kerr Neilson practised it. But having found something that made sense I stuck with it.

Of course, there are different styles within the value investing church, from cigar butts to growth at a reasonable price ('GARP') and more. Different conditions favour different approaches. But whatever the variety of value investing, they all reduce down to that same price/value equation. The difference is that value can take many forms. Believe in the value of a value-based approach and be flexible about where you find it.

Jumping from one completely different style to another only increases your opportunity to lose money. To get to investing heaven, find your religion, study it and practise it.

Economic theories don't carry the same weight as those developed in genuinely scientific disciplines. If an apple falls from a tree 100 times, Newtonian physics accurately forecasts it will hit the ground each time.

Economics isn't like that. Eugene Fama's popular ***Efficient Market Hypothesis*** hypothesised that asset prices fully reflect all available information at any one time. It soon developed, though, from hypothesis to mantra, with adherents insisting that stocks always trade at fair value and that any market outperformance is down to chance. The investors named above, therefore, and our good selves, have been the recipients of Lady Luck, decade after decade.

Perhaps you can sense my cynicism. There are occasions in economics and finance when the apple does not hit the ground. Which is to say asset prices do not always fully reflect value.

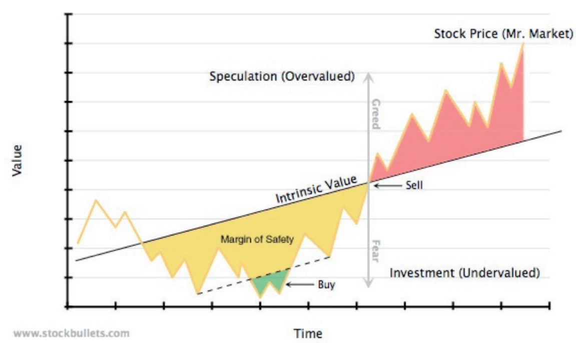
Warren Buffett debunked the idea of efficient markets in his famous essay, ***The Superinvestors of Graham and Doddsville***, but ultimately the explanation comes, believe it or not, from another flaky discipline – psychology.

Ego gets many of us started in investing but is also what brings us undone. Our brains are psychologically wired to make poor financial decisions. It is the collective expression of such decisions that creates the market inefficiencies on which value investors feast.

The logic is irrefutable. If psychology makes markets inefficient, taking advantage of such inefficiency entails a more adept, rational and perceptive mindset than that exercised by the general market. The first step is to understand **how your brain undermines performance and what to do about it**. In other words, we must be our own shrinks.

Share prices get too much attention, while the underlying factors that drive them over the long term never get enough. Focus on the long-term value of a business, not the collective expression of what day traders, insider traders, dumb money and speculators think it's worth from one moment to another.

Chart 5: Margin of safety



Share prices tell you nothing about the underlying dynamics of a business and what it might be worth in 10 years. They are useful, but only in conjunction with value. It is the gap between them – the **margin of safety** – that matters, not the price itself. Chart 5 makes the point.

The principles of value investing are straightforward enough: think independently, focus on the long term and hunt for value. Unfortunately, this is easier said than done. As Joe Wiggins writes at ***Behavioural Investment***:

'There is a simple heuristic for gauging the investment style adopted by a fund manager; it is based on how you feel when

looking at the holdings in their portfolio. If you feel comfortable, they are a quality investor; if you feel excitement, they are a growth investor; and if you recoil in horror, they are a value investor.'

It's not quite that simple, of course. As well as loving cheap, horror-inducing out-of-favour companies, we're also happy to pay a fair price for a good business and an even higher one for an exceptional business. There are different ways to get to value investing heaven.

But Wiggins' point stands. Herd animals do not like being out on their own, and that is what value investing is all about. You need a bag of psychological fortitude to do it well, which brings us to our next lesson.

Nothing better illustrates this better than one of our most memorable Buy recommendations: RHG Group, popularly known as Rams Home Loans.

Rams company floated at $2.50 a share, three weeks before the Global Financial Crisis hit, *The New York Times* suggesting 'it may be the worst initial public offering of the decade'.

We didn't disagree, as the headline for our review of the float confirmed – ***Rams set for a shearing***. It didn't take long for the company to confirm that theory, with a warning just a few weeks later that the early stages of what has become known as the global financial crisis had increased funding costs, putting a large dent in profits.

After the stock had fallen over 60%, we upgraded RHG to Speculative Buy at a price of 95 cents. As the chart above shows, the share price fell to a low of 5 cents and we were repeating our Buy recommendations all the way down.

This didn't go down well. With each passing day more members contacted us in a state of understandable panic. This one was going to zero and we should get out while we still could was their message.

As things turned out, this was one of our more successful Buy recommendations of the past decade. We even went in for a final bite, issuing another Buy in April 2011 at a price of $1.05.

Those investors earned a 58% return following the acquisition of the company by Resimac and a series of special dividends. Members that acted earlier did far better. They also accumulated more psychological scars along the way.

Who wouldn't when a stock you've just purchased falls 95% and the idiots who recommended it just carry on telling you to buy?

In truth, even we were second-guessing our decision, constantly wondering what we were missing. Each time we returned to the company's mortgage book and looked at its value. The panic in the share price was in no way reflected in the loan book, which showed mortgage repayments coming in pretty much as expected.

Just because you've bought a cheap stock does not mean it won't become cheaper still. Good opportunities can become great after you've invested much of your spare cash in them. That's one way they hurt (the solution is to buy in parcels). The other is in the growing suspicion that the market is right and you may be wrong.

You don't get amazing returns without enduring a lot of pain along the way.

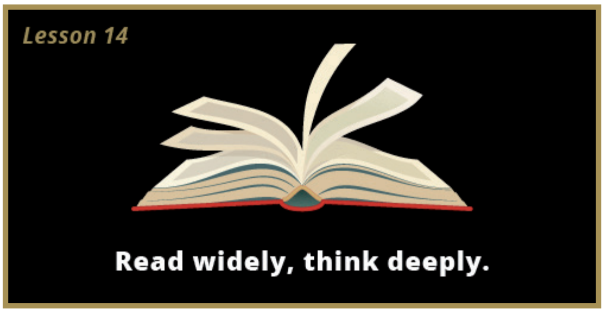
Chart 6: RHG Group recommendation history

Despite criticising the efficient market hypothesis in lesson nine, let's acknowledge that while the market is *sometimes* irrational it is mainly rational.

This is implicit in the spread of recommendation across the stocks we cover. Over the past 20 years the number of Hold recommendations has been many times that of our Buys and Sells. The market tends to get valuation about right.

At its most fundamental level, successful investing is about two things. First, being able to spot inefficiency and then having the confidence to act when you find it. And second, being comfortable sitting tight when prices are charging and valuations are stretched.

Again, both are easier said than done. There is nothing worse than watching your teenager's idiot friend make a killing on Bitcoin while you're getting 2.5% in a term deposit. But that's what successful investing demands; acting when stocks are crazily cheap and doing nothing when they're crazily expensive.



Economists love specialisation, and rightly so. If humans repeat the same task they get better at it and do it more quickly. But specialisation inevitably requires a narrowing of focus, often at the expense of other fields of knowledge that might aid and deepen understanding.

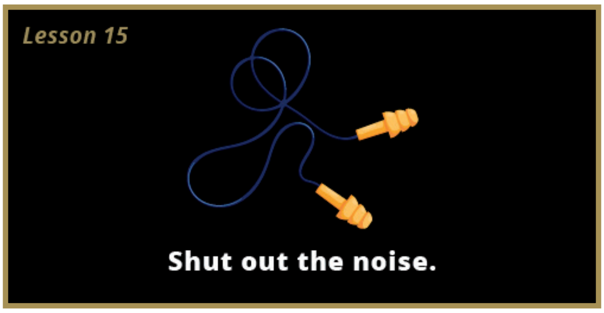
A few years into the life of *Intelligent Investor*, Greg Hoffman, our first research director, and I exchanged reading lists. His was full of Buffett, Graham, Lynch and Fisher. To his horror, I recommended novels, and books on psychology and history. He wanted to deepen my knowledge of the particular; I wanted to expand his of the general. Both of us were right.

Investing is a science and an art, which is why a basic understanding of history, psychology and economics will make you a better investor. Investing is also a deeply human activity, and nothing helps us understand the human condition more than a well written novel. Reading widely will help you think more deeply about the decisions you're about to make.

But don't forget the specialisation, either. Work your way through the classic investment texts and search out new ones. There are no secrets to successful investing waiting to be written. Everything you need to know is already out there. You just have to read it and put it into practice.

Recommended Reading Lists

- Reading List #1
- Reading List #2
- Advanced Reading List
- Top value investing websit e and podcasts



Better environments make for better decisions. Warren Buffett chose Omaha; Kerr Neilson chose Sydney; and we chose Bondi Junction.

Okay, maybe we got that one wrong. But being away from finance's centre of gravity and the hubbub it attracts has its benefits.

You might not be able to change where you live but you can turn off the phone, shut down your computer and silence the kids with some gaffer tape. You can also take your most important decisions early in the day when you're refreshed and energetic, dealing with the important stuff first, not just what pops up. This will help you make better decisions.

You can also reduce the number of decisions you have to make day to day. Our minds are like muscles; they get tired the more we ask of them. Buffett has dined at Gorat's Steakhouse in Omaha for decades, ordering pretty much the same thing each time. Sure, it's boring but he literally doesn't have to think about it, and neither does the waitress.

Chart 7: Cochlear recommendation history

Before buying or selling a stock, write down your reasons for taking action. If you find this difficult, you probably aren't clear about why. And once you have acted, keep quiet about it. Discussing your decision with others makes it harder to change your mind if and when the facts change.

We've broken this rule so many times it's not funny. Had we not done so our performance record would be even better than it is. Good businesses usually appear expensive. But they also tend to deliver pleasant surprises, proving their worth.

Cochlear, a very good business, first joined the Buy List in late 2003 at a price of $20.70. We hung on, enjoying the ride for a full decade, eventually selling out at $86.08 in February 2015. Then look what happened (see Chart 7).

Twelve years was a sufficiently long holding period to do well. Members enjoyed a 316% share price gain over the period and got some handsome dividends along the way. But 12 years still wasn't long enough. Eager to bank our gains we sold a great stock at too cheap a price, underestimating the company's ability to grow at an even faster pace.

The lesson? Sell high quality, apparently expensive stocks slowly and reluctantly. A high price-earnings ratio does not mean a stock is necessarily expensive.

Some of the biggest mistakes we've made over the past 20 years were in recommending low quality, smaller stocks at apparently cheap prices. Not wanting to pass up another opportunity to self-flagellate, some examples; ROC Oil, Miller's Retail, Infomedia and Timbercorp, perhaps our biggest ever mistake.

How did this happen? We slipped down the quality curve because high-quality businesses were too expensive to justify buying. Share prices were flying and members were keen for us to make new Buy recommendations.

We should have sat it out. Instead, we got restless and our members paid the price. Sometimes, the best thing to do is nothing at all.

Years ago, the aforementioned Greg Hoffman persuaded me to take an accounting course part time. I walked out at morning tea. Accounting just isn't my thing. Fortunately, I do love business models, understanding why some companies succeed and others fail.

This has served me well because a few hours spent understanding how a business makes money, its strengths and weaknesses and competitive position, is more useful than a few hours wading through a company's accounts.

Once you've got a grip on how a company makes money, the accounts make more sense anyway. And if the thought of grappling with the back end of an annual report terrifies you, as a member of *Intelligent Investor* you need not worry. That's our job, to comb through the numerical details and accompanying notes, alerting you to any problems.

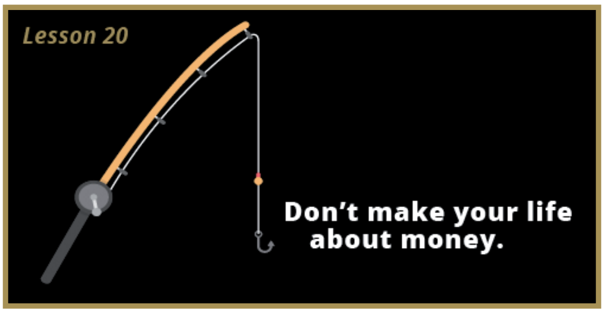
You don't have to be an accounting wizard to become a good investor. You do need to have a basic grasp of business, incentives and market dynamics across multiple industries.

Unfortunately, big businesses can and do fail. Former market darling **CBL is a recent example**. Upon listing at $1.62 a share on 13 October 2015, the share price rose to a high of $3.76 a year later. By then its market value was almost $900m. Last year, the company's managing director was crowned New Zealand's Entrepreneur of the Year by EY.

Followed by a few brokers but never recommended by us, it suddenly went under in February of this year. The demise was rapid and, although in retrospect there were a few warning signs, few investors picked up on them.

This may be unusual but it is in the way of things, the modus operandi of capitalism. From newly minted start-ups to the death of esteemed corporate brands like Kodak, Pan Am and Dick Smith, the cycle of birth and death is a part of investing, and one that cannot always be avoided.

Don't think that as you develop as an investor the rules no longer apply. If you have too much money in any business that goes under it will hurt. Follow the basic rules of diversification and do not have too much money in one stock.



Money suffers from what economists call diminishing marginal returns. A 2010 Princeton study by Daniel Kahneman and Angus Deaton found that earning more than US$75,000 per year doesn't significantly increase day-to-day happiness.

And yet we chase it as if it did, painfully aware that wealth is the ratio against which individuals in a consumer-driven society are measured.

We will all die and a bit of money helps to reduce misery. A lot of money probably won't make you much happier and will bring its own problems. Keep everything in perspective, don't take investing too seriously and you'll find it easier to keep the fear and greed out of your decision making.

Studies show that spending money on others and experiences (rather than goods) make people significantly happier. Money spent on good health and nurturing relationships is also probably well spent.

As for the rest of it, it's a means to an end, not an end in itself. Don't get lost along the way.