MJK Investments
Simplicity Trumps Complexity

Preface: A guiding hand with a light touch

- Highly sceptical of much of what we read and hear daily about market opportunities. History suggests that most of today's hot new stock issues will be in cold storage in five years.
- Chief concerns of the early 1970s were inflation, the federal deficit, the balance of payments, and high interest rates. If you wait for problems to disappear before investing in stocks, you'll never commit-or earn-a penny.
- If you go with the consensus, your performance will be consensus – ho-hum average. If you want to buy a stock when it is cheap, you have to go against the grain. It is cheap because most people think it should be and will stay cheap until the company is downsized, upgraded or turned inside out (even though its recent poor earnings could be nothing more than the equivalent of a head cold). And when a stock is skyrocketing, you've got to question the prevailing euphoria relentlessly, too.
- In the investment world, the serious, establishment people stick with the so-called blue chips, secure in the belief that what is now respectable can be counted on to behave well forever. Well, it cannot. 15 years ago Schlumberger was the favourite stock of most institutional investors, and though it is still a major company, its super star status is long gone. 10 years ago, IBM's dominance of the computer industry was considered unbreakable. For that matter, a hundred years ago the company considered the best managed and most profitable in the country was the Pennsylvania Railroad. Superior investors, then, look at the current icons with a high degree of scepticism. These folks are the first in the crowd to point out that the emperor is stark naked.

A zebra in lion country

- If you are zebra and live in a herd, the key decision you have to make is where to stand in relation to the rest of the herd. When you think that conditions are safe, the outside of the herd is the best, for there the grass is fresh, while those in the middle see only grass that is half-eaten or trampled down. The aggressive zebras, on the outside of the herd, eat much better. On the other hand- or hoof- there comes a time when lions approach. The outside zebras end up as lion lunch. The skinny zebras in the middle of the pack may eat less well but they are alive.
- It's so much more comfortable to play it safe and be an inside zebra. But if you want to stand out from the pack, you have to stand outside the pack.
- A portfolio manager for an institution such as a bank trust department, insurance company or mutual fund cannot afford to be an outside zebra. For him, the optimal strategy is simple: stay in the center of the herd at all times. As long as he continues to buy the popular stocks, he cannot be faulted. On the other hand, he cannot afford to try for large gains on unfamiliar stocks that would leave him open to criticism if the idea failed.
- I learned a lesson that's been repeated many times over the years; when a large segment of the market gets overpriced and eventually corrects, everybody gets nailed.
- Market herds, like zebra herds, can't run for long without tiring. I never worry if I am early or late with some trend. Rather than chase the herd, we can wait until it comes back by us again.
- When Warren Buffett was asked by Forbes in October 1974 how he felt about the market, he replied, “Like an oversexed guy in a warehouse. This is the time to start investing.”
- Human psychology doesn't change. In fact, in this day of high-speed telecommunications, money managers quickly react- and overreact- to recent events with frightening unanimity. Long-term thinking has practically disappeared.

- We really must be grateful that this herd mentality persists, because if it weren't for these overreactions throwing good stocks on the bargain table, it would be a lot harder for the rest of us to make money.

Think small

- At big companies you talk to executives. At small companies you talk to owners.
- Small companies are not blanketed by research coverage. You can actually discover things that others don't know.
- Since small companies don't get analysts' attention, won't they just stay ignored? Why own a cheap stock if it's going to stay cheap?
  - ➢ These are 4 different ways that a stock price can rise:
  1. **Growth:** As the company grows, the market price of the stock will go up in line with earnings, dividends, and book value. This is generally true even if the company is sparsely followed.
  2. **Acquisition:** The company can be acquired by a larger company as a price well above the market.
  3. **Repurchase:** If a stock sells well below its economic vale, the company may repurchase sizable blocks of its own shares.
  4. **Revaluation:** As a company grows and prospers, it can cross the threshold of institutional interest. The ugly duckling is pronounced a swan, and its price-to-earnings ratio increases.
- Good quality smaller companies can produce stock market profits by any of these 4 mechanisms.

A tale of 2 strategies:

One upon a time, 2 rich men lived in the town of N----, near the mouth of a great river. They both had pondered long on the best way of protecting their gold and silver and carpets and tapestries.

In the end, Mr. C built himself a solid stone house and locked his treasures safely in the cellar. Mr. B felt it was better to outrun thieves, who could besiege a house, so he bought a sturdy ship and put his valuable in the hold.

As chanced to happen, next year there was a flood. Mr. B's yacht floated easily enough, but Mr. C's house was inundated and his beautiful possessions ruined by the muddy water.

Mr. B sailed up and removed the disconsolate Mr. C from the roof of his nearly submerged house. "You see," said Mr. B, "that flexibility is better than solidity."Mr. C tried to smile at his rescuer.

A few months later Mr. C was back in his bedraggled house. Suddenly, a great storm arose, and tremendous waves threatened to swamp Mr. B's heavily laden boat. In panic, Mr. B threw his fine goods overboard to lighten his ship. This enabled him to steer toward the light from Mr. C's window, drop anchor, and swim ashore to Mr. C's beach.

As Mr. C brought poor Mr. B, soaked and forlorn, into his house, Mr. C couldn't help but remark, "There are time when a solid foundation is better than flexibility."

A bond portfolio produces solid income, safe as a stone house, but the floodwaters of inflation will eventually ruin its purchasing power. A stock portfolio has the ability to rise with inflation, but the storms of recession can cause rough sailing and eroded values, at least temporarily.

My advice to the widow was twofold. First, diversify, using an equity portfolio as well as the tax-exempt bonds that generate current income. Second, look for equities that are likely to provide an increasing dividend stream over time. Small but growing companies are an excellent place to start such a search.

- If you don't make some misjudgements, you're doing it wrong: you've not taken enough risk and you will never score a big one. You do best when your investment are controversial- when you stray farthest front the herd.

- Look for a company that has carved out a special niche for itself.
- Believe in investing, in quality small companies, seasoned rather than nearly new, with financial strength, dominance in their market segment, entrepreneurial management, and understandability.
- A portfolio of well-researched small companies should be no riskier than a portfolio of large, well-known companies.
- When people comment on the health of "the market," they mean the Dow Jones Industrial or The S&P 500 Index. The chart of the patient in the next bed- that is, small stocks- may look quite different. There are really two distinct markets, and their fortunes alternate.

Growth, Value, or GARP?

- For the growth advocate, the important assets, such as brands, management skills, patents, or a natural monopoly, which don't appear on the balance sheet anyway.
- The market overreacts to news, good or bad.
- A growth stock that works- that delivers 15% or more annual earnings growth for 5 years- will more than double your money. You will also experience the thrill of concluding that you are a financial wizard. The high you get from finding a growth winner is very much like what a poker player feels after taking in 4 large pots in a row.
- If you are pursuing a style that doesn't fit your temperament, you won't be happy. Show me an unhappy investor and I'll show you an unsuccessful investor.
- A growing stream of earnings is certainly worth more than a static stream of earnings. You could even say that growth generates value.
- A low P/E, too, can disappear, if earnings shrink.
- Say the lobster costs $10 a pound and chicken $1 a pound. The store will sell, to pick arbitrary numbers, a dozen lobsters and 600 chickens. But if lobster suddenly goes from $10 a pound to $30a pound, the next day you may sell zero lobsters and 615 chickens. If lobster drops to $3 a pound, you'd sell every lobster in sight. People are very conscious

of prices and of the relationship between prices and value, and they're quick to shift behaviour. Momentum players buy more lobsters as the price goes up.

- In 1980, silver spiked to $40 an ounce. Today it is back to $5. Price bubbles soon burst.
- There is a great difference between the best company and the best stock.
- The chance of a company's having one and only one bad quarter is equivalent to the chance of your kitchen's having one and only one cockroach.
- In 1990, when the absolute favourite of almost all growth stock investors was Wal-Mart, I took a good look at the stock- though not as a possible investment; it was fat too expensive at that point for me. My chance had come earlier, when Wal-Mart was just starting up in Arkansas. A Chicago bank loan officer who specialized in the retail industry suggested I take a look at 3 discounters, two of them in Arkansas. And I did. Trouble is, neither of the two recommended Arkansas companies were Wal-Mart. They were sterling stores and United Dollar, both long bankrupt now. (The loan officer came to a bad end, too, but that's another story.)

  By 1990 Wal-Mart had been growing at a 25% per year clip for a long time. If the chain's expansion rate were to continue, Wal-Mart would be the only retailer left in the country after only 25-years. For about 5 more years Wal-Mart did continue to manage 25% a year or better growth. But finally the tree got too high. In fiscal 1996 sales were up only 13.5%, and the company that had reported 99 consecutive quarters of earnings growth announced that profits for the 4th quarter of 1995 were down about 10% from profits of the year before.
- But just as growth stocks don't grow forever, value stocks, too, have their flaws. For very often the thing valued turns out to be ephemeral. You bought a stock that was trading at half book value and it turns out the book value evaporates, as was true of the open-hearth furnaces on the balance sheets of the steel companies. Or inventory turns out to be worth less than projected. Or, more fundamentally, the stock is cheap because the company is sick, and instead of recovering as the value buyer expected, the patient dies.
- The greatest investment profit comes when an ugly duckling becomes a swan.

- The fact that a stock has already moved up sharply doesn't mean that it can't still have plenty of room left to climb.
- One fact is undeniable: you can't make 5 or 10 or 20 times your money if you don't hold on to stocks. Most people are delighted when a stock doubles, and quickly sell to lock in their gain. If a company is still performing, let its stock, too, continues to perform.

Bad news bulls

- There is a steady flow of wealth from hopeful gamblers to the men who know what the odds really are.
- If most investors act risk-averse way, we can understand why they will accept a lower return from bonds and other fixed-income investments rather than hold stocks. And why they will stick with the blue chips instead of taking a chance on capturing the higher returns of small company stocks. I know that when I find a situation where it seems to me probabilities favour the rewards over the risks, I will have no trouble finding the other side of the trade. Because most people ignore probabilities, exaggerate the risks, and are prone to sacrifice returns in favour of perceived safety.
- People make up their minds differently according to how a problem is presented to them. The same thing happens to stock investors who have a loss on a stock. Unable to face the reality of what the stock is now actually worth. The unlucky owner is willing to take a sucker bet by holding on to the stock, even when he knows the company is in trouble, in the wild hope of a comeback that will erase his loss. The stock market is not a racetrack, but we do know that investors behave differently in bull and bear markets, and framing theory helps explain part of the difference.
- Investors assess information emotionally, creating price distortions that the astute and nimble can exploit.
- Note that we want the sound banks and good companies. When an industry gets bombed, you can't pick indiscriminately form the rubble. But research will usually turn up some legitimate bargains. Then all it takes is patience.

On your own, or call in the experts?

- The further you stray from stocks you really understand, the more likely you are gambling rather than investing.
- I still want to load the shopping cart with cheap stocks of small, sound companies with products or services in demand- increasingly, in worldwide demand.
- Too often people start with a discipline but abandon it.
- If instead you develop a set of convictions you adhere to, you can turn your back on thousands of stocks and concentrate on a manageable universe. A set of guidelines- and I urge you to put them down on paper- gives you confidence when times are rough. It helps you to make toughest decisions: when to sell. It makes it possible to get better and better through cultivation of a repeated skill. And it keeps you from the folly of the amateur who leaps from fad to fad, usually just about the time the fad is fading.

  But it has to be your strategy, what is right for you. Every singer must sing her own song.
- Investors constantly rotating their portfolio to catch the dazzling performers of the moment have had disappointing results in an extraordinary bull market.
- Brokers earn a living only when you move your money around, and Wall Street knows how to trumpet the latest fad.
- Considering the time, discipline, skills, knowledge, resources, and personality that investing demands, mutual funds are the sensible course for 95% of the public.

Themes and variations

- The market areas and the groups I want to concentrate on are those that I believe will benefit from strong economic, social, or technological trends.
- I want to see something that convinces me not only that the company’s management is competent and its product line exciting but, in addition, that its particular industry, or niche in an industry, is one with superb prospects. I want everything going for me.

- As Sherlock Holmes, with his usual maddening superiority, chastised Watson, “You see but you do not observe.” The investor has to develop an observing mind-set and get in the habit of looking for trends in his reading and experience. Perhaps a newspaper account of what is going on in the job market will suggest a thriving area of the economy that can lead to an investment opportunity.
- Industry will increasingly rely on companies that can concentrate on the technologies and skilled personnel needed to do specialized jobs.
- If you can see where the con men are flocking, you can tell which groups are about to peak.

Downstream from technology

- Since the industrial revolution began, going downstream- investing in businesses that will benefit from new technology rather than investing in the technology companies themselves- has often proved the smartest strategy.

The portfolio jigsaw, stock by stock

- If you don’t look at companies with a fresh perspective, you can’t hope to find stocks that are priced below their true value.
- As for my own approach, I cannot overemphasize that I believe in entrepreneurially managed small companies that are benefiting from an important economic, social, or technological trend and whose domination of a niche promises superior earnings growth. And that I acquire them only if I can get them at a reasonable price.
- Usually the market pays what you might call an entertainment tax, a premium, for stocks with an exciting story. So boring stocks sell at a discount.
- Good management to Wall Street also means nothing more than a company with 3 consecutive quarters of rising earnings. Make it 4 quarters and you have *great* management.

- If you judge management solely by a company's numbers and then pay more for the stock because of "good management," you are guilty of what bridge players call the double-counting of face cards.
- It's particularly hard for the individual investor to find out much about management. Annual reports can be useful, give you a sense of the integrity and vision of the chairman and his policy makers, but you have to remember that what is most important may be precisely what the company doesn't want you to read. If you know someone who works in the company, or sells to it, or competes with it, you may be able to get better information.
- Management can be guarded about what they tell you, but their competitors will usually talk freely about them.
- Financial strength- low debt, adequate working capital, conservative accounting- makes corporate growth sustainable.
- Stick with proven companies.
- Fundamental value means that stocks are a buy only if they are cheap, but you can measure cheapness in 2 ways. You can look at a stock's price in relation to a company's replacement cost, what it would take to reproduce its assets. Or you can concentrate on the company's earnings-growth prospects. A company's earnings may be flat but its stock cheap in terms of its underlying worth; or its market capitalization may be higher than the value of its assets, but its earnings potential still labels it a bargain.
- A company that is highly profitable, and whose profitability is recognized by the market, it doesn't matter: the multiples will be high no matter which ratio you look at.
- When it comes to investments, we can never learn every detail about a company. Still, we can try to understand the sources of profit and growth in a company, the plans and the philosophy of the management, the competitive environment, and the negatives that might alter its prospects.
- We tend to overestimate the probable earnings of our stocks, because we buy the ones we like best. Prices are set by optimists.
- A stock is cheap, and a probable buy, if our expectations are higher than the consensus.

- Data mining will come up with exciting patterns, but they are merely coincidental. Computers find a trend that's been in place for a couple of years and may persist for another few but then suddenly disappear, because it wasn't really there in the first place.
- I think I am better at identifying trends and stocks with staying power than I am at guessing a company's earnings for the next quarter or a stock's short term behaviour. So I am a reluctant seller.
- Have a reason for buying every stock you own. As soon as that reason comes into doubt, ask yourself if it isn't time for a change.

Is there a time for timing?

- Trying to predict what the market will do is a fool's game. We pay little attention to the market. All our attention is on the companies we own.
- Every market timer has a set of signals he follows because they worked the last time. The trouble comes when they don't work the next time.
- The extrapolation method of forecasting is natural, plausible- and wrong.
- Exceptional growth usually sows the seeds of its own decline.
- So much of what happens in the market, in the short run, is just random, but that is seldom acknowledged. There has to be a reason the market went or up down yesterday, so *The Wall Street Journal* and the other papers call up analysts and money managers and ask them why. What you usually read in the paper is simply a logical fallacy. Something happened after something else, and therefore the first event must have caused the second event. The bond market goes up a quarter of a point, and a reporter rings up somebody at Salomon Brothers, and the trader she gets on the phone figures his name in the paper would impress his girlfriend, So he looks at his terminal and say, "Well, the Bank of France lowered interest rates yesterday and that had a favourable impact on the U.S. market." So the reporter writes it down, it appears the next morning, and readers nod as though they now understand. The truth is, no one knows why the hell the bond market did what it did.

- Why do we listen to market forecasters who are no better than astrologer? Because the human mind is a pattern seeking mind.
- All those indicators that are supposed to tell you when the bull market is over can, again, be unreliable extrapolations of past behaviour. As a prime example, in October 1992 the dividend yield of the S&P 500 fell below 3%, and it has been common wisdom that whatever that occurs, the market is ready for a tumble. It always happens, proclaimed the soothsayers (citing 1987 as another instance), and it always will. When the bear didn't pounce, the timers blamed dropping interest rated and rising corporate earnings but declared they were only stalling the inevitable. But still no great correction came, even though the yield stayed under 3%. By mid-1996 the dividend yield on the S&P 500 hit a record low of 2.1%, while the market was still making new highs.
- Even the timers with the best records have added no return to a buy-and-hold policy. They can claim only that since they are often in cash, they've lowered portfolio volatility.
- Market levels simply have little to do with whether the economy is up 3% or down 1%. They have a great deal to do with cash flow into and out of markets.
- You simply have to buy stocks you believe in because you think you've found people who have an important reason to be in business, and then you have to stick with them as long your faith in them remains.
- Nothing seems to stop people from trying to call the market's direction. I sometimes think they are less interested in making money than they are in proving their brilliance."The market has a will of its own, does it? Very well, I'll tame it and show who's boss." It's a silly challenge. When the market's going down, it's not because you are stupid. And when it's going up, it's not because you are smart.
- A market may indeed be "overpriced," but it can stay overpriced for years. Bull markets come in all lengths. Your only defence against every sort of market jitters is to talk like a long-term investors.If you stare the monster down with focus, patience, and a calm eye, you will be rewarded in the end.
- Bull market returns are highly concentrated. A University of Michigan study showed that the market's 90 best trading days between 1969 and 1993- barely 1% of that period-

accounted for 95% of the market's gains. Another, even longer term study showed that if you, in your timing efforts, were out of the market a critical 7% of the 780 months from 1926 through 1990 you would have earned absolutely nothing from 64 years of investing.

Living through the crash

- How many pundits were wailing at the end of 1994 that the market was too high and poised for another October 1987? Then the Dow Industrials proceeded to skyrocket 37% in 1995 and another 29% in 1996. You can't predict how long the bad times will last either. So you might just as well stay invested.
- A flat market doesn't mean you can't find stocks that go up.
- In bleak periods falling stock prices are not part of the problem. They are part of the solution.
- As a bull market gathers steam, investors pay less and less attention to the problems and more attention to the opportunities. And vice versa in bear episodes.
- Bad things happen to companies, industries, even the economy as a whole for a time, somehow society as a whole still moves forward. Problems usually get solved. Recessions end. Somehow the country stumbles on and companies continue to make a profit. If you don't need to put your hands on your money for a few years, I'd say stocks are still the best place to keep it.

While you're at it, include the world

- I can't think of any place in the world that, as it gets richer, doesn't eat more meat and protein foods and less bread and rice. Everybody would like to have nicer clothing, a car, and a large air-conditioned house, and feel entitled to a pair of reeboks and a meal at McDonald's once in a while. Investors have to find the companies that satisfy these desires.

Parting reminders

- If the system convinces everyone that it has evolved into an ever-upward path, it means only that more distortion is being stored up before the reversion comes. The more sophisticated the system that maintains the distortion, the bigger the smash ahead. You might well find out that what you're going to end up with is the mother of all bear markets. It has to happen. It happened in Japan. It will happen here after the distortion builds to an untenable level. We have to get back to the average.
- Maintain independence of thought and a healthy degree of scepticism, so you won't be drawn into the herd. Invest in themes that will give a company a long-term franchise. Invest downstream from technology. Think and invest globally. Find stocks to own, not trade.