

INTRODUCTION

It is a fact of investment life that most people aren't satisfied with their stock market performance. And wanting to do better is the American way. So what do we do? Do we work harder? Do more research?

If the answer were that simple, there would be millionaires on every street corner, because there is no shortage of investors willing to work hard to achieve superior results. But mere analytical prowess is not enough unless we understand the personal and psychological attributes that can either contribute to our investment success or make that success hard to come by. The plain truth is that anyone who is willing to examine his or her own personal foibles can become a much better investor. That's what this book is all about.

Consider Warren Buffett and George Soros, two of the greatest investors of the twentieth century. Though linked by their stock market successes, the two men have *absolutely nothing in common* other than their dedication to their chosen styles. Buffett is the consummate buy-and-hold strategist, whose holdings are almost exclusively well-known, large-capitalization companies such as Coca-Cola, American Express, and Gillette. Soros, on the other hand, is the mercurial trader, willing to make huge short-term bets on currencies, futures, emerging markets,

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you name it. The point is that each of these legends invests in a way that comes naturally. If Buffett tried to emulate Soros, he'd be a dismal failure, and vice versa.

That point sounds obvious, doesn't it? Yet so much of our investment literature doles out advice along the lines of "Do this," "Don't do that," or simply "Be like me," the idea being that the advice has worked wonderfully for the person who is doing the writing. All well and good, but many readers aren't psychologically positioned to convert those good words into action. For example, to tell someone "Don't buy a stock on a hot tip"—advice with which no expert would disagree—just isn't enough, because it ignores the question of why people feel inclined to act on those tips in the first place. Does Alcoholics Anonymous reach out to its members by merely saying "Stop drinking," as if those words alone will do the trick? Of course not, and the same principles apply to the investment world: You can't break your bad habits without knowing a little more about them.

Over the past 15 years, I have had the privilege of watching a wide variety of investors—from private citizens to magazine editorial boards, from neighborhood investment clubs to institutional investment committees. And at every step along the way I have found that personalities make their mark on investment styles.

I think of Glenn Greenberg, a friend, an erstwhile rival on the tournament squash circuit, and a codirector (with John Shapiro) of Chieftain Capital, an investment firm that made its name by seeking out a select group of companies with highly predictable cash flows: shipping company Gotaas-Larsen, oil service company Tidewater, timber company Burlington Resources to name a few. Chieftain buys, waits for Wall Street to catch on, then waits some more. But the style isn't for everybody. Just months after the firm's founding in 1984, two members of a flagship investing family bailed out. Interest rates were rising, their portfolios were down almost 20 percent, and the "sit tight and wait" philosophy sounded somewhere between stale and downright bogus.

But a third family member held on after a little thought, and 15 years later he remained a client—small wonder, for his holdings were worth 23 times what he started with. Beyond the virtue of patience, the unstated message is that you can be wrong about hundreds of stocks (namely, the growth stocks Chieftain sneered at throughout some glorious runs in the 1990s) and still succeed, as long as you have the wherewithal to make the most of your chosen strategy.

Then there's Gretchen Morgenson, a veteran financial writer (*Forbes*, the *New York Times*) and a former colleague of mine at *Worth* magazine. Gretchen vaulted to stardom with some outstanding exposes: On the macro level, she delivered a watershed proclamation of "Brand Names are Dead" back in 1991, well ahead of the so-called "generic craze" that forced consumer companies such as Kellogg, Procter & Gamble, and Bausch & Lomb to slash the prices of their products—and see their earnings and share prices stagnate. On the micro level, Gretchen dissected the flagging fortunes of Canadian bottler Cott Corporation in 1994 and opined that the worst was yet to come. Was it ever! Finding potholes in a bull market is a perilous practice, though, and Morgenson's supremely negative piece on computer stocks in late 1994 was too much of a good thing. Compaq and Dell defied her doomsday scenario and rallied by an average of 600 percent in the next three years. No one is right all the time, of course, but when caution is in your blood, selling too soon is a constant pitfall.

Sell-too-sooners might consider morphing their investment traits with my father, a savvy part-time investor who has a history of beating the Street to some undiscovered gems: Damon Corporation in 1982, before the first biotech boom; Carter-Wallace in 1990, sensing that AIDS and condoms were going to increase the company's profile; and, best of all, the Haloid Company—soon to become Xerox—circa 1960. Unfortunately, these brilliant insights were sometimes offset by his reluctance to get out when the times were good—as when biotech companies soared to 100 times earnings and condoms became a mania of

their own. His problem was that selling during these peaks would have stripped him of his cherished label of “long-term investor.” That’s right—his gains came too quickly.

Of course, it would be a mite churlish of me to scrutinize colleagues and family while introducing a new book without confessing that my single biggest source of idiosyncratic investment behavior is, well, me. When I started in the investment business in 1982 as the proverbial lowly analyst, I found it easy to glom on to underdog stocks like Chrysler or less-celebrated winners such as shoe manufacturer Cherokee Group—a 20 percent grower whose stock sat at just four times earnings before Wall Street atoned for its neglect. Not bad for a beginner, right?

Meanwhile, though, I harbored pathological aversions to fabulous companies such as McDonald’s and Coca-Cola (which, after all, *anyone* could buy). I thought I was being contrarian, when in fact I was just closed-minded. By the time the 1980s rolled to a close, I couldn’t help but feel that my isolated successes had been dwarfed by the ones I let slip away, to say nothing of a few offbeat selections that remained offbeat years later. Looking back, I desperately needed someone to help me get out of my own way.

As unpleasant as these realizations were, by then I was fortunate enough to have landed a role as a stock market columnist at Fidelity, from which perch I could make amends. For starters, I ended up successfully recommending many of the stocks I had once avoided. (Can you imagine the results if I hadn’t stuck up my nose the first, second, and third times around?) Then, recognizing that my own shortcomings ran the gamut from misplaced contrarianism all the way to outright gullibility, I began to dream about what it would take to create the perfect investor. If you could only reassemble the strengths of the various investment types we’ve just looked at, you’d be unstoppable.

But guess what? You can’t do it. It’s impossible to be everything to everybody. What *is* possible is to better understand how various personality quirks and predispositions interact with that maelstrom of

activity known as the stock market. After all, there are only a finite number of mistakes that we can make: We can sell too soon, we can buy too late, we can hold on too long, and perhaps we can commit few other sins along the way. But for any one investor, some mistakes are far more likely than others. Recognizing and eliminating those mistakes is the major theme of this book. With any luck, you'll be able to identify your stock market personality a whole lot quicker than I did. I'm envious already.

SOME MARKET BASICS

Although the title of this section is "some market basics," you might be surprised to hear that I have no intention of talking about dividend yields, market multiples, debt/equity ratios, or any of the other various terms of Wall Street. Those can all wait.

In order to place our discussion of psychology and the stock market on the proper wavelength, there are really only two comments that I need to make up front. The first comment is that the market is not crazy. The second is that the market is not efficient. As long as these comments can be backed up, we'll be free to set some strategies in motion. Here goes:

The Market Is Not Crazy

If you've followed the stock market to any degree, you've surely encountered situations in which a company reports terrific quarterly earnings, only to see its stock *fall* five points on the news. Events like these give the market a bad name. Even worse, they give new investors the impression that the link between corporate performance and stock-price behavior is tenuous or even inverted. But that's not so. My proposition for the day is that good is good and bad is bad, even where the stock market is concerned.

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So how can a stock plummet in the wake of a favorable earnings report? Probably because one of the following has taken place:

- The announcement of the most recent quarterly earnings (the good news) was balanced by a cautious outlook from the chairman for the quarter ahead (the bad news). Lo and behold, the market was reacting to the forward-looking bad-news component of the press release, not the backward-looking good part.
- The earnings, though perhaps good relative to other companies or to the market as a whole, came in below the expectations for the company in question.
- The stock had already gone up a lot in anticipation of the event, and some investors decided to take profits once the news was out.

Okay, what about the reverse situation? A company announces that it will lay off 5,000 workers, and its stock soars. How perverse is that? Well, when the market reacts positively to layoffs, the underlying logic is simply that a smaller workforce will translate into lower costs and therefore higher earnings. Note that this good-is-good reaction is typically reserved for stodgy companies in low-growth businesses, where bottom-line improvements are more likely to come from newfound efficiencies than from an upward spike in sales. When a young *growth* company reverses field and announces cutbacks (invariably because its hoped-for growth did not materialize), Wall Street isn't nearly as happy.

Is there really anything so strange about these reactions? Not at all. Yet the weird combination of zig and zag often sticks in our minds purely because of the timing of the reportage: when a company reports its earnings or announces layoffs, that's *news*; and when we see the stock acting a little funny *at that time*, an impression is made. Unfortunately, we almost always lack the background information that might have put the stock's behavior in perspective. My first encounter

with the zigzag phenomenon was in 1983 when I happened to notice Liz Claiborne shares down five points (almost 20 percent) following an earnings release that looked pretty good to this newcomer. Little did I know that the stock's falloff was a mere blip in what became a 10-fold gain over five years.

You see, none of the foregoing suggested that the market's short-term reactions were *correct*. The market is capable of being dreadfully wrong for months at a time, even years. But there's a big difference between a mistaken reaction—which can be the source of future opportunity—and the image of a bad-is-good reaction, which makes some investors throw up their hands and denounce the stock market game as one of luck. It's not so.

The Market Is Not Efficient

The other hurdle we have to overcome lies at the opposite extreme, wherein investors view the market not as a den of perversity but as an all-knowing soothsayer. Some people fall into this trap because of a fatuous ivory tower invention called the *efficient market theory* (or EMT), which maintains that all publicly available information concerning a company is already woven into the price of its stock. This theory is not only false, it's dangerous. It implies either that you can't consistently beat the market without inside information or that research is expendable because everyone else is doing it. Nonsense. As a former academic, I take particular delight in saying that the efficient market theory* is an absolute pile of hooley, a claim that will be backed up at countless points within this book.

Yes, the market *tries* to be efficient. It *tries* to react to events as they occur. Yet the market's progress toward efficiency is inevitably futile for the simple reason that investors are human beings.

* It's sometimes called the *efficient market hypothesis*, but there's no need to get into the fine points of when a hypothesis becomes a theory.

If you are selling your house, you are unequivocally better off if your windows are squeaky clean, your rugs vacuumed, your plaster holes touched up, and so on. Attending to these simple and inexpensive items is recommended by any real estate agent still in business. In theory, a savvy house buyer could see through the facade and appraise these improvements at face value, but it doesn't work that way. Evidence is worth much more than mere possibility.

Try as we might, there is a limit to our ability to discount the future. When actors and actresses land important roles, they are understandably excited; they, like the market, react favorably to good news. But did Henry Winkler fully appreciate what lay in store the day he was tapped to play Fonzie in *Happy Days*? And what about Goldie Hawn in *Laugh-In* or Jason Alexander in *Seinfeld*? Think of how many times you've seen a stock go up four points on some pivotal news and marveled at the market's efficiency. But if you happened to look at those same companies a few years later, you might find that the favorable news was really worth 30 points or even more.

The downside is no different. Legend has it that the designer of the *Titanic* knew immediately upon hearing the extent of the damage that his beloved ship was doomed. But do you suppose that his initial reactions truly embraced all of his future emotions—such as when the ship lurched toward 90 degrees and began its descent to the bottom of the Atlantic? Did he appreciate right then and there that the disaster would rivet the globe for an entire century? Not a chance.

For a stock market equivalent of going down with the ship, let's go back to 1993, to a company called Lomas Financial. Lomas was in the mortgage-servicing business, and its primary asset was its mortgage portfolio. The only problem was that a sharp decline in interest rates was causing this portfolio to wither away as homeowners refinanced their mortgages. Even worse, the exodus of mortgages brought an immediate end to the company's apparent profitability, which had been created by stretching their costs over the lives of the held mortgages, a period that was shrinking before their eyes. Toss in some reckless spending and some

high-risk swap deals gone sour, and you had a complete disaster. Small wonder that every Wall Street analyst who followed the company gave it the lowest rating possible. The stock traded for all of \$7 per share when I first came across it, well off its earlier highs.

For those who believed in the efficient market theory, there was no reason to act; surely the market understood the company's dicey financial position. Not being a believer, I had no trouble putting Lomas on the monthly "Ten Stocks to Avoid" list I was running for *Worth* magazine. Two years later, Lomas shares were trading at $\frac{3}{4}$, as in *seventy-five cents per share*. For those keeping score at home, that's a decline of almost 90 percent, even after the public availability of all the negative information that inexorably sank the Lomas ship.

The reason such declines are possible is that investors can be shockingly slow to throw in the towel. Many Lomas diehards were doubtless unfamiliar with the fine points of cost amortization—not a grievous fault in modern society, but not quite as forgivable among shareholders of a mortgage-servicing company. In addition, a meaningful percentage of a doomed stock can be tied up by those with vested interests (top management comes to mind), and those people are often too steeped in denial to sell. The capper is that companies with depressed share prices can on occasion become takeover candidates, yet another excuse folks conjure up to hold on. Soon after I panned Lomas Financial, the stock leapt 20 percent in one farcical trading session, from $7\frac{1}{2}$ to 9, on a takeover rumor. But as time wore on, the bad-is-bad principle won out, as there could be no reversing the jam that Lomas had gotten itself into. So please don't tell me that the market was being efficient.

One area in which the market *is* reasonably efficient is within a closely watched industry. With drug stocks, for example, you can be virtually certain that the company with the most exciting new-product portfolio will have a higher price/earnings ratio than the company whose top drugs are about to lose their patent production (a phenomenon that opens the door for generic drug manufacturers to come in at far lower price points). The reason these efficiencies exist is that most

major industries are under constant scrutiny by dozens of top-flight analysts who on balance do an excellent job with the basic pecking order of their companies' fundamentals.

However, it is much, much harder for the market to be efficient when it comes to setting price standards between *different* industries, different countries, and so on. One laughable aspect of the efficient market theory is that it has existed in the minds of market academicians for decades—before and during times when many foreign stock markets were categorically out of sync. If those markets were so damned efficient, then how did John Templeton and his billion dollars find an early retirement in Lyford Cay?

Perhaps the market is more efficient today than it was 15 years ago, but so what? You can still make money in drug stocks despite the industry's apparently efficient pricing. Warner-Lambert was seemingly efficiently priced at \$30 in 1994. Four years and several impressive new drug releases later, it had soared past \$200.

Furthermore, there is a gigantic barrier to the attainment of a truly efficient market, namely, the fact that there are just too many stocks for us to keep track of. Exciting stories fall through the cracks with every passing day. Even though there are more active investors than ever before to monitor the market, with this population explosion comes more and more people who haven't kept up-to-date with any particular stock. If the *Wall Street Journal* makes some positive comments about a company *based solely on already available information*, there will always be those to whom the information is new, and they'll be pushing the stock up as soon as the market opens.

The reason why it is so important to decry the efficient market theory is the widespread abuse that the EMT creates among inexperienced investors: namely, that there is no advantage in doing research simply because everyone else is doing the same thing. By that reckoning, a professional sports team needn't worry about physical conditioning—after all, everybody else is doing the same thing. Conditioning taskmaster Pat Riley found a simple way to express what every EMT abuser should keep

in mind: “Being in shape doesn’t *guarantee* you anything . . . but without it you don’t stand a chance.”

In sum, the stock market is neither crazy nor efficient. I will concede that it needn’t be fair, and it certainly needn’t be right. There can be plenty of luck involved, especially in the short term. But that’s where we must part ways with the efficient market theorists. Our goal is to create a long-term advantage by understanding the role of psychology, and there is no reason in the world why that goal cannot be achieved.

WHY RESEARCH ISN’T ENOUGH

Having decried those misapprehensions that cause investors to go easy on their fundamental research, it’s time for me to set the stage for the rest of the book by claiming that research alone is not enough. Basic company analysis is the be-all but *not* the end-all of investing in common stocks.

The reason behind this claim is that we are human beings first and investors second. In this section we’re going to examine a few syndromes that the average investor faces before, during, and beyond the decision-making process. Some might be foreign to you, but others will be all too familiar. The net effect of these syndromes is that human nature casts an enormous shadow on the entire investment process. And as the first two syndromes demonstrate, psychology can play a decisive role before the research ever begins.

The Implanted Idea

We all get funny ideas in our heads from time to time, and before penning another word I should stress that I’m no exception. Here is a true confession away from the investing world:

Have you ever gotten a song lyric wrong? Not as many times as I have. I thought Aimee Mann (of Til’ Tuesday fame) was singing “Hush,

hush, even downtown, voices carry,” when in fact the lyrics were “Hush, hush, keep it down now, voices carry.” Even worse, I thought Linda Ronstadt (then of the Stone Poneys) started a “Different Drum” passage with “We’re both doing our laundry,” when in fact she was singing “We’ll both live a lot longer . . . if you live without me.” Did you notice that in each case the actual lyrics have the advantage of *making sense*?

The problem is that once an off-the-wall notion gets implanted in our heads, any lack of sense the notion may have is irrelevant because by definition it never gets investigated. With song lyrics, there may come a day when we get set straight—ideally not while performing for the queen. In investments, however, the implanted ideas typically go on and on until we pay a price, as in this sad story: In the rocky market year of 1994, one of my top recommendations was Scott Paper, now part of Kimberly-Clark. The reason for my interest was that Scott was just beginning a major cost-cutting program, and the odds seemed high that a more streamlined and profitable company would emerge. Yet one particular couple was dubious. They had met Scott’s chief executive officer (CEO) at a Montana dude ranch and had apparently found him quite underwhelming.

The dude ranch story was perplexing to me, inasmuch as Scott’s new CEO Al Dunlap was a confirmed workaholic and most unlikely to be spending any of his first year on the job riding horseback. In fact, Dunlap’s insatiable appetite for corporate cost-cutting was at the root of my recommendation. Was I missing something? (Please cut me some slack regarding Al Dunlap. His debacle with Sunbeam had yet to occur.) Anyway, only later did I find out that the fateful Montana meeting had taken place in 1962. Yet its impact was powerful enough to cause this couple to miss a 200 percent gain in Scott shares between the summer of 1994 and the end of 1995, when the sale to Kimberly-Clark concluded Dunlap’s whirlwind tenure.

Hapless tales such as this get played out every day. I can count dozens of investors in Boston alone whose antipathy toward Bill Gates made them unable to objectively analyze the treasure chest known as

Microsoft. Meanwhile, thousands of Macintosh users across the country couldn't separate their devotion to their "superior" machines from the sagging fortunes of the company that produced them. As these words were written in 1998, shares of Apple Computer traded lower than they did in 1986. The point is that all the great research in the world isn't worth anything if you're barking up the wrong tree.

Before you say, "Good investors wouldn't make these mistakes," let me assure you that there isn't a professional investor alive who hasn't been hurt by a similar blind spot. As Gillette soared to its umpteenth record high in early 1998, the well-known hedge fund manager Jim Cramer exclaimed, "For just a moment, a brief second today, right about when I was about to shave, I was overcome by my hatred of Gillette." (Hence the goatee?) Well, in Cramer's defense, some of his aversion was well placed: As he said at the time, "Gillette sells at 40 times earnings and has flat sales growth. Did you hear me?" So there was more than mere psychology behind his stance, and before long he would be vindicated. But how far back did his distaste go? The only way that stocks become overpriced is by going up a lot, and one suspects that Cramer wasn't along for Gillette's long ride.

Where the stock market is concerned, we develop mental blocks for a very good reason, and that's the pure size of the investment universe. Without some type of screening mechanism, we might feel totally lost as we confronted the 10,000 or more public companies now cluttering the financial pages. What I intend to encourage in this book is for each of us to develop a *rational* screening process instead of the bias-laden filter of implanted ideas that we might otherwise develop.

Scarcity of Time and Opportunity

One of the most important limitations that part-time investors encounter with their research activities is time itself. Whereas professionals can afford to spend all day investigating a potential investment and deciding *not* to invest, most individuals don't have that luxury.

Isn't it time to acknowledge that many, many individual investors have already decided to buy a stock *before* they ever sit down to analyze it? New ideas don't come along every day, and it is all too easy to tailor information to conform with the thrust of a bullish hypothesis or tip. Truly objective research can be as scarce as a nonpartisan reaction to a convention speech.

I am reminded of Andrew Tobias's wonderful early 1980s tale about a friend who called excitedly with news (mistaken, as it turned out) that Allied Corporation was going to bid \$85 per share for 27 percent of Bendix—this for a \$57 stock that was already ballooning with takeover speculation. Whether this tidbit constituted inside information is beside the point; Tobias rightly cautioned that an offer for only a percentage of the company would be a disappointment that would push the stock *down*. The friend was momentarily caught off guard but soon came up with an ultraflexible response. "Okay, let's short it then." The story ended in disaster because Allied Corporation, in fact, bid for all of Bendix and the stock jumped up 17 points right after the short had been put in place. So why didn't our friend (or, to be more accurate, Andrew Tobias's friend) simply leave well enough alone? Because for many investors an *opportunity cost*—the official term for the money you *didn't* make on a stock—feels every bit as bad as a loss.

Yes, professionals will tell you you're being silly if you don't distinguish between opportunity costs and actual losses, but there is a fine line between them. Would a baseball manager ever blurt out, "Hey, I don't care that we failed to score after loading the bases in the top of the ninth. We're still up one run"? Of course not. I'm not recommending that investors flog themselves every time they miss a winning stock, but I am suggesting that (1) opportunities don't come around every day and (2) a psychic cost should never be given a value of zero. When professional investors say otherwise, it only proves they've been spending too much time immersed in spreadsheets and not enough time mingling with their own species.

The bottom line is that it goes against human nature to find some titillating information and do nothing. And if our investment program requires that we stop experiencing human nature, we could be in for some very uncomfortable times. Creating the proper balance between recklessness and gratification is a goal worth understanding and pursuing.

Perils of the Buying Moment

Personalities not only affect our universe of eligible investments, they also play a decisive role at the all-important moment of purchase. What follows is an especially thorny issue for the unsuspecting investor, one that adds a new wrinkle to the theoretical preeminence of first-rate research.

Do you own shares of Disney? Microsoft? Fannie Mae? Merck? Gillette? Well, why not? It's hard to take issue with the fact that these are superior companies and in fact they've been that way for a long time. That's what any half-serious research would show, and it's not as if these companies are obscure. Looking back, one could argue that any point in the past 10 years offered a terrific buying opportunity in these stocks. For some of them it's more like 20 years.

Ah, but on what day do you actually pick up the phone and call your broker? There is a paradox in all of this: The cold logic of fundamental analysis notwithstanding, there can be a gigantic gap between those companies whose fundamentals we know to be outstanding and those companies that actually make it into our portfolios.

In an effort to explain this paradox, I came up with a phenomenon that I dubbed "acceptance," which works as follows: When we don't latch onto a success story early on (otherwise the problem doesn't apply), it is all too natural to *accept* the fact that we don't own the stock, whether it be Disney or Fannie Mae or whatever. We smile and say, "You can't win 'em all"—at which point our nonownership becomes a subconscious part of our daily equilibrium, a balance that we as human

beings are notoriously reluctant to tinker with. The shame of this whole process, of course, is that a company can go on being successful long after we first rued not buying it.

A significant corollary of the acceptance principle is that arithmetic and emotions can diverge: It is only marginally more painful to miss a stock that's gone up sixfold than to miss one that's merely doubled. This skewing effect is why psychologists might describe *acceptance* as a "maladaptive defense." Whatever the name, we should remember that beating the market is a purely arithmetical goal, so we are well advised to identify these divergences when they occur.

There is another poorly understood yet vitally important issue that relates to the moment of purchase. I'll state it as follows: The act of buying and selling stocks isn't nearly as satisfying as is popularly believed.

Microsoft, for example, is a stock that I first recommended in late 1988. Looking at what's happened to it since, you'd think that the moment of purchase was a tremendously satisfying event, as in, "Bursting with enthusiasm, the young analyst confidently made his case for Microsoft, a once-in-a-lifetime opportunity in the increasingly vital computer software industry." More headlines that never made it into print.

What I was actually thinking at the time of my initial, tepid recommendation was what an idiot I was for not acting *sooner*. By late 1988, Microsoft shares were worth eight times their value at their public offering just two years earlier. Being ever so aware of that price movement, it was impossible for me to act like the purveyor of an original idea—which Microsoft wasn't. Its utter unoriginality grated on me to the point where I almost never mentioned the stock at all. But as an investment columnist I was lucky: I had to write *something*. And Microsoft worked out just fine. If I wasn't writing this book under the influence of truth serum, I'd say I saw the whole thing coming.

When it comes to doling out satisfaction, selling is even stingier than buying. Whereas we needn't be encumbered by the past when we buy a stock, we inevitably encounter psychological issues when we contemplate getting rid of one.

A few years ago I came across a nicely reasoned sell recommendation of CML Group (of NordicTrack fame), written by top-flight analyst Skip Wells of Adams, Harkness, & Hill. CML's problem was that NordicTrack's heyday was over and the other main subsidiary (garden supply company Smith & Hawken) was unable to take up the slack. CML, at \$9, had been "sent to jail," to use Wells's term. But if you understood his personal history with the stock—which included riding it up for some wonderful gains from 1989 to 1991 but then riding it down from its peak of \$30—you knew how wrenching the entire experience must have been for him. Think about it: On what day do you walk into your office and tell all your clients how wrong you had been for the prior year? Recommending a sale at a lower price in a sense confirms that you were even *more* wrong to begin with. Personally, I admired the courage hidden between the lines of his sell recommendation. And later I was able to admire its accuracy as well. Within four years of Wells's sell recommendation, CML had dropped to below \$1 per share.

So the good news is that there is satisfaction in the stock market. There can be plenty of it, at that. But don't avoid investment moves just because they don't feel great at the moment of action. Satisfaction, like practically everything else in the market, can take time.

Discreditation

Our final syndrome kicks in after we've taken investment action. By the phenomenon of "discreditation" I am referring to the fact that even the most impeccably reasoned decisions can be near-term disasters, and there is nothing in the textbooks that prepares the investor for this nasty experience.

Consider Polaroid and Avon Products, two stocks that hit extraordinary peaks in the giddy market climate of 1972. I can't tell you how many times I've read about the factors that made these stocks such obvious sale candidates way back then. Polaroid and Avon have been written about so much because (1) both stocks went down awfully far,

awfully fast, (2) there was ample evidence at the top that a big decline was in store, which leads to (3) the stocks are wonderful models that can be kept in mind for future sell decisions.

Here's the background. Both stocks were charter members of the so-called "Nifty Fifty," the then-cute but now ridiculed coinage for an elite group of institutionally favored buy-and-hold stocks that seemed to assure infinite prosperity. Polaroid shares were trading at 50 times earnings in 1972; Avon was trading at 64 times earnings. Not only were these valuations ludicrous on their face, there weren't enough housewives in America or picture-takers in the free world to support multiples that high. And what happened in the two years that followed was devastating. Between 1972 and 1974, Polaroid tumbled from a high of 143 all the way down to 14; Avon from 140 to 18. The lofty levels of 1972 remained unattainable for years to come.

The problem with using these stocks as your canonical lesson of when to sell lies with the storytelling itself. In order to make the drops of these stocks look as precipitous as possible, the stories typically start at the peak, which is a much different view than the investor has at the time the stock market action is actually being created.

Suppose you had owned Avon in, say, mid-1970, when it was trading at about \$70 *per share*. Using the identical argument as before, this was one seriously overpriced stock. It declined 80 percent in the next four years, didn't it? But if you acted on that justifiably bearish view, you would have been forced to look on as the market showed a sickening disregard, pushing Avon shares to two times what you deemed an absurd level. *Viewing this type of market behavior is not fun*. By the time the seller at 70 saw Avon at 140, his or her bearish viewpoint, although utterly sound, would also have been utterly discredited—hence the title of this section.

The illusion persists that there was a moment when you could have concluded that Polaroid and Avon were overpriced, acted on that conclusion, and then sat back to reap your reward while everyone else suffered. But it wasn't so then, and it needn't be so in the future. However

immaculate your research, you might well have to contend with a market that refuses to share your pessimism.

This last example by no means minimizes the role of research; on the contrary, it is the well-informed investor who will survive the best when the market is going the wrong way. Discreditation can be temporary, and redemption can take its place. Yet the net effect of all of the syndromes we've just discussed is that the complete investor is more than a mere analyst. The complete investor is one who understands the psychological makeup of the marketplace and who can use that knowledge to leave the competition behind.

CONTRADICTORY ADVICE TO END ALL CONTRADICTORY ADVICE

In the chapters that follow, I'll be dissecting various personality types, one at a time. In preparation, I should mention one teensy-weensy wrinkle of the next chapter that you'll surely notice: The advice won't be consistent.

Sounds odd, doesn't it? After all, a stock that goes up for me will surely go up for you. Yet it's time for investment advice to do a better job of recognizing the individual, because our circumstances and problems are all different. Obese people should eat less. Anorexics should eat more. Alcoholics should drink less. Teetotalers should, well, you get the idea.

I should acknowledge that any portfolio manager worth his or her salt does make an effort to understand a client's basic individual circumstances, including factors such as income requirements and risk tolerances. However, those of us who go it alone must sift through bushels of written and televised advice that purports to be "one size fits all" but that leads to the bewildering and annoying conclusion that the experts often disagree. And I'm not talking about the daily type of disagreement that brings people together to make markets. I'm talking

about printed advice, where it can be extremely disconcerting to see one “expert” (time to bring in the quotation marks) recommend the practice of selling a stock after it has gone up 50 percent, only to see another “expert” recommend selling after a stock has gone *down* 20 percent. A new investor may quite reasonably ask what in the world is going on. The following is my attempt at a simple explanation.

If you’re wondering who the people are that recommend selling after a 50 percent gain, the most frequently cited advocate is none other than Benjamin Graham—as in the coauthor (with David Dodd) of the classic book *Security Analysis*; as in the sobriquet “the father of fundamental analysis”; as in the mentor of Warren Buffett. With credentials such as these, we are well advised to listen.

What has to be understood, though, is that Graham’s sell discipline evolved as the logical companion to a very specific purchase strategy. What Graham recognized many decades ago was that the stock market sometimes forgetfully pushed companies to such a low level that their entire market capitalization was less than what he termed their “net current assets,” defined as current assets minus total liabilities. In other words, the ongoing businesses of these companies were given a value of *zero*. Graham didn’t actually care what these companies did, but he reckoned that most of the businesses were worth *something*; he therefore held three years or until the stock had gone up 50 percent, whichever came first. The 50 percent figure was somewhat arbitrary, but it proved both realistic and profitable. Once attained, Graham would sell the stock and invest in something else that happened to satisfy his original purchase criteria. And if the stock didn’t move in three years, well, nobody’s perfect.

Dr. Martin Zweig, author of *The Zweig Forecast* and *Winning on Wall Street*, has lived by a very different set of rules. He will almost automatically get out of a stock if it goes down 20 percent, sometimes through the mechanism of a *stop-loss order*, which is basically an instruction to the broker to sell if the stock hits the predetermined loss trigger (15 percent, 20 percent, or whatever). Many if not most traders

and technical analysts follow this same pattern. Their objective is to make money by latching on to popular stocks and riding the positive momentum. The idea is that even a success ratio as low as 60 percent can lead to tremendous performance, as long as the gains from the winners exceed the losses from the losers. Maintaining a price-sensitive sell discipline helps to achieve that outcome.

Now, one of these strategies may be of far greater personal appeal to you than the other, but no matter; the point is that the two selling strategies are so different because the underlying *purchase* strategies are so different. You can be certain that Ben Graham didn't have to fight off any momentum investors to establish his positions, and vice versa. Nonetheless, these conflicting bits of advice land on our heads without any sort of reconciling backdrop. Quite a shame, because there is nothing more frustrating or unprofitable for the new investor than to accidentally merge two conflicting strategies. Investing in the stock market can be extremely dangerous when done à la carte.

If you think you can avoid this destructive mismatching simply through the route of long-term investing, guess again. It is vital to understand that an individual company can drastically change its investment stripes in even a few short years, thereby wreaking havoc with a conventionally tailored investment plan. The company I've chosen to illustrate this is Callaway Golf, pioneers of the Big Bertha golf club. The company went public in 1992. Here's what happened in the six years that followed. (See chart on page 22.)

Six intervals stand out:

1. *The flip.* Some of the early Callaway investors participated for only a matter of hours. In the company's very first day of trading (fittingly, February 29, the leap day), the stock jumped from the \$20 offering price all the way to \$36, a gain of 80 percent. This gain is now totally obscured by the long-term price chart—which also includes the three stock splits enacted by Callaway over the years—but it was very real at the time.

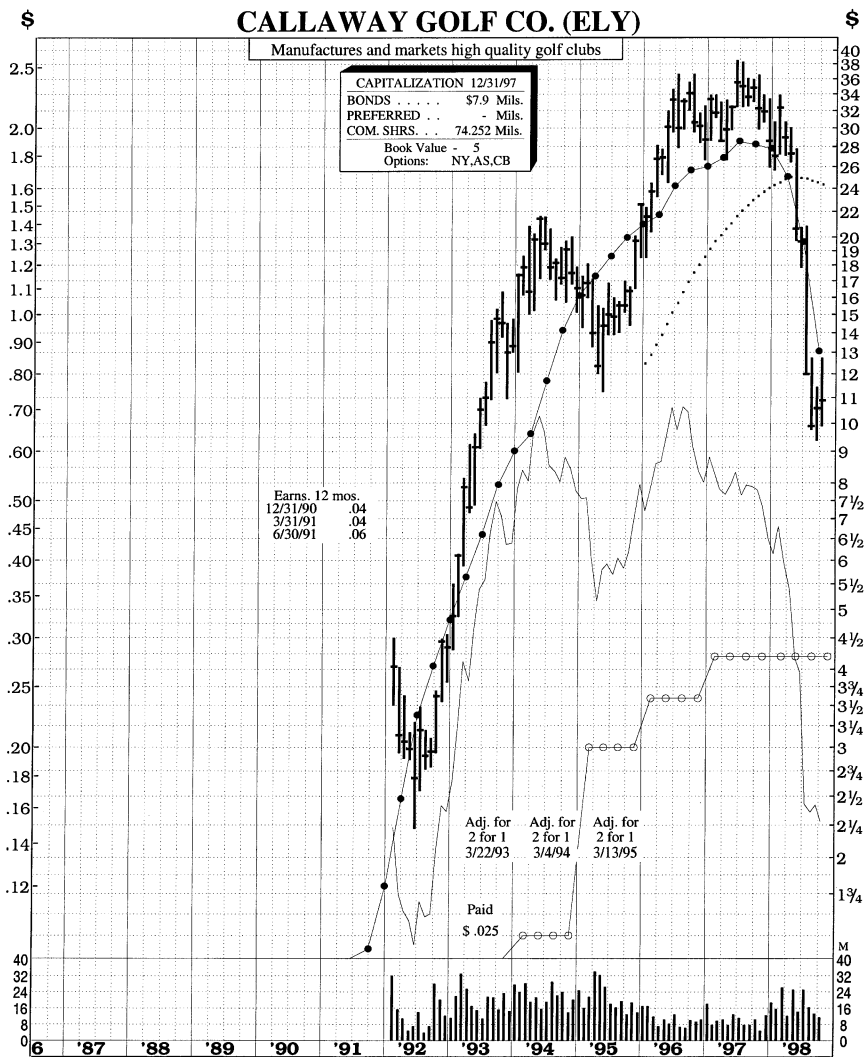


Chart courtesy of Securities Research Co. Reprinted with permission.

2. *IPO backlash.* Unfortunately, the more “flippers” that participate in an initial public offering (IPO), the more unstable the stock price tends to be. Within four months of the offering, the stock had dropped 50 percent from its high. Callaway investors at that time had to deal with snickering from all directions about the priciness of the stock and the inherent riskiness of IPOs. Ultimately, they had to decide whether they still wanted to participate in a perverse arena where short-term return on investment can shrink as corporate performance skyrockets.
3. *Glory days.* Once the IPO hangover subsides, fortunes can be made: in this case, up 10-fold in two years. Momentum investors love situations like this. Don’t we all love to make 900 percent on our money? Well, after the fact, yes, but keep in mind that holding the stock throughout this time, while requiring no physical effort, wasn’t the easiest decision in the world. The enemy was that inner voice crying out that the good times couldn’t possibly last, a perception that for some people tainted the stock even in early 1993—never mind that there was plenty of upside remaining.
4. *Comeuppance.* Every company has its time of reckoning, and Callaway’s finally came in 1994. The year started brightly—in fact, earnings rose almost 80 percent for the year—but investors were already looking ahead to a softer 1995, in which earnings would increase “only” 30 percent. This is the type of short-term disappointment that the market rarely tolerates. Momentum investors were now through for good, short-sellers were having their day in the sun, and it remained to be seen whether the company could recover.
5. *Rebound.* In mid-1995, arguably for the first time, Callaway gained some appeal as a *value* investment. Typically, value investors start to move into a stock only after the momentum players are all out—in fact, it is the very exodus of the momentum

investors that helps create the value! At \$11 per share, a paltry 10 times trailing earnings, Callaway was now priced to perform. And when earnings moved up strongly for the following two years, the stock followed suit, appreciating 200 percent from its undeserved lows of 1995.

6. *Orient expressed.* In theory, there was no reason why the rebound couldn't keep going, but in fact it didn't. Some investors became frightened by the talk that a tightening of PGA standards could actually outlaw the core of the Callaway line. That didn't happen, but what did happen in 1998 is that the company became a victim of the Asian economic crisis, and any investor who saw the link had an advantage in getting out.

It is no secret that the Japanese love the game of golf, so much so that the island can't accommodate enough courses to satisfy demand, which then spills over to indoor driving ranges and the like. (True story: A friend of mine, while serving as a Japanese/English interpreter for the State Department, lost track of a conversation and was forced to improvise by asking the visitor, "Do you like golf?" knowing that the answer would be affirmative and that the conversation would be given a fresh start, albeit a manipulated one.) Well, when the Japanese economy did its sharp pullback, Callaway's expensive titanium golf clubs were an early casualty. The company eventually released its new and cheaper steel "woods" in the summer of 1998, but by then the stock had backtracked into the midteens, as investors concluded that lower-priced products could result in a permanent downward shift in Callaway's profit margins.

So much for buying a stock and leaving it alone. The most important message from this "Cliff Notes" history is that investment success isn't limited to any one personality type; and if that's true for a single stock, it's emphatically true for the market as a whole. There's room for

all of us, as long as we forge a strategy that's consistent with who we are.

In discussing these various strategies, whether they be for contrarians, visionaries, or bargain hunters, my approach will be strictly non-judgmental. As far as I'm concerned, each of the upcoming styles has plusses and minuses, and most of us will find pieces of ourselves in many different categories.

Also in keeping with sound therapeutic practice, my recommendations will follow parallel tracks. On the one hand, I will encourage each group to try and break through the shackles of whatever limited market orientation it happens to live by. On the other hand, I will recognize that at some point we have to acknowledge our limitations and make the most of what comes naturally. Those are the ground rules. Without further ado, let us go on to the main stock market personality types.