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Lessons to be learnt from losses

Whitney Tilson
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In their fascinating book, *Mistakes Were Made (but not by me)*, psychologists Carol Tavris and Elliot Aronson describe the classic study in which researchers infiltrated a group of people, led by a woman named Marian Keech, who believed the earth was going to be destroyed by a flood on December 21 1954.

While some of Ms Keech's followers waited at home in despair as midnight approached on December 20, many others had rid themselves of their belongings and joined Ms Keech to await the flying saucer she promised would whisk them to safety.

As midnight passed, even the fervent believers became restless. At 4.45am, however, Ms Keech had a new vision: because of the unwavering faith of her followers, God had spared the planet. The mood shifted among those awaiting the spaceship from despair to exhilaration which, as researcher Leon Festinger reported, translated over time into an even more impassioned belief in Ms Keech's mystical abilities.

Here is how Ms Tavris and Mr Aronson describe the motivational power of what Mr Festinger termed "cognitive dissonance":

"The engine that drives self-justification, the energy that produces the need to justify our actions and decisions – especially the wrong ones – is an unpleasant feeling called 'cognitive dissonance'. It is a state of tension that occurs whenever a person holds two cognitions (ideas, attitudes, beliefs, opinions) that are psychologically inconsistent, such as 'smoking is a dumb thing to do because it could kill me' and 'I smoke two packs a day'. Dissonance produces mental discomfort, ranging from minor pangs to deep anguish; people don't rest easy until they find a way to reduce it."

The recent cruel market climate has no doubt provoked much cognitive dissonance in investors. After all, what's more mentally uncomfortable than holding the belief "I know what I'm doing as an investor", while being pummelled with evidence to the contrary.

The unproductive response to this discomfort is to rationalise it away, absolving yourself of responsibility for losses because of proverbial "circumstances beyond your control".

More productive, but also tricky, is to ask what lessons you can draw from recent errors that will make you a better investor. The reason I consider this tricky is because the recent market environment has been so unusual that it may be that lessons arising from it won't be the ones that will help you profit in the future.

One star money manager who has decided an investment strategy change is in order is Mohnish Pabrai of Pabrai Investment Funds. Having endured a humbling 2008 after several years of outsized returns, Mr Pabrai concluded that his “10x10” approach to position sizes – targeting 10 per cent positions for all his most compelling ideas – needed refining.

His new guidelines for diversification set the target position size at 5 per cent, for which “a double has a meaningful impact on the portfolio and a 50 per cent drop means a 2.5 per cent hit – both of which are acceptable”, he says.

Position sizes up to 10 per cent will occur only on an exceptional basis, he says, “if seven moons line up”. All other positions will be closer to 2 per cent, especially those in highly correlated stocks – such as those of a zinc producer and iron ore miner – or those with highly asymmetric risk/reward profiles.

In fact, Mr Pabrai says he’s finding many opportunities today that fit his 2 per cent position.

He is pragmatic in explaining his strategy change. “One needs to be a learning machine and be willing to give up some of one’s best-loved ideas when the evidence suggests they are flawed.”

I’ve come to a somewhat similar conclusion with respect to paying more attention to macro considerations in individual stock selection and overall portfolio positioning.

Like many dyed-in-the-wool value investors, I have traditionally left macroeconomic or political forecasting to the pundits and focused almost exclusively on individual, bottom-up stock selection.

Early last year, however, we started to develop a conviction that the mortgage crisis was nowhere near over and that, as it worsened, large segments of the US financial industry faced big trouble. This served us well as we increased significantly our short exposure last year, primarily among financials.

Our mistake, though, was in not reflecting aggressively enough our macro view in our long portfolio. We thought a company such as **Barnes & Noble**, for example, trading at only four times earnings before interest, taxes, depreciation and amortisation, was cheap enough and that its business was resilient enough that the stock would do well regardless of the macro environment.

What we’ve learnt the hard way in the past year is, first, that the earnings of very few companies are immune to a terrible economy; second, even if earnings hold up, the multiple that investors are willing to pay probably will not. On much reduced earnings, Barnes & Noble now trades at 2.7 times ebitda.

If macro considerations are more important, what is our macro view today?

Goldman Sachs recently estimated that the total financial system losses from the credit meltdown would eventually reach more than $2,000bn worldwide while Nouriel Roubini – an economics professor at New York University who has got much right so far about the crisis – puts the number north of $3,000bn. Whatever the eventual total, with only some $1,000bn in losses booked to date, it's clear that the coming stresses on financial institutions will be immense and that the de-leveraging such strains have set off throughout the economy is unlikely to abate soon.

As a result, the consensus view of economists that US gross domestic product growth will be negative in the first and second quarters of this year but will then turn positive after mid-year, is unlikely to occur. More likely is Prof Roubini's expectation that GDP growth will be negative throughout 2010, followed by stagnant growth rather than a strong recovery.

Given this dour view, does that mean our portfolio consists of only short positions and cash? No, but it does mean that the types of stocks that attract us today have evolved.

For example, we're putting significant emphasis on cash-rich balance sheets that will protect us on the downside if things get even worse than we expect. Our holdings in **EchoStar**, the digital media equipment company, and clothes retailer Delia's are so cheap that they trade at market values at or even below their levels of cash on hand, so we're getting their operating businesses for free.

We also hold several special situation stocks, in which we believe there has been forced selling or there are specific upside catalysts that could help offset challenges to near-term operating results. We believe **Huntsman**, the speciality chemical company, is dramatically undervalued based on mid-cycle earnings, but own it because of the enormous potential upside from litigation surrounding the collapse last summer of a deal for it to be bought by a portfolio company of Apollo, the private equity firm.

What we've sold or trimmed significantly are more traditional value plays that trade at low earnings multiples, with the thesis almost exclusively driven by an eventual return to economic normalcy.

While such stocks can often prove fruitful, in an environment in which it is so difficult to have confidence in earnings estimates – and when our view of overall economic prospects is so dismal – we're finding what we think are better and safer alternatives among asset plays and special situations.

Another way our macro view is affecting how we manage our portfolio is that we will almost certainly be quicker to take profits on winning positions.

Historically, we would try to buy 60-cent dollars and sell 90-cent dollars but today those numbers are more likely to be buying 30-cent dollars and selling 75-cent dollars. This is not a market in which to be holding out for the last dollar of value.

If it sounds as if I'm hedging my bets, I am. The range of potential outcomes – for the economy and for individual companies – is as wide today as I've seen it in my investment career.

Jeremy Grantham of investment manager GMO put it well recently in an interview with Value Investor Insight (which I co-edit) – "Now we have to earn our living the usual way. The probabilities of things we're looking at today are 60/40 or 55/45. Most of the near certainties are gone."

Something to keep in the front of one's mind in a market such as today's.

Whitney Tilson is a money manager who co-edits Value Investor Insight and co-founded the Value Investing Congress. E-mail: feedback@tilsonfunds.com