CHAPTER 1

The Return of Common Sense

During the latter half of the 1990s, investors created one of the greatest stock market bubbles in our nation's history. What began as a typical late-cycle push into aggressive growth stocks morphed into a self-perpetuating feeding frenzy of greed. Mesmerized by technology issues, market participants threw away common-sense investment principles and eventually propelled stock prices to incredible heights. "This time is different" became the mantra of investors.

As the technology bubble swelled, individuals staked their retirements on risky stock market bets. Like lemmings ignoring the cliff ahead, investors piled into grossly overvalued securities simply because they had been racing upward in value, hoping the party would last just long enough for them to make their fortune and leave. However, once they made their fortune, the seduction of still greater gains held them spellbound in a hypnotic clutch and kept them dancing into the wee hours.

A minority resisted the tide and sounded the alarm of a coming correction, but most investors ignored them as too old-fashioned to comprehend the potential of the new economy and the digital age we had entered. The forces of competition no longer applied. Earnings were a passé concept. The first companies to stake their claims in digital territories would rule for the foreseeable future.

Then common sense prevailed. Late in the cycle, many investors realized that entire classes of stocks were glaringly overvalued, and they decided to lock in the extraordinary profits they had garnered. Selling gained traction as stock prices tumbled. The market tried to rally back periodically as those desperate for further profits refused to concede defeat, but blind enthusiasm by investors who came to the party late could not overcome the dreadful fundamentals of a classic bubble.

The prophets of technology did not give up easily. As prices fell, they made their voices heard. “We haven’t seen a decline of 10 percent in tech stocks for years. This is a unique buying opportunity!” “A 20 percent discount in technology prices is unheard of. Buy now!” In the end, however, their efforts proved to be in vain as the turn in investor sentiment drowned their rally cries.

In addition to the valuation problems, other factors colluded to create a perfect economic storm. A contested presidential election that was eventually decided by just a few votes kept Americans glued to their television sets instead of spending at the malls. The impact of September 11, 2001, and the new specter of terrorism wreaked havoc with consumer sentiment. Spiking oil prices acted as a major drag on the economy. Finally, a parade of accounting scandals and corporate fraud destroyed investors’ confidence in the equity markets as several major corporations publicly acknowledged faulty bookkeeping and high-profile CEOs being led away in handcuffs became an all too familiar sight. Before it was all over, the stock market collapsed in an emotional sell-off that spared few companies.

In the two and a half years that followed March 2000, investors lost trillions of dollars of wealth accumulated during the previous five years. Businesses once thought of as keys to unlocking the future potential of our economy were crushed in the worst stock market downturn since the Great Depression. Multitudes of Internet companies folded, and major technology and telecommunication firms struggled for survival. The stocks of many fundamentally sound, reasonably valued corporations plunged alongside those of speculative enterprises. Even businesses such as Home Depot and General Electric, which continued growing their earnings throughout this period, eventually lost over half their market values.

At its nadir, the Standard & Poor’s (S&P) 500 dropped by half, while the tech-laden Nasdaq index lost 72 percent. The Dow Jones Internet index, the superstar of the stock market only a short while earlier, dived 93 percent.

As investors rummaged through the carnage that followed the bursting of the bubble, they asked themselves numerous questions:

"How did we let this happen?" "Why didn't we see this coming?" "How can we prevent something like this from happening again?"

WE'VE OVERCOME BEFORE

With all the problems since the turn of the millennium, many have concluded the stock market no longer represents a field of sound investing. However, the troubles we have faced in recent years, as bad as they seemed, were not too dissimilar from difficulties the financial markets have weathered in times past. Since the early 1960s, we have witnessed the assassination of a president, an unpopular multiyear war, two oil embargoes that eventually drove oil prices up twenty-fold, double-digit inflation, the resignation of a disgraced president, the threat of nuclear war, and unceasing conflicts across the globe. Yet because our economy rests on the foundation of free enterprise principles and the ingenuity of hardworking Americans, we have endured all those past storms and emerged from them a stronger nation. We will do so this time as well.

KEY POINT

The stock market is essential to the smooth functioning of our economy. If we believe our economy will rebound from its travails and continue to grow, then we must believe that a portfolio of well-run American companies remains a sound and viable investment option. The appropriate question is not whether we should use stocks to accumulate wealth but, rather, how can we distinguish between quality investments and poor ones. Fortunately, there are those who can teach us.

THE INVESTMENT MASTERS

Any field of endeavor, such as sports, business, or music, is typically populated by three classes of participants. First there is the majority, whose members establish the average and defend the status quo. They enjoy the activity in which they are involved, but they never become fanatical about it. Those participants fail to master the finer points that separate the winners from the also-rans.

Then there are those that comprise the minority who consistently perform above the average. Hungry to succeed, those individuals understand there is always room to refine their abilities, so they study their fields and work hard at mastering those things that make a difference in what they can accomplish. They realize that above average performance does not come by luck, but it results from skills they can learn and improve upon. These are the men and women who turn their activity into an art.

But almost assuredly a few individuals go beyond even the attainments of the minority to achieve an elite status and ascend into a class all their own. Those individuals don't just push the envelope, they establish new envelopes. They are the true masters, the Bobby Fischers, the Wayne Gretzkys, and the Hank Aarons.

So it is in the investment world. A multitude plays the market and wants hot stock tips. Unwilling to learn the rudiments of investing, they invest in companies because "they've been going up." The thrill of the action is as important to them as the profits they make. Those individuals invest for a number of reasons other than maximizing their returns over time. They may be looking for status among their peers by obtaining bragging rights about one of their winners. Or the brokerage commissions may simply be less expensive than airfare to Vegas. Those individuals know little about investing, but because they constitute the majority, their collective opinion often carries sway.

A minority studies the art of investing in a constant effort to increase their knowledge and improve their skills. Those individuals take the time to learn what matters when buying the stocks of publicly traded companies. They don't gamble; they invest deliberately and purposefully, and they outperform the average investor as a result.

The true masters—legends such as Warren Buffett—set new standards and provide others with the vision for what can be achieved. Those individuals always seem to know what to do during troubling times when others are at a loss. They exercise tremendous discipline, holding religiously to a set of consistent beliefs they have developed over time. They focus on things and care about details others dismiss as unimportant. Most of all, they trust their judgment more than the opinions of others, regardless of how many people contradict them.

> **KEY POINT**
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> What is often beguiling about the masters is the simplicity of their techniques. They often act puzzled when quizzed about the secrets of their outstanding success. "There are no secrets," they will say, "only an unwavering dedication to time-proven principles."

In the investment arena, many of the complex strategies only draw investors away from what really matters. What kind of pattern is the stock's price chart forming? What was the stock's relative strength last week? The masters classify these questions as irrelevant distractions. By staying focused on the important elements, the elite money managers have achieved tremendous success with their straightforward methodologies. Great investments sometimes demand gutsy moves, but more frequently they require executing the fundamentals with a single-minded passion.

The shame is that the straightforwardness of the money masters' techniques often causes others to overlook those strategies. Investors are frequently not impressed with the faithful execution of investing fundamentals. Instead, they often want something flashy, something unusual, to give them an edge. So they search for something new and different while the money masters keep executing the same techniques that have served them faithfully for years, willing to miss out on fads to stay focused on long-term objectives. The naive talk of what should do well over the next few weeks; the masters consider the long run.

INVESTORS' ATTITUDES ARE CHANGING

After experiencing the worst bear market in seventy years, like professional baseball players returning to spring training, investors are coming back to the fundamentals. As common sense returns to stock investing, so does the desire to learn what matters when selecting individual securities for accumulating wealth over the long term.

For this book, I have interviewed five of the country's top money managers. All five are professionals who have consistently outperformed their peers over time.

In the pages that follow, I lay out the investment strategies and philosophies that have made these professionals among the best at what they do. Novice investors can absorb the fundamentals from what our experts graciously shared, while experienced investors can glean much from the masters' accumulated wisdom and experience. Readers can focus on learning the techniques of any of the professionals, or they can assimilate important points from all of them into their own unique strategy.

Investors often experience frustration because while they understand investment principles, they do not know how to implement what they know. Therefore, instead of just discussing general principles and philosophies, I spend the latter half of the book developing a step-by-step investment process that incorporates the common principles found in the strategies of all the masters. The process breaks down the principles into action steps that ensure each potential investment receives the same level of attention and is graded by the same objective criteria.