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Insights

3 questions to fine tune your investments

-Barton Biggs

Hedge fund manager Barton Biggs had an upbringing that left him rich in stock picking.

His father instilled a tradition whereby each of his sons, on turning 18, would be presented with a portfolio of about 15 stocks worth roughly $150,000. They were encouraged to ask questions and learn more about the stocks.

One year, his father organised a family stock-picking contest. Each family member had to pick 5 stocks. Biggs did not mention the tenure by which the stocks were evaluated or the basis for evaluation. All he stated was that he finished last and his mother was the winner. She knew nothing and cared nothing about the stock market, so picked companies whose products she liked. Two of her big winners were Procter & Gamble and Iowa Power (she had been born and raised in Iowa).

Taken from his book Hedge Hogging, here are three questions you need to honestly answer to fine tune your investment strategy.

Q1. What's your religion: Growth, Value or Agnostic?

Growth stock believers argue that you want to own stock in companies whose earnings and dividends are consistently increasing. What you pay for the shares of these companies is important, but not as crucial as correctly identifying true growth companies. By definition, these companies tend to have excellent managements, proprietary positions in businesses that are not particularly cyclically sensitive, and highly profitable. Ideally growth stock investors want to hold shares in great businesses, and they sell only when the business itself falters, not because the price of the shares has risen.

The problem is that no one has perfect foresight. In fact, we are all generally overconfident and overoptimistic about our skill in picking growth companies. Identifying growth ex ante is extremely difficult. By the time you can clearly identify a stock as a growth stock, it usually will be valued accordingly. Therefore, you end up buying the expensive stocks of good companies.

Value investors want to own stocks that are cheap not only in relation to other equities but also in absolute returns. They believe all investors are fallible and often misjudge the fundamentals of a company. By buying cheap, a value investor creates a margin of safety for his investment. True value investors are not dismayed by unattractive companies; in fact, hard-core value investors sometimes seem to say the uglier the better.

They want the 3 U's – Underowned, Unloved, Undervalued.

They would rather buy a well-managed, good business at a depressed price, but such situations are few and far between. Instead, they buy stocks that can be purchased well below their intrinsic replacement-cost value as a business, where current profits are beneath the sustainable earning power of the company, and that also are cheap by the traditional measures of value.

Growth investors are included to fall in love with the companies that have treated them well. They like their portfolios filled with companies with great, growth franchises that they can be proud of.

Value investors don't fall in love with their stocks. When the prices of the shares of the ugly companies they own go up and become expensive, they sell and go searching for cheapness elsewhere.

Don't fall in love with your stocks. Fall in love with people, children and dogs. Not stocks. Sell when they become outrageously expensive.

Biggs considered himself to be agnostic with a strong value bias as he believed that buying cheap beats buying expensive most of the time.

Agnostics opine that everything in the investment business is temporary. Consequently, when growth stocks are relatively cheap and the economic environment favours them, agnostics will own growth. When value is cheap and growth is expensive, they will look for value. Sometimes, they will own a little of both.

Q2. What would you do if you had to start over?

Biggs sometimes suggested to his partners that they go home, reflect as thought they held nothing but cash. What would be the fresh opportunities to capitalize on and would be the most compelling buys at that moment? This is a great discipline to pretend that you are going to build a brand new portfolio from scratch and unencumbered with stale positions, where the story has deteriorated, has gone down, and is too cheap to sell.

When you are working with an existing portfolio and reshaping it, there are unrecognized, subconscious, emotional hang-ups that block you from impartial, cold-blooded investment actions like selling. Your baggage is what you already own, and it gets in the way of excellence.

There are always positions you believe in, but for one reason or another, the market has not discovered them. It's hard to make yourself give up on a position, especially since you suspect, as soon as you do, it will rally. There is a bias against switching, because subconsciously you know you can be wrong twice. By the same token, it's hard to sell winners because of what they have done, and you hope they have more to deliver.

As investors, we often personalize and become emotionally involved with positions when the investment decision-making process should be completely intellectual and rational. Remember, the stock does not know you own it. There is no reward for faithfulness.

Q3. What gets your attention?

The intellectual problem an investor must wrestle with is the constant barrage of noise and babble.

Noise is extraneous, short-term information that is random and basically irrelevant to investment decision making. Babble is the chatter and opinions of the well-meaning, attractive talking heads who abound.

The investor's task is to distill this overwhelming mass of information and opinion into knowledge and then to extract investment meaning from it. Meaning presumably leads to wisdom, which should translate into performance. Noise and babble can be very hazardous to your investment health. The wise man listens for meaning but the fool gets only the noise.

Read, but read smart. The investor must dominate his own intellectual intake environment and not let the outside world control him. Internet and e-mailing can be brilliant, time-saving inventions, but also huge distractions.

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