CHAPTER 9

Investment axioms

'There is nothing we receive with so much reluctance as advice.'
Joseph Addison, poet.

Investment axioms, or rules, are very helpful as they examine the minds of gurus who have vast experience of being successful investors. Some axioms are the trademark of a single or select number of gurus, whereas others are widely shared. Sometimes they are contradictory. The lessons to be learned should be invaluable. They generally support the ideas in this book and, where they do not, it recognises that investors have different systems. For example, a few gurus pay little heed to the macroeconomic view or technical analysis. The investment world is a broad church and accommodates the whole range of investment styles, so select those that most appeal to you. There are many ways to make a profit, depending on such aspects as attitude to risk, skill, experience, time, financial objectives and personal characteristics. The first two axioms are arguably the most important: cut losses and run profits, and the trend is your friend until the bend.

The distilled wisdom of 35 gurus

'Great stocks are extremely hard to find. If they weren't, then everyone would own them.'
Philip Fisher

The distilled wisdom of 35 gurus with an estimated 1,000 years of the very best experience has been summarised. This approach is different as it is an amalgamation of gurus' ideas on each topic rather than each guru's individual philosophy. This is likely to be more powerful, as this collective wisdom reinforces the credibility of the axiom. The gurus include: Anthony Bolton; Warren Buffett; Phillip Carret; David Dreman; Stanley Druckenmiller; Philip Fisher; John Galbraith; Dennis Gartman; Benjamin Graham; Stanley Kroll; Leonard Licht; Jesse Livermore; Peter Lynch; Michael Moule; John Neff; William O'Neil; Thomas Rowe Price; Jim Rogers; the Rothschilds; Ian Rushbrook; Ed Seykota; Jim Slater; James O'Shaughnessy; George Soros; Michael Steinhardt; Nils Taube; Sir John Templeton; Larry Tisch; and Ralph Wanger.

Some gurus share common personal characteristics and it is likely that these contributed to their success. These characteristics have included the following in several cases. They had an early tragedy, such as the death of a parent, and many were poor as a child. They know the bitter experience of a crash that has wiped

out the family coffers and made them aware of the threat of disaster. Their natural innocence and naivety were eliminated early and thoroughly. They have a strong craving to be financially secure and this drives them hard. They prefer to live modestly, even after being successful, probably reflecting the saying that ‘the dumbest thing you can do with money is to spend it’. They are important philanthropists with charitable foundations. Being loners allows them to think independently and go against the herd instinct. They trade their own money and are convinced that they will succeed in the long-term. Many have found a system, have remained loyal to it and are disciplined with an unyielding approach to controlling risk. They are very serious traders and, although decisive, they are not particularly academic. In short, they love their job.

1. Cut losses and run profits

‘Some people automatically sell the winners and hold on to their losers, which is about as sensible as pulling out the flowers and watering the weeds.’
Peter Lynch

Cut losses and run profits is simply the best advice that the gurus offer, as it is imperative not to incur large losses. This also reinforces the second best piece of advice that ‘the trend is your friend’, as discussed in the next axiom and in chapter 6. A share that has risen will be in an up trend and run the profits. A share that has fallen will be in some down trend and should be earmarked for cutting. Selling a winning investment and hanging on to a losing one is a cardinal sin. Cutting losses recognises that mistakes are often made and action must be taken swiftly, decisively and objectively. This is a rare gift and, to be a winner, learn how to lose and do not be afraid to take a loss. Profits take care of themselves but losses never do, especially in a bear market. The key is not to lose money so avoid the big losses.

Cutting losses is difficult because of ego, as investors do not like to admit they made a mistake. The pain of a loss is much more than the pleasure of a gain. There is the problem at what point to cut the loss, i.e. 10%, 20%. This is subjective but it easier and preferable to take a small loss rather than a large one. Also, should the loss be absolute or in relation to the market? If the market falls 10% and the share falls 10%, does that mean the loss should be cut? An investor must try to minimise absolute losses, so if a share has fallen by the predetermined amount it should be cut, notwithstanding what happened to the rest of the market. There is the fear of regret that the cut position will then turn into a winner. This

does hurt but such sudden reversals do not happen often. It feels wrong to abandon an investment but this is less painful with practice. Accept small losses cheerfully and expect to experience several while awaiting a large gain. Automatic stop losses can remove emotion. Stop monitoring the share once it has been sold, as it is no longer a relevant investment and, if it does recover, then unhelpful and stultifying regret may take hold. However, you might want to monitor the share if you want to re-invest later. Learn how to lose and thus avoid hostile feelings.

It is a great mistake to average down by buying more of a losing investment, rather than cutting it. Instead, consider if you would purchase it now on its own merits rather than because you hold the dud anyway. If the conclusion is no, then do not average down and, if it is yes, beware you are not kidding yourself. The very idea itself can be a comfortable but dangerous reason for avoiding decisive action.

Running profits also needs discipline. Hold winners for the longer term, i.e. three to five years, providing that the story does not change or if it hits your profit target and is sold. Do what is right, not comfortable, so avoid the temptation of selling sure winners and resist the urge to take the cash now. Many people trade well with good timing but they make little profit because they go in and out of the market. The big profit is made by remaining invested in a bull market until it falters. You never go poor by taking profits but neither do you grow rich by making small profits in a bull market. Many get doubts or become impatient and do not give their investments sufficient time to prove themselves. The market does not beat them as they beat themselves. It is not difficult to be right about the markets but to have excellent timing and remain invested is very rare. It is the major move in the market that is important and trying to trade in and out can be a grave mistake. It is far more important to spend time considering when the bend in the market trend is going to happen than worrying about individual shares. The bull market ends before there is a general drop in the index and is evidenced by some shares starting to come off their highs.

2. The trend is your friend until the bend

'The trend is your friend most of the way, trend followers only get hurt at inflection points, where the trend changes.'
George Soros, billionaire trader and philanthropist.

The chapter on technical analysis also covers this subject. For some, a trend following or momentum approach can work amazingly well, compared to any

other trading system. Wait until a major trend is clearly established and the broader the market trend the better. The real inside reason is unknown but you should climb on board by following the line of least resistance by buying an up trend and selling a down trend. The trend usually continues in the same direction and, by following it, an investor will not 'buck the markets', in the words of Margaret Thatcher. Do not be necessarily discouraged by the price, as a share is rarely too expensive to buy or too cheap to sell, although they may well look that way at the time.

Buy after a rise, even though you missed part of it, because catching the mid-range, broad momentum is fine. If you buy on the first correction of an up trend, then again on the next correction you buy less and carry on doing this. You have restricted the amount bought near what may be the top. This tests the market and verifies its strength so that if there is a loss, even briefly, then you know the timing was premature. You may thus incur a small loss but the main firepower is ready when the time is right. Therefore, do not be afraid of buying a rising market so that each purchase is at a higher price and profitable each time. As you buy more, you can raise the stop loss so that profit is locked in if the trend reverses. You should be going with the flow of the market and thus, for a share in an up trend, there will be other buyers out there and thus buying should not be too easy for you. Be wary if it is too easy, as it means that the sellers have the upper hand. The reverse is the case for a falling share, as there will be other sellers out there too and thus selling should not be too easy. This strategy does not make a few, big, high-risk gains but numerous, small, low-risk gains. Maximise the amount of gains, not the number of wins. Being right is more important than being a genius, so aim to ride the trend. Arguing with the markets can be very expensive. Being a trend follower means being bullish in a bull market and bearish in a bear market, the opposite of a contrarian.

Selling a share when it hits its peak would be a pure and unrealistic fluke. Instead, an investor can sell before the top or wait until the market weakens and there is no bounce back, thus selling shares that are in a down trend. This means forgoing a very elusive and difficult part of the profit that was available at the top but you will get out near the top, easily bagging most of the profit. Many investors have no fear and do not recognise that unrealised gains can disappear, as they never become a profit until you sell. Down trends can also be used for shorting, although this should be left to experienced investors.

Bottom fishing for bombed out shares, before an up trend is established, is a high-risk gamble. That does not stop amateurs, speculators and stock pickers from trying. They want to squeeze the last percentage of profit from a trade and are

reluctant to buy if a share moves up a little. However, if they overcome their reluctance and buy, then the results are often good, which is unsurprising as the trend is more established. Bottom fishing takes a special feel for the market and if an investor just does not have this then it should be avoided.

Avoid guessing the breakout in a sideways trading market. Establish your limits in either direction and when the market moves through one of them then trade and ride the trend. This is much safer, as you trade from a position of knowledge, now that the direction is established rather than guessing.

A few gurus disagree and suggest forgetting about technical analysis. They may have been unable to find anyone who makes consistent profits and point to institutions which have poured fortunes into technical analysis 'black boxes' only to discard them. Other gurus are more forgiving and recognise that a chart can be a useful forecasting tool in the hands of an expert. The average technical analyst erroneously thinks that is all he needs to know about investing.

3. Avoiding shares

'I avoid fads like the plague.'

Philip Carret, described by Warren Buffett as the person with the best long-term investment record.

Avoid popular shares, fad industries or anything that is 'hot'. If you buy what everyone else is buying you will not enjoy a superior return. If you buy when everyone thinks a popular share is cheap, it is probably overvalued, since all the growth and good news is in the price. Glamour shares are the same and are overpriced. This also applies to shares receiving short bursts of enthusiasm. The best shares are often odd, uncomfortable, obscure and seem more risky. The best insurance is to check that very little has been written about it for a good while, nor are there recent broker reports. Never follow speculative crazes and often the best time to buy a security is when nobody else wants it.

To buy greedily when others are selling in despair and to sell determinedly when others are stampeding to buy requires great nerve and self-confidence but offers the highest return. Not everyone can outperform the market and if investors jump on a bandwagon of a share selection methodology or a way of evaluating the market then these tools will cease to work, just when the winning formula seems guaranteed. Once a country, sector or type of share is pursued by the masses, there will be a boom and the subsequent bust may be long-lasting. For those with

an appetite for risk, booms can be ridden with momentum investing on 'the trend is your friend' basis but stop losses are essential. A buy and hold strategy will be very painful.

One way to spot a bubble is to watch the multitude of new funds launched to chase the far receding bandwagon. Also, there will be glowing and reassuring articles in the media. Another pointer is if a company's price jumps on news that it proposes to enter the hot area, for example anything with Net or .com in the name during the TMT mania.

Avoid official growth shares, as they tend to be overpriced. Hot new issues will not do well and avoid turnaround loss makers. Avoid quirky products that are difficult to understand, expensive to run and have uncertain value, such as derivatives and tax efficient investments. Avoid venture capital, as this is a high-risk area where bankruptcies are frequent and amateur outsiders will play second fiddle to the professional insiders, who may have conflicts of interest. Warren Buffett, for example, says why take such an unproven risk, with promoters getting fat fees when, in a recession, you can pick up superb companies selling for less than net assets? Avoid blue chip companies in dying industries, such as metal bashing and chemicals, because they are cyclical with poor economics. Their size seems to promise safety but they deliver death by a thousand cuts.

4. Consensus

Disregard the consensus opinion, as it is probably wrong, and think matters through for yourself. The media relentlessly emphasises that the majority is right and so it can feel unnerving to hold a contrarian view, which can undermine your determination. Be alert to this, unlike amateurs who are ignorant of it, especially during manias. It is more often the case that reality has dawned on the few rather than the many. However, do not be stubborn and just do the opposite of the majority for the sake of it but have an objective mind which constantly questions their influence instead of acquiescing to it.

5. Diversifying risk

'In my 70 years of looking at markets, I have known a lot of people who went bankrupt, many of them because they ignored the need for diversification.'
Sir John Templeton

It is important not to have all the investment eggs in one basket, so diversifying by country, asset class, sector and company increases the margin of safety, since the future is uncertain. Investing worldwide greatly increases the choice of finding the best opportunities compared to just your own country. Currency considerations do increase the risk of investing worldwide, however, and investing in a fund is a sensible approach rather than an investor buying individual shares. Countries should be avoided which discourage investments, such as those with left wing governments, depreciating currencies, high taxation and inflation. Instead, choose those that are stable, flexible and responding to international competitive advantage and lend support to business. Spread a single asset class, such as cash, shares and gold, across a number of accounts in case of default or fraud. Bonds do not preserve capital and shares are much better over the long-term.

6. Do not own a zoo

'If you have a harem of forty women, you never get to know any of them very well.'
Warren Buffett

Always invest significant amounts and avoid over-diversification. Large stakes can really make a difference but small ones will not, as they will be drowned out by other small under-performers. You also spread your time too thinly with many holdings and inertia is the result. Twelve holdings is a good size for a portfolio and will diversify 90% of the risk. Spread them across at least five sectors and be very knowledgeable about a few shares. Aggressively monitor your investments, especially any that are struggling, since change is ever present. There are no shares that you can just buy and forget. Avoid having long-term investments, where you pay no heed to performance as it is held for its dividend. Such investors are lazy and are the real risk-takers. Also, high yields are often a sign of trouble rather than opportunity.

7. Economic cycle

'Buy when most people including experts are overly pessimistic, and sell when they are actively optimistic.'
Benjamin Graham, author of *The Intelligent Investor*.

Please see chapter 3 for more detail. Invest from a top-down macro level by taking into consideration the economic cycle, interest rates and currencies to give country weightings and then choose the shares. Thus, an investor can then take advantage of the economic cycle and the mistakes of others. You can make exceptional profits by buying growth shares in a market wash-out, so time the market by raising cash at the end of a bull market and sell high beta shares, as they are more volatile than the index. Identify cyclical sectors and invest at the correct moment. The best time to buy is in the depths of a recession, rather than when the consensus says the outlook is encouraging, because bull markets begin when the clouds appear darkest. Buy those shares with the biggest prospective rebound and sell after the rebound.

Avoid the losing years and invest heavily in a few, really good years. There is nothing wrong with being out of the market in order to preserve capital, as it is your choice whether to participate or not. Spot the broad and most important megatrends in social, political and economic factors and buy shares that ride those trends. Some gurus do not take into account macroeconomics or try to time the market, as they are long-term investors. Others trade opportunistically, profiting from the public's emotions.

8. Fear and greed

'The market, like the Lord, helps those who help themselves. But, unlike the Lord, the market does not forgive those who know not what they do.'
Warren Buffett.

Fear induces pessimism and greed induces optimism. They are the raw emotions that fuel the stock market, as fear causes the bear market and greed causes the bull market. Be most afraid when there is no fear. Conversely, fear and pessimism of others greatly reduce the risk of investing. The best time to buy is when pessimism is at its greatest and the best time to sell is when optimism reigns supreme. The surest and greatest profit opportunity is when the masses are panicked into selling. They buy during a boom and sell in a bust, so there can be

no value in the former, only in the latter. If you can spot a bandwagon then it is too late. To be contrarian and buy at the bottom is easier said than done, as bottom fishing is a risky strategy. This is because the bottom will only be proven in hindsight. Those who have a great fear of the market make the best traders. However, long-term investors should not be pessimistic too frequently, as shares rise in line with the long-term growth in the economy. Have the thought of what you can lose uppermost in your mind rather than what you can gain. Consider gearing up on crises, such as war, a government coup, terrorism and economic turbulence.

Greed and optimism greatly increase the risk of investing. You expect the best but need the self-assurance to deal with the worst. Do not trade if you are just merely optimistic. Optimists tend to assume 'if' is 'will', so keep hope and lucky thoughts out of your investments but, instead, be realistic about losing. Many amateurs are unrealistic and are wiped out. The professional is not optimistic but confident due to employing pessimism constructively. Assume a dire situation is exactly that, rather than kid yourself. We naturally prefer being optimistic rather than pessimistic, as it is a psychological boost. Therefore, there are more bulls than bears. Optimists also make better press, as the media likes to sell its wares and the public likes to hear positive stories. Therefore, beware the media's partiality that also infects broker forecasts and recommendations. When optimism is most abundant, it is least helpful, whereas when pessimism is most abundant it is very helpful. This is because bull markets are born on pessimism, grow on scepticism, mature on optimism and die on euphoria.

Greed means demanding more than you should expect. Determine at the outset what profit you expect from a trade and you should sell when that point is reached. As the trades are profitably concluded, the subsequent ones become starting points again, rather than ending points, and you have moved away from what was originally expected. Eventually, it may be very hard to sell out for the anticipated profit, as you are expecting too much. Set a sell price on all your shares and thus determine the end of the trade, rather than having it determined for you because of forced selling or a takeover. If a trade has no set ending then the share may wallow aimlessly in the portfolio. There will be times when shares take off but you do not know when or for how long so sell, locking in a decent profit.