The VIEW from BURGUNDY

JULY 1993

THE MONEY MASTERS

THE MONEY MASTERS, BY JOHN TRAIN, is one of the greatest books that we know of on how money is really made. Train is a successful money manager in his own right and an investor of some note. We have recommended this book for years to friends and clients because there are few better books for those with a sincere interest in learning the principles of successful investing. For many years, Train has studied the "investment greats" of our time. You will know some of these great investors, and some have been previously cited in *The View from Burgundy*, including Warren Buffett, John Templeton and Larry Tisch. *The Money Masters* studies nine of these great investors in some detail, exploring in particular their investment beliefs and philosophies, and the methods they use in making investment decisions.

In the book's final chapter, Train draws a number of conclusions from his study of these "Masters." One of the most useful conclusions is a list of "don'ts," which we are reprinting here for our readers because we feel the list is very relevant in today's investment world – that is, a world of high valuations for many stocks, some industries brimming with popularity and resultant high prices, and new equity issues abounding.

We think that you might be able to think up specific examples of situations that match up with the various points that Train is making!

Investment "Don'ts"

1. Avoid Popular Stocks

First must come the general class of anything that's too popular at the time, stocks that are on everybody's list. If you buy Polaroid when everybody feels it's cheap, you can be fairly sure that the stock is overvalued. It's not that the business won't do well or even that the stock will never rise; it's just that you will first have to work off that overvaluation, which takes time. IBM, then selling for 300, was a "religion stock" in the late 1960s, a certified member of the so-called Vestal Virgins. The company fulfilled all its owners' dreams: earnings went up 700% over the next decade, and the dividend rose 1,000%. Still, for 10 years the stock never rose above 300. I often save the lists of "consensus" stocks published in magazines and check the results a year or two later. One may safely expect that they'll do about 30% worse than the averages. That's the sinister meaning of the term "glamour stock." A glamour stock is a good company overpriced because it's everybody's darling at the time. It's hard to make money buying one.

The same principle works for bursts of short-range enthusiasm. If a stock has run up widely over a period of days or weeks, it's better to let it rest for a while.

A highly favourable purchase is very likely to seem odd, uncomfortable, risky, dull, or obscure at the time you buy it. Propitious reactions are: "That dog?" or "I can't see it doing anything for the next six months." Later, everybody gets the idea and feels comfortable or enthusiastic about it. Then it's too late.

2. Avoid Fad Industries

Fads and brokers' stories are variations on popular stocks. The number of them you can remember is limited only by how old you are: the atomic energy craze of the fifties, the computer mania of the sixties, the gambling stock intoxication of 1978-79. There's an easy way to spot the terminal phase of these bubbles: if mutual funds are formed to concentrate on the industry in question, or if companies' stocks jump in the market because they announce that they propose to

enter the field, then the buying is speculative and disappointment will probably follow. IBM and Xerox each made most of the money that was ever made in their respective industries. One would have been safer selling the stock of any other company that announced it was going into computers or copiers.

As I've mentioned, a good rule is that when a company changes its name to indicate that it's going into a new industry, it's time to have a skeptical look at that industry.

The easiest way to be sure that you are not buying into a fad or popular stock is to consult the index of the Wall Street Transcript or ask your broker to check his research file; if nothing's been written about a company for a few years, you're probably safe. If I'm interested in a company, I usually contact its shareholder relations officer and ask him what the best brokerage write-up is on his company. If there isn't any that really gets the point, then the discovery (or rediscovery) period is ahead of you.

A few years ago, for instance, H&R Block, the tax preparation company, seemed like a gift. They had a prodigious growth rate and no significant competition. The industry is imperishable, and the company was selling in the market for barely more than its cash in the bank. I asked Richard Bloch (that's how the family name is spelt), who didn't enjoy this state of affairs and was glad to be helpful, if there were any good current brokerage-house studies around. He said that there was only one he knew of, by an obscure individual practitioner. I considered that very bullish, and in fact the stock eventually did extremely well.

Perhaps the archetype of this principle was the first great American oil strike, the fabulous Spindletop Dome. It attracted so many investors that at its height one was said to be able to walk across the field stepping from one drilling platform to the next. Result: more money went into the ground at Spindletop than ever came out of the ground.

3. Avoid New Ventures

Venture capital is for pros, not passive portfolio investors. By far the majority of new ventures – probably nine out of ten – go bust. Warren Buffett's argument is overwhelmingly convincing: There's little point in buying a gamble, of uncertain prospects and management, with the likelihood of financial asphyxiation in the future, and with the promoters getting a big free cut. If you wait a few years for the next bear market, you know you'll be able to buy the greatest companies in the world with superb managements already in place, for no more than their net quick assets, and with the company itself free – the plants, the patents, the goodwill.

4. Avoid "Official" Growth Stocks

Stocks that have the growth label – and corresponding price tag – often are no longer growing rapidly enough to justify their prices. You might call them the "old champs." Many famous companies that have "Growth Stock" printed on the back of their robes and still wear the championship belt and buckle they won in 1958 are really over the hill.

5. Avoid Heavy Blue Chips

A similar disappointment is likely to come from buying cyclical heavy-industry "blue chips" with static earnings, which sell for too high a price because of their "security." When you buy U.S. Steel and its famous peers you buy a cross-section of the modern world – whose problems for the investor exceed its opportunities. After realistic depreciation, the profits of these companies are usually substantially lower than reported, and even if there is a profit in accounting terms, there may be a cash deficit, covered by increasing the debt.

When you buy either the old champs or the heavy blue chips, the key is price: Is the rate of return really there? Will the reasonable flow of dividends give you what you need without any particular "leap of faith" and without any speculative assumptions about what

the stock will sell for 10 years down the road at the end of the rainbow?

6. Avoid Gimmicks

Gimmicky investment "products" with high transaction costs and no intrinsic growth of value, such as option programs and commodity flyers, aren't investments at all. They're casinos. Forget about them. The economic function of real investment is to provide the capital needed for industry, for a fair return. The economic function of the casino customer is to be fleeced.

7. Bonds Don't Preserve Capital

A final bad deal for the investor, generally, is bonds, unless he reinvests all the income. The notion that they're "conservative" is grotesquely unrealistic. Franz Pick, in his sardonic way, has called them "certificates of guaranteed expropriation." After tax, bonds generally yield less than the inflation rate. The present half-life of money is eight to ten years; so, if you spend the income only half your buying power will remain after eight to ten years in real terms, and only one quarter after 16 to 20 years. You'll have to run through your capital without even realizing it. Incidentally, the Dow stocks plus their dividends have vastly out-performed savings accounts, with dividends compounded, over every 20-year period since 1928, and have more than kept up with inflation.

8. Forget About Technical Analysis

One "system" of stock market investing not represented in this book is so-called technical analysis. The reason is that I have been unable to find any successful practitioners.[†]

Endnotes

†. Train, John. The Money Masters. New York: Harper & Row Publishers, 1989.

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