DARWIN, THE MARKETS, AND ME: THE POWER OF DIRECT OBSERVATION

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INTRODUCTION

- Good afternoon. It's an honor for me to be here.
- I have tremendous respect for the CFA Institute and the work it does to develop future generations of investment professionals.
- Having been in the industry for over 50 years, I appreciate the importance of thoughtful research combined with creative thinking.
- To your credit, in just over 20 years the number of CFA charterholders has increased from 20,000 to over 120,000. That's growth!
- Of course, a by-product of your success is more talented competition for active managers. I welcome the challenge.
- My presentation is divided into three parts: my early years; investing observations; and finally, a look at the current transformation of the industry.

PERSONAL AND PROFESSIONAL INSPIRATION

- Thinking back, a quote from Charles Darwin has always resonated with me: "It is not the strongest of the species that survives, nor the most intelligent, but the one that is most adaptable to change."
- Like Darwin's approach to the natural world, I've learned that investment knowledge is often gained through continuous observation.
- This requires significant focus, dedication, and hard work.
- Importantly, this knowledge must be applied in the context of a rapidly changing economic and investment landscape.

- Throughout my life and career a willingness to embrace change and adapt has served me well.

- As George Bernard Shaw said: "Life isn't about finding yourself. Life is about creating yourself."

- Growing up, my family lived in a comfortable bungalow in Brainerd located on the southwest side of Chicago. We enjoyed a modest living.

- My two sisters, Dorothy and Elizabeth, and I attended the neighborhood Catholic school. Mom nurtured and took good care of us. Dad, always a hard worker, strived to make our lives better.

- In the early 1950s my father owned a residential lot in Beverly. He hired an architect to design an aesthetically pleasing English Tudor-style home. Beverly was the desired community for almost all Irish Catholics living on the Southwest side.

- I remember when the estimate came in. The house would cost over $50,000! But that didn't bother me. After all, my father was a successful mechanical engineer at a coal mining equipment company. He held numerous patents, was intelligent, hard-working, and devoted to his family. Certainly, I thought, the cost wouldn't be an issue.

- Over the next several weeks, I overheard a number of discussions at the kitchen table between my mom and my dad where they discussed the feasibility of this house. The realization soon came that my parents couldn't afford it.

- I thought my Dad earned a sufficient income to build such a house and recall asking mom what he earned. She said about $10,500 a year. This was not nearly enough to afford our dream home. Our savings were meager.

- My father had many valuable attributes, but he did not earn enough money because he was in the wrong industry. With the discovery of large oil and gas reserves, the importance of coal and coal mining equipment diminished. His industry entered a state of decline.

- Having worked in the same industry for 30 years he was not able to apply his skills to other areas. This struggle to adapt to changing circumstances limited his ability to earn a larger income and achieve his goal of building our dream home.

- I began to think over the words from my early years at grammar school with the School Sisters of Notre Dame: "You are responsible for your own actions." I realized they meant only I could determine my destiny through my efforts.

- If I wanted to be able to provide a home for my future family, I'd have to assume this responsibility.

- However, none of the more conventional professions – doctor, lawyer, or accountant – appealed to me. Nevertheless, I was determined to figure out how to achieve my goals.

- When I was 13 I was looking through the Chicago Daily American and came across a page with corporate names, numerous columns, and numbers showing lots of fractional changes in small print.

- I asked my father what were all the quotations about? He told me it was the New York Stock Exchange. Suddenly, I knew, this was the industry for me!

- The principles of investing are basic. The successful implementation is the challenge. William Blake summed it up best when he wrote, "Execution is the chariot of genius." I needed to begin my own research. To make decisions using a greater number of resources such as stock fundamentals, technical information, and market movements.

- I realized that picking stocks is a difficult business. Just being well-educated or a nationally recognized columnist doesn't guarantee success.

- These discoveries formed the foundation upon which I later created my investment business.

- Throughout the next several years I continued to invest and deepen my knowledge of the stock market.

- I finally started working at a small firm called Rothschild & Co. for $450 per month. This was below the average pay rate of $500-$550, but that didn't matter in the least – I was finally in the business I wanted.

INVESTING OBSERVATIONS

- There is a very interesting book written over 30 years ago titled "The Tao Jones Averages." It applies the teaching of Lao Tsu, the founder of Taoism, to market behavior.

- Taoism is one of the three great philosophic teachings of China. It stresses the unity and interrelationship of all things – good and evil, the yin and the yang, the right brain and the left brain.

- Most importantly, Taoism advocates cooperation with the universal laws of nature while avoiding the artificial doctrines invented by man.

- I have found many of the basic principles of Taoism are applicable to the stock market. Particularly as they relate to using both the creative and analytical parts of one's brain.

- Since opportunities for truly attractive investments are not obvious, successful investors have to apply unconventional thinking and readily adapt to new information.

- These concepts, among others, have been incorporated into the aggressive growth investment philosophy I developed and have practiced for over 35 years.

- Having experienced several market cycles I've gained some insights I believe are worth sharing.

- The first is that a stock's price is rarely the same as the company's intrinsic value, particularly in the short to medium term. The reason is that the traditional valuation process is flawed.

- Aside from earnings and cash flows, stock prices are heavily affected by market dynamics, and by investors' sentiment. Their emotions swing widely from pessimism to optimism.

- You need to incorporate these dynamics into your thought process and trading strategies in order to maximize your return.

- The second thing I've learned is that it's better to concentrate your investments.

- Some sectors and industries are much greater beneficiaries of secular change than others. Why hold onto stocks of companies in sectors and industries with poor outlooks?

- Don't over-diversify just for the sake of diversification. Look for companies in favored sectors with strong market positions and an improving fundamental outlook. You're better off with a good house in a growing neighborhood.

- Also, if you've spent the time to identify a handful of high conviction ideas, failure to concentrate simply dilutes the impact if you're correct.

- Next, unlike the conventional wisdom of "buy low, sell high", I believe far more money is made by buying high and selling at even higher prices.

- That means I buy stocks that have already had good moves. They are making recent or long term new highs, have positive relative strength, and are in groups that demonstrate similar characteristics. These are stocks in demand by other investors.

- What is the risk? Obviously the risk is that I'm buying near the top. But I would much rather be invested in a stock that is increasing in price and take the risk it may begin to decline than to invest in a stock already in decline and try to guess when it will turn around.

- Fourth, it's critical to respond to new information and adjust your positions accordingly.

- Many investors buy stocks with the intention of holding them for several years based upon information that only applies to a much shorter time horizon. While the information used in their decision-making process may be valuable, that value diminishes over their longer investment time-frame.

- If people invest in a company based on current information, they have to be prepared to act on any changes to that information in a much shorter timeframe than most investors are prepared to do.

- Lao Tsu said: "To resist change is like holding your breath – if you persist, you will die."

- Next, I believe you make the most money by hitting home runs not just a lot of singles.

- Some of my biggest winners have included: Houston Oil & Minerals in the mid-1970s; This Can't Be Yogurt in the early '80s; MCI and Home Depot after the '87 crash; Home Shopping Network and Blockbuster Video in the late '80s; U.S. Surgical in the early '90s; and Ascend Communications, Q Logic and Emulex in the late '90s.

- However you also need a discipline to avoid striking out. That's my sell discipline. I cut my losses and let my winners run.
- As Tsu said, "Take care of what is difficult while it is still easy."
- Sixth, a higher turnover strategy actually reduces risk instead of implying greater risk.
- High turnover reduces risk when it is the result of taking a series of small losses in order to avoid larger losses.
- I don't hold onto stocks with deteriorating fundamentals or price patterns.
- Since I want to protect capital, this type of turnover makes sense to me.
- My final observation is that standard deviation is a poor measure of investment risk.
- Of course standard deviation is a way to measure an investment's volatility. However, the metric only reflects the dispersion of the returns not the direction. This is only relevant for short-term liquid assets. We are discussing long-term investment objectives.
- For many, if not most, investors, their greatest long-term risk is the lack of sufficient exposure to high returning, more volatile asset classes.
- In my opinion portfolios that provide the least short-term volatility often embody the greatest long-term risk to achieving your financial goals.
- I hope some of these observations will provide you with a different perspective on market behavior. I have learned that sometimes going against conventional wisdom can deliver attractive investment returns over time.
- In 2000, Barron's featured me on its "All-Century" team of the 25 individuals identified as the most influential within the mutual fund industry over the past 100 years.
- It was an honor to be mentioned along with the other investors, many of whom I've greatly admired over the years.
- Certainly, since the financial crisis it's been a more difficult environment for active managers, particularly in the aggressive growth space.
- However, like now, there will be many periods that test your stamina and faith in your investment philosophy.
- In my experience, maintaining belief in your core principles while adapting at the margin is the key to long-term success.
- Tsu said that, "When men do not have a sense of awe, there will be disaster."
- Always remember to keep that sense of awe with respect to the stock market's highs and lows. Remember that the only constant is change.

ONGOING TRANSFORMATION OF THE INDUSTRY

- Speaking of change, countless companies and industries have been displaced by new technologies, new products, or new competitors over the years.
- For example, Sears was the largest department store retailer in the United States in 1957. In 1991 it was overtaken by Walmart.
- Mistakenly, Sears management narrowly defined itself as a department store business. It didn't see itself competing with specialty retailers and, ultimately, discount retailers that were growing at a much faster rate.
- By not understanding it was competing in the retail industry, the company failed to identify and adapt to a changing environment and, ultimately, went into a decline it couldn't halt. A perfect example of survival of the fittest.
- The investment management industry has certainly experienced its share of disruptive innovations over the past few decades – index funds in the 1970s, ETFs beginning in the early 1990s, and smart beta in the past decade.
- Clearly the significant growth of passive investments is putting pressure on active managers in the form of lost market share and lower fees.
- While many people are calling for death of active management as was highlighted on the front-page of the Wall Street Journal last year, I see opportunity.
- I can recall an article published in Businessweek in August 1979 that declared the death of equities – just before one of the longest and most robust bull markets in history began. As I discovered in my teens, financial columnists are NOT always right.
- However, unlike Sears, we can remain relevant by outperforming the passive alternatives through meaningful alpha generation. It's certainly not going to be easy, but it can be done.
- So, there are two key reasons why I'm optimistic on active management:
- First, since the financial crisis, central bank intervention has flooded the world with cheap money which caused a "rising tide lifts all ships" situation. In this environment, there has been less return dispersion which has made it difficult for active managers to add value.
- I believe that as liquidity is withdrawn from the system through interest rate normalization, equity dispersion will increase and create the conditions for outperformance.
- Secondly, as increased ETF flows blindly push capital into the indices, distortions are created between good and bad companies which can be exploited by observant, nimble active managers.
- A few final observations on the market:
- First, as people continue to live longer, the traditional 60/40 mix of stocks and bonds is less likely to provide sufficient returns through retirement, particularly given persistently low interest rates.

- Given longer time horizons, investors are likely to shift more towards equities which will increase capital flows into the asset class.

- In addition, expected tax changes may result in the repatriation of capital which may be deployed into stock buybacks, further reducing supply and supporting equities.

- Secondly, as economic growth improves in the U.S. and inflation expectations move higher, returns from bonds will increasingly look less attractive compared to stocks.

- Although investors may shift to shorter duration fixed income instruments, I also believe that may be well served by allocating capital to income-producing equities like REITs or MLPs.

- Furthermore, it's possible to identify interesting growth opportunities in these asset classes and there is a degree of implicit inflation protection.

- Third, having begun investing in international growth equities in 1989, I can tell you that most U.S. investors remain underexposed to non-U.S. stocks.

- In the coming years, I expect to see an accelerated shift into international equities due to more attractive growth rates and increasingly compelling valuations.

- Lastly, from a style perspective, I have noticed that we are seeing an improvement in price and earnings momentum factors. This is creating a tailwind for our aggressive growth investment approach.

- We're finding interesting investment opportunities in both the classic growth areas like technology, notably in the optical space, and in recovery growth areas like energy and materials.

- In closing, while others may be throwing in the towel, I'm focused on adapting to a changing environment by incorporating new quantitative tools, adjusting our research processes, and testing new strategies.

- As Benjamin Franklin said, "When you're finished changing, you're finished."

- Ladies and Gentlemen, I'm far from finished. Thank you for listening today.