INVESTMENT FABLES

EXPOSING THE MYTHS OF "CAN'T MISS" INVESTMENT STRATEGIES

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1 INTRODUCTION

Investing is full of stories that sound good when they are told but don't hold up under close scrutiny. Consider a few: Buy stock in good companies and the returns will surely follow. Buy after bad news. Buy after good news. Stocks always win in the long term. Follow the insiders. Buy stocks with big dividends. Buy stocks that have gone down the most. Go with stocks that have gone up the most. What makes these stories alluring is that there is a kernel of truth to each one of these stories but none of them is foolproof. You will examine these and other investment sales pitches in this book, consider the potential downside with each, and study how you might be able to modify each one to reduce downside risk.

THE POWER OF THE STORY

Human beings are much more likely to be swayed by good stories than they are by graphs and numbers. The most effective sales pitches to investors tell a compelling story, backed up by anecdotal evidence. But what makes a story compelling in the first place? Investment stories are convincing not only because they are told well but also because they draw on several common factors:

- Most good investment stories appeal to a fundamental component of human nature, whether it be greed, hope, fear or envy. In fact, what often sets apart successful investment salespeople from unsuccessful ones is their uncanny ability to gauge an investor's weak spots and create a story to take advantage of them.

- Good investment stories are also backed up by the evidence, at least as presented by the storyteller. As you will see in this book, though, the evidence may only tell part of the story and much of what is presented as incontrovertible proof of the efficacy of an investment strategy falls apart on closer examination.

In each chapter that follows, you will see the rationale that allows the stories presented in this book to resonate with investors. As you read these sections, you will undoubtedly remember variants of these stories told by your broker, investment advisor or neighbor.

CATEGORIZING INVESTMENT STORIES

Investment stories come in all forms. Some are designed to appeal to investors who do not like to take risks, and they generally talk about low-risk ways to play the stock market. Others are oriented toward risk seekers who want to get rich quickly; these stories emphasize the potential upside and hardly ever talk about risk. Still others are structured for those who believe that you can get something for nothing if you are smarter or better prepared than others in the market. Finally, there are stories for the optimists who believe that you always win in the long term. In this section, you will get a preview of the stories that are examined in detail in the coming chapters.

STORIES FOR THE RISK AVERSE

Some investors are born risk averse, whereas others become risk averse because of circumstances—an insecure job or impending retirement can make you far more concerned about losing money. Still others are scared into risk aversion by an extended bear market. Whatever the reason for the risk aversion, the investment stories that sell the best to these investors emphasize low-risk strategies while promising much

higher returns than they are making currently on their safe investments.

High Dividend Stocks. Risk-averse investors generally prefer the safety of government or high-grade corporate bonds to the riskiness of stocks. They feel more secure with bonds, knowing that they can count on these bonds delivering income in the form of coupons while they hold them and that the principal invested in these bonds is intact. To attract these investors to stocks, you have to try to offer them comparable income and safety, while also providing them a premium for taking the additional risk. Stocks that pay high dividends are attractive to risk-averse investors because they resemble bonds in terms of generating income, with the added bonus of price appreciation. The dividends on some stocks are higher than the coupons earned on safe bonds, and while the principal invested in stocks is not protected in the same way that the principal invested in bonds is, the risk can be alleviated if the company paying the dividend is large and has substantial assets.

Stocks with Low Price-Earnings Ratios. Stocks that trade at low multiples of earnings have historically been viewed as both cheap and as safe equity investments. While you can see why a stock that trades at 5 times earnings is considered cheap, why would it be classified as safe? The presumption is that the firm will continue to make these earnings in the long term and that this earnings power should provide a floor on the price. In fact, value investors like Ben Graham have long argued that buying stocks with low PE ratios is a low-risk, high-return strategy. For investors who are concerned about the risk in equities, this strategy seems to offer a low-risk way of entering the stock market.

Stocks That Trade at Less Than Book Value. A close relative of the low PE stock in the cheap stock family is the stock that trades at below book value. To some investors, the book value of a stock is not only the accountant's measure of how much the equity in a firm is worth but is also a more reliable measure of a stock's worth than the market price, which is set by investors swayed by fads and fancies. Thus, a stock that trades at less than book value is viewed as an undervalued stock. To some risk-averse investors, who believe that book value is equivalent to liquidation value, stocks that trade at below book value also come with what they see as backup insurance. If the stock price does not go up, the firm should be able to liquidate its assets and deliver the (higher) book value.

Stable Earnings Companies. For many investors, the risk of investing in the equity of a company is tied to uncertainty about the company's capacity to earn money in the future. Even the best-run companies can have earnings that are volatile and unpredictable. Consequently, if you could invest in a company that has stable and predictable earnings, you could essentially combine the benefits of stock ownership with the reliability of bonds. How would a company achieve this earnings stability? It could do so by diversifying into multiple businesses or countries and becoming a conglomerate or multinational; bad times in one business or country would then be offset by good times in another, leading to more stable earnings over time. It could draw on a variety of products now available in financial markets—futures, options and other derivatives—to protect itself against interest rate, currency or commodity price risk and thus make its earnings more predictable. In its least benign form, the earnings stability can be purely cosmetic, created by accounting ploys and sleight of hand.

STORIES FOR THE RISK SEEKER

In buoyant markets, investors often seek out risk, hoping to make high returns to compensate. Not surprisingly, they are not interested in stocks that look like bonds. Instead, they want to find companies that provide the best upside potential even though they might be risky. The investment stories that work best for them are the ones that emphasize risks, but present them as a chance to make a killing (upside risk) rather than as a danger (downside risk).

Great Companies. Buy good companies, you are told, and the returns will follow. While the definition of good can vary from investor to investor and from investment publication to publication, most definitions of good companies revolve around financial yardsticks. Companies that earn high accounting rates of return and have done well for their stockholders in the past usually qualify. In recent years, a new category has been created with good defined more broadly to include social benefits. A good company with this broader definition would be one that does well for its stockholders, employees, customers and society at the same time. The rationale for investing in these companies is that the superior management of these companies will find ways to turn threats into opportunities, leading to dual benefits—higher returns and lower risk.

Growth Stocks. If you put your money into the companies with the highest earnings growth in the market, you are playing the segment of the market that is most likely to have an exponential payoff (or meltdown). While growth stocks do not offer much in terms of dividends, usually trade at high multiples of earnings, and are usually risky, risk-seeking investors are not fazed by any of these concerns. They buy stocks for price appreciation rather than dividends, and their view is that the high earnings multiples will only translate into even higher prices as the earnings grow over time. To the skeptic's question of what happens if the growth does not manifest itself, these investors will respond that they have the skill to pick the right companies—companies that have found the key to sustainable, long term growth.

Loser Stocks. Stocks that have fallen dramatically in the recent past offer interesting opportunities for investors who are willing to take risk. While these companies generally have serious problems—some have incompetent management, others have too much debt and still others have made strategic missteps—the argument used to justify investing in them is that they have fallen so much that they cannot fall much more. Risk-seeking investors, who believe that markets have overreacted to bad news and pushed prices down too far, buy these stocks hoping that stock prices bounce back.

Hidden Bargains. To the bargain hunters, the best stocks to buy are the ones that few other investors are aware of. In a market like the United States, in which thousands of professional money managers and analysts track stocks, this may seem like a tall order, but there are thousands of stocks in smaller companies that are neither tracked by analysts nor held by institutions. The ranks of these ignored stocks are swelled each year by initial public offerings that bring new firms into the marketplace. The hope of finding the next great growth company—a Microsoft or a Cisco—before anyone else does drives many risk-seeking investors to forage through these smaller, less followed segments of the market, looking for young and promising companies. In fact, some investors with more funds at their disposal try to get in even earlier in the process by being venture capitalists and private equity investors in small, private businesses. If they pick the right businesses to invest in, they can cash out when these businesses eventually go public.

STORIES FOR THE GREEDY

In any listing of human vices, greed usually finds itself somewhere near the top. Philosophers and priests have inveighed against greed through the ages, but it is also the fuel that drives financial markets. The demand for stocks would be limited in a world where investors were not greedy for higher returns. Not surprisingly, those selling investment stories have also recognized that even a subtle appeal to the greed of investors is sufficient to get them interested. The investment stories that play to greed share a common theme: they allow you to believe that you can get something for nothing.

Get on the Fast Track. Growth companies can be good investments in the long term, but it usually takes a long time for a small firm to grow into a big one. For impatient investors who want their payoff now, the wait can seem endless. Some firms accelerate the growth process by acquiring other companies, in their own and in other businesses. By paying for these acquisitions with new stock issues, these firms can speed the process even further. Investors are attracted to these companies for two reasons: The first is that they are usually the newsmakers in any market; acquisitions attract a great deal of press attention. The second is that the limitations of acquisition accounting often make these firms look much better than their peer group; in fact, with the right accounting treatment the growth can be made to look close to costless.[1] Investors play both sides of the acquisition game, with some buying acquisitive companies, hoping to ride their growth to high payoffs, and others trying to invest in potential target companies, hoping to gain a share of the premium paid on the acquisitions.

No Money Down, No Risk, Big Profits. Every investor dreams of finding the investment equivalent of a free lunch: an investment with no risk and high returns (at least relative to what you could have earned on a bona fide riskless investment like a government bond). For these "arbitrage" opportunities to exist, you have to find two identical investments that are priced differently at the same time by markets and a guarantee that the prices will converge over time. Not surprisingly, these pure arbitrage opportunities are rare and are most likely to exist in futures and options markets. Even in those markets, they are accessible only to a few investors with low transactions costs and superior execution capabilities. You are far more likely to find near-arbitrage opportunities, in which two assets that are not quite identical trade at different prices, and speculative arbitrage, which is more speculation than arbitrage. Since there is no guarantee of price convergence, these investments will remain risky even to the most sophisticated investors and become even riskier when a significant portion of the investment comes from borrowing.

Go with the Flow: Momentum Strategies. To some investors, a low-risk and high-return strategy is to buy stocks that are going up and to go along for the ride. Implicit in this strategy is the assumption that there is significant momentum in stock prices: stocks that go up will continue to go up and stocks that go down will continue to go down. Chartists and technical analysts have used chart patterns—trend lines, support lines and resistance lines, to name but three—for decades to both decipher the trend and, just as importantly, to get advance notice of a shift in the trend. After all, the momentum that brought you profits can very quickly turn against you. In recent years, momentum investors have also expanded their analysis to include trading volume. A stock that surges on high trading volume has both price and volume momentum and is considered a better investment than one that goes up on low trading volume.

STORIES FOR THE HOPEFUL

No matter how poor their past investment choices have been, some investors seem all too willing to forget the past and to try yet again to find a way of beating the average investor. For some, the hope for success rests on finding and following the right investment experts, investing in the stocks they pick. For others, the hope comes from an almost religious belief that stocks always win in the long term and that all you need to succeed is patience.

Just Follow the Experts. There is no shortage of experts, self-anointed or otherwise, in financial markets. There are equity research analysts, touting their superior access to information and management, making recommendations on which stocks to buy and sell. You have insiders at firms, from chief executive officers to board members, acting as cheerleaders in public but telling us far more about what they really think about their companies when they buy and sell stock in them. There are investment newsletters and advisory services, too many to keep track of, each claiming to have found the secret formula for great stock picking. For some investors, who are confused by the cacophony of contradictory views on markets and the

volume of news about stocks, these experts offer welcome solace by taking on the responsibility of picking the right stocks.

Stocks Always Win in the Long Term. It has almost become conventional wisdom in the United States that the stock market may have a bad year or even a string of bad years but that stocks always win in the long term. Take any 10-year period in market history, you will be told, and stocks have done better than government bonds or bills. If you buy into this reasoning and you have a long time horizon, you would put all of your money in stocks since they will earn more for you than less risky alternatives over long periods. Of course, you can augment your returns if you can invest in stocks only in the good years and avoid them in the bad years. There are dozens of indicators, from the winner of the Super Bowl to the level of interest rates, that claim to tell you when to get into stocks and when to get out. The payoff to timing markets correctly is so large that everyone who invests in the stock markets, individual or institution, tries to do it at one time or another.

DECONSTRUCTING AN INVESTMENT STORY

Every investment story outlined in this book has been around for decades. Part of the reason is that each story has a kernel of truth in it. Consider, for example, the rationale for buying stocks that trade at low multiples of earnings. They are more likely to be cheap, you will be told. This makes sense to investors, not only because it is intuitive, but also because it is often backed up by evidence. Over the last seven decades, for instance, a portfolio of stocks with low PE ratios would have outperformed a portfolio of stocks with high PE ratios by almost 7% a year. Given the claims and counterclaims that make investing so confusing, it is important that you take each story apart methodically, looking at both its strong and weak points. In this section, the steps in the process that will be adopted in each chapter to analyze each story are laid out.

I. Theoretical Roots: Isolating the Kernel of Truth

Most investment storytellers claim to have contempt for theorists. They believe that theory is for academics and other ivory tower residents, who do not have to make investment choices for a living. The irony is that every investment story that has survived in the long term has done so because it is firmly rooted in financial theory. After all, you can use a valuation model to illustrate why stocks that trade at low multiples of earnings may be cheap and why companies with good management should trade at much higher values.

You will begin by examining the theoretical foundations for every story in this book. For instance, if your sales pitch is that stocks that have gone up the most in the past are more likely to continue going up—the classic momentum story—what types of assumptions would you have to make about investors and markets for this to happen? While this may seem like a diversion, there are three reasons why understanding the underlying theory is useful:

- Even if you think that you have discovered the ultimate investment strategy, you should be curious about what makes the strategy work. This will allow you to modify and adjust the strategy as the world changes. For instance, if you believe that stocks exhibit price momentum because investors learn slowly about new information, you may have to modify the strategy to reflect the fact that news reaches investors far more quickly today than it did a decade ago or earlier.
- No investment strategy works all the time. Understanding the theory will help you determine the periods when a strategy is most likely to work and when it is most likely to fail. If you view stocks with high dividends as an attractive alternative to bonds, for instance, the attraction should get even stronger in periods when interest rates on bonds are low.
- Every strategy also has its weak spots. By beginning with the theory and working forward, you can identify what you as an investor need to worry about most with each investment story and what you might be able to control to reflect your concerns. For instance, using a valuation model to assess the price-earnings ratio will lead you very quickly to the two primary concerns that you should have when investing in stocks with low PE ratios: that they will not have much growth in earnings to offer and that they may be very risky.

If you lack a quantitative bent, rest assured that the theory needed to illustrate the investment stories is simple.

II. Looking at the Evidence: Getting the Full Picture

The sheer magnitude of data that you have available on financial markets going back a century can be both a boon and a bane to investors. On the one hand, having the data available allows you to test almost any investment proposition that you want to. On the other hand, if you wanted to push a point of view, such as the notion that high growth companies are better investments than low growth companies, you can find backing for this view in some periods of market history and with some stocks. Given that almost all evidence that is presented for or against investment strategies comes with some bias, each of the chapters in this book attempts to do the following:

- *Look at the viability of each strategy in the long term across the broadest cross section of stocks.* Rather than look at small subsamples of stocks over arbitrary time periods, you will look at all stocks listed in the United

States over the longest period for which data is available. Thus, to examine whether stocks that trade at a discount on book value are, on average, good investments over time, you will look at the returns an investor would have earned on all stocks with this characteristic from 1926 to the present. As you will see, some highly touted strategies do break down when they are exposed to this level of scrutiny.

- *Look at subperiods of history to see when the strategy has succeeded and when it has failed.* Every strategy in this book has good periods, during which it has generated substantial returns, and bad periods, when it has failed. If you adopt an investment strategy of buying stocks with low price-earnings ratios, you will find that there are some subperiods in history in which this strategy does much better than others. By taking a closer look at market conditions—interest rates and GDP growth, for example—during these periods, you may be able to fine-tune your strategy and make it more effective.
- *Put the returns from the strategy under a microscope to see if they can be explained by chance.* Strategies that are built around holding stocks deliver volatile returns, beating the market by large amounts in some years and underperforming badly in others. Consequently, you have to be careful how you read the final results of your analysis. For instance, if you do find that stocks in small companies deliver 2% more in returns each year, on average, than larger companies, over a ten-year period, it is possible that this extra return can be explained purely by chance. Luckily, there are statistical tests that allow you to assess whether this is the case.

As a final note, every strategy examined in this book has been tested before by both advocates and skeptics of the strategy. While some of these studies are dated, you can get a fuller picture of whether a strategy works by looking at these different points of view.[2]

III. CRUNCHING THE NUMBERS: DEVELOPING A FRAME OF REFERENCE

Investment strategies are often based upon rules of thumb—8 times earnings is cheap, a stock that trades at a PE that is less than its expected growth rate is cheap, etc.—and these rules have wide appeal among investors. After all, with more than 7000 listed stocks traded in the United States, investors are faced with an overwhelming amount of information. With this information overload, any rule that makes life simpler is welcomed. While there may be good reasons to adopt rules of thumb when investing, there are costs associated with using them as well:

- *Rules of thumb developed in a market can quickly become outmoded as market conditions change or in a different market.* Consider, for instance, the rule of thumb that stocks trading at less than 8 times earnings are cheap. While this may have made sense when the rule was developed in the 1960s, about half of all stocks in the United States traded at less than 8 times earnings in 1981 (making it too loose a definition of cheap) and less than 10% of all stocks did so in 1997 (making it too tight a definition in that year).
- *Rules of thumb are no substitute for the whole picture.* Investors who use rules of thumb as a substitute for the whole picture can sometimes miss useful and important information that they could have used to better their strategies.

But how can you consolidate and make sense of the information that is available on so many different stocks? With each investment strategy, you will be presented with how the measures used in that strategy varied across the market at the time this book was written. For instance, you will look at the distribution of earnings growth across companies in the United States—how many companies in the market have earnings growth greater than 25%, between 20% and 25% etc.—when you analyze a strategy of buying high growth companies. Since these values will undoubtedly change in the months and years to come, the numbers will be updated and provided to readers on the web site for the book.

To get a true sense of an investment strategy and whether you would want to adopt it, you should also take a look at the portfolio of stocks that would emerge from this strategy. With each strategy in this book, you will do this looking across all of your investment choices at the time. If your strategy is to invest in low PE stocks, for instance, you will see the portfolio of the 100 stocks that had the lowest PE ratios in the United States at the end of 2002. There are at least two reasons for doing this:

- *Beyond anecdotal evidence:* By going beyond the anecdotal evidence, you will get a fuller picture of both the strengths and weaknesses of each strategy. You will find, for instance, that the typical low PE stock is not a mature, safe company (as is often claimed by its proponents) but a small, risky company that you have never heard of before.
- *Risk testing:* For an investment strategy to work for you, you have to be comfortable with the portfolio that emerges with that strategy. The only way you can see if this is true is by looking at the list of stocks that would qualify as good stocks with each strategy.

IV. More to the Story: Probing for Weaknesses

Every investment story has its strong points and its weak ones. While you can rest assured that you will be given a detailed analysis of the strengths, proponents of the strategy almost never talk about its weaknesses. To use an investment strategy effectively, though, you need to be just as informed about its limitations as you are about its potential promise.

Toward the end of every chapter in this book, you will examine everything that can potentially go wrong with each strategy, using the portfolio that emerges from that strategy as

your basis. Consider, for instance, the 100 stocks with the lowest PE ratios that would have been your portfolio with a low PE strategy. If one of the concerns you have is that low PE companies are riskier than the rest of the market, you can compare the riskiness of the portfolio of low PE stocks to the riskiness of the rest of the market and examine how many stocks you will lose in your portfolio if you want to avoid the riskiest stocks in the market (in the top quartile, for example).

If you have multiple concerns about a strategy and you eliminate stocks from your portfolio as a result of each concern, you may very well find yourself with very few stocks left in your final portfolio. In the process, though, you will learn about where each strategy breaks down.

V. Lessons for Investors

If the message you take away from this book is that you cannot succeed with any investment strategy, it will have failed in its mission. Each strategy has potential for success if it matches your risk preferences and time horizon and if you are careful about how you use it. At the end of every chapter, the lessons of the chapter—positive as well as negative—are summarized and presented as a series of screens that you can adopt to increase your odds of success. Consider, for instance, a strategy of investing in companies with low price-earnings ratios. After presenting the perils associated with this strategy—low PE ratio companies can have unsustainable earnings, low growth and high risk—you will consider a series of screens that you can use to construct a portfolio of low PE stocks with sustainable earnings, reasonable growth and limited exposure to risk. The portfolio that emerges using these screens is presented at the end of each chapter. You should not consider this investment advice, since stock prices and fundamentals will have changed by the time you read this book. Instead, you should view this as an ongoing process that you can use to find the best stocks for you in any market at any time.

CONCLUSION

Investment stories have been around for as long as we have had financial markets and they show remarkable longevity. The same stories are recycled with each generation of investors and presented as new and different by their proponents. The stories that are examined in the chapters to come have been laid out and categorized by the human emotion that makes each one so compelling; some stories appeal to the fearful (risk averse), others to the hopeful and still others to the greedy. The process used in each chapter to examine each of the investment stories is also laid out, starting with the story, followed by the theoretical foundations and the evidence of its effectiveness (or lack thereof) and closing with its potential weaknesses (and ways of protecting yourself against them).

ENDNOTES

1. With pooling accounting, which was legal until very recently, companies that used stock to acquire other companies were not required to show the cost of their acquisitions in their financial statements. Instead, they were allowed to show just the book value of the assets of the acquired companies.
2. The other studies are referenced in the footnotes of each chapter. If you are interested, you can trace the source articles and read them.