BLANKSTONE SINGTON
Investment Managers & Stockbrokers

INHERITANCE TAX PORTFOLIO

Investment Philosophy

by S. P. ENGLISH, CFA

Before any investor, be they professional or amateur, commits money to the stock market it is essential that they have a clearly laid out Investment Philosophy. This provides a structure and discipline to a field where errant decision-making abounds. The below musings outline my own Philosophy and while my attempts at humour may bypass you, the number of contradictions that run rife throughout the text will certainly not. This is quite deliberate. After all, investing is simple but not easy! Contradictions litter the investment landscape, a by-product of human emotion where temperament is reliably temperamental.

The Rational Economic Man beloved by economics lecturers the world over remains missing presumed dead. If you find him though please let me know as it would make my job altogether more straightforward. Until found, however, smart people will carry on doing stupid things with unerring regularity, a situation that presents plenty of opportunities for profit. Trying to exploit such opportunities without a suitable Investment Philosophy, however, can be very bad for your wealth and prove fatal to your ego.

The remaining short(ish) essay reflects what I believe to be the most cogent lessons gleaned from the world's best investors as well as from my own first-hand experiences from countless meetings with company CEOs, CFOs and professional fund managers. I've seen the Good, the Bad and the Mediocre and everything in between. A disproportionate number of professionals worship at the altar of mathematics, confident in their ability to predict sales, expenses, profits and cash-flows decades into the future. A few may be able to do this well but most cannot with any degree of regularity. The best mathematicians realise that maths is just a tool, sometimes a powerful one, but nonetheless just one tool in a box that should contain many others. After all, 'if all you have is a hammer, everything looks like a nail' (proverb). In mathematics and investing the rule of parsimony (less is more) always trumps complexity but only up to a point. As Einstein said, "everything should be made as simple as possible, but not simpler." This is one of the guiding principles I hold most dear.

At times I will venture down the rabbit hole as parts of the Philosophy become 'curiouser and curiouser' but like Alice these efforts to make sense of the nonsensical should pay dividends. That said, however, an Investment Philosophy should never be immutable; adaptability in mindset and approach is absolutely key to making money. What matters is what works.

*

Intrinsic Value

In theory shareholder returns should match the company's cost of equity and intrinsic value broadly tracks the cost of equity every year. An investor's objective therefore is simple. Buy when the share price is below a stock's intrinsic value and sell when it rises above it. That is the theory but as Yogi Berra said, "In theory there is no difference between theory and practice. In practice there is." Unfortunately a stock doesn't proffer its true intrinsic value so investors instead must guesstimate it. Like the blind men from India who each touch a different part of an elephant, however, the conclusions they arrive at often differ wildly.

More dishearteningly, even if it was possible to know a stock's intrinsic value with absolute certainty, it tells you little about the subsequent share price action. The price may remain adrift from intrinsic value for years before it eventually converges. This represents a potentially high cost, known as Opportunity Cost, and due to its more implicit nature (you lost out on potential upside) against a more explicit cost (you lost money) investors often fail to view the two as being of equal significance. This is a major shortcoming and one I will touch on again.

Intrinsic value is highly important, and investors must have an appreciation of it, but the more dominant driver of a share price is how other investors perceive the company and its prospects. If a company is perceived to have precarious finances due to high debt levels, despite having ample asset backing such as land and buildings, then it has weak finances. Accept it and, above all, don't let your own prejudices get in the way of making money. The truly wise know what to overlook. Philosophers have long studied this interplay between thinking and reality and when it comes to investing reality isn't reality, perception is reality. I cannot overstate how important these three words are. There is little point in admonishing a price action that performs entirely contrary to expectation; the stock market is world class at confounding as many people for as much of the time as possible.

If you can deduce both perception and reality all the better, as you can then juxtapose the two and identify when they deviate too far from each other. These are very profitable trades indeed. The company with the perceived weak finances can sell its land or buildings and in a stroke be in a net cash position transforming its prospects, dividend paying ability and risk profile. Investors' perceptions will rapidly snap back to this 'new' reality, driving the share price up for your benefit.

The bull market which started in 2009 is often dubbed the most hated in history. Why? Most sat on the sidelines believing QE policies would be at best ineffective and at worst fatal, while others made hay. They may well be proven 'right' eventually but the victory will be a pyrrhic one given the amount of gains that could have been harvested in the meantime. Being too early with a call is imperceptibly different to being wrong. They ignored other investors' perceptions in favour of their own version of reality, believing everyone else to be wrong. As George Soros said, however, "It's not whether you're right or wrong that's important, but how much money you make."

Efficiency

Stock markets are incredibly efficient at assimilating information. You can view the price as the single best 'indicator' available, distilling thousands of investors' fragmentary insights into just one all encompassing metric. While almost magical in its ability to do this, investors often confuse efficiency with rationality – the two though are absolutely not synonymous. Unlike the Rational Economic Man from Economania, there may be as many irrational investors contributing to a share price movement as there are rational. At market tops and bottoms there is certainly an abundance of the irrational. 'What a fool does in the end, the wise do in the beginning.' (Spanish proverb). The field of Behavioural Finance has uncovered dozens of psychological biases and quirks that explain why humans err with such regularity when it comes to investing. Investors have finally made contact with the enemy and discovered it is them.

The world is both incredibly complex and uncertain and people are ultimately fallible. Soros takes this one step further when he talks of 'reflexivity' where investors take their cue from the price action which itself comes from others reacting to others. It can often trigger a chain reaction (computer simulations using just 3 types of traders [optimists, pessimists and fundamentals driven] have replicated very precisely the extent and frequency of market crashes we've actually witnessed). Walter the wildebeest may just have easily as started running away from the watering hole because of a predator or because he's spotted a wildebeautie. Whether the reason was rational or irrational, that single animal can trigger a stampede. Price doesn't necessarily equal fair value, particularly in smaller-capitalised stocks (small-caps), where superior analysis can deliver outsized investment returns to the patient investor. Patience both in terms of holding an investment until value outs and sifting through dozens of ideas and waiting until just the right investment comes along. The best films have a cutting room floor littered with unworthy scenes.

Inefficiency

Small-cap stocks represent perhaps one of the last bastions of market inefficiency (price not reflective of intrinsic value) given the low analyst coverage and lack of interest from the monolithic fund management groups. If you are looking to pay a price for a piece of art that is below its true value would you prefer to frequent an auction hall that is standing room only or where the staff outnumber the bidders? Large-caps are generally more efficiently priced which reduces the amount of true pricing anomalies where price seldom deviates from intrinsic value for long and when it does it isn't by much. Small-caps on the other hand throw up much larger pricing anomalies with much greater regularity. This is fertile hunting ground for nimble stock pickers.

We've found that companies with a market capitalisation of below £150m offer particularly good value on a risk adjusted basis and is a space I deliberately target. As a company gets bigger it starts to attract larger fund management groups who were unable or unwilling to buy the stock when it was below some self-imposed market-cap threshold. It is akin to shunning a potential life partner, despite their many attractions, because they are below a certain height and then suddenly being enamoured with them when they don a pair of (Cuban) heels. Strange, but we are not here to judge and have no qualms exploiting such sizeism.

As small-caps get bigger and attract buying from the large fund management groups the Price Earnings (PE) ratio often re-rates higher, say from a low 8 times to a much fuller 20 times (price is equal to 20 times the earnings per share). This is likely at the same time that earnings are also growing providing further share price impetus. This re-rating allows us to effectively arbitrage company size, getting in early when it is smaller, cheaper and shunned and exiting when it becomes larger, dearer and coveted. We can do this by virtue of our own size, which allows us to tread where larger peers cannot. We will curtail inflows into the IHT strategy if and when we feel it starts to impair our ability to pick the very best value.

Multi-disciplines

To unlock hidden value within small-caps I believe requires an approach spanning three key disciplines:

1. Quantitative (30%)
2. Qualitative (30%)
3. Psychological (40%)

Master all three factors and you are way on your way to outperforming. Skimp on just one and you will at best be average, at worst be ruined.

No. 1 (Quantitative) is numerical in nature covering economics, accounting, mathematics, probability, valuations etc. One must have adequate competency in this and be comfortable navigating through accounts, where the balance sheet, cash-flow statement and income statement should all tell the same story.

No. 2 (Qualitative) deals with the more intangible aspects of investment such as weighing up the competence and integrity of management, gauging competitive threats, assessing pricing power, the composition of the Board, quality and extent of Research & Development, the incentives of management and the sustainability of profits. Qualitative factors will give positive and negative answers; it's up to the investor to properly weight each factor to arrive at an overall conclusion.

You can see then that No. 3 (Psychological) at 40% is the factor I consider to be the single most important and is the one that I will spend a disproportionate amount of time exploring.

Read, a lot

To enhance the above skill set it is imperative to read as much and as widely as possible, no matter how seemingly tangential. The aim is to be more 'T' with the horizontal part of the letter representing breadth of knowledge and the vertical depth of knowledge. Breadth and depth allow you to start to really compare and contrast investments giving you the resources to better decide whether a UK toilet roll manufacturer offers the best risk adjusted return or a coal fired Indian power station. This is a big advantage over more focussed analysts who specialise in only one sector. Reading widely doesn't provide you the map but it does give you some powerful navigational aids. Ironically the more knowledgeable you are the more comfortable you get asking simple questions. I often learn the most about a business from basic questions than I do complex ones. "There are no foolish questions and no man becomes a fool until he has stopped asking questions" (Charles Steinmetz).

Reading a lot also helps to identify emerging trends, threats, opportunities and builds up a rich tapestry of wisdom from which you can draw when assessing company prospects. This is not only invaluable in identifying tomorrow's winners but equally helpful in identifying tomorrow's losers. I take as much pride in sidestepping investments that sour as I do when they blossom. Avoiding a 33% loss is identical in every respect to making a 33% gain. Some of the best investments are the ones you don't make. Warren Buffett has three investment trays: Yes; No; and Too Hard. I've adopted this system too and it's kept me away from some lousy stocks. If a business model is Too Hard to grasp, it's either deliberately opaque and management are trying to obfuscate some truth or it's just fiendishly complicated. Whatever the reason there are dozens of far simpler businesses out there and by fully understanding them you will have a fuller understanding of the risks they face. You get the same kudos for making a pound of profit in the stock of a widget maker as you do in one that may or may not have cracked cold fusion (probably not cracked it at the time of writing).

<u>Driving using the rear view mirror</u>

Investing should be boring, with the most money made just by sitting rather than trading. This drudgery can be too much like hard work for some investors, especially if others are making money when they aren't. Envy leads investors to chase top-performing stocks often buying in the latter stages of a bull market. The renowned investor Howards Marks, founder of Oaktree Capital, got it spot on when he observed "There's only one way to describe most investors: trend followers." This applies equally well to both amateur and professional investors alike. Next time you simply must buy something, stop, take a step back and ask yourself why. Is it because, on a forward looking basis, you feel the price undervalues future prospects? Or is it because the price has risen appreciably and everyone is waxing lyrical about it? Invert their enthusiasm and ask if everyone is so bullish then a lot/most of the buying has already taken place. The higher the price you pay the less return you are accepting. By reframing it in these terms you are straight away ahead of most private (and professional) investors.

Just a quick detour on the issue of looking backwards, trend following, performance chasing, call it what you may. The fund management industry and practitioners are obsessed with past performance figures. Once the earth has orbited the sun 1095 times i.e. 3 years, a Rubicon is crossed where the hitherto uninvestable becomes investable. The disclaimer that 'past performance doesn't guarantee future returns' is a common phrase but often goes unheeded (fund management houses rely on this). Raw performance figures tell you absolutely nothing about how a manager or investor went about delivering returns. It may have been luck or skill or some combination of the two.

Of much more importance than past performance is the manager's process or Philosophy and whether it leads to added-value over the long-term and, crucially, if that added-value is repeatable. Past performance should be no more than around 20% of the overall decision making process but I fear in reality it is well over 90%. I call this obsession with past performance the 'here's what you could have won' effect in homage to 1980s UK game show, Bullseye, and the farcical feature where the top prize (often a speedboat) was wheeled out in front of the losing contestants. Align yourself to the process rather than what you could have won. You'll suffer fewer traumas than Rose and Vincent from Warrington who didn't even know they wanted a speedboat until they were shown one. Until a time machine is invented past performance is what you could have won but haven't.

<u>Unforced errors</u>

Another major common error is a lack of process which leads to unforced errors. One of the founding fathers of probability, Pascal, said "When we play tennis, we both play with the same ball, but one of us places it better." This beautifully sums up the investment arena where competitors are in constant battle with each other and fine margins dictate success or failure. When two world class tennis players compete the victor is often the one who makes the fewest unforced errors. Skill and experience has a major bearing on placing the ball/investing well but thankfully it is far easier to eradicate unforced errors in investing than it is in tennis. Note down losses, learn from them, avoid weak balance sheets or loss making companies, recognise when you were irrational, and above all don't panic when markets inevitably tumble.

Much of this Philosophy is in essence the process I follow. Process though is only half of the equation, the other is <u>execution</u>. The Australian cricketer Glenn McGrath was renowned for maintaining an accurate <u>line</u> and <u>length</u> when he bowled (a nightmare for batters as it introduces maximum uncertainty when trying to hit the little red ball). He wasn't the fastest bowler in the world but his metronomic consistency of line and length made him one of the most economical and dangerous bowlers of all time. Instead of line and length an investor must apply process and execution with the same zeal and level of consistency as McGrath. Execution is the actual pulling of the trigger and physically buying or selling when the process dictates that you do so. While the process is dispassionate, people aren't, and they often fail to execute when they should. Without execution process is impotent. A pilot has a checklist to physically force him or her to follow a predetermined sequence of actions to avert disaster during an emergency and investors should have their own version too.

Execution also encapsulates the portfolio and the rules that govern its construction. It's having a maximum limit of 40 stocks so capital is always competing for the best ideas and ensuring that risk has been spread properly. Too many investors instead 'diworsify' and fill the portfolio with stocks they lack conviction on or believe will appreciate significantly. It is far better to be certain of a reasonable payoff than be uncertain of a large payoff. We have a minimum of 25 stocks and found the 'sweet spot' to be around 30-33 of our best ideas. In times of high uncertainty we tend to nudge the holdings up towards 40 to further try and reduce risk with a higher spread of investments. Subtle but effective. Diversification is the only free lunch investors will get from the stock market so gorge on its generosity.

Execution is also about sizing the investment according to your conviction and the liquidity of the company's shares. We have a minimum initial investment limit of 1.5% up to a maximum of 5%. We run winners up to a point but don't let any single stock dominate and reduce positions once they reach 7.5% of the portfolio. This allows profits to be taken and reinvested in other good ideas and means even a hugely successful stock remains in the portfolio, constantly being pruned back, but never sold outright too hastily. The adage that 'you never go poor by taking a profit' is only half true, you never get rich either by selling too early.

Thinking two-shots ahead

It can be said that today's contrarian is tomorrow's conventionalist, where thoughts deemed ridiculous at the time come to be viewed as prescient and eventually accepted as common knowledge. As ever the share price keeps score on this evolving narrative. Is there a pathway then to reach such conventionalism? Thankfully there is, you just need to re-map the way your brain thinks.

Ronnie O'Sullivan, probably the best talent ever to play the game of snooker, thinks 'two shots ahead' when playing so he can best plan what order to pot the balls in to build the highest scoring break. Investors too should adopt this approach to portfolio building, to be positioned the right side of a stock (to hold or not to hold). People often think a 'good' company makes for a 'good' investment but if enough think that then the share price is high and future returns will be low. Identifying whether a company is a 'good' or 'bad' one today isn't terribly profitable, the trick is identifying a path where the 'good' turn 'bad' and the 'bad' turn 'good'.

I am mainly interested in what a stock looks like in 2 years time than I am in its current state because:

1. The current is priced in and much beyond a year isn't, and

2. You can get in or out of a stock in good time, and a better price, as opposed to peers who seek to exit just before midnight but 'are dancing in a room in which the clocks have no hands' (Buffett).

Case study

An oil price decline impacted Middle Eastern customers putting them under financial pressure this year. The driver was an oversupply of oil which wasn't likely to correct quickly. A business had reasonable exposure to that region, so perhaps one should see what money is owed to it by such customers who will be under pressure financially. Check the accounts and see how much of the receivables is past due by 60 days or more. This number is significant relative to profits and you note a new CEO has just been appointed. Thinking two shots ahead he's likely to cast a more sceptical eye on the recovery of debt owed to it by pressured customers. A few weeks later and a statement that a more 'prudent' view requires a large bad debt provision takes a third off the share price. This was Driver Group Plc and was the exact process I went through. You can see none of that took any sort of genius whatsoever; merely thinking not one but two shots ahead was enough. Buffett sums up what is needed to be a good investor, "If you have a 150 IQ, sell 30 points to someone else. You need to be smart, but not a genius".

The best contrarian investors are comfortable with appearing foolish and need thick skin as volatility will still be high after a bear market and losses will likely accrue initially. It is a lonely place but with the book of conviction to keep you company it gets more and more comfortable. A vital tool in thinking two shots ahead is a thorough understanding of supply and demand. Too often investors myopically focus on the demand side of the equation while the supply bogey man creeps up on them and hits them over the head. The miners were a classic case. The adage that the 'cure for high prices is high prices' was totally forgotten by investors and managers. Demand remained robust but the supply that came on stream overwhelmed demand and saw prices of commodities collapse. Grasp the likely movement in both Supply and Demand and you are in pole position.

Increase Robustness

Unfortunately investors crave certainty and one means of achieving this is by reconstituting history ex post so that it was entirely predictable. The outcome of history, however, massively understates the variability of potential outcomes. It is crucial therefore to make your portfolio as robust as possible to cope with a range of outcomes rather than just one or two that you feel certain will transpire. Knowing what you don't know lets you get on with what you do. It's hard enough trying to predict next quarter's results let alone multi-years out where forecasters tend to just extrapolate the recent past in a linear fashion. Events alas rarely follow such a straight line, "When the train of history hits a curve, intellectuals tend to fall off." (Karl Marx).

I strive to increase robustness by constantly recycling the expensive holdings back into cheap holdings. Forest managers learnt long ago that it is better to let a forest adjust by letting a series of small fires rage, in this way you avoid an inferno and huge loss. By recycling we are conducting a similar adjustment process, always looking to dampen the portfolio's overall valuation level before it gets to an unsustainably higher level and ultra-sensitive to a negative catalyst. That said, however, I've got a lot better at paying up for a stock with exceptional growth prospects and qualities. Some of the best investments are those with a Price Earnings ratio of 20x or more. That said I won't pay much beyond 20 times earnings and a stock will be seriously reviewed should its rating expand to 30 times or more.

I like to also have a good number on PEs of around 10 times or less. Risk is primarily a function of price. The higher the price, or valuation, the higher the downside risk. Moreover, as a stock's valuation rises its riskiness increases at an increasing rate. In other words the higher the expectation the greater the chance of disappointment - parents and children will both no doubt relate to this.

I also look to diversify by investment style, across Value and Growth, where the former tends to outperform the latter over the long-term. There are periods, however, where Growth's outperformance can last for several years (as I write in 2016 Growth has trumped Value since 2009). It is nigh on impossible to predict when one style will lose out to the other and when to switch styles. As such I prefer to maintain an ongoing balance in the portfolio between Value and Growth At a Reasonable Price (GARP). In this way we are hedging our bets which across the cycle should improve risk adjusted returns. GARP is quite different to out and out Growth investing, where the latter is concerned with identifying super normal earnings growth rate. GARP investing is associated with much more mature companies which are profitable today and offer good growth relative to the price paid.

Further robustness comes from only investing in companies that are dividend paying, or close to, which puts a discipline on management and indicates the business is of sufficient maturity and, crucially, is already profitable and generating cash. Profit isn't a profit unless it generates cash. This 'filter' alone has kept me out of some of the worst disasters that the AIM market is (in)famous for where the narrative surrounding the stock is incredibly seductive, promising to revolutionise the world. Such 'story stocks' are best saved for bedtime, although given the horrors they generate, perhaps not. The other major feature that drives up robustness is only investing in companies with strong balance sheets/asset backing. When the cycle turns these companies have their destiny in their own hands rather than their lenders', and survival is crucial when it comes to protecting wealth. A (very) rough rule of thumb is only investing in stocks whose Net Debt to Earnings (before interest, tax, depreciation and amortisation) is less than 2 times. Often the companies we invest in are in a net cash position, which is the ultimate 'fortress' balance sheet.

Win by not losing

We believe that true investment risk is permanent loss of capital, rather than volatility which is more a symptom of risk and more closely linked to liquidity. The more volatile the stock the less liquid it is (it may be at a depressed level so you hold off until it recovers). When flying I'm more bothered about the risk of crashing than the amount of turbulence. Paradoxically, we try to grow investment values by not focussing on stocks that will shoot the lights out (they invariably don't) but the inverse, concentrating on risk management and those stocks that will survive across the cycle. It's a subtle but key difference, akin to fighting a rear-guard action. Get your risk controls right and the upside will look after itself. This is about finding companies with growing demand for their product, a robust business model, long-term focussed management teams with sizable 'skin in the game' in terms of equity ownership, and which are reasonably priced.

There is one certainty when it comes to markets, they are inherently cyclical, and when people forget this, that's when the most money is gained or lost. Warren Buffett, a master of prose, puts it best when he says 'only when the tide goes out do you discover who's been swimming naked'. You'll be glad to hear I seek to avoid indecent exposure. To cope with this inherent cyclicality, as well as the balance between Value and Growth, I also tilt the portfolio between attack and defence. I will tilt the portfolio to defence when: euphoria is too high, IPOs are abundant and richly priced, Prudence has retired, M&A is reaching frenzied levels etc. Conversely when the pendulum swings from euphoria to abject hopelessness I tilt towards attack and pick up bombed out stocks where sentiment has overshot on the downside. There is a pendulum of investor emotion which is always swinging from one side to the other spending little time in the middle where everything is just fine. Identifying where the pendulum is currently and when it starts swinging the other way are great ways of being the right side of markets. This is exactly how junk bond investor, Howard Marks, goes about investing, and if it's good enough for the self-made billionaire it's good enough for us.

Time the market but not with cash

The nature of the IHT strategy means we must be fully invested at all times and this actually improves returns. To explain, some investors try to time the market by going into cash. This means you have to call the very top of the market with precision, getting bearish before the bulls do, and also spot the market before it bottoms to the day and get the money reinvested. This is impossible to do and statistics show just how damaging it can be to returns if you miss out on just the best 5 days of performance, a doubling of profit could and should have been a tripling of profit but due to missing the 5 best days gains were left of the table. Over a ten year period you could be 99.8% accurate in terms of choosing which days to be in and out of the market and still kill your returns.

To sum the above strategy, and sticking with Marks' terminology, investors should always be sceptical. Yet, scepticism isn't analogous to pessimism. You should be sceptical when everyone is bearish; the price has probably overshot the fundamentals and represents an attractive buy. You should be also sceptical when everything is too rosy and equities are 'priced for perfection'. By 'leaning against the wind' in this manner I've noticed I'm often right but for the wrong reasons. This may imply I'm just lucky, or have been to up to now, which would have appealed to Napoleon who favoured lucky Generals. I believe, and hope, that it is more indicative of 'listening' to valuations and letting that dictate matters. The narrative and reasons for a subsequent sell-off or rally aren't really important; it's the share price that is the ultimate arbiter.

The whole matters

When I talk of the portfolio I mean just that, the whole rather than a focus on the constituent parts. What matters only is the bottom-line portfolio valuation and over time hopefully nudging that value upwards. One of our jobs is to make that experience as palatable as possible but we are not designing a low volatility outcome. It's the consequence of volatility, rather than volatility itself, that has the most impact on investors. If you need to withdraw capital at short notice than volatility absolutely is of paramount concern. Yet, investing in equities should only be considered by those with a medium to long-term horizon. The longer you stay invested the less risky equities become. Time transforms risk. Too many investors now want the return without the risk but the balance between the two is one we need to get right. This is where the Philosophy steps in.

By viewing the important figure as the bottom-line you can more easily cut losing positions or those where the facts have changed and the investment case has become impaired. John Keynes, world famous economist and no mean investor, was criticised for often changing his mind should circumstances change but he never once felt guilty about it, quite the contrary in fact, where he would often rebuke the 'less nimble-minded'. An anecdote in Life magazine in 1945 nicely sums up his mental malleability:

Legend says that while conferring with Roosevelt at Quebec, Churchill sent Keynes a cable reading, "Am coming around to your point of view.' His Lordship replied, 'Sorry to hear it. Have started to change my mind."

Shocks happen in investing, some are internal and some are external. The internal may be cause for concern if you missed some red flags but other times there was nothing anyone could have done to predict it. Profit warnings come in many guises, and a post-mortem is required whether circumstances were suspicious or not. I have a low tolerance for blaming the weather, as retailers are oft prone to do. Never ask your barber if you need a haircut, they are somewhat conflicted. In the same way a retailer will never admit that their product was just not good enough or competition is hurting them. Always look at the numbers in a trading statement rather than the rhetoric from management who always try to put a gloss on them. I am a big advocate of looking at the gross margin, which generally should expand as sales increase. If it is falling, and there isn't a proper explanation as to why, it could be an early indicator that it has to lower its prices to compete harder. Best to get out early. A definite sell is whenever fraud of any description is referenced in a statement. Around 8 times in 10 the first revelation is only the beginning and losses tend to spiral. Management themselves may not have a true idea of the extent of any fraud when they first make investors aware. Malfeasance is an automatic sell trigger.

As a Liverpool-based stockbroker (Evertonian) it's perhaps unwise to cite Manchester United as an exemplar, but Sir Alex Ferguson was a master at replenishing the squad with a couple of new faces each season and booting out (literally in one case) those deemed surplus to requirements. So too with portfolios, a few new additions each year freshens things up and re-injects impetus into performance where ideas can and do go stale. Modern teams are also increasingly only as good as their substitutes bench. To be able to effect change then you need a well resourced bench from which to select. You may love to own a certain stock but the valuation is too rich currently. Put in on the subs bench and by the time you need an alternative it may have retraced to a more acceptable level. On the AIM market even the best growth stocks can disappoint, often giving you several chances to climb aboard a bull trend.

Sell discipline

Investing is practicing the art of the relative. Limiting the number of stocks to a maximum encourages a constant and healthy competition for capital; if the risk/reward deteriorates enough relative to another stock then it should be replaced. Your buys are distinguished by how well you sell. Over time by thinking relatively i.e. what do you think are the 25-40 best stocks relative to the whole investable universe, your portfolio should deliver very attractive risk adjusted returns. In other words, strong absolute performance is a by-product of skilled identification of the best relative ideas. It's a subtle but hugely significant point to note, and makes investing much more straightforward than trying to find stocks you believe will go up say 20%. This requires selling stocks if and when a better one comes along and/or you have higher conviction on it. Investors often fail to sell due to regret aversion, avoiding regret if they sell and the price goes up. Reframe a sell decision away from trying to pick the share price apogee 'to my conviction is now only 50% but is 90% on another stock'. Repeat this often enough and it will pay handsomely over the long-term (assuming your conviction levels are reasonably accurate).

You will only achieve the above pruning if you can control for the 'Disposition effect' – a psychological bias that makes investors reluctant to sell at a loss and cut winners too early. Ego gets in the way a lot. Businesses and economies are too dynamic and inherently unpredictable to allow all your investments to be exited at a price higher than you paid, the pursuit of such an endeavour would be Sisyphean and ultimately doomed to failure. Too many investors become preoccupied with winning every minor battle (every stock must be sold on a profit) to the detriment of winning the war (boosting overall portfolio value). To maximise gains you must take losses. The very best and brightest fund managers actually get 49% of their decisions 'right'. What matters more than the number of investments sold at a gain or loss is the magnitude of the losses and gains.

The price you paid is totally irrelevant as an anchor and bad for your overall portfolio returns if you fixate on it. The Market doesn't care what you paid for a stock and neither should you. Belligerence and waiting for a losing position to recover before selling carries Opportunity Cost. That capital could be tied up for years and years with your ego unwilling to take a hit and sell at a loss, when the money could have gone into far stronger ideas that rose appreciably. Soros viewed making mistakes as badge of honour and you should do too if you learn something from them. I don't want to be too decorated a veteran when it comes to medals though as that would be to the detriment of client returns but some adornments are necessary to know what not to do. The brevity of financial memory is astonishing where the experienced are viewed as relics seeking refuge in the past. As Churchill said though, 'the farther back you can look, the farther forward you are likely to see'. Remembering past cycles and industry dynamics (sell Chemicals when margins have expanded as new supply won't be far away, for example) is key to putting yourself ahead of the pack.

Charting returns

Charts are very useful indicators of broad trends but too much focus on them can put you off investing (if they have risen a lot) or dissuade you from selling (if fallen a lot). Some of my best trades have come from buying stocks that have risen a lot in value already, the trick is to be entirely forward focussed in terms of future prospects over the next 2-3 years. I've often glimpsed at charts and thought 'I've missed the boat' but took a meeting with management anyway and walked away a buyer of the stock given the outlook was so strong. These generally work out well.

Used correctly charts can give you an extra leg up on the investment ladder. Probably the most impactful book I've read isn't about investment but about trading, commissioned by Jesse Livermore and called 'Reminiscences of a Stock Operator'. He was probably the best speculator the world has ever seen, making and losing a fortune several times worth well over $1bn in today's money. Ironically Livermore lost it all when he didn't adhere to his own teachings, as is often the case. He was a true master of market psychology though and his aphorisms are as relevant today as they were in the 1920s.

There are dozens of important takeaways from his memoirs that are relevant to investors but I would highlight three as key. The first is the importance of trends, as stocks spend most of their time trending one way or the other. An upwards trend demonstrates the buyers are more motivated than the sellers and the share price will be more predisposed to shake off bad news and react well to the good. Conversely, a bear trend will leave a share price vulnerable to bad news and immune to good news. A great indicator of exhaustion points is when a share price stops falling on bad news or stops rising on good news. This has proven to be a wonderful canary in the coalmine.

Closely linked to trends is the 'path of least resistance' much like how water finds its own level. I talk about this here in more extended terms, when interviewing CEOs trying to find out their own 'path of least resistance'. Like Atticus Finch preaches in 'To Kill a Mockingbird', "you never really understand a person until you consider things from his point of view... until you climb into his skin and walk around in it". A common psychological mistake people make is to switch a hard question for an easy one. Rather than 'what would the CEO do if faced with X situation' they switch it for 'what would I do if I was the CEO faced with X situation'. This often leads to erroneous conclusions and can be costly. By understanding the business leader's incentives or vested interest you can work it into thinking 'two shots ahead'. Is the CEO incentivised via share options to get the earnings per share figure to a certain level? If so they may pull back on investment or operating expenses to improve short-term earnings to the detriment of long-term prospects.

I always remember The FTSE 100 plumber's merchants, Wolseley, were shocked when a German subsidiary suddenly stopped generating sales. Their incentive handed down from London HQ was to maximise cash generation. Understanding this incentive it shouldn't have taken more than 10 seconds to work out what will go wrong. When they sold an item of merchandise they didn't replace it, remember cash generation was their only incentive. Quite simply they sold out of everything! Only when sales stopping ringing through the tills did the Mandarins in head office realise they had messed things up. Astonishing. Sometimes huge scale benefits companies but at other times, as demonstrated by the banks, such hydra-headedness becomes too unwieldy to manage with proper oversight. Small can be beautiful.

The other key lesson from the book is...

'There is nothing new in Wall Street. There can't be because speculation is as old as the hills. Whatever happens in the stock market today has happened before and will happen again' – J. Livermore.

Thankfully the wise haven't patented their wisdom so gorge on their teachings; it's a free but priceless resource. Too many investors plough their own lonely furrow or waste incalculable time (re)learning lessons the best investors figured out decades ago. There really isn't anything new under the sun. If an old man called Newton is in the orchard preaching about the universal law of gravity put the scrumpy down and listen. You won't then be shocked when an apple lands on your head.

Investing well is full of paradoxes, some of which I've outlined, and Philosophy runs deep in stock markets. They are as beguiling as they are bewildering, their present state "the effect of its past and the cause of its future." (Laplace). The above Philosophy is designed to foster flexibility of thought, creativity and freedom to execute ideas. Like a parachute the mind works best when open. That said, if left unchecked those admirable and required traits can wreak untold havoc on a portfolio's bottom line. Portfolio construction is an absolutely vital component in the investment process, it is as fundamental as a skeleton is to a person. Remember, Process and Execution.

S. P. English

May, 2016.

*   *   *