Introduction

Trading and investing are not games, but you should think and act as though they are. You would not bet on a losing poker hand, and you should not bet on a losing investment position, either. Every time you put down money, it should be with an expectation of a gain. This is called "positive expectancy" and involves calculation of the probability of gain. It also involves calculation of the probability of loss. Every famous trader talks about loss. Some traders go so far as to say that when they sit down at their desk every morning, they say aloud: "how much will I lose today?" This is neither an unhealthy obsession nor a morbid emphasis on the dark side of life; it's a clear-eyed interest in the internal battle of the psyche when it stares failure in the face.

Positive expectancy is not just some vague idea that every trade will be a winning one; it should be a statement of a specific dollar number. Psychiatrist Ari Kiev finds that naming dollar targets improves results enormously. It is not true that results depend on "the market"—how trended it is, or how volatile. Results depend on the trader. A trained trader—or a natural-born trader—walks a tightrope spun out of self-confidence, and self-confidence is stronger than steel. Tightrope walking requires perfect focus and concentration; it is not a part-time hobby that leaves room for doing six other things at the same time. Self-confidence comes partly from doing the work that precedes the trade.

"Doing the work" of trading consists of finding the combination of analytical techniques for which you have an affinity.

These may be fundamental or technical, or rooted in sociohistorical insights—it doesn't matter. You cannot buy a winning technique in a book or a software program. Conditions will always be slightly different for you, and your implementation will always be slightly different from the next person's—because of you. No system is entirely rule based; some personal judgment is always needed. You will not be able to trade a system that embodies a holding period time frame or a win-loss ratio that you find unsympathetic. Discovering a trading methodology that is suited to your character and personality is a voyage of self-discovery.

The biggest obstacle to becoming a successful trader is your attitude toward losses. The value-investing school that is dominant in the United States today holds that losses don't count if you really have bought a value stock. "It will come back" is utter nonsense. You cannot know with certainty that you have a value stock, and there is no game in which losses do not count. Trading and investing are not games, and the theory of gambling and statistical logic is not arguable. The biggest con game in the world is the assertion, by stock brokers and mutual fund peddlers, that holding stocks for the long run will result in compound annual returns of 12 to 16 percent, as history has shown. There is no rate of return inherent in U.S. stocks—or in any other investment, except bonds.

Nobody knows where and when we started to accept a phony semantic distinction between "investing" and "trading." Old-time Wall Street legends like Bernard Baruch and Gerald Loeb would be appalled. *They viewed buy-and-hold as the real gamble.* You make actual money only when you sell. Moreover, you take no risk when you are out of the market. To say that you are investing your savings in the stock market and, at the same time, to say that trading in and out of the stock market would be too risky, is to accept an illogical proposition. This was blindingly obvious to commentators as early as 1870, when a large number of books about Wall Street started to appear. Many have been republished by the Fraser Publishing Company of Vermont, by Ed Dobson at Traders Press, and, in the 1990s, by big publishing houses such as McGraw-Hill and John Wiley & Sons. These wonderful books have titles like *The Theory of Stock Speculation* (1900), *Studies in Tape Reading* (1910), *Studies in Stock Speculation* (1924), and *The Art*

of Speculation (1930). If you see these books at a garage sale, don't hesitate. They contain exactly the same advice and perspective as any trading book today, without the pious and false distinction between "investment" and "speculation." Trading stocks and commodities has inherent risks, and you might as well face them head-on, acknowledge that all market trading is speculation, and learn as many of the tricks of the trade as you possibly can.

Pointing this out is probably like preaching to the choir. After all, you are holding a book with the word "trader" in the title. But, like most people who have been brainwashed by the prevalent equity culture today, you are probably quite tentative and not fully committed to the idea that you will lose money on over half of your trades and it is the minority of trades that will make your stake grow—or it will be the one based on a lightning flash of insight, on which you bet big.

As Alexander Fleming found when he accidentally discovered penicillin, our brains achieve synthesis of a new idea after long, grinding analysis. You may have to trade for many years before you spot a trading opportunity so big that it is worthy of a big bet. Meanwhile, the best approach to trading profits is to make consistent small bets where the odds are in your favor but no single trade can be a catastrophe that knocks you out of the game. In this book, trading opportunities are named "inefficiencies." This is what professional traders are looking for, although they may not use that word. An inefficiency is any misperception by market participants of the true value of a security. It is the basis of Graham and Dodd's advice to buy stocks when they are temporarily at 60 to 70 percent of book value, and it is the basis of technical analysis trading, whereby you take a position when the price is temporarily off the trend. Academics mistakenly believe that markets are always efficient. They are not. They are inefficient more often than they are efficient. *Efficiency is a process, not a state.* This is why Value Line, which identifies undervalued situations and statistically projects the correction to true valuation, has been so successful for over 50 years.

We chose global markets because they are less efficient than equity markets in the United States. Let's face it, the U.S. stock market is thoroughly picked over and analyzed to death. In Europe and Japan—let alone emerging markets—the securities industry is

less than 20 percent the size of the U.S. establishment, and that includes the number and quality of securities analysts. The citizens of foreign countries are not as involved in stock markets, either. Participation by individual Europeans is less than 20 percent (compared to 50 to 60 percent in the United States); and in Japan, participation is less than 10 percent. On the other hand, individuals in those countries are far more savvy about the foreign exchange market than Americans are, and foreign-currency-denominated accounts in both places are common. They are rare in the United States.

Americans are overinvested in the U.S. stock market. To diversify into foreign stocks is not necessarily the best answer, or the only answer. The stock markets in major countries are highly correlated with the U.S. market, or with one sector of the U.S. market. The Morgan Stanley Capital International index for Europe, Asia, and the Far East (EAFE), for example, was 50 percent correlated with the S&P 500 for the 30 years leading up to 1995, but 74 percent correlated with it in the five years from 1995 to 2000. The Taiwan Taipei index and the Korean KOSPI are highly correlated with the Philadelphia Stock Exchange Semiconductor Index (SOX). Other examples of correlation abound, but you won't find them neatly listed in a book or a financial periodical.

The diversification analysis performed by brokerage houses and Web-based services use long-dated correlations that are increasingly out of date, and many other untenable assumptions, such as the expected rate of return, also based on long-dated past returns. The result is that you have no idea what risk you are really taking. Portfolio theory is elegant, and impossible to refute. It's also impossible to implement without making a lot of assumptions and guesses. To diversify correctly, you would need to look at markets and securities as disconnected as possible from the S&P 500, the Dow, and Nasdaq, and evaluate their correlation—or the absence of correlation—on a one-by-one basis. Nobody is offering a "beta" today for each security in the world vis-à-vis the S&P 500, but this is not as hard as it sounds, especially since, as a trader (rather than an investor), you are no longer considering your holding period to be "forever." You can easily construct a correlation study in Excel or Lotus.

You can stay in stock markets, if you prefer, but you would be bypassing one of the great diversification opportunities of all time—the futures market. Leaders of the equity culture work very hard to keep you from noticing the futures market. They constantly issue warnings that the futures market is ultra-risky and nearly everybody who ventures there loses his shirt. But many securities in the futures market are *less* volatile than equities. What makes futures markets riskier is the use of leverage, or borrowed money. Most people cannot grasp the essence of leverage and do not apply sensible rules of trading, so horror stories abound. There is a vast difference in the mind-set of equity market participants and futures markets participants—and their brokers, analysts, software programs, and press. "Business" periodicals such as *Forbes, Business Week,* and *Barron's* focus exclusively on equities; when they write about futures trading, they are disapproving. This is partly because they view technical analysis, universally used in futures trading, as some kind of unproven voodoo that will inevitably lead the reader to ruin. And yet, unless you are going to "buy value stocks and hold forever," at least some rudimentary technical analysis is essential for trading success.

You will have to overcome the prejudice against futures trading that is widespread in the United States today. Futures trading is in fact a good place to practice trading any global security, whether it is a Chinese stock, German bond futures, or deep-discount Argentine sovereign debt. Futures trading forces you to consider the probable win-loss ratio *very* carefully, and that is the key to all trading success. The advanced academic work that is being done today on risk—measuring it, managing it, and systematically exploiting it—is being done in the futures markets. Technical analysis and its cousin, money management, are integral parts of futures trading precisely because they are the tools that help you calculate the probability of winning and the probability of losing. Technical analysis proponents sometimes claim too much for it; they say that it is like having inside information on what's going to happen next. You don't need to go that far to take advantage of a useful tool.

Don't think that you can bypass technical analysis and risk management if you chose to bypass futures trading. You still need

an estimate of the probability of winning in any trade and an exit strategy when prices move against you. You probably do not speak and read Chinese, Hebrew, or Turkish—and you wouldn't necessarily be any the wiser about specific securities and markets if you did. Technical analysis is the one tool that transcends language. Fortunately, this means it also transcends BS and is thus very liberating.

Technical analysis cannot, however, predict a price shock. A price shock arises from a surprise event that was not on anyone's radar screen, except the few who are carefully imaginative. A price shock develops from a series of events and culminates in one big event, whereupon, with perfect hindsight, everyone recognizes what has been going on all along. This is why we *read.* We are seeking information to build two insights: first, what securities price development exaggerates true conditions, either overvaluation or undervaluation. Once we find an obvious case of mispricing, we can imagine that some shock or event must come along to reverse the perception. The best story to illustrate this process is Jim Melcher's realization that, after the Russian sovereign default in September 1998, at one point the entire Russian stock market was worth less than half the value of Yahoo! He bought near the bottom and booked a 160 percent gain in only a few months. No newspaper reporter had observed that the Russian market was so undervalued. If one had, he would have become a trader instead of a newspaper reporter. But news reports are the raw material for creating insights and, make no mistake, a creative process is involved. Much pompous bumf is written about the creative process, but let's just say that it is not entirely rational and logical.

The second insight we seek by reading is to guess what will influence institutional investors, who, collectively, are the real driving force in every market. Chat-room visitors mistakenly believe that what influences them is also what influences institutions. They err in falling in love with their stocks, forgetting that a stock is not the company. Institutional investors are far more hardheaded but are, at the same time, just as susceptible to herd instinct as anyone else. The phrase "herd instinct" is a semantically insulting way to describe group behavior. But professional institutional investors are required, by their own rules and their contract with their clients, to meet or beat benchmarks, which,

by definition, are the grand sum of group behavior. An entirely contrarian institution may hit an occasional home run but is generally doomed to remain small. Individuals buy into professional management precisely because they want to meet or beat benchmarks. On the whole, professional managers fail to do even that, which raises the question again: what do we really seek when we trade securities markets? Is the goal to prevent the loss of capital (defensive) or to make money (active)? Anyone who made a first investment in the U.S. stock market in March 2000 failed to prevent the loss of capital one year later if he had bought into a standard index-tracking mutual fund. In what way is this defensive and protective of "savings"? What risk aversion means to the individual is very different from what risk aversion means to the institution. Risk aversion to the institution means avoiding anything that jeopardizes the ongoing existence of the institution. It does not mean maximizing *your* cash. Having said all that, we still need to be able to predict what institutions will do in the face of price shocks and watershed Events. There is no point in analyzing a situation correctly if the crowd does not also come to the same realization.

Economist John Moffatt, at Analytic Systems in New Hampshire, says that the price of stocks is determined by three factors: (1) 50 percent, market influences; (2) 25 percent, the macroeconomic background, and (3) only 25 percent, the fundamentals of the company itself. This suggests that picking a rising-star company in a falling market is likely not to yield the gains you might expect, especially if the company's home-country economy is in a slump. Further, you may want to keep the bulk of your investments in the United States, if only to avoid foreign exchange risk. The top-down approach would be: first seek a rising market, then make sure the economy is rising, then seek specific securities. Meanwhile, keep an eye on any situations that are bottoming or are oversold, because we can guess that the next wave of market sentiment will likely be upward—possibly, to an excessive degree. Many if not most of these situations will be high risk in the conventional way of looking at things. Country or sovereign risk may be high. Disclosure and transparency may be awful. Liquidity may be low and price volatility high. The currency may be a problem, including

convertibility (back into U.S. dollars). Nevertheless, these situations are where the high-probability gains are to be found.

The world is a big place, and trading is a zero-sum game—your gain is someone else's loss. You need a well-stocked toolkit to venture outside of a "strategy" of merely buying U.S. mutual funds. Don't be a cheapskate. Get the tools you need. Nicholas Darvas describes how he made $2 million from remote places in the world with no tools except stale copies of *The Wall Street Journal,* a hotel telex machine, and his theory of how prices move (Nicholas Darvas, *How I Made $2,000,000 in the Stock Market,* Lyle Stuart, 1971). You could do it, too. But the world is faster-moving than in Darvas's day (the 1950s), and the tools are cheap. If you are starting literally from scratch, you will need to get subscriptions to the major world newspapers and business periodicals, a data service, several newsletters, and a technical analysis software package, not to mention a PC to run the software and access the Internet. You will also need 10 to 20 books. The total cost of all this is $2,500 to $5,000, depending on how fancy a PC you get. Ongoing subscription and data costs will be about $100 to $300/month, or $1,200 to $3,600 per year. This may seem like a big investment, but consider what you pay in fees to a mutual fund—1 to 4 percent—and the return you expect to get on the outlay by doing the work yourself. You should be able to recapture the capital investment in the first month or two, and you should target your return to do precisely that (following Kiev's advice).

Almost every writer on trading has at least one valuable point to make that you can use in your own trading. You can buy books and file magazine articles for the rest of your life. At some point, you have to choose which market, which specific security, and which specific technique you will use. The secret of trading, which a lot of people do not want to admit, is that everything works. Cycle theories, with or without astrological overtones, work. Pattern recognition, once you train youself to see patterns (whether of the head-and-shoulders variety, or Japanese candlesticks), works. Statistical techniques, whether you use channels or arithmetic formulations such as moving averages and momentum, work. Neural networks, which find organization within apparent chaos, work. Today, we have computers and software to help implement all these techniques, and the techniques work.

No technique works all the time, and no technique works on every security, so you have to find what works on your security or pick a technique and find what securities it works on. In the end, the only really difficult question you have to address is the time frame of your trading. If you can see big-picture trends and therefore choose a long time frame, there is a set of long-term indicators that will work on your securities. Be aware that long-term trading, in which you hold a position for months and even years, is where big one-time gains are to be made—but also where big one-time losses may occur, too.

If you pick a shorter time frame—for example, today's popular "swing trading" of three, five, and eight days or weeks—you will use a different set of techniques and a different mind-set. You will need to be more opportunistic—that is, less emotionally committed to the trade—because, at this level, the market is throwing off a lot of "noise" (random moves). You therefore have to have a personality that is more accepting of high risk and of frequent losses.

Most individuals think that they need: first, a trading system; next, a money management system, and last, a way to train themselves to operate the trading and money management system with discipline and focus. This sequence is backward. The first thing you need to do is: take an inventory of yourself and find out what securities are suited to you. If you do not have the patience and the time to follow economic and market conditions in China, you have no business trading China Telecom, even if you are a world-class expert on the telecom industry. If you *have* the time and energy to follow conditions in China, it doesn't matter what trading system you adopt to trade China Telecom. Any number of equally valid trading systems will work just fine to give you buy/sell signals. Then, of course, you need to follow the signals scrupulously. Buying is easy, selling is hard. But as the great traders of history point out, you make money only when you sell.

It's important to acknowledge that the rules of the game are not what the brokerage and mutual fund industry would have you believe. A key theme of this book is that trading isn't what you think it is. Active trading is factually and logically far more defensible than index-tracking. Index benchmarks are meaningless because they are rigged to include the best and the brightest in a continual process of discarding losers. A company is not its stock,

anyway. Once you realize that the "value" touchstones peddled by the securities industry are dross, you might as well go global, where the opportunities are. Because it is very difficult to determine intrinsic value in foreign securities and to become fully familiar with market conditions in foreign countries, you are liberated to trade foreign securities (or derivatives) on the price action of the securities themselves. It is a deductive and rational process fully divorced from false-belief systems.

This is a harsh message. If you want to be a global trader, you have to devote a great deal of time and energy to the effort. You have to hold two ideas in your mind simultaneously: (1) the big-picture opportunity, and (2) the price vagaries of your specific securities. If, for example, the Chinese stock market is the place to be and you have selected a Chinese telecom stock, but suddenly the entire telecom sector worldwide starts tanking, including your stock, you need an exit rule that will keep your head clear. Then you need to apply the rule and actually exit, even though you have persuaded yourself that the "story" is a good one and "it will come back." Things change. It may not come back, even if it "should." In the meanwhile, some other security is worthy of your attention, and if you can't find such an opportunity right away, there is only one place for your cash—short-term U.S. Government paper. This is why global professionals rank markets according to attractiveness, and retreat to the zero-risk security when none of them measures up to the sure return on cash. Notice that the fall-back position is not a U.S. securities-based mutual fund.

Above all, you have to be realistic about the gains that can be made in your chosen securities, and the losses that will inevitably accompany them. It is usually unrealistic to expect a security that has already risen 150 percent to rise another 150 percent. It is also unrealistic to expect to recover losses at a pace of 100 percent, which is what is needed if you lose 50 percent of your stake—unless you are specializing in a security that routinely and predictably changes by 100 percent and you are sure that you are on the right side of it. Target each gain—and each loss, too. That's what professionals do that makes them different from the average trader.

A global trader is different from an average trader because he sees a bigger universe of opportunities—one that includes foreign bonds, emerging markets, futures, and all manner of newly developed instruments and securities. A global trader targets the one with the highest positive expectancy—and nails it down by not holding it too long and always entering a stop-loss. If the highest positive expectancy is in U.S. equities, so be it—but we should not automatically assume that U.S. equities are the "safe way to save." If you want to protect savings, buy bonds. If you want to trade, start looking for positive expectancies.

Chapter 1

TRADING VERSUS INVESTING

A mind stretched to a new idea never goes back to its original dimension.

Oliver Wendell Holmes

"Global trader"—a glamorous and sophisticated-sounding title. What exactly does it mean? If you buy the stock of a multinational company that operates worldwide, like Coca-Cola, aren't you already a "global" trader? And what's the difference between a "trader" and an "investor"?

Let's start with "global." It's true that U.S. multinationals like Coca-Cola, IBM, and General Electric all derive a high proportion of total sales revenue from foreign countries. Warren Buffett has been quoted as saying that he gets all the international diversification he needs from owning U.S. multinational companies. This is not, strictly speaking, true diversification. For one thing, U.S. multinational stocks do not trade very differently from their purely domestic counterparts. Aside from an occasional divergence due to special circumstances, multinational stocks are highly correlated with the S&P 500.

Multinational companies also vary widely in their management of currency exposure, the chief cause of earnings effects arising from international operations. Some hedge all currency exposure; some hedge none. During the second half of 2000 and first half of 2001, the stocks of many multinationals fell on earnings warnings from companies that had failed to hedge their

exposure to the falling euro. In dollar terms, sales and profits both fell solely from the currency effect. Stock analysts almost always ignore the currency hedging policies, practices, and outcomes of U.S. multinationals until there is an emergency like this. It's possible that they may not understand currency effects, but it's also true that companies disclose very little about it. They are able to be tightlipped because U.S. accounting rules allow them to keep foreign exchange hedges off the balance sheet. (They may appear in a footnote, but only when the effect is "material.") It's not going too far to say that you are taking an extra and unknowable risk in holding a U.S. multinational corporation's stock.

Another way to look at "global" is to confine the term to non-U.S. companies. United States investors are comfortable with familiar-seeming but nonetheless foreign companies such as Sony (Japan), Nestlé (Switzerland), or Glaxo SmithKline (United Kingdom). They have major operations in the United States and their stocks trade on a U.S. exchange. Sometimes they are listed directly, but usually they are listed on the American Stock Exchange in the form of American Depositary Receipts (ADRs). It's easy to forget that these global companies are really foreign, that their stock price is most influenced by events in their home country's stock markets, and that although you pay and receive dollars when trading them, their underlying stock is priced in the home-country currency. The case of Nokia and the Helsinki Exchange is notable. The telecom industry and the euro both slumped at the same time. American investors got hit with a double whammy, and so did anyone who bought a Finnish stock directly in Helsinki, since Nokia dragged the whole index down.

A subset of foreign stocks is the small but growing class of hybrids, from the point of view of nationality. Daimler-Chrysler springs to mind, but before that merger we had Anglo-Dutch companies like Royal Dutch Shell and Anglo-French Airbus Industrie, as well as Anglo-Australian Rio Tinto. Cross-border mergers are becoming ever more common. In addition to the inevitable effect on earnings of the choice of "home" currency, hybrids pose some serious management and corporate-culture problems that professional securities analysts—let alone inspired amateurs—have a hard time wrestling with.

"Global" can also refer to the time frame of trading—meaning, essentially, 24 hours a day. This is a bit of an exaggeration so

far. The only securities that can really be traded 24 hours a day are spot currencies and currency, bond, and stock index futures. But don't stick your head in the sand. The 24-hour trading of individual stocks, and of individual stock futures, will happen in our lifetime—perhaps as soon as five years from now. You may say to yourself that you don't want to be a slave to the quote screen, like spot currency traders who have to know, at 2:00 A.M., where their yen is. Markets that are open 24 hours are an inconvenience to those who prefer an orderly life and a full night's sleep. Even if you choose not to accommodate your schedule to the world's time zones, the very existence of price moves 24 hours a day will force upon you the need to sharpen your trading skills. Some very unpleasant surprises can occur overnight. Like all problems, however, 24-hour trading also offers opportunities, such as arbitrage between time zones—the strategy behind the Rothschild fortune in the nineteenth century—and intermarket analysis. (If the Nasdaq declines during U.S. hours, the Nikkei 225 index also declines, eight times out of ten, during Tokyo hours.) Many of these opportunities can be exploited without losing a minute of sleep.

Organizing Principles

To take advantage of the emerging global market, you need well-thought-out organizing principles and trading rules. You want trading rules so well established that they become almost mechanical; otherwise, you can become so overwhelmed by information overload that you can't make any decision at all.

Books and magazine articles abound in trading rules promulgated by famous investors and traders. They all sound sensible until you realize that many of them are mutually exclusive. Don't throw up your hands in despair. There is a way to separate rules into two camps by what can be named the "holding period philosophy." Once you know the preferred holding period of the guru, you can deduce the chain of logic that leads to the rule. Some aphorisms are appropriate to "investing" (a long holding period) and some are appropriate to "trading" (an indefinite holding period). We think of "investing" as a process of identifying a temporarily mispriced stock that has intrinsic value, and holding it for such a long time that the market has a chance to come to its

senses and price it higher. A value stock will fall less when the market falls because it is acknowledged as having high intrinsic value. It is "safe." "Trading," on the other hand, is perceived as more dangerous. Traders may place their money on securities without intrinsic value solely because they are rising, and they may risk losses because the prices of such securities are more volatile. Traders compound the risk of dealing in volatile securities by using leverage. Trading is a stressful occupation that is akin to gambling. Investing is a form of saving, and saving is a virtuous act.

This conventional differentiation is mistaken on many counts. The laws of probability and statistical logic apply to any venture in which money is staked on an unknown outcome, whether we name it "investing" or "trading." When we talk about trading, we use the semantically loaded language of gambling because the history of the study of probability and the most easily understood statistical models are exemplified by gambling cases. To illustrate a trading situation by using the language of gambling doesn't make trading itself "gambling." In fact, good traders place a portion of capital only on situations where the outcome is expected to be positive and the win-loss ratio has been estimated. Most "investors" place capital in situations where the outcome is not calculated statistically but is instead flavored with the nonspecific but equally loaded word "value." They bet without having a win-loss ratio in mind. Wise observers of this odd phenomenon, like Bernard Baruch and Gerald Loeb, marvel that it is the average investor who is, in fact, gambling.

You Will Take Losses

It is often said that the "first rule of investing" is to preserve capital. You can't play if you have lost all your chips. Therefore, the central issue is what attitude you should take toward losses. Everybody takes losses at one time or another. Losses are inevitable. How should you think about them? There are two competing philosophies and they have associated rules about stock market losses. The value-investing school of thought shrugs off losses as a temporary inconvenience. If you have selected the

right value stocks in the first place, losses should be only temporary. The other school of thought, which might be termed the pragmatic school, holds that controlling losses is the key to success. You can preserve capital only if you limit losses to predetermined levels and let the winners run. The goal of trading and investing is to make money—a positive statement, rather than the more negative orientation of "preserve capital."

Both can't be right. It is essential that you decide which philosophy you will adopt. You can't pick a rule or two from one school of thought if your overall orientation lies with the other school. A great deal of confusion arises from not being able to differentiate between some apt-sounding rule that actually carries a lot of baggage with it in the form of a chain of assumptions.

What's Wrong with Value Investing?

1. Markets are not efficient.
2. Value investing ignores risk management.
3. Analysts don't know how to do it, so how can you?
4. Companies are not stocks.
5. You invest to live, you don't live to invest. Value investing ignores personal risk management.

Value investing has, as its premise, that changes in the environment—specifically, market sentiment (whether bullish or bearish)—are always temporary. This is true. There is no such thing as equilibrium in stock prices. The process of "price discovery"—the continuous action of supply and demand—is never at rest. Sometimes prices are "too high"—given the P/E ratio or some other benchmark—and sometimes prices are "too low." The key to value investing is to acquire value stocks when they are temporarily "on sale," presuming that you can identify them in the first place. This is a function of financial ratio analysis and some other factors, such as the supremacy of a brand. Ideally, the true value of a stock is independent of what is going on in the market at large. If a stock should be valued at $25 and it is currently priced at $15, it is a bargain, and you should not care whether the S&P 500 is up or down at the time. Eventually, the price will be $25—but you will

continue to hold it on the assumption that it will lead the market when the market is up (and lag price declines when the market is down). Because the stock market has a long-term upward bias, historically, buy-and-hold is the correct approach if what you have is a true value stock.

There are any number of problems of fact and logic in the value investing approach. The first is that it assumes the market is efficient—that all relevant new information is known by everyone, and prices adjust immediately to the new information. You cannot predict new information and therefore you cannot predict what the price adjustment will be. You can't "beat the market" by anticipating big moves. Because the market is so big and has so many participants with different interests, you can't influence or control prices, either. You are, by definition, a passive observer of the scene.

1. Buy-and-Hold Is Bunk

"Buy and hold" gets its legitimacy from the *efficient markets hypothesis.* This was most popularly voiced by Burton Malkiel in *A Random Walk Down Wall Street* (W.W. Norton & Company, 1973). The theory holds that all the information that contributes to a security's price is known by everyone, and new information is known immediately and universally. The incorporation of fresh news into the price is efficient. Any inefficiency will be instantly arbitraged away. Only new information that was not foreseen can move the price. Just as unpredictable news is the only thing that can change a price, we cannot predict which way the price will change—up or down, or by what amount. Random news causes random price moves. The new random price move is unconnected to past price moves. Therefore, you can't predict stock prices and, observing that, over the long run, equities are a superior investment to bonds and other instruments, you might as well simply buy and hold as a practical matter. Market-timing cannot, logically, work.

You are probably getting weary of seeing the efficient market hypothesis mentioned in every book on trading and investing. Talk of efficient markets is tiresome because the mathematical

logic and statistical proofs offered by academics (and there are endless legions of them) are unassailable by the average investor. By the time you finish following the chain of reasoning, you are convinced that putting your money in an index fund is the only sensible and defensible course of action. Any other course of action is speculative, or at least embodies a risk that you can't effectively pin down. In short, academics and fund managers control the terms of the debate, and they structure it in such a way that it cannot be refuted. The efficient market hypothesis is now the "base case," and any other observation about the market is automatically relegated to the status of "minor side effect" or even "curiosity." Those who embrace the efficient market hypothesis have taken upon themselves the mantle of intellectual and moral superiority, and that can be very intimidating, especially when they have so much of what is obviously correct on their side.

The random walk argument seems beguiling, but it fails to address the observation that securities prices do move in trends, and some market-timers are systematically successful over long periods of time. *Any* random news may have a random effect, but not *all* random news has a random effect. The market does have a memory. We all know of cases where a stock that has been on a rising trend fails to fall on a bad earnings announcement, and rises instead in a "relief rally" after the bad news is out of the way. This may be irrational but it is not random. The response of securities prices to bits and pieces of news is not chaotic; it follows a pattern. If you can detect the main outlines of the pattern, you can outperform the benchmark indices.

Nonrandomness is also why we have 11,000 mutual funds in a universe of 7,500 stocks. In the "weak form" of the efficient market hypothesis, small companies, companies in certain sectors, and other groupings may have an advantage that will cause them to deliver higher earnings and higher stock prices. Concentration in these groupings may deliver higher returns than the benchmark. At the least, mutual funds seek to reduce the risk of the major indices or subindices without sacrificing the average return. But it would be a rare fund manager who would flatly say that the efficient market hypothesis is poppycock; instead, it is practically a religion. Hedge fund managers and managers of

other "alternative investments" say that the efficient market hypothesis may be correct, but the majority draw the wrong conclusion from it. Instead of seeking temporary undervaluation of high-quality securities, hedge fund and alternative investment managers seek inefficiencies of *all* stripes, whether in momentary market perception of a specific stock or the largest mispricing in a very large universe of mispricings.

The line of argument supporting the principle of diversification is thornier, but equally tinged with religious fervor. The formal statement was made by William Sharpe in *Portfolio Theory and Capital Markets* (McGraw-Hill, 1970), and Sharpe won a Nobel prize in Economic Sciences. This followed work by Harry Markowitz in 1953—so the investment world has had nearly 50 years to enshrine the concept and the rules that arise from it. The problem is that all models make simplifying assumptions that do not reflect real-world conditions, and portfolio theory is no exception. No one will argue with the idea—let alone the mathematics—that "Diversification reduces risk." But the theory requires, among other unrealistic requirements, that the correlation between two securities does not change over the period under study—and we know that the world's stock markets are increasingly influencing one another. To buy the Nikkei 225 as a diversification play from the Nasdaq, for example, is a fool's errand because they are highly correlated. To use the past 5 or 10 years' average returns in a market as the forecast for the upcoming 5 or 10 years lacks credibility, too, because economies and companies are dynamic, not static—they *change.* In *CNBC 24/7, Trading Around the Clock, Around the World* (John Wiley & Sons, 2000), we cite a study by an economist at the Boston Federal Reserve, showing that you cannot force a global portfolio optimization to include an Asian (ex-Japan) fund, due to negative returns in 1998 and 1999 arising from the Asia crisis (www.bos.frb.org/economic/neer/htm). The only way to include Asian stocks would be to discard the historical 10-year return and make a forecast of the upcoming 10-year return. Even the most seasoned professional would blanch at having to make such a forecast. It's an insoluble problem: to predict the future, you must use the past, but the past is unreliable.

A smart diversification rule is not to accept old data as perfectly reflective of the future. Before embarking on a search for the country or region that offers the most opportunity, consider that

recent research indicates that the best diversification comes not in the form of spreading money around in different countries, but rather in different industries. An International Monetary Fund (IMF) report (www.imf.org/external/pubs/ft/wp/2000/wp00216.pdf) shows that, over the past several years, industry-specific factors better explain global stock market returns than country-specific factors. This may partly be due to the higher weight of high-tech in many markets, such as Taiwan. Because over half of Taiwan's market cap is tech-related and those stocks rise and fall with the Nasdaq 100, you don't get diversification when you buy Taiwan stocks—even those that are not tech-related—because of the overall effect of "the market" on all stocks when high-tech founders. Logically, you want to find foreign small-cap stocks that are not influenced by global industry effects.

Another problem involves the calculation of indices themselves, and indices are universally employed to conduct diversification exercises. A corollary to "A company is not its stock" is the observation that an equity index is not its stocks, either. The continuous process of reconstituting indices to reflect the biggest names in a market or sector (or the "most representative" names, according to the index-compiler's judgment) results in what is called a success or survivorship bias. This is why the Russell 2000, for example, moves in odd spurts—its most successful companies grow out of it and graduate to the Nasdaq! Dimson, March, and Staunton, in *The Millennium Book, A Century of Investment Returns* (ABN AMRO-London Business School, 2000), recalculate U.K. stock returns to remove hindsight in share and sector selection and other factors, including researcher laziness (using data that is easy to get). They laboriously hand-collected data from the *Financial Times,* starting in 1899. The outcome is a new ABN AMRO/LBS equity index for the United Kingdom that "sets the record straight"—and the true performance is about half the figure generally accepted as the historic record. Applying the principle to other markets, they find that, on average, national stock market returns are exaggerated by 2.2 percent. There is wide variability, though: U.S. returns are overstated by only 0.8 percent, but the overstatement is 5.3 percent in France and 4.3 percent in Germany.

This is a bitter pill to anyone who paid $400 or more to a broker to concoct a personal optimum global portfolio. Over the past few years, brokerages and other vendors have offered optimum

portfolio construction as a fee-based service to the public, and already the less-than-sterling results are attracting scathing criticism in the financial press. Again, the central issue is that adherents have taken the intellectual and moral high ground—and there is no competing theory. There are only two ways to deal with the shortcomings of portfolio theory: (1) roll up your shirtsleeves and work around the issues—which is little more than guessing in most cases—or (2) ignore them.

To ignore portfolio theory is to subject yourself to the charge that you are a financial ignoramus, adrift in a sea of unknown risks without an understanding of each specific risk you are taking or of the combined risk of every item you own. You have a "collection" of securities rather than a "portfolio." And yet, people were putting together portfolios before portfolio theory came along, and the principle that diversification reduces risk is hardly a novel and revolutionary idea. We like to joke that common sense is not common (i.e., not widespread), but in practice, only people who do no homework at all would assemble a collection of concentrated risks if they were actually seeking a diversified-risk portfolio.

Besides, what is so wrong about concentration rather than diversification? Gerald Loeb says, in the introduction to *The Battle for Investment Survival* (Simon & Schuster, 1935), "Diversification is a necessity for the beginner. On the other hand, the really great fortunes were made by concentration." It goes without saying that if you are going to put all your eggs in one basket, as Loeb also phrased it, they must be good eggs in the first place and you have to watch the basket very carefully.

Of course value matters. Nobody in his right mind would seek to place his hard-earned money in second-rate securities with a high probability of falling in price. Many gurus are available today to offer advice on the extent of value in individual U.S. stocks. The Web site www.validea.com will even use the techniques of some of the top gurus to score stocks of your choice. At www.stockcharts.com and other technical analysis Web sites, you can find specific recommendations with full explanations. But neither "value" investing nor pure technical analysis alone provides the one thing you need to know about a security: is it mispriced? What specific inefficiency or set of inefficiencies is at work? How much is it mispriced, and why? If you buy it, what can go wrong? If you short-sell

it, what can go wrong? In short, what is the probable risk/reward ratio over a specific time frame? To determine the numbers, such as a $5 probable upside gain versus a possible worst-case $1 downside loss, you need to combine big-picture economics and market intuition, fundamental analysis, industry knowledge, and at least some idea of immediate support and resistance. The less you know or are sure you know, the shorter should be your trading horizon.

If you cannot synthesize all these factors and come up with winning trades in real time, then you should place your funds in bonds, where the rate of return is known.

Selecting Good Eggs

We can believe that the market tends toward efficiency (i.e., it prices stocks correctly when fresh information is released), but is not always efficient. Efficiency is a process, not a permanent condition. Financial markets theorists confuse a flow with a state, like the comparison of a cash flow report to a balance sheet, which is a fixed snapshot of assets and liabilities that changes five seconds after it is completed. There are times when the market does not have information. The information may exist, but it isn't widely known. A second case occurs when the market has the information but is interpreting it incorrectly. (Information is not knowledge, and knowledge is not wisdom.) Both of these situations are so common that we may say efficiency is often the exception rather than the rule. In other words, the market is pricing the security efficiently on the basis of what it knows or thinks it knows, but in reality, an inefficiency exists in the form of not-known information or improperly processed information. Inefficiency is a catch-all term; it encompasses a cornucopia of information that is not known to all or is at least not interpreted the same way by all.

In the first instance, where the information does exist but the market doesn't know it yet, some insiders may know it (and some outsiders may guess it). Inside information is the very essence of an inefficiency. When the market gets to know the new information, it may be efficient in pricing the stock higher (or lower, as the case may be). Meanwhile, as long as the information is not

known, the insider can exploit the inefficiency. The best way to select a stock that is sure to rise is to have inside information about an invention or patent, FDA approval, a merger or acquisition, or another major discovery. Actual trading on inside information is illegal in the United States, as various people have discovered to their rue (including printers of documents, and secretaries and their brothers-in-law). The illegality of insider trading means that assiduous study of insider transactions doesn't necessarily tip you to real inside information, although some claim it can come in handy, if only as an overall barometer of management confidence. Of course, it can also mean nothing at all.

The next-best way to pick a surefire stock is to get in on initial public offerings. In recent years, some 90 percent of IPOs have resulted in immediate gains (within the first three months). The problem here is that everyone knows this statistic, and there tends to be a shortage of IPO shares available to the general public. Those who are included in an initial allocation are big customers of the underwriter, or those able to return the favor. IPOs are an instance of inefficiency, too, not because of unknown news, but because of the supply constraint. As we noted in *CNBC 24/7, Trading Around the Clock, Around the World,* foreign companies that may have traded for years on their home exchanges often behave like IPOs when they are listed for the first time as ADRs. Supply constraints are typically less onerous then.

Inside information and IPOs are two examples of situations where almost no judgment is required to pick a high-probability trade. *Everything else takes work.* It seems ridiculous to mention it, but many people seem to feel that it doesn't take any special skills to pick winning trades. If you wanted to become an engineer, a gardener, or a cook, you would go to school, read books, and practice, practice, practice—but, for some reason, people feel they should be able to make investing and trading decisions with no preparation at all. In the real world, though, there are two essential paths down which you must go in order to succeed in investing and trading.

On the first path, you train yourself to identify the inefficiencies that offer profit opportunity. Warren Buffett, for example, has said that if electric utilities become deregulated, it's a business in which he would like to invest. This is a meaningful statement.

Buffett has identified an inefficiency (regulation) that inhibits electric utility companies from maximizing their performance. But he thinks it's a good business (and Mr. Buffett's judgment on company valuation is always worth consideration).

The second path is a form of self-discipline. It's conceivable that you could be given 10 insider tips and 10 first-round IPO allocations and still lose your entire capital stake if you failed to apportion correctly among the choices or if you failed to sell at the right time. Each trade has its own risk-reward characteristics that are roughly knowable in advance. You should apportion a higher percentage of total capital to the trade that has the higher win-loss probability ratio—but most people do not. If you are playing a game of chance in which the probability of winning is 3 to 1, you should put a higher proportion of total capital on each round of play than if the probability of winning is 1.5 to 1. If you have just had a big gain and your total capital is now doubled, you should continue to invest the same fraction of total capital in each probability category.

What is not so obvious is that when you have just had a big loss, you need to reduce proportionately the amount invested in each round of play. Instead, many people fall prey to the gambler's fallacy; after a series of losing trades, they increase the amount of capital on the next trade, on the assumption that "it's time" for a winning trade. This is simply nonsense. The market does not owe you a winning trade after a series of losing trades. In fact, the odds on a particular transaction have not changed at all or may have fallen, if it's the same security and if it is on a newly emerged falling trend. Moreover, a series of losing trades can easily happen even in a situation where the probability of winning remains at 3 to 1. The only way to stay in the game (preserve capital) is to trade a fixed fraction of total capital—and to trade only when the expected return is positive in the first place. It's always possible that your estimation of 3 to 1 is wrong, and a series of losing trades is the market's way of alerting you to that unhappy fact.

This raises another key issue of trading discipline. After you have discovered the market inefficiency that is your own special insight, you have to believe in it. True faith in your judgment can only come from having done exhaustive analysis, including an honest listing of all the things that can go wrong and a reasonable

estimation of the gain/loss probability. If you don't truly believe in your idea and in your ability to create a realistic estimation of the win-loss probability, you will exit at the wrong time.

Buy-and-hold is bunk because of these two points: (1) you are supposed to buy value stocks when they are temporarily cheap *but (2) you are not supposed to sell them when they are temporarily overvalued.* This runs directly contrary to the most basic rule of trading, investing, or playing a game: risk a portion of your capital stake only if you have an expectation of a positive return. When a stock becomes overvalued, it no longer has a positive expectancy. You wouldn't buy it today on its present valuation, whether you are using its P/E or any other criterion. If you wouldn't buy it, why should you hold it? Some other security is undervalued. It makes more sense to sell the overvalued security and buy the undervalued one, doesn't it? This is, in fact, the formula that John Templeton used in developing his first successful mutual fund.

2. Value Investing Ignores Risk Management

The value-investing school of thought starts with a holding period of your entire lifetime. Warren Buffett says, "My favorite time frame for holding a stock is forever." Once you have found a stock that meets the value criteria, it can fall from $50 to $10 but you will continue to hold it, unworried. It will come back. True value stocks always come back. In fact, true value stocks weather bear markets better than glamour stocks. Because it is a value stock, you don't need to follow the stock or the news about the company very closely. Philip Carret, the founder of one of the first mutual funds (in 1928), said you should evaluate your stocks only every six months. If you do it more often, you are likely to sell too soon. It can take years for the stock market to appreciate your value choice, and after all, even the bluest of blue-chip companies has to issue negative news once in a while. As John Bogle, founder of the Vanguard Funds, puts it, "Think long term. Don't let transitory changes in stock prices alter your investment program. Stocks may remain overvalued, or undervalued, for years. Patience and consistency are valuable assets for the intelligent investor. The best rule is to stay the course." In other words, don't let a loss get under your skin. Be loyal to your stock picks. Bull markets follow

bear markets and even the most beaten-down sector comes back eventually [*The Little Book of Business Wisdom, Rules for Success from More than 50 Business Legends* (John Wiley & Sons, 2001)].

Being able to hold a stock forever and to view losses as temporary requires that you really have identified a true value stock (i.e., it is not a buggy-whip stock in the age of the automobile). The first value investing rule is: "investigate before you invest." Warren Buffett's main source of information is the annual reports of the prospect companies and their competitors. Legendary investor Bernard Baruch said of the two principal mistakes made by nearly all amateurs, "The first is to have an inexact knowledge of the securities . . . to know too little about a company's management, its earnings and prospects for future growth." As a practical matter, most people do not have the time or the analytical skills to identify value situations. Thus, a huge industry of securities analysts, advisors, touts, and chat-room posters has sprung up.

To select a value stock on its internal criteria is to ignore its riskiness vis-à-vis the rest of the market (beta), and to ignore the riskiness of the market itself. When the luminaries of the stock brokerage industry appear on TV ads, they tell you that stocks are the only place to be, with a nod once in a while to bonds. But stocks are not the only class of securities available today to the average investor, nor the least risky. Stocks are far riskier than many other classes of securities, which is precisely why the average return on stocks is so high. You've heard of the one-for-one trade-off between risk and return. It is, roughly, true. In every other class of securities, especially futures, we hear that harsh risk-management discipline is needed to be a successful investor. But somehow, in "value investing," we need no risk management at all because "value stocks will come back." This is nonsense on the face of it. Companies change over time and can lose their intrinsic value through bad management, competition, failing to keep up with technological change, lost liability lawsuits, fraud, federal antitrust breakups, and for many other reasons.

3. Professional Analysts Can't Do It

Professional securities analysts who work for brokerage houses are trained in financial statement analysis, the heart of the

investment decision. Criteria for selecting value stocks were laid down in 1932 by Benjamin Graham and David Dodd in *Security Analysis* (McGraw-Hill, 1997), and have been modified, refined, and added to ever since.

On the simplest level, we know what makes a winning stock. We get the highest rate of return over a long period of time when we buy stocks with the lowest price-book ratio, lowest price-cash flow ratio, and lowest price to sales. James O'Shaughnessy gave us Table 1.1 in *What Works on Wall Street* (McGraw-Hill, 1997).

We all have available today the ability to scan the universe of stocks for companies that meet these criteria. At www.multex.com and many other Web sites, you can quickly and easily screen all the stocks to find those that have the best ratios. You don't even have to do the work yourself; www.worldlyinvestor.com has already done it in its "Value Stock Screen." This uses a large-cap bias to embrace companies with a low price-to-book ratio, recent market performance that is below average, and good earnings prospects.

Notice that the price-earnings (P/E) ratio is not on the O'Shaughnessy list in Table 1.1. It is on the list of a sophisticated analytical approach taken by Yale University Professor of Finance Zhiwu Chen, whose www.valuengine.com offers modeling based on three factors: (1) trailing 12-month earnings per share (EPS), (2) the analyst consensus estimate of the company's future 12-month EPS, and (3) the 30-year Treasury yield to derive a company's "fair value." It also uses some important

Table 1.1. The Best Ratios

	Annual Return, 1952–1994
All Stocks	14.6%
50 Stocks with lowest price/book ratio	17.5
50 Stocks with highest price/book ratio	**11.9**
50 Stocks with lowest price/cash flow ratio	17.1
50 Stocks with highest price/cash flow ratio	**10.8**
50 Stocks with lowest price/sales ratio	18.9
50 Stocks with highest price/sales ratio	**8.2**

Source: Reproduced from Timothy P. Vick, *Wall Street on Sale* (New York: McGraw-Hill, 1999), p. 29.

technical indicators for short, medium, and long-term reversals. ValueEngine puts it all together to calculate the probability of a doubled stock price as well as the probability of meeting and exceeding any given investment target by a stock or a portfolio of stocks. You can also create portfolios that are aggressive or conservative. ValueEngine's track record is impressive, but notice that, again, we stuck with dependence on the consensus of analysts as to future earnings per share, which is a two-pronged forecast—not only earnings in absolute dollar terms (knowable, within a range), but earnings per share, with the price set by the market (not knowable).

Earnings per share is an awful statistic that gets just about everyone in trouble, whether they use it to make dire or rosy predictions. The P/E ratio is a snare and a delusion. A study cited in *The Economist* magazine (April 7, 2001, p. 84) states that the average profit forecast for stocks tracked by I/B/E/S (www.ibes.com) was 19.8 percent as of March 2001—but only 10 percent of firms *ever* had profit growth of 18 percent or more over any 10-year period during 1951 to 1997. Further, the median forecast growth rate for any three-year period was 14.5 percent over 1982 to 1998, when the actual number was 9 percent. In other words, analysts are consistently overoptimistic—and yet we accuse them of lowballing the numbers so that their stocks will rise when the company beats the consensus (Louis Chan, Jason Karceski, and Josef Lakonishok, "The Level and Persistence of Growth Rates," University of Illinois Working Paper, March 2001).

Securities analysts can't just name the stocks that meet the O'Shaughnessy criteria because new companies sometimes burn up the quote screen. Especially in the high-tech mania 1990s, analysts didn't have performance for five years, or even three years, as a basis on which to calculate the standard ratios, but the new companies were outperforming everything in sight. In many cases, analysts failed to separate out the "objective" value of the stock from their opinion on where the market would take the stock. It's not clear that this is a failure that can be avoided. During the early stages of the telecom and dot-com frenzies, just about any company associated with the Internet saw big stock gains. Individual stocks are heavily influenced by "the market," if only because index funds have to buy the market as new money comes in (or

sell it as money goes out), so it's not entirely appropriate to divorce particular stocks from the overall market trend. The environment has an important effect on individual stocks. It is the context. How does one discriminate among them? Analysis can't take place in a vacuum, and valuing a stock like its peers in the same industry or sector is not *per se* a bad process, but it certainly can result in big mistakes.

Some professional securities analysts deserve the opprobrium and scorn heaped on their heads. In 1999, one analyst "valued" Qualcomm at $1,000 per share, which, multiplied by the number of shares outstanding, would have made the company's market capitalization $300 billion at a time when its sales were $4 billion. Common sense—let alone established value-investing concepts—makes a mockery of such a forecast. Analysts who issued exaggerated forecasts for dot-com stocks (such as amazon.com) got their comeuppance in the dot-com crash of 2000. Many publications, especially *Barron's,* publish barbed pieces that discuss the real numbers and how some analysts are missing the juicy revelations to be found by a thorough grinding of the facts—including accounting gimmicks and loopholes, such as merger and acquisition accounting and cash-flow timing, that pull the wool over the eyes of unwary analysts.

Of particular concern is a trend by companies to modify the meaning of "earnings" to exclude unfavorable items. According to generally accepted accounting principles, or GAAP, earnings are sales minus the cost of goods sold, depreciation, and operating expenses, including interest and taxes. "Earnings" is another word for "net income," or used to be. Now companies use new categories (not recognized by GAAP) like "operating earnings," "pro forma earnings," and "economic," "core," or "ongoing" earnings. By these definitions, earnings are anything the company wants them to be. JDS Uniphase, for example, reported "pro forma" earnings for the fiscal year ended June 30, 2001, of $67.4 million. According to *The Wall Street Journal,* it arrived at that number by excluding 98 percent of the $52 billion in operating expenses. Under GAAP, the company actually had a $50.6 billion full-year net loss (August 21, 2001). It goes without saying that professional securities analysts are hard to trust when they swallow whoppers like this.

The public has other reasons to distrust professional securities analysts, too. The most obvious is the hint of big-institution market manipulation arising from analysts' manipulation of certain numbers, especially earnings. When a company's earnings exceed the earnings estimates of the pros, the stock rises. Analysts may have an inherent conflict of interest that gives them an incentive to lowball earnings estimates, thus ensuring a stock rise when the actual earnings number is announced. They are accused of serving two masters: the companies that spoon-feed them the information on which earnings estimates are based, and their employers, which may, in other divisions, have business with the very same companies.

Companies are forbidden to announce earnings estimates (and stock-price targets) under Securities and Exchange Commission (SEC) regulations aimed at preventing companies from manipulating their own stocks. They do, however, make public other information (such as contracted future sales) that allows someone else to make earnings estimates. Until the SEC put an end to it with Regulation FD (for "Fair Disclosure") in late 2000, companies gave preferred treatment to securities analysts, disseminating more information and earlier information to them than to the public. The new regulation is intended to level the playing field for professionals and amateurs alike, although some professionals are squawking that corporate fear of running afoul of Reg FD has turned the spigot of company information and insight to a trickle insufficient to the job. Critics respond that now, perhaps, the analysts will have to look at actual numbers rather than junketing off to hear public relations hype.

A different charge is that analysts may actually own shares in the companies on which they are reporting. According to an article in *Institutional Investor* magazine (April 2001, pp. 60 ff.), one analyst owned 100,000 shares, worth about $10 million, in an IPO managed by his firm. His report on the company was glowing. Securities firms may state, in the fine print of an offering memorandum or elsewhere, that "the company and/or its employees may have an interest in the securities described," but the general disclaimer does not help you figure out whether the analyst of any particular report has a conflict of interest. You may think that it's just dandy if an analyst does have a position because it means he

believes in his work—but what about when he starts feeling that the stock has reached a peak and he would like to sell it—but cannot because of his company's internal rule on his minimum holding period? If he says the stock is topping, he is working against his own self-interest.

Mistakes and incompetence are one thing, but venality is another. The uproar over whether the integrity of analysts is compromised has already resulted in formulation of a code of ethics by the Association for Investment Management and Research (www.aimr.com). The U.S. Congress held hearings on conflict of interest in June 2001. The Securities Industry Association (www.sia.com) is concerned, not only for the sake of its image but also because investor lawsuits—charging that analysts issued misleading "guidance" on some stocks, and underestimated risks—are starting to pile up. The U.S. Attorney General for New York has opened a case file on specific conflicts of interest.

It can be difficult to know whether professional securities analysts are competent to identify true value stocks that will always come back, and independent enough to be motivated to have that as their only goal. These analysts are trained in financial analysis. How can you hope to duplicate or surpass their skills, let alone find the time to exercise them? The answer is: you can't, and it's not clear that you should try. Possible solutions include buying newsletters of independent analysts with good track records. (The *Hulbert Digest,* which evaluates advisors on a risk-adjusted basis over long periods of time, is indispensable.)

At the least, learn the true meaning of financial terms. Books abound. A good one is John A. Tracy, *How to Read a Financial Report* (John Wiley & Sons, 1999).

4. A Company Is Not Its Stock

Of the 500 companies selected for the Standard & Poor's 500 index in 1957, only 74 were still on the list in 1998 and only 12 outperformed the index over those 41 years. According to *Creative Destruction* by business consultants Richard Foster and Sarah Kaplan (Doubleday, 2001), two-thirds of those on the S&P 500 list will be acquired or will die over the next 25 years due to

their inability to keep pace with technological and other changes. This is because companies that are "built to last," like IBM, can become hopelessly rigid in their thinking. In fact, this already happened to IBM, which built the first personal computer and then failed (at least initially) to capitalize on it. IBM's stock lost half its value between 1990 and the end of 1993.

Arie de Geus, in *The Living Company* (Harvard Business School Press, 2000), agrees that the life span of a typical Fortune 500 company is not much longer than the average executive's career. Using a biological metaphor, strategic planner de Geus says that companies that survive longer than average are like living entities that perpetuate themselves as ongoing communities rather than "economic companies," which are in business solely to produce wealth for a small inner group. Living companies manage for survival; economic companies manage for profit. Like living creatures, living companies are sensitive to their environment (they learn and adapt), they have a strong sense of identity, they are tolerant of unconventional thinking and experimentation, and they conserve (financial) resources for a rainy day, gaining flexibility.

What this means is that stock picking on the basis of financial ratios—price/earnings, price/book, and so on—may have worked in the past, as amply demonstrated in many books and papers, but in an environment of unbelievably rapid technological and social change, the only thing that counts is management. That's why top executives like Jack Welch, CEO of General Electric (and before him, Lee Iacocca of Chrysler) are the subjects of endless interviews. But what about the other 499 companies in the S&P 500? How can the average investor learn whether senior management has the right stuff to push its company along the evolutionary path?

The determining role of top management is increasingly coming under the microscope. *Forbes* magazine (www.forbes.com/valueceos) has dedicated a portion of its Web site to a new CEO yardstick of its own devising. In its "First Annual CEO Value Survey," it looked at 278 CEOs who have been in place for at least five years at companies that did not post a loss in that time. The average annual pay of this group is a stunning $7.64 million. The *Forbes* formula divides each CEO's five-year pay package by something called a "total growth rate"—the average of sales, net income, and share-price growth, including dividends reinvested.

This results in what 1 percent of growth cost each company. Warren Buffett, for example, earned $500,000, and Berkshire Hathaway had a five-year total growth rate of 26 percent. That means he delivered one percentage point of growth for $19,000, which makes Buffett the top value among CEOs. Citigroup's Sanford Weill, in contrast, has compensation of $785 million for 33 percent growth, or a $23.8 million cost of 1 percent of growth. To the officers and staff at Citigroup, this must be hard to swallow. It's not clear that Weill's overcompensation affects the stock price, though.

Forbes' financial ratio is not the only way to measure management. We may also cite imagination, inventiveness, employee stock plan generosity, and a hundred other hard-to-quantify factors. Is it a joyful place to work, or is it like Dilbert's job?

Looking at companies that deliberately seek to regenerate themselves, Sony stands out, although it, too, is subject to some of the same constraints as other large companies—mostly imagination versus bureaucracy. It was the first Japanese company to list its ADR in the United States (1961). It invented or popularized the transistor (1957), Trinitron TV tube (1968), Walkman (1979), digital CDs (1982), and PlayStation game consoles (1990s to today). It made a mistake with Betamax (1980) but recovered to focus on content (Columbia Pictures). Sony stumbled in late 2000 and early 2001 by not producing enough game consoles, and now faces heightened competition from others, including Microsoft. Still, as of 2000, Sony was the most esteemed brand name in the United States, according to a Harris poll. And its stock? From February 29, 2000, to February 28, 2001, it fell from $156.80 to $74.86, losing more than 50 percent of its value.

In contrast, we read that the same management at Motorola that caused Iridium to fall from the sky, literally, is still in place. Motorola stock made a new all-time high in March 2000, after this awful fact was known. Xerox, one of the Nifty Fifty in the 1970s, and inventor of the graphical user interface, ethernet communications, and digital printing, famously "fumbled the future" in the early 1980s. Twenty years later, it is still under harsh criticism for financial irregularities and almost unbelievable management mistakes. The stock hit a low of $3.75 in December 2000—but had more than doubled less than six months later.

The business consultants and strategic planners propose convincing models of what makes a great company that will survive—but so what? It doesn't mean that the stock will do well, or that bad company stocks will do poorly. John Maynard Keynes said it best, in 1936: "the market is like a beauty contest. You shouldn't bet on the girl you think is the prettiest, but rather on the girl the other judges will think is the prettiest."

The market is usually willing to be influenced by hype and spin. We have all seen the range of responses to a bad earnings "outlook" by a CEO. If he comes to stage center with a gloomy air, semantically negative words, and discouraged body language, the stock falls. If he bounces around the stage and uses upbeat language, the stock rises. Similarly, the investing crowd is willing to overlook earnings downgrades from professional analysts based on a diminished earnings outlook if the company can create favorable sentiment. Maybe the stock "should" fall on the basis of objective ratio analysis, but what "should" happen to a stock is not necessarily what we get. In fact, it's seldom what we get. Nobody can untangle actual company and industry news (like awful earnings) from crowd psychology. This is the central failure of fundamental analysis. If economist John Moffatt is right, only about 25 percent of a stock's price has to do with its fundamentals, anyway. Another 25 percent is due to the macroeconomic environment, and a full 50 percent to market conditions. We might do better to find a stock with a beta of one (perfect correlation with the S&P 500, Dow, or Nasdaq) and simply buy and sell when the market is up or down by *x* percent, known as a filter rule. It would certainly save a lot of time and grief.

5. You Don't Live to Invest

Another reason "value investing" doesn't work for most people is that you don't live to invest, you invest to live. In other words, you want to spend the money at some point. At the very least, you want to give to your heirs more money than you started out with. As long as you imagine that your holding period is indefinitely long, it's comforting to think that the compound interest function

is in your favor. But to apply the compound interest function retroactively to historical returns and then to turn around and apply it to the future is bad logic. Technically, the only time you actually earn compound interest is in a security with a stated interest rate, such as a savings account, CD, T-bill, or bond. Those instruments carry a rate of interest and you can compound the interest going forward in time at various rates as interest rates change. Stocks do not carry an inherent rate of interest. You are not lending money to the company. You become an owner when you buy stock in a company. You are owed no rate of interest at all. You might be owed a dividend, but any company can terminate its dividend payout at any time. While it may be true that over *x* number of years, you are likely to earn a rate of return in stocks that is similar to the return over the past *x* number of years, you cannot and should not count on it. *To repeat: stocks do not have an inherent rate of return.*

Finally, we circle around to personal risk management. In value investing, you don't need risk management because value stocks "always come back." Let's say you buy a stock and it immediately falls by 50 percent. You now need to make 100 percent on that stock in order to get back to your starting point. If you are counting on the usual 15 percent per annum long-term "normal average return" in stocks, this is going to take you several years—4.8 years, in fact (using the Rule of 72s). *A bad first period can never be made up except by expecting a higher return than the market can be expected to deliver.* The hold-forever value investing philosophy has an internal inconsistency: it's okay for a value stock to fall 50 percent, because it will "come back." But if you hold the stock for a long period of time, it will come back to the long-term average rate of return of the total market or a bit more—from a permanently reduced level. Logically, if you are the poor soul who has a bad first period, the correct response is to dump the so-called value stock that just gave you a 50 percent loss, buy a so-called speculative stock that is already rising, and hope for a 100 percent return to get back to your starting point. Such an action, of course, invalidates the principle of the entire value-investing process. Remember, it took 25 years for the Dow to recover the prices that were at the peak in 1929.

Inescapable Conclusions and a New Definition

The five objections to buy-and-hold are a justification of active trading. This is the inescapable conclusion. It's the same conclusion arrived at by the great traders and investors of the past, who used the negatively charged word "speculation" without apology. As each of them noted, of the many investors who try, few excel at speculation. It takes a combination of skill, talent, and imagination. As Philip Carret wrote, in *The Art of Speculation* (*Barron's,* 1930):

> Speculation is no simple business. The amateur cannot take a few thousand dollars' capital, fifteen minutes a day of time, treat it as a side-line and be any more successful than he would be in any other business. Indeed, speculation requires broader knowledge, closer attention, sounder judgment than the average business. Prices on the New York Stock Exchange are affected by French politics, German banking conditions, wars and rumors of war in the Near East, the Chinese money market, the condition of the wheat crop in the Argentine, the temper of the Mexican Congress as well as by a host of domestic influences. The successful speculator must carefully weigh the effect of all these influences, set down the pros and cons and arrive at a sound conclusion as to the side on which the balance lies. When he has done all this, he has only made a beginning. If he concludes that the balance favors an upward movement, he must still decide which stocks he is to buy for maximum profit.

Seventy years after Carret wrote this, we find mention in the *Financial Times* of every single one of the factors he named. Carret was referring to domestic stocks under these influences; today, the individual can buy and sell securities directly affected by those influences instead of domestic securities more remotely affected.

In practice, trading foreign securities is still quite difficult. You can easily trade foreign stocks listed on a U.S. exchange as ADRs, but they are subject to almost the same level of scrutiny as

other U.S. stocks, meaning opportunities have already been seized *under normal conditions.* You would want to trade an ADR only when conditions are not normal. To buy and sell foreign stocks as they trade on their home-country exchanges is just as difficult today as it was 12 and 18 months ago, when we first started to hear about it. Every broker and data vendor promising foreign stocks by 2000 or 2001 has so far failed to deliver. Foreign stocks are still the exclusive property of the professionals. This is not really surprising; U.S. regulatory authorities believe that foreign stocks are not adequately regulated in their home countries as to disclosure, insider trading, and so on. The brokerage industry (quite rightly) fears liability in offering such securities to an aggressively litigious public. Unless you are a high-net-worth individual with a big account at one of the major brokerages, you will find it difficult or impossible to trade (say) a Greek stock on the Athens exchange. This is a one-sided situation. Many U.S. stocks trade on exchanges overseas. Microsoft, for example, is listed in Argentina, Hong Kong, London, and probably, by the time you read this, the new Nasdaq Europe.

Similarly, you can buy and sell foreign bonds, but the brokerage industry doesn't make it easy for you to do small lots, and you may feel that the exchange rate, over which you have no control, is rigged against you. It would be far easier to trade developed-country bonds in the futures market, and emerging-market bonds off the established exchanges altogether in the newly developing market for "emerging market" securities. Once you start looking at foreign or global securities, meaning those that can be traded around the clock and around the world, foreign exchange as an asset class has to come to your attention, and so we spend rather a lot of time on it in this book. It is not as mysterious and difficult as it may seem on the surface.

Our new definition of the global trader is one who is not afraid of the word "speculation," who appreciates that it's hard work and not a hobby, and who is aware that, in this area, more persons fail than succeed. The global trader never goes into a position expecting to hold it forever—in fact, he has an exit strategy. The global trader may never venture outside U.S. stocks, but by understanding as many of the outside influences named by Carret as possible, he is a better big-picture investor all the same. The quintessential

global trader is George Soros. What exactly did he do that people are still talking about 10 years later? The answer may surprise you.

The Ultimate Inefficiency—What Soros Really Did

Ten years ago, George Soros reasoned that the British pound would fall dramatically against the German Deutschemark (DM) and U.S. dollar, and he invested $10 billion in his reasoning. He was correct, and the market rewarded him with a $1 billion gain during the course of only a few weeks. Many people today misrepresent not only what happened, but what it means to the investing world. A CNBC anchorwoman, for example, said in April 2001 that the Soros "gamble" had "bankrupted" the Bank of England.

This statement is a complete misrepresentation of the situation and a misunderstanding of what global trading is all about. It was not a gamble. It was an investment decision as carefully and thoroughly researched as any stock purchase for a portfolio by an experienced investment professional. The counterparties who bought British pounds from Soros may or may not have taken a loss on their purchases—depending on whether they sold the pounds right away or waited until later, when they were worth a lot less—but the counterparties did not include the Bank of England, at least initially. The Bank of England is the central bank of the United Kingdom. It did not go bankrupt and is in operation today.

The Bank of England was not a direct counterparty to Soros's transactions, and it is inaccurate to set the scene as though Soros were sitting across a table from the Bank of England and playing a single hand of poker in the Wild West. Soros's counterparties were banks acting on their own account or for the accounts of their customers. The Bank of England comes into the story only because the U.K. government had signed a treaty with other European countries to defend the price of the U.K. pound at a particular level. The Bank was the instrument to implement a government policy. It was not entering into a transaction with Soros or anyone else, in which the terms of the transaction were negotiable (as in the case of the auction of government bonds, for example). It was,

however, in the background as a potential counterparty to the banks with which it had a relationship, in the event that the pound rose or fell too far from the level mandated in the treaty. In the end, it became an actual counterparty, just like any other commercial or speculative buyer and seller of pounds.

Why is the event so widely misunderstood? Possibly because it makes a better story to display the lone cowboy who brings down the self-important and wrong-headed forces of authority. Possibly also because going short is still viewed as wildly risky, whereas to couch the transaction as buying the Deutschemark or U.S. dollar would not be seen as risky—even though in the foreign exchange market, if you are buying one thing, you must be selling another. To go short a currency is no riskier than buying or selling any security using the same level of leverage. And that's the third part of the glamour—leverage in the foreign exchange market can be, literally, infinite when trades are conducted with no money on deposit with the counterparty.

Unfortunately, glamorizing the story has resulted in just about everybody missing the point. This must be a terrible disappointment to Mr. Soros, who in fact won a billion-dollar vindication of his theory of how markets work, only to see a different theory win the mind of the majority. The winning theory (the efficient market hypothesis) ended up costing the market $3.6 billion when Long-Term Capital Management collapsed in 1998, only six years later.

George Soros was a successful equity-market investor long before he earned the $1 billion. Most accounts would say he "won" the money, but this was not a game and was not viewed as a game by any the participants, least of all Mr. Soros. Once you understand Soros's way of looking at how the world works, you see that there was nothing of a gamble about it. In gambling, the outcome of each toss of the coin is independent of the one that came before (and the one that will come after). The player cannot control or even influence the outcome. According to Soros, however, in markets as in life, price outcomes are deeply influenced by what comes before. In fact, price events develop in a predictable way if you can only discern the bias inherent in market participants.

In classical philosophy, Plato questioned whether objective reality exists, and if it does, whether anyone can perceive it. Soros

believes no one can see the world objectively, and thus everyone operates with a perceptual bias. A prime influence on markets is the players' own imperfect understanding of what is going on. Market participants are not capable of being solely rational; their beliefs influence their thinking. Perceptions flawed by beliefs in turn influence market prices when participants act on them. Market participants do influence the outcome of price behavior, unlike the coin toss. The price behavior (the fact) is again interpreted in the light of beliefs, which cause the next price, and so on. Soros named this feedback loop "reflexivity" and reasoned that, in a long chain of belief-influenced price outcomes, prices could journey very far from where they should be on the basis of a bias-free analysis.

Reflexivity is akin to the Heisenberg uncertainty principle, which states that you cannot accurately measure subatomic particle movements because the act of measuring alters the movement. (This is why Soros named his fund the Quantum Fund, referring to quantum physics.) Reflexivity never caught on as a commonly used concept in the market. Some thought it was too obvious a phenomenon to deserve a name. Some claimed they couldn't understand it, although *The Alchemy of Finance* (John Wiley & Sons, 1994) is no more unreadable than many other books. Soros's explanation of what caused the stock market crash in 1987 is still the clearest and most plausible of all the scenarios proposed over the years.

At the time *The Alchemy of Finance* was published, the market was increasingly embracing a contradictory idea: the investor is rational and solely rational. Moreover, all investors are rational all the time, and they discount expected future events according to a numerically accurate and appropriate table of net present values. Thus, market prices are always "right." This is not possible in Soros's eyes because the chain of causation is not fact to fact, but fact to perception to fact. Prices are not a passive reflection of value; they are an active ingredient in forming the perception of value. Thus are born booms and busts; both are functions of a self-reinforcing process of misconceptions and mistaken perceptions. Markets are capable of becoming unstable and chaotic when the chain of mistaken perceptions leads prices to extremes. Then you get a one-way market, known as severe disequilibrium.

The phrasing may be in the form of economic theory, but the idea is to identify *crowd behavior.*

This is precisely what Soros did in shorting the U.K. pound in September 1992. He saw a chain of mistakes being made by the U.K. government in the management of monetary and fiscal policy, and foresaw a scenario in which eventually the market would wake up and say, "The emperor has no clothes." By perceiving how the government was deluding itself and carrying the market along in the same cloud of mistaken thinking, Soros predicted a crash. The delusion was in the form of an unworkable institutional arrangement whereby Britain had agreed, in the Maastricht Treaty, to maintain the exchange rate of the pound within a narrow band against the Deutschemark (with a central parity of DM 2.95 for each pound). But Germany had just reunified West with East, which was an expensive undertaking that pushed up inflation. The Bundesbank, the inflation-obsessed German central bank, accordingly kept interest rates high. High rates were not appropriate for the British economy, though; by the summer of 1992, it was falling into stagnation, if not recession. The government, which at the time controlled the Bank of England, was not willing to lower interest rates and thus potentially weaken the pound to the point where its value in Deutschemark terms would have to be defended—according to the exchange rate treaty just signed in February—in the form of the Bank of England's buying pounds from all comers. The alternative would have been to raise interest rates, exactly the opposite of what a central bank should do in the face of an economic downturn.

Soros's great achievement was to listen and to hear what the head of the Bundesbank was saying—it would not cut rates against its own self-interest in order to help out Britain. If Britain had to spend billions to defend the agreed-upon rate, well, tough, that's what the treaty called for. Soros also perceived that the British government was not facing unpleasant realities. It hoped, perhaps through respect for its sovereign authority, to achieve two mutually exclusive goals: (1) membership in the European Rate Mechanism established by the treaty and the associated uneconomic pound/Deutschemark rate and (2) the freedom to manage interest rates for the best interests of the British economy. Alternatively, the British government could have goosed economic activity by

increasing government spending or reducing taxes, but these fiscal options were not seen as politically acceptable by the Conservative government.

Economists and traders were saying the same thing as Soros at the time. Whenever a government interferes with the free-market setting of prices, distortions appear in the allocation of resources. This is why California has had an energy crisis in 2001. It is a well-known fact of economic life that capital, the resource in question in this context, will flow to the highest expected real rate of return. If the nominal rate of return is perceived to be eroding through inflation or devaluation, capital will flee elsewhere. The price of capital happened to be denominated in pounds in this instance. All Soros did was apply this simple rule of market economics, which in itself is no great feat. And he was certainly not alone; his special triumph and his act of courage was that he invested such a large sum in the expected outcome. (Later, he was to say that the crisis occurred earlier than he had expected, or he would have done more.)

The exact chain of events that led to the U.K.'s abrogating its treaty responsibilities started when many foreign exchange trading houses—commercial and investment banks, as well as hedge funds like Soros's—sold pounds both spot and forward (i.e., for later delivery). The bandwagon very quickly gained momentum as market participants observed that bids to buy pounds were falling drastically, minute by minute. Exactly the same thing happens when bad news or an unfavorable rumor about a stock starts spreading through the equity market. Everyone wants to sell, no one wants to buy. Just as the designated specialist serves as the ultimate market maker on a stock exchange, a nation's central bank serves as the ultimate market maker in foreign exchange. The Bank of England became the only party willing to buy pounds; it paid for them out of its foreign currency reserves of dollars, Deutschemarks, and other currencies. The Bank of England bought £24 billion over the course of two days (September 15 and 16, 1992), and raised interest rates twice in a single day (from 10 percent to 15 percent), before formally announcing that it was withdrawing from the European Rate Mechanism. Robert Slater, in *Soros—The Life, The Times & Trading Secrets of the World's Greatest Investor* (Irwin, 1996), reports that the United

Kingdom had £44 billion in reserves to start with, so the intervention wasted more than half of the country's savings.

Slater notes that Soros was not alone in shorting the pound, and names other hedge funds that made hundreds of millions, including Paul Tudor Jones, not to mention Citicorp, J.P. Morgan, and Chemical Bank, which together made $800 million more, in that quarter, than the normal amount. A glance at Figure 1.1 shows that this was a runaway train that anyone could jump on, especially if he was using two moving-average-crossover technical analyses (as shown). But it was Soros who got the spotlight. In fact, he made about $2 billion, or double the amount usually mentioned, on other related transactions at the same time, mostly by buying British equities that would rise once the pound fell. As Soros himself said, the principles behind his analysis of the situation were no different from any other analysis of

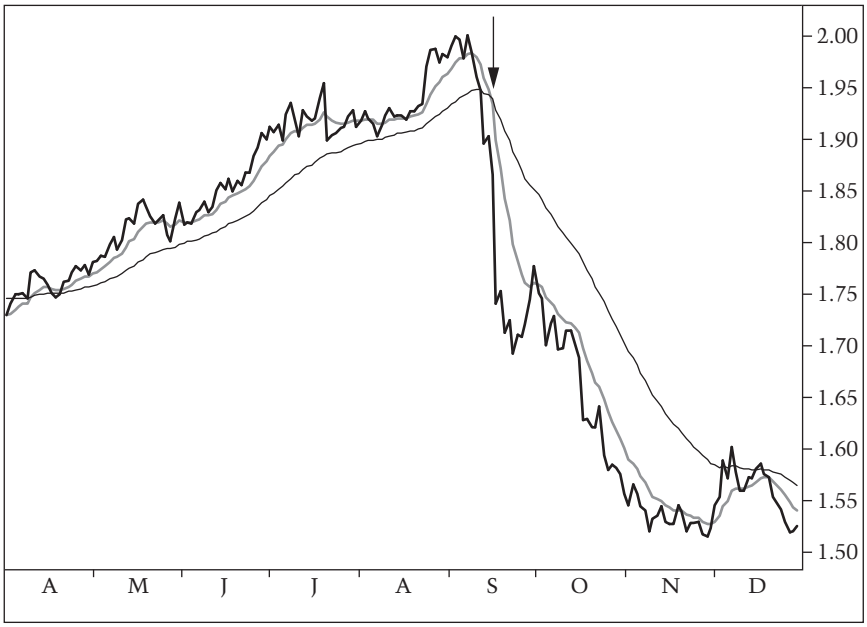

Figure 1.1 Devaluation of the British pound, 1992.

whether a security is undervalued or overvalued, the central purpose of all securities analysis.

When observers say that "Soros broke the Bank of England," what they are really saying is that lots of people, personified by Soros, correctly detected that a security was artificially overvalued and therefore vulnerable to a price decline. A trading decision is not a moral judgment or a political statement—it is a price estimate. The British government broke itself by having made a political decision (the treaty) that had unintended consequences. Its intentions may have been honorable, but its economic analysis was wrong. The same thing happens every day to die-hard holders of mispriced securities. In this instance, the holder of the security happened to be a government. The market does not care. Short-selling in equities is considerably harder to achieve, but companies that write to shareholders asking that they forbid their custodians to lend shares for shorting are acting in the same spirit as the Bank of England. Actually, the Bank of England did have another arrow in its quiver that it did not use this time, although it was known to have used it in the 1967 devaluation: calling up the banks where ultimately all foreign exchange transactions reside, and urging the banks not to take such big positions. Governments theoretically control bank licensing, so there is an implicit threat in such "moral suasion." It is increasingly harder, however, for governments that wholeheartedly embrace raw capitalism in public to revert to such authoritarian measures behind the scenes, especially since the chief outcome would be for banks and brokers merely to relocate outside the sovereign boundaries of the annoying sovereign.

A Change in Perspective

This most successful speculation of all time seems to stand in blinding contrast to the Buffett mode of investing—buy undervalued but top-flight securities and hold them forever. Buffett says you should buy securities and not object if the stock market were to close for five years. Soros, of course, was following every tiny movement of the pound moment by moment, looking for the

optimum exit point. To hear Buffett, there is never an exit point, although he may be exaggerating this issue—Buffett does sell stocks (such as Disney). What is central, though, is that, in both cases, the investment decision is made on the basis of deep and thorough research. The purpose of the research is to identify a market inefficiency, whether it is information not yet known or information not correctly perceived by the rest of the market.

Three other issues obscure the centrality of the inefficiency thesis. First, Soros was not involved in the equity market, but rather the currency market in this instance. Aside from their purchasing power, currencies do not have intrinsic value. Companies do. Currencies do not manufacture products, deliver dividends, or have any of the ownership characteristics of an equity. Well, so what? *The nature of the security is secondary to the act of identifying a tradable inefficiency.* Soros had been an equity analyst—and a highly successful one—for many years. To choose a currency trade was only to recognize that the profit potential in that case was far higher than in any of the other equity, bond, or commodity trades available at the time. In terms of inefficiencies, the Maastricht Treaty had created a whopper. In terms of probabilities, the short sterling trade was a million-to-one gain/loss ratio, while everything else on offer had a lower gain/loss ratio. To invest in a fall in the pound was an act of supreme rationality.

The essence of successful trading or investing is to take a position in an inefficiency, with a high expectation of gain and a high gain-loss ratio. To recognize this can be tremendously liberating. It frees you from semantic servitude to the common usage of the word "saving." If you invest in a stock as an act of saving, and it falls 50 percent, you have lost 50 percent of your savings. To say "It will come back" because it is a value stock is to delude yourself that because you named it "savings," it has some kind of permanent value. In practice, only cash or near-cash should be considered savings, and even then it is at risk of diminution from inflation. About the stock that has fallen 50 percent, you can legitimately say "It will come back" only if you have a specific reason for believing such a thing. If you do, then the gain-loss ratio must be even better today than it was when you initially bought it—and you should buy some more. This is called "averaging down," a practice frowned on by everyone because a big price

decline prompts a reevaluation of the security by the market at large. To use a stale evaluation in the face of new information is to be irrational and nonadaptive.

The second issue is Soros's use of leverage. To many, this is what made him a speculator rather than an investor. Leverage, however, is not necessarily an essential part of the trade. The U.K. pound futures contract was worth $125,550 at the beginning of the move (September 8, 1992) and $62,499 at the end of the move (February 12, 1993). An individual could have sold the contract at the beginning and bought it back at the end for a gain of $63,051, or 50.22 percent, with no leverage at all.

The third issue is that Soros was shorting the security. We think of "investing" as always buying something of intrinsic value in the expectation of a rise in that intrinsic value through the work and value-added of land, labor, and capital. But this is a limited and limiting point of view. If the purpose of investing is to make money, it makes no difference whether we make it when the security is rising or when the security is falling. The prejudice against shorting is a moral judgment, not a business judgment. It arises (in large part) from stock exchange rules that were implemented to prevent competitors from driving one another out of business, or to prevent a selling panic from getting out of hand. The minute we understand that to hold forever is against our best interests, and that to hold only securities with a high win-loss expectancy is the superior approach, we are liberated from the "intrinsic value" fiction. Instead of owning a shareholding, which makes us a part owner of a business, we hold a *position in a security*. It doesn't matter whether the position is long or short, as long as we have a positive expectation of gain.

Summary

To "invest" is to buy an equity with an indefinite holding period and to ignore risk management—specifically, the rule that says you should hold a security only if you have a positive expectation of a gain. Traditional "value investing" does not acknowledge any inefficiency except the one that temporarily put your stock on sale and provided the buying opportunity. You are supposed to

Table 1.2. Trading versus Investing

	Investing	Trading
Goal	Preserve capital	Make money
Holding period	Indefinite	Not determined in advance
Fundamental research	Intensive	Maybe
Technical analysis	No	Maybe
Orientation	Intrinsic value—long only	Price trend—long and short
Worldly outlook	No	Yes
Risk management	None	Dominant
Leverage	None	Maybe

ignore an inefficiency that makes the same stock temporarily overvalued.

To "trade" is to seek any inefficiency in the market pricing of any security (not just equities), regardless of intrinsic value, with the goal of exploiting the price disparity over some time frame not determined in advance, and with a positive expectancy of a gain.

To "speculate" is to take an unusual risk with the expectation of an unusual gain; to trade with leverage is to speculate, since leverage constitutes an usually high risk of loss. Good speculators work extra-hard at identifying the unusual risks that may deliver the unusually high return. Bad speculators are buyers of lottery tickets, where the positive expectancy is infinitesimal (see Table 1.2).