April 11, 2014 — Transcript

Thank you for this opportunity to speak at my alma mater, where I earned my BS and MBA degrees. I am pleased to be here today.

I learned much as a student at DePaul. I transferred from a small junior college. I applied at two schools, but remember clearly that DePaul was more organized and welcoming to new applicants. The school also was willing to take all of my 58 junior college credits.

I recall how tough it was to land that first job out of school. In fact, I was one of the last students graduating from DePaul University with a finance degree to be employed. But, as Molière said, "the greater the obstacle, the more glory in overcoming it."

I started at $450 a month while the average finance student was offered between $525 and $575.

It has been said that "A life isn't significant except for its impact on other lives." Many of my DePaul professors, and fellow students, had a significant impact on my life.

Professor Muldoon made finance fascinating, regaling us with stories of market speculators of the past and the great fortunes they made.

Frederick Miller, a conservative free market thinker, exposed me to the Austrian school of economics. He was convinced there could never be a common currency. Never in a hundred years would it work he said! I wonder what he would think now about the Euro experiment.

Then there was Dr. William Hayes in international finance. Talk about caring for his students. He actually called to remind me of the deadline for submitting my master's thesis. I wrote about "Growth Investing: A New Investment Theory."

The intellectual development I experienced through DePaul University, as both an undergraduate and through the graduate school of business, was an important factor in how my career and life have evolved.

I developed, and have been practicing, an aggressive growth investment philosophy for over 25 years. I've learned quite a bit over the years and want to share with you some of my thoughts and experiences with respect to market behavior.

Often the opportunities for truly attractive investments are not obvious. I find, in fact, that I frequently have to challenge what appears to be conventional wisdom.

This is what I refer to as *"right brain"* investing. Where my intuition, or gut feelings, lead me to an investment decision different from that reached through traditional, analytical research or *"left brain"* investing.

There is a very interesting book written over 10 years ago titled *The Tao Jones Averages*. It applies the teachings of Lao Tsu, the founder of Taoism, to market behavior.

As most of you may know, Taoism is one of the three great philosophic teachings of China. It stresses the unity and the 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 stock market behavior. To explore this concept, I would like to draw on my years of experience in aggressive growth investing and focus on two areas:

- First what I've learned over the years as an investor that has helped shape my thinking and caused me to approach investment management much differently from most other portfolio managers.

- And the second area covers conventional wisdoms or paradigms that many investors follow, leading them to mediocre performance. I want to share my thoughts about avoiding those errors.

WHAT I HAVE LEARNED

The first thing I've learned is that a stock's price is rarely the same as the company's value. The reason for that is the valuation process is flawed. Stock prices are heavily affected by market dynamics and by investors' emotion. These emotions swing widely from pessimism to optimism.

Also, many investors buy stocks with the intention of holding them for 1 to 5 years based upon information that really only applies to a short-term time horizon. While the information they are using to invest may be valuable, it is often the wrong information for their investment time-frame.

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

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

He also said to: *"Take care of what is difficult while it is still easy, and deal with what will become big while it is yet small."*

The second thing I've learned is that some sectors and industries are much greater beneficiaries of secular changes than others. It's best to concentrate your investments. Why hold stocks of companies in sectors and industries with poor current outlooks?

If it's for diversification purposes, satisfy the needs in other ways. Don't diversify just for the sake of diversification. Look for companies in favored sectors with strong market positions and improving outlooks.

In doing so, you may be able to identify trends or secular changes earlier than the herd and *"deal with what will become big while it is yet small."* Additionally, by selling stocks of companies with poor outlooks, one may be able to *"take care of what is difficult while it is still easy."*

Third, an investment manager must adjust to new concepts and ideas. Many investors find comfort with money managers who say they have rigid disciplines that they have adhered to consistently. Unfortunately, those managers may be making decisions without the full benefit of the rapidly changing technology that is available today.

Finally, I have learned that you must be willing to do things differently from most other investors. Many investment managers follow investment paradigms and this leads them to mediocre results.

INVESTMENT PARADIGMS WORTH AVOIDING

So far, we have discussed some of the lessons I have learned. Now let's discuss our second and final area — conventional wisdoms or paradigms to avoid.

I don't know how best to define a paradigm other than to give you one. But, I might say, that they are beliefs most people have that are almost always outdated and are really no longer true.

People tend to hold onto these beliefs, however. In fact, they search for evidence to support them and reject information that conflicts with the paradigm.

Paradigm #1: Buy Low and Sell High

Perhaps the best known investment paradigm is — *"buy low, sell high"*. I believe far more money is made buying high and selling at even higher prices.

That means, I buy stocks that have already had good moves. That 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 a decline and try to guess when it will turn around.

Let me give you a good example. In November 2012, I began purchasing a Chinese e-commerce company. Those purchases certainly violated the "*buy low, sell high*" rule.

- First, the stock was hitting new all-time highs.
- Second, the stock had already doubled from its IPO price of $6.00 in March 2012 to $12.00 in November 2012.
- Third, it was historically losing money and selling at a relatively high price to sales ratio. But it was a classic growth stock, with accelerating sales and sales metrics, and first mover advantage.
- Additionally, it was expanding its breadth of products in a very strong group (Chinese e-commerce) whose future sales had the potential to help the company dramatically exceed its secular growth rate.

The company recently reported an outstanding quarter with revenues increasing 117% year/year led by its active customers and total orders increasing 120% and 102% year/year, respectively.

Due to strong margin expansion, the company also reported $0.49 per share, beating consensus estimates of $0.41, which represented its largest earnings beat since turning profitable in the 4th quarter of 2012.

Since our initial purchase, the stock price has increased from $12.00 in November 2012 to $150.00 as of April 9, 2014, representing an increase of 11.5 times in only 18 months.

Paradigm #2: Just Buy Stocks of Good Companies... and Hold onto them

Another mistake: *"just buy stocks of good companies and hold them."* That way, you don't have to pay close daily attention.

I would say: *"buy good stocks of good companies and hold onto them until there are unfavorable changes."* Closely monitor daily events because this will provide the first clues to long-term change.

As Tsu said, *"deal with what will become big while it is yet small."*

Paradigm #3: Don't try to hit home runs. You make the most money by hitting a lot of singles.

I couldn't disagree more.

I believe you make the most money hitting home runs. But, you also need a discipline to avoid striking out. That is my sell discipline. I cut my losses, and let my winners run. Perhaps that's a paradigm, too, but it is one that works.

As Tsu said, *"take care of what is difficult while it is still easy."*

Let's consider the impact of hitting just one home run on a total portfolio's results.

Assume the base case portfolio of $1 million invested in the S&P 500. Now assume we allocate 5 percent or $50,000 of our $1 million portfolio to one home run.

The incremental value of this one home run impacts the total portfolio very powerfully. Over an eight year time horizon, the portfolio's value is increased from $2.3 million to over $5 million or 125%!! A few home runs are all you need.

Paradigm #4: A High Turnover Strategy is Risky

Most people believe high turnover is risky. Again, I think just the opposite.

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 on to stocks with deteriorating fundamentals or price patterns. For me, this kind of turnover makes sense. It reduces risk.

Paradigm #5: An Investment Process Needs to be Very Systematic

Many people also believe an investment process needs to be rigidly systematic. I believe a good process involves discipline, but must be flexible enough to respond to changing market conditions. Let me give you an example.

At the beginning of 1995, one year before I first wrote this speech, people thought the market was overvalued and would correct. The market's price-earnings ratio was 17.2. The price-to-book ratio was 3.52 and the yield was 2.60 percent.

A rigid, systematic process would have told you to get out of the market with at least a portion of your assets. In fact, the market had one of its strongest performance records in 1995 with the S&P 500 returning over 34%.

I believe the market failed to take into account other relevant factors, such as strong money flows that helped the market make new highs.

There is historical precedent that suggests after the market has made a big advance, it tends to make a further advance in the following period. This is not a time to rigidly adhere to valuation disciplines.

Over the last several decades, I could think of many reasons why not to be in the market. But, instead, I stayed invested. Don't invest because of what you think should be happening. Invest because of what is happening.

As Tsu said, *"the more stuffed the mind is with knowledge, the less able one can see what's in front of him."*

Paradigm #6: You Must Have a Value-Based Process

People say *"you must have a value-based process."* Often, when I talk to consultants, they prefer to see a very systematic, value-based process. They think that each stock has to be submitted to some type of uniform evaluation.

The real world is not that precise. I'm convinced there is no universal valuation method. In fact, in the short run, valuation is not the key factor. Each company's stock price is unique to that company's place in the market environment and to its own phase in its corporate development.

Paradigm #7: You Need to Buy Good Street Research and Have Contact with the Best Analysts

Conventional wisdom says: *"You need to buy good street research and have contact with the best analysts."* I find that news reports, company contact and technical information are really the best sources of research.

This research combines many factors that directly affect the fortunes of companies. They deal with things like product development, patent awards and secular changes which can materially impact a company's sales and earnings.

Paradigm #8: The Best Measure of Investment Risk is the Standard Deviation of Return

Another paradigm, and one I deal with frequently, is that *"the best measure of investment risk is the standard deviation of return."* In other words, volatility. But volatility is only a risk for short-term liquid assets. We are discussing long-term objectives.

For many, if not most investors, their greatest long-term risk is the lack of sufficient exposure to high returning, more volatile assets. In my opinion, investment vehicles that provide the least short-term volatility often embody the greatest long-term risk.

Paradigm #9: It's Risky to Place Your Money with a 'Star System' Manager

A final paradigm is *"It's risky to place your money with a star system manager."* I disagree.

In any industry, top performance is achieved by the star. Working with a diversified group of investment management stars is probably the safest way to invest.

SUMMARY

In summary, I hope some of the lessons I have learned will provide you with perhaps a different insight into market behavior.

I have learned that sometimes going against conventional wisdom can lead to attractive investment opportunities. That is why I believe it is important to use both your *"right brain"* and *"left brain"* in the decision-making process.

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. Remember the stock market is illogical and the only constant is change.

Finally, remember that the *"mind is like a parachute it is only good when it is open."*

Thank you. I appreciate the opportunity of speaking to all of you today.