

THE SECRET SAUCE: CHARACTERISTICS OF SUCCESSFUL INVESTORS

This publication is the final installment in my series on investing in stocks (“Characteristics of a Good Company” and “Surviving Emotional Investment Mistakes”). It captures the essence of scoring goals or runs within a portfolio using a proper mix of anticipation and evidence.

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INTRODUCTION

Wayne Gretzky said he was successful because he would “skate to where the puck is going, not where it has been.” This influential advice was taken from his father at an early age. For those of you not hockey fans, Gretzky was nicknamed “The Great One” as he became the all-time leading goal scorer in the National Hockey League.

In baseball, the “on-base percentage” measures how often a player gets on base safely during a game. This statistic is typically the leading indicator for the teams most likely to be at the top each year. Winning teams improve scoring chances by consistently getting on base, rather than hitting homeruns. “Swinging for the fence” can frequently involve reckless abandon or too risky attempts. Instead, successful teams win with steady progress of singles, doubles and being walked to drive in total runs, not by swinging wildly with aggressive or greedy ambition.

This publication is the final installment of my series on investing in stocks (“Characteristics of a Good Company” in April 2011 and “Surviving Emotional Investment Mistakes” in July 2011). It captures the essence of scoring goals or runs within a portfolio using a proper mix of anticipation and evidence, just like Wayne Gretzky. It stresses a process for self-control and staying mindful of risks like “on-base percentage”.

COMMON TRAITS AND CHARACTERISTICS

The most successful investors exhibit many of the following traits:

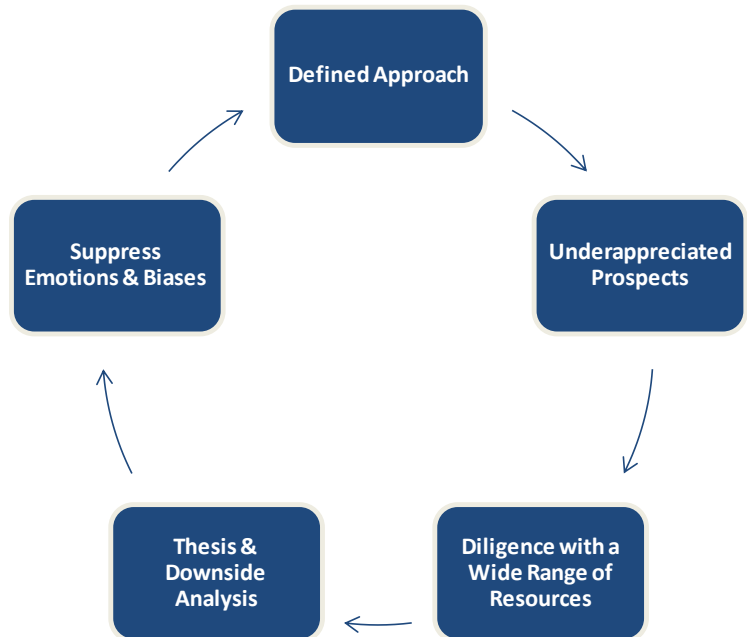
- **Defined and Disciplined Approach** that can be consistently and repeatedly applied to each stock selection decision. Successful investors have an easily articulated philosophy and approach to stockpicking, comprised of steady and repeatable criteria, not flip-flopping or trying new strategies each year.

Great investors conduct “post investment” analysis for each buy or sell for best practices. Their sell criteria are based on some combination of declining company fundamentals, expensive stretched valuation or a better opportunity to swap into.

- **Acknowledge That Process Is As Important As Outcome.** Success arises not just from results, but also from the underlying rationale for each decision to buy or sell a stock. There is no magic silver bullet strategy that outperforms every quarter for many years. An investor cannot continue to navigate choppy markets or outperform for years in up markets if there is not a repeatable sound process in place. Searching, studying and evaluating companies require criteria and a sense of ideal characteristics, as well as knowing which tough questions to ask in order to help alleviate risks. Great investors let winners run for years and cut losers short before they decline much more.
- **Discover Unexpected Growth or Underappreciated Prospects Before Others.** Spot developments before other investors do or before they occur. Be early to sense a major change or inflection point. What is being overlooked by other investors? Does the company have an underappreciated, sustainable and unique business model? Is the company’s addressable market much bigger than most expect? Can its profit margins expand rapidly or will sales growth accelerate? Are its advantages durable enough even in the face of new competition? What expectations for its future results are being priced into the stock today and how easily achievable are those expectations?
- **Carry Out Thorough Due Diligence** and do not cut corners or take things at face value. Filtering out distracting data and optimizing daily process is paramount to building rational conviction for buying a new stock or exiting a holding. A daily agenda is helpful for splitting time between reviewing holdings, looking at new ideas or evaluating general market conditions and themes. Building conviction and courage is a difficult task in volatile markets, but easier if the proper homework was done beforehand.
- **Utilize a Wide Range of Resources** to avoid tunnel vision or being overly influenced by only 1-2 sources. Constantly reading a breadth of news, articles, reports and books is a lifelong pursuit, similar to “kaizen”, the Japanese approach for daily continuous improvement. Proactive and passionate learners prosper.

- **Write Out Their Thesis and Rationale for Buying a Stock** with an upside/downside calculation of worth in good and bad scenarios. They stick to their thesis and test it regularly. Without this yardstick of top 3-5 things to monitor, then one cannot know when to enter or exit a stock without sacrificing too much price. A written thesis also allows great investors to stay ahead of surprises in either direction (positive or negative). It also reduces the number of assumptions or unknowns needed for a stock to do well and provides exit watchpoints.
- **Retain Proper Temperament** without becoming “emotionally attached” to a stock. Egos are checked at the door each morning. Wrong decisions are not rationalized away. Decisions are made on logic, not emotions. When fundamentals or a thesis starts to fall apart, the better investor has courage to sell, especially if others became wildly enthusiastic about the stock and overpriced it. Falling in love with a stock leads to indecisiveness and hesitation to sell. Pointing to valuation as cheap can be wrongly relied upon as the sole reason to retain the stock. Pride can dangerously lead to “doubling down” by adding to a dropping price and eroding story. Successful investors combat pride. They possess critical skill to recognize true temporary “hiccups” and have patience to hold onto those cases without prematurely selling. They ask themselves, what is the environment’s temperature right now? Is this a one-time bad event that only temporarily hurts a great company? Or is the panic selloff by others warranted and likely to worsen? News often leads to overreaction and clouds long-term thinking. Overreactions by others can bring about great opportunities or overvalued stocks.
- **Perform Downside Analysis.** This is often skimmed on, but is at the root of protecting assets by thinking through the “counter-thesis”. What can go wrong and how likely is it? What are the company’s flaws? Many investors neglect risks and basic probabilities. Without considering what can go wrong and its potential impact, how can one decide whether to keep or sell the stock? Does the firm have too much debt that eats away at its earnings or future investments? Can it pay interest expense easily if the economy slows? Is management on a dangerous spending spree? Recognizing a tail of risk with large loss probability helps avoid landmines. It also acts as a sanity check and quantifies risk.

- **Know What Can and Cannot Be Measured.** If one does not have a checklist for how to measure a company's progress versus expectations, then how can one determine if a company is on track or derailed? The best investors realize they will never have 100% of the answers; otherwise, that would take too long and they will have already missed a stock price moving up 10-40%. Yet, they are keenly aware of what they can live without versus what it is critical to know before investing. Actual holdings drive performance, NOT unowned stocks.



- **Acknowledge Their Mistakes.** They do not cover up or downplay mistakes; otherwise, they are likely to repeat the same error and not learn from it. The most common mistake is not selling an eroding company to preserve gains, waiting too long and watching a 50-75% gain dwindle to only 10%. Having the courage to admit being wrong is not easy. “This time is different” is often an excuse. Rationalizing away the negatives is harmful. Successful investors are willing to change their opinion on a stock when faced with new data that contradicts their thesis.
- **Pattern Recognition.** Successful Investors have enough experience (not just reading accumulation) to spot trends as they emerge. They are able to catch a “slow-moving” trainwreck before it occurs, or conversely, a slowly mounting great opportunity to buy. Better investors step back for a minute and roll up their sleeves to spot recurring stories.

Comparing firms within an industry or portfolio to one another acts as a filter for identifying the more unique and stronger business models, ones that have lasting power, great brands or strong management teams. Building this pattern recognition arsenal allows quicker sorting out of distracting unimportant information. It also allows successful investors to be ahead of surprises in either direction.

- **Realize Cheap is Not Reason Enough to Buy a Stock.** Headline Valuation (low price-to-earnings ratio) can create a false lure into a company with skeletons in the closet, poor capital allocation, disintermediation, no pricing power, weak management or market share loss. Honing in on only one valuation metric is usually not adequate.
- **Do Not Extrapolate Trends into Infinity (either direction).** Most companies cannot maintain very high growth rates (revenues or profits) for more than 3-5 years. Failing to recognize that and instead assuming it will go on much longer can lead to overpaying for a stock. Market conditions can change overnight, as can a company's reputation or competitive position. Instead, great investors recognize inflection points in a thesis. They are also aware that some very high growth companies require a "beat and raise" mentality when quarterly results are released – otherwise the stock price could collapse rapidly.
- **Avoid Groupthink and Herding Mentality.** They diverge from the crowd if based on sound reasoning. Successful investors do not believe they have oracle insights into the stock market or guaranteed company-specific future outcomes. They recognize that chasing the next fad or a biotechnology company at a peak price is similar to buying a scratch-off lottery ticket. The seller usually wins! Great investors avoid the pressure to conform to a benchmark index and are undaunted by peers. They do not make radical changes to their investment approach, even after an underperforming string of quarters. Exit strategies for individual stocks are kept in mind along with yardsticks to measure for an unemotional sell if needed. The future is unpredictable, but successful investors prepare ahead of time. They do not jump from stock to stock or onto new themes or crowded bandwagons.

Searching and Digging for the Best Stocks



- **Employ a Consistent Sell Discipline.** Better investors have recognizable sell triggers, typically based on deteriorating fundamentals or eroding thesis, too expensive valuation (stock prices has appreciated beyond rationale prospects), worsening industry or macroeconomic fundamentals, heightened competitiveness, accounting issues, poor strategic decisions by management or too large of a position size in the portfolio. Another sell trigger occurs when a better opportunity arises, like another stock offering much more upside yet similar or less risk. Letting go of a losing stock is often the solution. It is important to have a loss discipline or maximum loss threshold in mind for some protection.
- **Ignore the Cost Basis.** “Getting back to even” or staying fixated on original cost can become a downward spiral. Great investors forget the price paid and ask themselves “would I buy it today still at this price?” Original reasons for investing in it might not hold anymore. They reallocate sell proceeds to better opportunities.
- **Retain Diversification but Some Flexibility.** Too much diversification leads to mimicking the benchmark with lackluster performance. A great stockpicker will apply a proven consistent discipline with some flexibility for evolving market conditions or opportunities. Not every stock fits into the same cookie-cutter mindset. Drivers, metrics and catalysts are different across each industry. Successful investors balance their time between researching new ideas and staying aware of current holdings. But are not overly rigid in their views since external factors can often be unpredictable and change quickly. Investing does not exist in a vacuum because companies are constantly evolving or eroding.
- **Do Not Disregard Valuations.** An important backbone to capital appreciation or protection is valuation, which cannot be overlooked. Valuation acts as the first line of defense in downside protection. Valuations need to be supportive and not overly stretched for a company’s prospects. There is little room for error if expectations cannot be met or exceeded for high growth stocks. Successful investors have some sense of a predetermined “unloading” valuation level to protect current gains. An effective rule of thumb to sidestepping inflated stock prices is to compare its valuation metrics and growth potential to its peers. Absolute valuation is also an important reality check since overall stock markets become overheated every few years.

- **Do Not Constantly Increase Their Sense of Stock Worth** simply because the stock price goes up. Even heavy buying by large institutions can prop up prices but tail off quickly, sending trading volumes down sharply. Naturally, an investor's conviction level can rise just as quickly as the stock price. But a stock price jump over a few days should not be the bellwether indicator, since that is too myopic and expectations can become unrealistically high for a company to deliver on. Stretched valuations occur.

- **Be willing to Act on Imperfect Data and Uncertainty** by performing adequate diligence and quantifying both the prospects and relevant risks. This builds conviction by forming insights as tough questions or gaps are answered. Incomplete information can lead to indecisiveness or paralysis, as can extreme macroeconomic events. Yet, both of these can present good buying opportunities for long-term holders. Successful investors are aware of this and have a sense for recognizing the differences between temporary "soft patches" or truly deteriorating fundamentals (either at the company or in the economy).

Key Takeaways

Identifying trends early on with an anticipatory sense goes a long way. This allows capturing great stocks sooner and exiting them before mounting problems derail the story and ultimately the stock price. The sell price is nearly as important as the entry price. If a business is doing well, the stock price should reflect this later on. Stock prices go up if the company's future prospects and cash flow or earnings are likely to be good, not because of profit made a few years ago. Poor or eroding businesses might be able to solve one problem, yet as soon as they put out that fire, another one starts. The most dangerous issues are slowing sales or contracting profit margins. Think of Kodak, Blockbuster, Dell, Krispy Kreme Doughnuts, AOL Time Warner or Cisco. It can take 5-20 years to build a solid reputation and brand, but just one day to lose it. Think of BP during their oil spill or Toyota during their accelerator recalls last year.

Successful investors not only need to recognize good characteristics of a company, but also need to have a consistent discipline in place for implementing buy and sells without emotional distractions. By avoiding the landmines and not swinging for the fence, a logical and unemotional investor can outperform the market over many years. It takes discipline, logic, commitment, passion, patience and emotional stability to avoid fear and greed traps. There is no surefire single strategy that will not lose money in all environments over the long-term. Even the best investments sometimes feel uncomfortable when first being purchased. Nevertheless, more successful investors display many of the aforementioned traits from their vast experience and not just wisdom.

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