CHAPTER 1

Ten Traits of the World's Greatest Bargain Hunters

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If you expect to be a net saver during the next five years, should you hope for a higher or lower stock market during that period? Many investors get this one wrong. Even though they are going to be net buyers of stocks for many years to come, they are elated when stock prices rise and depressed when they fall. This reaction makes no sense. Only those who will be sellers of equities in the near future should be happy at seeing stocks rise. Prospective purchasers should much prefer sinking prices.

Warren Buffett

Successful investing isn't rocket science; it's harder.

Michael J. Moore, portfolio manager

The world's greatest investors are like rock stars. Masters of the universe, from a distance the great ones are larger than life. They possess an almost magical ability to extract great sums of wealth from thin air. And they make it look easy, or the result of plain old-fashioned luck. Perhaps that's why the conventional wisdom holds that "investing is not rocket science." However, the assumption that anyone, regardless of training, can make money using money is false. My colleague and business partner Mike Moore likes to say that if investing were rocket science, it would be far easier to succeed as an investor than it actually

is. After all, rocket science relies on the immutable laws of physics, which work every time. Successful investing requires that you train yourself to be skeptical of what everyone seems to know at the time, including investment soothsayers of all stripes.

Look back over the last 200-plus years of investing in the U.S. stock market, and markets of all kinds, and you will see a road littered with the good intentions of people who, relying on irrefutable logic, thought they would make money, but instead lost it all. Sprinkled among the losers are the consistent winners, who generally buy and sell at the right times and consequently profit from their investments. The process itself is straightforward enough—buy a stock or a business or some real estate at one price and sell it at a future date for a higher price. It couldn't be any easier, could it?

Of course, anyone with experience in financial markets knows that making consistent, solid, profitable investments over time is anything but simple or easy.

Why do some people have a magic touch and others the kiss of death when buying and selling stocks?

In answering this pivotal question, one very helpful exercise is to study the habits of successful investors, in much the same way that a researcher such as Jane Goodall studies the behavior of chimpanzees to learn how they thrive in the wild. Fortunately, for this endeavor, we don't have to camp out in the African bush and sleep with gorillas. Instead, we can study the trades made by the world's top investors over the years and glean insight into the methods behind their astonishing successes. We can gather these bits and pieces together to form a set of rules to live by in the rough-and-tumble arena of stock marketing investing. I call these rules the Ten Traits of the World's Most Successful Investors. They are intended as a guide for anyone who wants to dip a toe in the water of investing without taking a bath. They form the foundation of my approach to successful investing and serve as a jumping-off point on any discussion of the finer points of making money in the stock market.

It's important to recognize that the traits of top investors run counter to the instincts of most, if not all, human beings. As I will discuss in more detail in the coming pages, we are hardwired to avoid pain and seek pleasure, and that means we want, even need, to sell when prices are plunging and buy when they are rising.

When the value of our investments is dropping, our DNA literally programs us to sell to avoid further losses, and when we see everyone

around us complacently whooping it up over a market that only seems to go up, it programs us to follow the herd even though common sense and our observations of the most successful investors would tell us otherwise.

The good news is that with proper preparation, education, and planning, we can overcome our impulses and make decisions that are diametrically opposed to what the mob is doing at any point in time. In this way, we can avoid the psychological and behavioral forces that cause many people to panic and lock in losses when the market takes a downturn. In the face of hysteria, we can buy bargain-priced stocks when the market is tanking. We can temper our delirium when prices are rising and force ourselves to make a cool, calculated decision to sell, thus locking in profits and eliminating our risks.

Trait #1: Buy When Everyone Is Complaining, and Sell When They Are Celebrating

> Buy when everyone else is selling and hold until everyone else is buying. That's not just a catchy slogan. It's the very essence of successful investing.
>
> *J. Paul Getty*

The number one trait of successful investors is the ability to buy stocks (or whatever) when everyone else is panicking, and to sell when others are overly optimistic. This has been a hallmark of the world's greatest investors since the days of Homer. Renowned oilman and investor J. Paul Getty said he got rich by buying when everyone else was complaining, and selling when they were celebrating. Former prominent hedge fund manager Mark Sellers told a graduating class of Harvard MBAs that the ability to succeed as an investor has nothing to do with IQ or education. "Everyone thinks they can do this, but then when the market is crashing all around you, almost no one has the stomach to buy." Warren Buffett has observed that you always pay a premium for a cheery consensus.

Sure, the price of an undervalued stock may continue to fall after we have made a thoughtful purchase, and it might keep going up after we have cashed out. Timing the market to the precise top or bottom of any particular stock or industry segment is, for all practical purposes, impossible. The trick is to avoid getting rattled by the fluctuations of the market, leading to a precipitous

buy or sell decision. Rather, the successful investor relies on his or her inner compass, based on a dispassionate analysis of the intrinsic value of a stock and market sentiment.

Trait #2: Have a Methodology to Weigh the Value of Your Holdings

> If I had eight hours to chop down a tree, I'd spend six sharpening my axe.
>
> *Abraham Lincoln*

The number two trait of top investors is to have a methodology for valuing the investments you hold or are thinking about buying. The price determined by an independent analysis is likely to be different from the current market price.

The world's best investors look at a company's share price relative to revenue, free cash flow, earnings momentum, and the rate at which shareholder equity is compounding. All of these factors can help determine the intrinsic value of a given stock, independent of what the market says that day.

This gives investors the luxury of ignoring market fluctuations; instead, they determine by their own objective criteria whether a stock is overpriced, priced near its actual value, or priced below its intrinsic value, making it a potential bargain and a candidate for our label of "Fallen Angel," which was originally an old Wall Street term to describe a stock or bond whose market price has declined due to such circumstances as business cycles, recessions, or setbacks for the company in question.

Not all marked-down stocks qualify as Fallen Angels; some companies deserve to be devalued and should not be purchased even if their share prices are depressed.

Trait #3: Stick to Your Methodology When Times Are Tough

> If investing is entertaining, if you're having fun, you're probably not making any money. Good investing is boring.
>
> *George Soros*

The third trait of successful investors is having the wherewithal to stick to their guns, even when their actions run against the grain

of market behavior and open them to criticism. We humans crave affirmation of our actions from our peers, friends, relatives, even total strangers. We feel comfort in knowing we are in the same boat as others, as evidenced in the old adage "misery loves company." Unfortunately, misery is often the fate of investors who blindly follow the market's rollercoaster swings. When it comes to successful investing, the crowd is often wrong. Those who mimic the crowd's actions also share in its financial losses.

That's why I urge you to develop your own criteria for deciding what a stock is worth, and then use those criteria even when it means bucking market trends. In the end, you should be better off for setting your own financial course. That means basing both buying and selling decisions on the stock's intrinsic value, rather than getting swept up in the irrational highs or lows brought on by market swings.

Don't get complacent and expect a stock to keep going up forever, because it won't. Set a target for when to sell in advance, based on the analytical tools at your disposal, and stick to it, even if you think the stock is likely to keep going up. The chances of figuring out exactly when a stock has peaked are about as good as predicting the odds of a football game. Follow the lead of savvy investors and do your homework, determine when a stock has met or surpassed its intrinsic value by a reasonable margin, and then sell while others are eager to buy, locking in your profits.

Trait #4: Have an Exit Strategy

> If a speculator is correct half of the time, he is hitting a good average. Even being right three or four times out of ten should yield a person a fortune if he has the sense to cut his losses quickly on the ventures where he is wrong.
>
> *Bernard Baruch*

The fourth trait of successful investors—having an exit strategy—dovetails with my last point. As I discussed earlier, decisions on whether to buy or sell are infinitely easier—and smarter—when you have pegged the intrinsic value of the stock based on your own measuring stick, apart from the fickle feelings of market mavens.

Great investors don't pull the trigger on a purchase or sale based on a spur-of-the-moment impulse tied to the emotional ups and downs of the market. Instead, they plan and think about the

optimum time to get in or out, then follow through with their strategies in logical, dispassionate fashion. The rest of us would do well to follow the lead of world-class investors, who chart their own course and often act in a manner contrary to the investing masses.

By paying careful attention to the intrinsic value of the companies, you are buying and selling in relation to what the market thinks they're worth. By watching the reactions of the market to external stimuli, over time you will hone your ability to judge the most opportune times to enter or exit the stock market.

Under the Fallen Angels strategy, three occurrences generally inform us that it's time to sell: The company has met or exceeded our estimate of its intrinsic value; a fundamental change has taken place in the market or the company that negatively affects the company's ability to generate returns for shareholders; or we need to raise cash to invest in another, more favorable, opportunity.

The decision to sell should always be tied to a specific reason or goal, rather than following the investing crowd. Further, I advocate that whenever possible, investors should hold their purchases for the long term, a horizon of three to five years, to reap the benefits of compounding after-tax rates of return.

That's not to say I advocate joining the "buy-and-hold" crowd, who buy a stock and hang on to it forever, regardless of the prospects of the company.

Paul Samuelson, Nobel laureate and professor of economics at MIT, conducted research that convincingly refuted the "buy and hold" strategy. Samuelson called that method of investing a young person's game, reasoning that younger people have more time to recover from market crashes. While that may be true, no one has forever, and history shows that the longer you hold on to a broadly diversified portfolio, the higher the odds you will experience a significant market downturn.

As an example, stock market investors in the 1920s were flying high, enjoying fat profits. They were comfortable and complacent, but a few years later their portfolios had lost 81 percent of their value. Eventually, prices did climb back to pre-Depression levels. But few of us can wait 20 or 25 years for our investments to recover from a major crash. The world's greatest investors recognize that investing over the long term does carry its own risks.

Trait #5: Be Properly Diversified, Not Overly Diversified

> I don't want a lot of good investments. I want a few outstanding ones.
>
> *Phillip Fisher*

For the next trait of top investors, let's take a peek inside their carefully managed portfolios. Trait number five is being properly—but not overly—diversified.

Diversity in a portfolio can be a good thing, but too little or too much of a good thing becomes a liability. With a properly diversified portfolio, a savvy investor can expect a 70 percent chance, or better, of making a profit. Who wouldn't like those odds?

Successful investors do their homework, find stocks they rate highly, and confidently buy large positions in those issues.

It's just as bad to have too little diversity. One common mistake made by investors is to buy only the winners, the darlings of the last market cycle. People come late to the party, wanting to put all of their money in whatever stock is hot. They pay little attention to fundamental valuations, but instead act on the "news" of the day, which is out of date by the time it hits newsprint, the airwaves, or cyberspace. Another way to be poorly diversified is to keep too much money in cash, with just a small position in quality companies. Investors believe they are mitigating risk with such a strategy, when in fact, they are guaranteeing that even if their investments do phenomenally well, they'll make little or nothing. Such a strategy, if you can call it that, has no upside.

When it comes to investment allocations, I like an approach I've heard referred to as the rule of 100. Some have referred to it as the *Couch Potato strategy* because you can lounge in your La-Z-Boy, and make asset allocation changes just once a year. Start with 100, and subtract your age. If you're 40, put 40 percent of your investment dollars in bonds, cash, and other low-risk instruments, and put the remaining 60 percent in growth-oriented equities. If you're 60, reverse the allocation, with 60 percent in bonds and 40 percent in stocks. Under this rule, as you age, you'll reduce your exposure to more volatile investments, but you'll never be completely out of the stock market until you turn 100. And even young people, who think they'll live forever and are prone to excessive risk-taking, will keep some of their loot in bonds and safer investments.

Trait #6: Live with Volatility without Changing Your Investment Strategy

> Most of the time stocks are subject to irrational and excessive price fluctuations in both directions as the consequence of the ingrained tendency of most people to speculate or gamble . . . to give way to hope, fear and greed.
>
> *Benjamin Graham*

Now that our world-class investor has devised a method for valuing of stocks, established an exit strategy, and assembled a properly diversified portfolio, we can turn to trait number six, living with volatility. This trait may be the toughest of all the traits to emulate, since it teaches you to act in a way that will feel counterintuitive, even uncomfortable, when the market experiences periodic ups and downs.

Volatility is similar to turbulence on an airplane, in that it makes you jittery, it happens all the time, and there's nothing you can do about it. Unlike airplane turbulence, however, which can make you nauseous; stock market volatility can actually be your friend. It can deliver great bargains to smart investors by temporarily lowering the stock prices of otherwise sound companies.

Volatility occurs in all markets, and many investors counter it by over-diversifying in hopes of reducing their risks. But, as we've already discussed, spreading your investment dollars too thinly usually results in reduced profits.

Instead, the greatest investors rub their hands with glee when the market goes south. They whip out their checkbooks and buy, buy, buy. When market downturns put a dent in their existing holdings, they often buy more, or just ride out the volatility, refusing to give in to the temptation to sell and lock in their losses. Because these investors know the difference between volatility and risk, they know that if they hold on to their investments, the prices will eventually rise, making them whole, and even bringing profits their way.

Trait #7: Recognize That Volatility Is Not the Same as Risk

> Absent a lot of surprises, stocks are relatively predictable over twenty years. As to whether they're going to be higher or lower in two to three years, you might as well flip a coin to decide.
>
> *Peter Lynch*

Successful investors know the difference between market volatility and true risk, which is the seventh trait on our list. Learning to make that distinction is tricky and takes practice. Confusing the two is easy to do; it's a mistake made by many investors less seasoned than our world-class pros.

In short, volatility is the day-to-day price fluctuation that occurs in any market, be it stocks, soybeans, or crude oil. Even real estate values move from day to day, depending on sentiment and the cost of capital. These fluctuations are caused by many factors, but at their heart is the mood of the investors making buy and sell decisions at any given moment in time. Moods are the result of psychological factors, a state of mind, and have no business being part of important decisions like when to buy or sell an investment. But, because humans are subject to moods, and humans run markets, moods take on an exaggerated importance when it comes to investing.

Volatility can bring prices up or down with breathtaking rapidity, and these changes most often have little to do with the underlying value of the commodity in question.

Risk is an entirely different animal; it's the chance of experiencing a permanent loss of capital. When investors stubbornly hold on to a company whose true value is declining, that's taking an unnecessary risk. Those who confuse volatility with risk—something the best investors rarely, if ever, do—can make critical mistakes from which recovery can be very difficult. A panicky investor who confuses volatility with risk is prone to sell rather than hold or buy more, bringing a double whammy—the panicked investor misses an opportunity for additional future profits *and* turns a paper loss into a real loss. Successful investors benefit from the irrational fears caused by sharp market swings, buying up great companies at bargain prices.

One way to tell the difference between volatility and risk is to recognize the factors that create Fallen Angels—a one-time calamity affecting a single company, an overall market downturn, or a temporary recession affecting a specific industry.

Having the confidence to act on your convictions takes determination, self-discipline, and good research. An example of a temporary setback might be a legal judgment that wipes out a company's earnings for an entire year. If the company still has a strong and expanding customer base, it will likely ride out the storm and return quickly to profitability. Merck, the giant drug-maker, experienced just such a financial hit in 2004 when revelations surfaced about side effects from the pain-killer Vioxx. Investors who bought

the depressed stock at its trough doubled their money in a little more than two years as the stock recovered.

The world's greatest investors know that if a company has low debt, good management, and a low price, it's an investment worth owning. The lower the price, the lower the risk and the greater the potential return. Price fluctuations caused by volatility are different than those caused by risk, which occurs when a company can't compete. A company that is part of a dying industry, such as today's large newspaper holding companies, might be a bad deal no matter how cheap the stock's price. When a company is in danger of failing, that represents real risk, and investors are right to stay away.

The hallmark of a great investor is the ability to figure out the real story before putting his money on the table.

Trait #8: Learn from Your Mistakes

> What we try to do is take advantage of errors others make, usually because they are too short-term oriented, or they react to dramatic events, or they overestimate the impact of events, and so on.
>
> *Bill Miller*

Great investors also learn from their mistakes, which is the eighth trait on our list. Everyone makes mistakes, and the trick is to recognize and learn from them so we don't repeat them. Even better is to observe and learn from the mistakes of others so we can avoid making them ourselves.

One common investor mistake is chasing returns from the "flavor of the day." Whether it is emerging markets, electric cars, or some other hot stock, today's darling is usually tomorrow's dog. The problem is, once word of a charmed investment hits the popular press, it's over. Those who spotted the trend early made their money, and those who try to get a piece of the action once the train has left the station are more than likely going to be run over. The old Wall Street adage, "What everyone knows isn't worth knowing," is certainly applicable here.

Even the greatest investors aren't immune to making mistakes. Warren Buffett tells the story about his own infatuation with airline stocks. After buying several airline companies and eating big losses, Buffett concluded airlines are risky investments, because the industry is so competitive, it requires large infusions of capital, and

profits are tied so closely to oil prices, which are out of the control of even the best airline company managers. In short, the airline business is unpredictable, which goes against another fundamental rule of good investing: sticking with sectors and companies that are highly predictable. To his credit, Buffett recognized his irrational attraction to airlines and installed a special red phone on his desk, which he pledged to pick up whenever he had an urge to buy an airline stock, so that colleagues could talk him down.

The rest of us would do well to follow Buffett's lead. Don't dwell on your mistakes, but do learn from them.

Trait #9: Understand Risk

> The crowd is always wrong at market turning points but often times right once a trend sets in. The reason many market fighters go broke is they believe the crowd is always wrong. There is nothing further from the truth. Unless volatility is extremely low or very high, one should think twice before betting against the crowd.
>
> *Shawn Andrew*

Trait number nine goes hand in hand with the earlier entries on our list about knowing the difference between volatility and risk. The world's best investors understand both. Unfortunately, based on my observation of the markets in action, this ability to grasp the distinction between risk and volatility is relatively rare. As Voltaire wrote, "common sense isn't so common." In every market cycle, we see evidence of this through history's frequent booms and economic busts. Whether we are talking about subprime mortgages, real estate, or dot-com stocks, successful investors avoid potential problems by understanding risk.

Risk rears its head on the heels of complacency by investors and in industry, when people expect profits to continue rolling in and expanding effortlessly.

The 2006 crash of the housing market is a great example. Everyone, from borrowers to bankers to brokers, expected the party to keep going forever. They figured people need a place to live, many cities were experiencing housing shortages, and besides, you get a tax break for owning a home. What they didn't count on was the end of the low-interest, easy money that financed the housing boom,

and the fact that incomes couldn't possibly keep up with endlessly rising home prices. When the bubble finally burst, many people and companies that had overextended themselves crashed and burned.

Another classic example was the dot-com boom of the late 1990s. The Internet was very exciting and real. It was truly a revolutionary technology that changed the face of entire industries, from retail to journalism. It turned out to be everything pundits said it could be, including the source of billions of dollars of commerce. However, back in the day, dot-com businesses sprouted up like weeds, and even solid companies became hyperinflated, with stock prices soaring to unreasonable, unsustainable highs. Top investors recognized the real risk of that frenzy. But many others did not. Anyone who bought eBay, Cisco, Amazon, Microsoft, or Yahoo! stock at the peak of the dot-com bubble in 2000 ended up losing at least half the value of his or her investment.

After the dot-com bust, a joke circulated about two old men sitting on a park bench. One says, "I've fooled around during my life, and now that I'm in my golden years, I've got a big problem, I've got syphilis at 81." The other guy looks at him and says, "That's nothing, I got Yahoo! at $200." Some might chuckle, but not the people who really did buy Yahoo! at $200. Those overinflated prices represented real risk. The prices bore no resemblance to the underlying value of the companies.

The lesson here is that it's easy to get caught up in the trends and rhetoric of the day. Top investors keep their wits about them and stick to their time-tested strategy of buying value.

Trait #10: Program Yourself to Take Advantage of Opportunity Quickly

> All mankind is divided into three classes: Those that are immovable, those that are movable, and those that move.
>
> *Arabian proverb*

That brings us to the tenth and last trait of the world's most successful investors: Program yourself to take advantage of opportunity quickly.

Successful investors are comfortable acting alone, without the benefit of crowd consensus. They are often selling when everyone else is clamoring for what they're unloading. They are buying

when no one else is interested. What they sell may go higher still, and what they're buying may continue to decline. But successful investors ignore the market's short-term moods, knowing that with the benefit of a reasonable time frame, value always prevails on or off Wall Street.

Bernard Baruch, recognized as one of the greatest investors of the late 1800s and early 1900s, liked to say there are two kinds of people on Wall Street, the quick and the dead. On Wall Street, winners are those who recognize opportunities and act quickly and decisively to take full advantage of them. Losers are those who passively watch the parade march past.

If you want to emulate the world's top investors, don't buy and sell when the mood strikes you. Develop a plan and stick to it. Like the best investors, use a carefully thought out rationale for your buy and sell decisions, and have the fortitude to follow that rationale even when the crowd is doing the opposite.

This approach is essential whether you are buying or selling. Let's say you have purchased a position in a stock, and you're looking down the road, to the time when you might want to sell. You complete a forecast for that company based on predicted earnings and determine that the company's value, and your shares, ought to double in five years.

But the market, as so often happens due to volatility, speeds up the process, and the stock price doubles in just one year. You ponder whether to hold on for even greater returns, but that would be a mistake. Using the disciplined approach embraced by top investors, you sell your holdings, take your profit, and enjoy the gift the market has handed you.

If you wait, chances are the price will fall, and you'll have to wait longer for your target return. I say, if you've done your homework and determined a reasonable goal, and the price meets that goal, don't wait. Sell and begin looking for your next great investment opportunity.

The process works the same way when market fluctuations cause the stock of an otherwise solid company to tumble. The worse the news, the better things are for the informed, disciplined investor. Once again, the market has handed you a gift, in this case stock in a quality company at a discount price. Be quick or be dead, as Bernard Baruch said. If you have programmed yourself to buy when a stock reaches a certain level, follow through on your plan, or live

to regret it. You're doing what the world's greatest investors have always done; buying when everyone is giving it away.

If I can pull one single overarching lesson from these ten traits of the greatest investors in history, it is this: Your own well-reasoned, deliberate evaluation of a given investment's value is always worth more than the highs and lows assigned by a fickle market governed by mood swings, panic, and hysteria.