

Traits of Successful Money Managers

Successful long-term money managers, Whitney Tilson says, share 16 traits, divided equally between personal characteristics and professional habits. Understanding these traits not only helps you identify exemplary professional money managers, but may also help you understand how you stack up as an individual investor.

By Whitney Tilson

Published on the Motley Fool web site, 7/17/01

(<http://www.fool.com/news/foth/2001/foth010717.htm>)

I have spent an enormous amount of time studying successful money managers, ranging from those still active today -- like **Berkshire Hathaway's** ([NYSE: BRK.A](#)) Warren Buffett and Charlie Munger, and Sequoia Fund masterminds Bill Ruane and Richard Cunniff -- to earlier ones such as Peter Lynch, John Neff, Philip Fisher, John Templeton, and Ben Graham. (This is by no means a comprehensive list.)

My goal has been to learn from their successes -- and equally importantly, their failures. Given that investment mistakes are inevitable, I'd at least like mine to be original ones.

So what have I learned? That long-term investment success is a function of two things: the right approach and the right person.

The right approach

There are many ways to make money, but this doesn't mean every way is equally valid. In fact, I believe strongly -- and there is ample evidence to back me up -- that the odds of long-term investment success are greatly enhanced with an approach that embodies most or all of the following characteristics:

- Think about investing as the purchasing of companies, rather than the trading of stocks.
- Ignore the market, other than to take advantage of its occasional mistakes. As Graham wrote in his classic, *The Intelligent Investor*, "Basically, price fluctuations have only one significant meaning for the true investor. They provide him an opportunity to buy wisely when prices fall sharply and to sell wisely when they advance a great deal. At other times, he will do better if he forgets about the stock market."
- Only buy a stock when it is on sale. Graham's most famous saying is: "To distill the secret of sound investment into three words, we venture the motto, MARGIN OF SAFETY." (For more on this topic, see my column, "[Trembling With Greed](#).")
- Focus first on avoiding losses, and only then think about potential gains. "We look for businesses that in general aren't going to be susceptible to very much change," Buffett said at Berkshire Hathaway's 1999 annual meeting. "It means we miss a lot of very big winners but it also means we have very few big losers.... We're perfectly willing to trade away a *big* payoff for a *certain* payoff."
- Invest only when the odds are highly favorable -- and then invest heavily. As Fisher argued in *Common Stocks and Uncommon Profits*, "Investors have been so oversold on diversification that fear of having too many eggs in one basket has caused them to put far too little into companies they thoroughly know and far too much in others about which they know nothing at all."

- Do not focus on predicting macroeconomic factors. "I spend about 15 minutes a year on economic analysis," said Lynch. "The way you lose money in the stock market is to start off with an economic picture. I also spend 15 minutes a year on where the stock market is going."
- [Be flexible!](#) It makes little sense to limit investments to a particular industry or type of stock (large-cap growth, mid-cap value, etc.). Notes Legg Mason's Bill Miller, the only manager of a diversified mutual fund to beat the S&P 500 index in each of the past 10 years, "We employ no rigid industry, sector, or position limits."
- Shun consensus decision-making, as investment committees are generally a route to mediocrity. One of my all-time favorite Buffett quotes is, "My idea of a group decision is looking in a mirror."

The right person

The right approach is necessary but not sufficient to long-term investment success. The other key ingredient is the right person. My observation reveals that most successful investors have the following characteristics:

- They are businesspeople, and understand how industries work and companies compete. As Buffett said, "I am a better investor because I am a businessman, and a better businessman because I am an investor."
- While this may sound elitist, they have a lot of intellectual horsepower. John Templeton, for example, graduated first in his class at Yale and was a Rhodes Scholar. I don't disagree with Buffett -- who noted that "investing is not a game where the guy with the 160 IQ beats the guy with the 130 IQ" -- but would point out that he didn't use the numbers 160 and 100.
- They are good with numbers -- though advanced math is irrelevant -- and are able to seize on the most important nuggets of information in a sea of data.
- They are simultaneously confident and humble. Almost all money managers have the former in abundance, while few are blessed with the latter. "Although humility is a trait I much admire," Munger once said, "I don't think I quite got my full share." Of course, Munger also said: "The game of investing is one of making better predictions about the future than other people. How are you going to do that? One way is to limit your tries to areas of competence. If you try to predict the future of everything, you attempt too much." In addition to what Munger is talking about -- understanding and staying within one's circle of competence -- there are many other areas of investing in which humility is critical, which I discussed in "[The Perils of Investor Overconfidence](#)."
- They are independent, and neither take comfort in standing with the crowd nor derive pride from standing alone. (The latter is more common since, I argued [last week](#), bargains are rarely found among the crowd. John Neff said he typically bought stocks that were "misunderstood and woebegone.")
- They are patient. ("Long-term greedy," as Buffett once said.) Templeton noted that, "if you find shares that are low in price, they don't suddenly go up. Our average holding period is five years."
- They make decisions based on analysis, not emotion. Miller wrote in his Q4 '98 letter to investors: "Most of the activity that makes active portfolio management active is wasted... [and is] often triggered by ineffective psychological responses such as overweighting recent data, anchoring on irrelevant criteria, and a whole host of other less than optimal decision procedures currently being investigated by cognitive psychologists."
- They love what they do. Buffett has said at various times: "I'm the luckiest guy in the world in terms of what I do for a living" and "I wouldn't trade my job for any job" and "I feel like tap dancing all the time."

Obvious?

Much of what I've written may seem obvious, but I would argue that the vast majority of money in this country is managed by people who neither have the right approach nor the right personal characteristics. Consider that the average mutual fund has 86% annual turnover, 132 holdings, and no investment larger than 5% of the fund.

Those statistics are disgraceful! Do you think someone flipping a portfolio nearly 100% every year is investing in companies or trading in stocks? And does 132 holdings indicate patience and discipline in buying stocks only when they are on sale and odds are highly favorable? Of course not. It smacks of closet indexing, attempting to predict the herd's next move (but more often mindlessly following it), and ridiculous overconfidence -- in short, rampant speculation rather than prudent and sensible investing.

The performance trap

I have not discussed historical performance as a metric for evaluating money managers, not because it's unimportant, but rather because it's not as important as most people think. Consider this: If you took 1,000 people and had them throw darts to pick stocks, it is certain that a few of them, due simply to randomness, would have stellar track records, but would these people be likely to outperform in the future? Of course not.

The same factors are at work on the lists of top-performing money managers. Some undoubtedly have talent but most are just lucky, which is why countless studies -- I recommend a 1999 [article](#) by William Bernstein -- have shown that mutual funds with the highest returns in one period do not outperform in future periods. (Look at the Janus family of funds for good recent examples of this phenomenon.)

As a result, the key is to find money managers who have both a good track record *and* the investment approach and personal characteristics I've noted above.

Conclusion

The characteristics I've described here are not only useful in evaluating professional money managers. They can also be invaluable in helping you decide whether to pick stocks for yourself. Do you have the right approach and characteristics?

-- Whitney Tilson

Guest columnist Whitney Tilson is Managing Partner of Tilson Capital Partners, LLC, a New York City-based money management firm. Mr. Tilson appreciates your feedback at Tilson@Tilsonfunds.com. To read his previous columns for The Motley Fool and other writings, visit <http://www.tilsonfunds.com>.

The Arrogance of Stock Picking

By Whitney Tilson (Tilson@Tilsonfunds.com)

Published on the Motley Fool web site, 1/3/00

(<http://www.fool.com/boringport/2000/boringport000103.htm>)

NEW YORK, NY (Jan. 3, 2000) -- One of the best columns I've ever read on The Motley Fool -- or anywhere else for that matter -- was penned by former Fool Randy Befumo. His Fool on the Hill [article](#), written on November 12, 1997, was entitled "When NOT to Invest." (The article appears in the old Evening News format, so make sure to scroll down past the "Heroes" and "Goats.") I'm afraid I won't be as eloquent as Randy, but I'd like to highlight some of his ideas and add a few of my own.

I hate to start the new year by saying something a lot of people aren't going to want to hear, but I think it needs to be said, and given what's going on in the market, it needs to be said sooner rather than later. I believe an awful lot of people who are investing in individual stocks shouldn't be doing so. I realize that as a professional money manager, that sounds self-serving and arrogant, but hear me out.

Over the past 25 years, Americans have enjoyed the most remarkable period in the history of the stock market. During that time, the S&P 500 Index has only declined in three years, the worst being a mere 7.4% decline in 1977. The S&P was even up 5.1% in 1987, a year best remembered for the 20-plus percent crash in a single day in October. And the past five years have seen an unprecedented 20% or greater increase each year (the old record was two consecutive years). Little wonder that millions of average Americans are flocking to the stock market.

As I wrote in a recent [column](#), I think this is great, as stocks have always provided superior returns vs. bonds and T-bills for long-term investors. And despite the market's high valuation levels today, I expect this will continue to be the case for investors with at least a 20-year time horizon. But the means by which people are investing in stocks concerns me. Rather than investing in diversified funds run by professionals -- or, better yet, in index funds -- record numbers of people are picking stocks on their own. Despite the mantra preached on this website, I think this is a mistake for many -- perhaps most -- people.

Why do I believe this, especially given the success that individual investors have had in recent years? Because I think that beating the market over long periods of time will be difficult and will require a number of things (discussed below) that most people don't have. Based on what I read in the media, on message boards, and in e-mails I get from readers, I fear that many people have been drawn into the market because they felt like they were missing out on a party in which everyone else was partaking. Just buy large-cap, brand-name stocks, especially riskier stocks in the tech/Internet area -- and maybe some IPOs as well -- and you'll get rich quick. You know what? There's been nothing but positive reinforcement for this approach, which of course lures more people to the party and leads everyone to invest even more money (or, heaven forbid, start borrowing money to invest). To some extent, this phenomenon creates a self-perpetuating cycle, but I don't believe it can go on forever. Burton Malkiel, author of the brilliant book [A Random Walk Down Wall Street](#), wrote an eloquent article, "Humbling Lessons From Parties Past," about this in yesterday's *New York Times* that I urge you to read.

Let me be clear: I'm not a bitter money manager who has trailed the market (quite the opposite in fact) and who expects a collapse of today's high-flying stocks. I even own some of these stocks -- Microsoft, for example. But, I don't own them because they're popular. I own them because I feel that

I have a strong understanding of their businesses, economic characteristics, and competitive positions, and believe that the companies will do well enough over the many years I intend to own them to justify their high current valuations. I don't kid myself about the risks in these stocks, and am careful to diversify by owning some value stocks and small- and mid-cap stocks.

Who Should Invest in Individual Stocks

I wholeheartedly endorse stock picking, but only for people with realistic expectations, and who have what I refer to as the three T's: time, training, and temperament.

Expectations

We all know the statistics about the percentage of highly trained mutual fund managers with enormous resources at their disposal who have trailed the S&P 500 Index -- well over 90% over the past five years. On average, individual investors also underperform the market for many of the same reasons, taxes and trading costs in particular (see Odean and Barber's landmark [study](#) of 78,000 individual investors). Given these odds, it takes real confidence, bordering on arrogance (or perhaps just naivete), to try to beat the market. And I'm as guilty as the next person. So why do most people try? I explored some of the reasons in my [column](#) on "The Perils of Investor Overconfidence."

Time

Before I started managing money professionally on a full-time basis, I was doing what most of you were doing: investing in stocks part-time while holding down a full-time job. In retrospect, though I was having success, I realize that it was due in part to good fortune, not because I truly understood the companies and industries in which I was investing. Today I have a much deeper understanding -- and I have the time to research more investment ideas -- both of which I believe give me a better chance of beating the market in the long run.

I know that Philip Fisher and others who I respect immensely say that once you've picked a few good companies, it requires no more than 15 minutes per company every three months to review the quarterly earnings announcements, but I just don't think this is realistic -- especially if you're investing in companies in the fast-moving technology sector. Were I no longer able to invest full-time, I think I would put most of my money in index funds.

Training

Remember the first time you ever tried rollerblading or skiing? You were probably a little wobbly and started by going slowly and learning how to turn and stop. Of course, nothing prevented you from heading for the biggest hill, but I hope you had the good sense not to. Or maybe you didn't, but ask yourself: even if you didn't crash, was it a good idea? Investing is much more difficult than skiing or rollerblading -- and the consequences of mistakes can be severe -- yet countless people are buying stocks without the foggiest notion of what they're doing.

Identifying and exploiting market inefficiencies is the key to successful long-term investing. To do so, you need appropriate skills and training to understand at least a few industries and companies, and think sensibly about valuations. In his column, Randy outlined a number of hurdles:

"In my opinion, you should NOT be investing in stocks... if you cannot define any of the following words: gross margin, operating margin, profit margin, earnings per share, costs of goods sold, dilution, share buyback, revenues, receivables, inventories, cash flow, estimates, depreciation, amortization, capital expenditure, GAAP, market capitalization or valuation, shareholder's equity, assets, liabilities, return on equity." To this list, I would add the flow ratio and return on invested capital, among others.

How many people have even these tools, much less the many others required to be a successful long-term investor?

Learning these things isn't overly difficult and -- I can assure you based on personal experience -- doesn't require an MBA. But it does require quite a bit of time and effort. So where should you start? I, for one, taught myself almost all of what I know about investing by reading (here are my favorite [books](#) and [quotes](#) on investing). Warren Buffett and Charlie Munger were asked this question at last year's Berkshire Hathaway annual meeting. Munger replied, "I think both Warren and I learn more from the great business magazines than we do anywhere else.... I don't think you can be a really good investor over a broad range without doing a massive amount of reading." Buffett replied, "You might think about picking out 5 or 10 companies where you feel quite familiar with their products, but not necessarily so familiar with their financials.... Then get lots of annual reports and all of the articles that have been written on those companies for 5 or 10 years.... Just sort of immerse yourself.

"And when you get all through, ask yourself, 'What do I not know that I need to know?' Many years ago, I would go around and talk to competitors, always, and employees.... I just kept asking questions.... It's an investigative process -- a journalistic process. And in the end, you want to write the story.... Some companies are easy to write stories about and other companies are much tougher to write stories about. We try to look for the ones that are easy."

Temperament

Numerous studies have shown that human beings are extraordinarily irrational about investing. On average, we trade too much, buy and sell at precisely the wrong times, allow emotions to overrule logic, misjudge probabilities, chase performance, etc. The list goes on and on. To invest successfully, you must understand and overcome these natural human tendencies. If you're interested in learning more, see the books and articles I recommended at the end of my [column](#) on "The Perils of Investor Overconfidence."

What About the Fools?

What I am saying here is in many ways in contrast to what The Motley Fool stands for (and it is to their credit that they are publishing this heretical column). For example, in the [Rule Breaker Portfolio](#) a few days ago, David Gardner wrote:

"In August of 1994, we began with \$50,000 of our own money. The aim was to demonstrate to the world what was our own deeply held faith: Namely, that a portfolio of common stocks selected according to simple Foolish principles could beat the Wall Street fat cats at their own game. We're simply private little-guy investors -- not a drop of institutional blood in us -- taught by our parents, by our own reading, and by our experience as consumers and lovers of business. And there's not much more magic to it than that."

These average Joes have compounded their money at 69.6% annually since they started in 8/5/94. If they can, why can't you? A number of reasons. I think they would admit that they've been lucky, but it's clearly more than that. I've met the Gardners and read a great deal of what they've written over the past four years. They are most certainly not average Joes. They live, eat, and breathe investing, adhere to a disciplined investment strategy, generate and analyze investment ideas among a number of extremely smart people, and are very analytical and rational.

What About the Dow Dogs and Other Backtested Stock-Picking Methods?

This topic warrants a separate column, but I'm generally skeptical of backtesting (boy, am I going to

get a lot of hate mail for this one!). I've looked at the various methods in the Foolish [Workshop](#) (Keystone, Spark 5, etc.) and my main concern is that all of these methods have only been backtested to 1986 or 1987. I know that might sound like a long time, but it's not, especially given the steadily rising market during this period. I'm not much interested in methods that will do well should the market continue to soar -- we're all going to do fine if that happens. I'm more concerned about a scenario such as the decade of the 1970s repeating itself. In this case, I don't think the Foolish Workshop methods will work very well. Think about it: What if you had backtested various strategies in 1982. I'll bet the most successful methods would have involved buying many natural resources companies -- which would have been a disaster as an investment approach going forward.

But what about the [Foolish Four](#) and other Dow Dog strategies, which did very well during the 1970s, and for which there is data going back to the early decades of this century? I think there is more validity to these approaches, but I'm still skeptical of blindly following them -- instead, I use them as a source of investment ideas.

The bottom line is that I don't think there's any substitute for doing your homework and truly understanding the companies and industries in which you're investing.

Conclusion

It's hard for me to discourage anyone from investing in stocks because I enjoy it so much. I find it fascinating to learn about companies and industries and observe the ferocious spectacle of capitalism at work. To me, watching Scott McNealy and Bill Gates and Larry Ellison go head-to-head is the best spectator sport going.

But I don't think picking stocks is going to be as easy going forward as it's been for the past few years, and I fear that many people are in over their heads and aren't even aware of it. As Warren Buffett once said, "You can't tell who's swimming naked until the tide goes out." Who knows? Maybe I'm swimming naked too.

I understand why people don't invest in index funds -- it's natural to want to do better than average. But the refusal to accept average performance causes most people to suffer below-average results, after all costs are considered. I encourage you to invest in individual stocks, but only if you're willing to take the time and effort to do so properly.

-- Whitney Tilson

Whitney Tilson is Managing Partner of Tilson Capital Partners, LLC, a New York City-based money management firm. Mr. Tilson appreciates your feedback at Tilson@Tilsonfunds.com. To read his previous guest columns in the Boring Port and other writings, click [here](#).

Further Discussion on the Arrogance of Stock Picking

By Whitney Tilson (Tilson@Tilsonfunds.com)

Published on the Motley Fool web site, 1/10/00

(<http://www.fool.com/boringport/2000/boringport000110.htm>)

NEW YORK, NY (Jan. 10, 2000) -- Whoa! I got more e-mails from last week's [column](#) than I typically get in a month. Thank you. I appreciate the feedback, and, though it was a struggle this week, I do my best to reply to every e-mail.

Frankly, I was surprised. While I expected flack for questioning mechanical investing (and got some), I thought the rest of my ideas were pretty straightforward. Since there were some creative interpretations of what I said, let me try to boil it down into one (long) sentence:

Picking stocks can be fun and profitable, but it's also risky and very difficult to beat the market over long periods of time (recent history notwithstanding), so if you're going to invest in stocks -- as opposed to index funds, a fine alternative -- then make sure you have the time, skills, and discipline to do it right.

I think it's a sign of the times that this sentence would be considered by some to be controversial or insightful. Heck, I'd give you the same advice were you to undertake any challenging endeavor: piloting a plane, teaching a class, starting a business, building a house, whatever. But when it comes to investing, people are bombarded with messages that they should jump into the market and buy stocks, and of course there is no mention of the risks involved or the skills required to invest properly. Though I'll admit that they make me smile, those online brokerage ads -- such as the tow truck driver who earned enough by trading stocks to buy his own island, or the one with the crazy redheaded kid who calls his girlfriend's father a chicken for not buying more of a stock that he knows nothing about beyond a two-second glance at its price chart -- are doing a real disservice to Americans, and I can't believe the SEC allows them. (When my daughters grow up, if either of them brings home someone who behaves like that kid, I'm not sure who will be in bigger trouble -- the boyfriend for acting like such an idiot or my daughter for dating him.)

Let me be clear: I'm 100% in favor of The Motley Fool's main message that average Americans should take control of their finances and stop letting Wall Street and the mutual fund industry exploit them with hype, poor advice, high fees, and underperformance. But that doesn't mean that everyone should run out and buy individual stocks.

I'd like to use the rest of this column to address some of the issues raised in the e-mails I received.

Who Am I and What's My Motivation?

I acknowledged at the beginning of my column last week that as a professional money manager, my ideas might sound self-serving -- and sure enough, I was accused of trying to scare average Americans out of stocks and into professionally managed funds like mine. It's a hard case to make, though, given that I recommended index funds as the preferred alternative for those who decide not to pick stocks. And I have no interest in helping professional money managers since I don't really consider myself one. I've never worked for a financial firm, and not too long ago I was an individual investor just like you (click [here](#) to read my bio). After teaching myself the fundamentals of investing, I began managing

my own money, then some of my parents', and now a handful of others' in the form of a single fund structured as a private investment partnership. By law, partnerships like mine are limited to 99 investors, two-third of whom must meet minimum income or net worth criteria, so the idea that I'm trying to scare people away from stock picking for my own benefit is unfounded.

I'm not the manager of the Bore Port and am not being paid for my columns, so what *is* my motivation? In part, I feel a sense of obligation. I'll confess to doing some pretty stupid things as a novice investor, and the writings of Warren Buffett and those on this site, among others, helped straighten me out. In particular, I learned a lot from the Boring Portfolio and its previous manager, Dale Wettlaufer. I think the perspective here adds a nice balance to The Motley Fool, so I don't want to see the Bore Port wither away.

I also find that putting my thoughts in writing -- and getting plenty of feedback -- helps me think more clearly. And I am motivated by some of the e-mails I receive, like this one:

"Wow, thank you. The pressure to buy individual stocks without having the time was becoming unbearable. For now I'm going to buy the index and spend my limited spare time away from being a surgeon with my spouse and four beautiful children. There is lots of time to get rich (or poor) later."

Or this one:

"I feel, like so many young graduates, at my age (24) that I need to participate somehow, right away in the grand market. I feel guilty that I've wasted time watching on the sidelines. Your article made me realize how irrational I'm behaving about starting to invest."

Or this one:

"After a year of researching investment theories (via reading The Motley Fool, Die Broke, The Truth About Money, DRIP Investor, etc.), I spent another year paralyzed by uncertainty, unable to act on even the simplest investment opportunity. Why? Fear. And thanks to your recent article, I now know it's a rational fear. Because I KNOW I have no talent for generating earnings by investing in this merry-go-round market. It's confusing and overwhelming to the average investor and anyone who says it's not is kidding themselves."

Did I Mischaracterize Individual Investors?

Speaking of average investors, one reader wrote, "I believe your mistake to be an underestimation of the amount of reading and research many individual investors conduct. I've read all the books you mentioned and many, many more, and I study companies inside and out before buying. I'm doing better than the Rule Breaker Portfolio. There may be foolish people investing in companies based on rumor and hype, but frankly, in my circles, I see many educated individual investors, and most are crushing the average. The message you profess scares intelligent people away from fortunes, and into mutual funds."

Well, I don't know about fortunes, especially going forward, and I certainly hope I didn't scare anyone into mutual funds (as opposed to index funds), but I think there's a valid point here. Do I know how many individual investors are informed and prudent, how many are rashly speculating, and how many are somewhere in between? No. Maybe I was way off base when I wrote last week that "countless people are buying stocks without the foggiest notion of what they're doing." But I remain steadfast in

my opinion -- based on hundreds of e-mails I've received and thousands of hours reading on the message boards and elsewhere -- that, as I wrote, "an awful lot of people who are investing in individual stocks shouldn't be doing so."

What About Picking Above-Average Mutual Funds?

I received many e-mails from people who, after reading my article, were persuaded that they should not be picking stocks. But the urge to try to do better than the market is very strong -- hey, I've got it too -- so many asked me to recommend mutual funds that would beat the index in the future. I am not a financial advisor so I'm not qualified (nor is it legal for me) to give specific advice to anyone about how they should allocate their assets, etc. But even if I were, I don't have any confidence in my ability -- or anyone else's -- to pick a fund that would beat the market, after fees and taxes, over a long period of time. Why?

First, given how few funds beat the market, the odds of picking a winner are stacked against you from the beginning (especially if it is a fund that is part of one of the large brokerage firms, as [this](#) damning article in yesterday's *New York Times* highlights; to read it, you'll have to register, which is free). According to data in *Fortune* last month, here is the percentage of domestic equity funds that have beaten the S&P 500 over different time periods:

1 year:	33%
3 years:	10%
5 years:	7%
10 years:	12%
15 years:	11%

Pretty grim, isn't it? Ah, but you wouldn't pick just any fund. You'd pick one with a great track record, that would therefore be more likely to outperform in the future, right? Unfortunately, numerous studies have shown that when it comes to mutual funds, past performance is no indicator of future success. An article in *The New York Times* on July 4, 1999 noted that:

"A number of studies confirm that obsessing over mutual fund performance is largely a waste of time. One report, issued in March by the Financial Research Corp. of Boston, found that from 1988 to 1998, the average performance of funds placing in the top 10 percent of their peer groups in one year almost invariably fell back toward the middle the next year.

"In fact,' the study found, 'out of the 40 quarterly periods measured, only once did the average performance of top-decile funds place into the first quartile in the subsequent year.' (That was in the first quarter of 1991.)

"The Financial Research study also found that Morningstar's closely watched five-star rating system didn't matter much either, because there wasn't much difference in the subsequent performance of funds awarded three, four, or even five stars. The study's conclusion: 'Past investment performance fails miserably as an indicator of future performance.'"

Yet investors continue to chase performance, with disastrous results. As I wrote in an earlier [column](#) on "The Perils of Investor Overconfidence," the average stock mutual fund posted a yearly return of 12.3% (versus 15.4% for the S&P 500) from 1984 through 1995, yet the average investor in a stock mutual fund earned only 6.3%. This means that over these 12 years, the average mutual fund investor

would have ended up with nearly twice as much money by simply buying and holding the average mutual fund, and nearly three times as much by buying an S&P 500 index fund. Factoring in taxes would make the differences even more dramatic. Ouch!

If you need further convincing, see the links I've provided below. Still, there's not much I can say to the person who e-mailed me with the comment, "Now what is the average investor supposed to talk about at cocktail parties? Their index fund?" I'm afraid there's a lot of truth to this comment.

Investing for Entertainment, Learning, or Empowerment

A number of people e-mailed me with comments like these:

"When people ask me for stock picks, I always tell them to get into indexed mutual funds. But, my wife and I get great personal satisfaction picking our own stocks. This is as close as my wife and I will come to owning our own business. We are captains of our destiny."

Or, "My wife and I enjoy investing in stocks more as a shared pastime than as a route to riches. We do our research but understand our limitations. Ninety-five percent of our investments are handled through our professional service."

Or, "Don't forget that a lot of us are investing what we can afford to lose, much the same as the winning 10-20 Holdem player stepping up to claim a seat in the 20-40 Holdem game simply to measure his worth against all the others."

To those who want to pick stocks for reasons other than returns, I say go for it, but please be careful about how much money you're wagering.

Am I Nuts? Are My Investors?

In the past two columns, I've pointed out how hard it is to beat the market and argued in favor of index funds. Yet I don't believe that it's impossible to beat the market, or I wouldn't be trying to do so. Next week I will share my thoughts on my strategy for beating the market.

-- Whitney Tilson

Whitney Tilson is Managing Partner of Tilson Capital Partners, LLC, a New York City-based money management firm. Mr. Tilson appreciates your feedback at Tilson@Tilsonfunds.com. To read his previous guest columns in the Boring Port and other writings, click [here](#).

Additional reading on the argument for index funds:

Rule Maker Portfolio, 1/29/99: [Funds vs. Makers: The Three Fs](#)

Fool on the Hill, 12/9/98: [Actively Managed Money](#)

Fortune, 12/20/99: [The Man Your Fund Manager Hates](#)

Fool on the Hill, 12/2/99: [Vanguard 1, Fool 0](#) (on the impact of taxes)

Boring Portfolio, 10/21/98: [Turnover Kills](#)

Forbes, 8/23/99: [The Hidden Cost of Trading](#)

Get Help, If You Need It

Flying an airplane and picking stocks both require practice and temperament. Both are also risky. But while licenses and training are required to be a pilot, a brokerage account can be opened with little difficulty. While Whitney Tilson doesn't believe certification should be required before one can begin picking stocks, he does feel that investors would be well-served to act as if this is the case -- and consider hiring help if they're not up to the challenge.

By Whitney Tilson

Published on the Motley Fool web site, 10/9/01

(<http://www.fool.com/news/foth/2001/foth011009.htm>)

One of my readers sent me the following desperate email:

“My portfolio has declined 65%. My whole life savings is now down the tubes. I am really scared. I can't sleep at night. Please let us know your educated opinion on this BLOODBATH. Will there ever be a bottom?”

Stories like that one are all too common these days, and they break my heart. Driven by reasons from greed to naiveté and spanning everything in between, many people were drawn into the market at or near the top and have suffered devastating losses. Some of these people invested in mutual funds, but many got into trouble by buying former “blue-chip” stocks such as Priceline, Ariba, Exodus and the like, all of which have seen their market value evaporate -- or worse.

Beginning with “[The Arrogance of Stock Picking](#)“ in January 2000, I've repeatedly pleaded with readers and cajoled my readers in numerous columns to stop picking stocks unless they had the “Three T's”: time, training, and temperament. Most people don't have all three, and I believe those people would be better off investing in a broadly diversified [index fund](#) -- the QQQ Nasdaq 100 tracker doesn't count! -- and, perhaps, adding a few solid, value-oriented mutual funds.

It may sound arrogant to discourage people from doing what I do for a living, but consider the following analogy between picking stocks and piloting a plane, an activity many members of my family enjoy:

- Both piloting a plane and stock picking can be enjoyable and exciting.
- Both activities are extremely dangerous without the right skill set. Some people with inadequate skills or bad judgment die piloting. Similarly, some people with inadequate skills or bad judgment lose a lot of money picking stocks.
- In both cases, by investing enough time, one can generally become proficient enough to undertake the activity safely.
- However, many people -- perhaps not a majority, but certainly a large minority -- should not undertake either activity, regardless of how much training they have. People who are easily frightened shouldn't try piloting because if you panic, you can die. Similarly, those who are predisposed to follow the herd, or who lose their heads when a stock they own declines, shouldn't be picking stocks.

- In both cases, there is no substitute for experience, so one is generally better off starting slowly in low-risk situations.
- There's no shame in deciding you don't enjoy -- or don't have the time for -- either activity, and calling it quits.

There's one big difference between the two activities, however, that explains why so many people get into trouble picking stocks, while far fewer do so piloting: Anyone can open a brokerage account, while one must undertake lengthy, expensive training and pass a test before being allowed to fly. I'm certainly not advocating that similar certification be required before one can begin picking stocks, but investors would be well-served to act as if this is the case.

In so many aspects of life, we face decisions about whether to do something ourselves or get a professional to do something for us: painting a house, teaching our children, drafting a will, unclogging a stopped-up pipe, setting a broken bone, installing a satellite dish, and so forth. For each of these activities, most of us could probably learn to do them adequately, yet we generally don't. We hire an expert instead. Why? Partly because we are too busy to do everything ourselves, but also because no matter how hard we tried, we probably wouldn't ever be as good as a professional.

So why do so many people think differently about investing, and refuse to hire a professional -- a financial adviser or stock picker -- to help them? I can think of several reasons:

Financial advisors, as a group, have a dismal -- and, in my opinion, often well-deserved -- reputation, as this site has highlighted countless times. Painfully few mutual funds manage to beat their relevant indices, stockbrokers make money by encouraging heavy trading or investing in certain products pitched by their employers, and many financial advisors steer clients into lousy -- or at least high-fee -- mutual funds because they are compensated via a kickback (known as the "load").

But there are solutions to these problems, such as sticking to index funds or hiring a fee-only financial advisor. While everyone knows that to successfully set a broken bone requires training and experience, it's not as generally accepted that successfully picking stocks also requires lengthy training and experience. This danger is compounded by the fact that all of us know, or have read about, many completely unqualified people who have -- or at least claim to have -- made a lot of money picking stocks.

People consistently overestimate their abilities as stock pickers, often despite overwhelming evidence to the contrary. Given that 82% of people say they are in the top 30% of safe drivers, why should we expect people to assess their stock-picking prowess any more accurately? (For more on this topic, see ["The Perils of Investor Overconfidence."](#))

Picking stocks is often a social activity: Millions of people belong to investment clubs or simply like to talk stocks with friends or at [cocktail parties](#) -- which is a fine diversion but can get investors into trouble if casual tips turn into capital allocation decisions.

It can also produce reactions inconsistent with the idea that effective investors should operate unemotionally. An article in the May 24th issue of the journal *Neuron*, the Associated Press reported, said a research team

“...used magnetic resonance imaging to map the brain responses of 12 men while they participated in a game of chance involving winning or losing money. They found that in the gambling experiment, blood flow to the brain changed in ways similar to that seen in other experiments during an infusion of cocaine in subjects addicted to that drug and to low doses of morphine in drug-free individuals. The changes varied in accordance with the amount of money involved, and a broadly distributed set of brain regions were involved in anticipating a win. The more money involved, the more excited the person became.”

Conclusion

If you have the time, interest, and ability to manage your financial affairs and even pick stocks successfully without any assistance, then by all means, do so! But make sure you have accurately, honestly, and humbly assessed your capabilities, and don't hesitate to hire someone to help.

-- Whitney Tilson

*Guest columnist Whitney Tilson is Managing Partner of Tilson Capital Partners, LLC, a New York City-based money management firm. Mr. Tilson appreciates your feedback at Tilson@Tilsonfunds.com. To read his previous columns for *The Motley Fool* and other writings, visit <http://www.tilsonfunds.com/>*

The Cocktail-Party Test

Following the crowd and investing in fashionable companies is a recipe for disaster. Instead, says Whitney Tilson, seek out solid companies with strong balance sheets -- even if they are out of favor with Wall Street or not even on Wall Street's radar screen. This simple formula can be extremely rewarding, especially in tough economic times.

By Whitney Tilson

Published on the Motley Fool web site, 7/10/01

(<http://www.fool.com/news/foth/2001/foth010710.htm>)

Studies have shown that humans tend to seek the approval of others and want to be part of the crowd. It shouldn't be surprising, then, that when it comes to investing people are drawn to the best-known and most popular stocks. It's a trend that has risen over time as more and more inexperienced investors have been drawn into the market, and talking about stocks has become a national pastime.

So what's the matter with this? Nothing -- as long as you don't mind losing money. But if you do, then I suggest you habitually steer clear of the hottest stocks, in the hottest sectors, that are priced for perfection. To do so, try applying what I call the "Cocktail-Party Test."

Imagine that you meet a couple old friends at a cocktail party and, during the course of your conversation, you start swapping stock ideas. What would their reaction be if you shared your five largest holdings? Would they recognize the stocks and nod approvingly? If so, while you might be patting yourself on the back, you might have a problem. But if, on the other hand, a blank or disgusted look crosses their faces, you may have a portfolio that is better positioned for success.

Why? Because investing is, at its core, buying something for substantially less than it is worth. Doing so isn't easy. Despite its occasional absurdities, the market is remarkably efficient. Thus, it is rare -- though certainly not impossible -- to find a widely known, popular stock that is also significantly undervalued. (Before you email me to argue, I'm aware that for a number of years, ending only recently, one could simply buy the hottest stocks and laugh all the way to the bank. Those days have passed....)

Instead, I have found that the most mispriced stocks tend to fall into two categories: Either they're well-known but hated, or obscure and unknown. Warren Buffett seems to agree. At Berkshire Hathaway's 1999 annual meeting, he said: "If I had \$10,000 to invest, I would probably focus on smaller companies because there would be a greater chance that something was overlooked in that arena."

The test in action

As I review the stocks mentioned in my 22 columns in the first half of this year -- I discussed 12 I wanted to investigate further and 17 I wanted to avoid -- I can see the cocktail-party test at work.

Can you imagine boasting to a friend about buying **Imperial Parking** ([AMEX: IPK](#)), **Huttig Building Products** ([NYSE: HBP](#)), and **Handleman** ([NYSE: HDL](#))? How much easier it is to brag about owning **Cisco** ([Nasdaq: CSCO](#)), **EMC** ([NYSE: EMC](#)), and **Nortel** ([NYSE: NT](#)). Yet the former have increased by an average of 37% since I discussed them in late March, while the latter have crashed by an average of 43% since the end of February. (I've posted the [data for all 29 stocks](#) on the Fool on the Hill discussion board.)

Updated comments

Much has happened over the past six months, so I'd like to update my comments about many of these stocks.

I continue to own Imperial Parking and Huttig Building Products, and remain bullish on their prospects. I sold Criimi Mae when I became aware that it had a preferred security outstanding that could potentially cause unlimited dilution. Galileo was purchased by **Cendant** ([NYSE: CD](#)). I consider the remaining eight companies all solid and reasonably valued, though not cheap enough for me. I continue to recommend the website [ValueInvestorsClub.com](#), which is open to guests for the time being, as a great source for investment ideas. The site has good write-ups of many companies, including [Imperial Parking](#) and [Huttig](#).

I'm still leery of many of the stocks I have expressed reservations about in the past despite, in some cases, dramatic declines in their stock prices. Here are some specific comments:

- In January, I wrote that **Sunrise** ([Nasdaq: SNRS](#)) "is a pretty good bet to go to zero." (I [posted](#) my reasoning on the Fool on the Hill discussion board.) The stock has since declined 72% from \$2.96 to \$0.84. Suffice it to say that my opinion remains unchanged.
- A recent earnings warning showed that **Manugistics** ([Nasdaq: MANU](#)) is not immune to the slowdown affecting pretty much the entire tech sector. Despite the stock's tumble, it still trades at a ridiculous 96x this year's expected EPS of \$0.24. As the momentum investors that were propping up this stock flee, I see it dropping like a rock.
- **Active Power** ([Nasdaq: ACPW](#)) has cool [technology](#) and is growing revenues rapidly, but has yet to show any profits and still trades at a rich valuation. There also appears to be quite a bit of [insider selling](#). These are the type of situations prudent investors should avoid, especially in this tough market.
- **Krispy Kreme** ([NYSE: KKD](#)) has gone nuts since January, reporting strong earnings and splitting its shares two-for-one *twice*. This is a great case study for why I don't short stocks and don't [recommend](#) that anyone -- other than real pros -- do so either, as many people who shorted this stock have gotten killed. Do I regret avoiding it? No. Trading at 74x trailing earnings in January, it was a bad bet. The fact that the market has bid the stock up to even more preposterous levels (it now trades at 117x trailing earnings) doesn't mean it was a good buy in January. I still won't short it, however. I'm just staying away from it. While Krispy Kreme's doughnuts may be irresistible, its stock doesn't have to be as well.
- **IBM** ([NYSE: IBM](#)) and **GE** ([NYSE: GE](#)) have shown surprising resilience in the face of the economic slowdown, but I still question whether their reported growth truly reflects the health of their underlying businesses. Shortly after my initial column panning them, the companies reported stronger-than-expected earnings and I subsequently removed the stocks from my "[least-favorite](#) list." I still wouldn't touch the stocks, but I'll keep them off the list for now.
- With \$2.1 billion in debt, a \$5.7 billion market cap, and an unproven economic model, **Amazon.com** ([Nasdaq: AMZN](#)) is way too risky for me.

- **Siebel Systems** ([Nasdaq: SEBL](#)) and **Starbucks** ([Nasdaq: SBUX](#)) are, in my opinion, as absurdly overvalued as Manugistics and Krispy Kreme. Good businesses, bad stocks.
- I [tried to guide](#) investors away from Cisco, **Oracle** ([Nasdaq: ORCL](#)), EMC, Sun, Nortel, and **Corning** ([NYSE: GLW](#)) in October. Then they fell an average of 55%, so I [repeated the message](#) in February. They've fallen 36% since then, and I *still* wouldn't touch them! The story is different at each of these companies, but in general the underlying businesses all have big question marks -- yet not one of them is even remotely cheap.

Conclusion

Following the crowd and investing in what is fashionable is a recipe for disaster. Instead, look for solid companies with strong balance sheets that are either out of favor with Wall Street or, better yet, not even on Wall Street's radar screen.

-- Whitney Tilson

Guest columnist Whitney Tilson is Managing Partner of Tilson Capital Partners, LLC, a New York City-based money management firm. He owned shares of Imperial Parking and Huttig Building Products at press time. He does not short stocks. Mr. Tilson appreciates your feedback at Tilson@Tilsonfunds.com. To read his previous columns for The Motley Fool and other writings, visit <http://www.tilsonfunds.com>.

Posted on the FOTH message board
(<http://boards.fool.com/Message.asp?mid=15333994&post=true>)

These charts show each stock that I've expressed an opinion on in my Motley Fool columns this year (picks first, then pans), the date of the column, the stock's closing price that day, the closing price yesterday (7/9/01), and the percentage change. (Links to all of my columns are on my web site at www.tilsonfunds.com.)

PICKS

<u>Stock</u>	<u>Date</u>	<u>Price Then</u>	<u>Price Now</u>	<u>% change</u>
Autozone (NYSE: AZO)	1/30	\$26.84	\$37.75	+41%
Graco Inc. (NYSE: GGG)	1/30	\$25.19	\$32.50	+29%
Strattec Security (Nasdaq: STRT)	1/30	\$30.68	\$34.70	+13%
Outback Steakhouse (Nasdaq: OSI)	2/6	\$26.17	\$27.10	+4%
American Express (NYSE: AXP)	3/27	\$39.65	\$38.20	-4%
Imperial Parking (AMEX: IPK)	3/27	\$20.51	\$23.95	+17%
Blyth (NYSE: BTH)	3/27	\$23.21	\$24.32	+5%
Criimi Mae (NYSE: CMM)	3/27	\$0.81	\$0.68	-16%
Huttig Building Prod. (NYSE: HBP)	3/27	\$4.08	\$5.05	+24%
Tractor Supply Co. (Nasdaq: TSCO)	3/27	\$13.68	\$16.30	+19%
Galileo International (NYSE: GLC)	3/27	\$22.46	\$32.75	+46%
Handleman Company (NYSE: HDL)	3/27	\$9.80	\$16.60	+69%

Of the 12 picks, 10 are up, and the average increase of all 12 is 21%.

PANS

<u>Stock</u>	<u>Date</u>	<u>Price Then</u>	<u>Price Now</u>	<u>% change</u>
Sunrise (Nasdaq: SNRS)	1/16	\$2.96	\$0.84	-72%
Manugistics (Nasdaq: MANU)	1/16	\$43.09	\$23.29	-46%
Active Power (Nasdaq: ACPW)	1/16	\$22.75	\$15.99	-30%
Krispy Kreme (NYSE: KKD)	1/16	\$16.20	\$36.25	+124%
IBM (NYSE: IBM)	1/16	\$92.75	\$104.72	+13%
General Electric (NYSE: GE)	1/16	\$47.37	\$46.85	-1%
Amazon.com (Nasdaq: AMZN)	2/6	\$15.81	\$15.81	0%
Starbucks (Nasdaq: SBUX)	2/6	\$24.94	\$20.94	-16%
Siebel Systems (Nasdaq: SEBL)	2/20	\$55.12	\$43.41	-21%
Nasdaq 100 Trust (AMEX: QQQ)	2/27	\$49.40	\$42.01	-15%
Cisco (Nasdaq: CSCO)	2/27	\$24.00	\$17.25	-28%
Oracle (Nasdaq: ORCL)	2/27	\$21.68	\$18.91	-13%
EMC (NYSE: EMC)	2/27	\$41.66	\$22.32	-46%
Sun Microsystems (Nasdaq: SUNW)	2/27	\$19.81	\$14.82	-25%
Nortel Networks (NYSE: NT)	2/27	\$18.28	\$8.22	-55%
Corning (NYSE: GLW)	2/27	\$29.07	\$15.10	-48%
Loudcloud (NYSE: LDCL)	3/20	\$5.25	\$2.20	-58%

Of these 17 pans, 14 are down -- 10 by more than 20%. Even with Krispy Kreme's huge rise, the average decline of all 17 is 20%.

Should You Be in Stocks?

Long-time investor and author Charles Ellis recently shared some insight on investing. His main message: For most people, stock picking is a loser's game, but for those who want to try, there are three ways to beat the market.

By Whitney Tilson

Published on the Motley Fool web site, 5/29/01

(<http://www.fool.com/news/foth/2001/foth010529.htm>)

Last week I read an interview in the latest *Money* magazine with Charles Ellis, who is the author of many investment books (the best known is probably [Winning the Loser's Game](#)) and who currently oversees the \$10 billion endowment fund at Yale University. I thought his comments were interesting enough to share with you and urge you to read the [entire interview](#). Below are some highlights and my comments.

Investing is not a game

I've long been concerned that investing has become America's latest, most popular sport, in which people partake for entertainment, excitement, or to have something to talk to their friends about. I can understand this -- I too enjoy investing and like talking about it -- but I never forget that the point of investing is to compound money at a decent rate over a long period of time, while minimizing the chances of permanent losses. Ellis agrees that investing "isn't supposed to be interesting. It's a responsibility. If you go to the stock market because you want excitement, then sooner or later you will lose. Everyone who thinks the stock market is a game loses -- everyone, to the last man, woman, and child."

The perils of overconfidence

Even those who treat investing seriously run the risk of becoming overconfident, a topic I addressed in [The Perils of Investor Overconfidence](#). As Ellis notes, "in a rapidly rising market, the faster you trade, the better you'll do -- and that makes you forget that those whom the gods would destroy, they first make confident. The more you know, the higher the odds that you'll make a serious mistake."

The arrogance of stock picking

It's hard to beat the market, as evidenced by the few people who are able to do so over time. And the penalties for trying can be severe. As Warren Buffett noted in his 1982 [annual letter](#) to Berkshire Hathaway shareholders, "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."

Ellis uses a compelling analogy to underscore the difficulty of being a winning stock picker:

"Watch a pro football game, and it's obvious the guys on the field are far faster, stronger and more willing to bear and inflict pain than you are. Surely you would say, 'I don't want to play against those guys!' Well, 90 percent of stock market volume is done by institutions, and half of that is done by the world's 50 largest investment firms, deeply committed, vastly well prepared -- the smartest sons of bitches in the world working their tails off all day long. You know what? I don't want to play against those guys either."

He concludes that “stock picking is a loser’s game, but Wall Street loves creating the perception that you can win at it.”

How to beat the market

While I think Ellis’s general message, which I echoed in a column that remains my all-time favorite, [The Arrogance of Stock Picking](#), is correct, he overstates his case a bit. I think small investors, with enough time and the right training and temperament, *can* beat the market. To do so, however, one must have a clear strategy and the capabilities to succeed in executing that strategy. Ellis lays out the strategic options:

“You can succeed intellectually, physically, or emotionally. The intellectual way is how we would all like to succeed: being so smart that we understand things more clearly and see farther ahead than every other investor. The pre-eminent example, obviously, is Warren Buffett. But people like him are very, very, very rare.

“The physical way to succeed is simply to work harder, to start at dawn and grind away till midnight and carry home a heavy briefcase full of research and keep working right on through the weekend too. This way is the most popular on Wall Street, where nearly everyone seems to try it. And for some of them, this way works -- well, I can’t say I’ve met many people for whom it actually works, but they must think it does, or they wouldn’t keep trying so hard.

“The third way to succeed as an investor is difficult emotionally. When that seductive fellow Mr. Market comes around, you have to pay absolutely no attention to him, no matter what happens. You have to control your emotions, and most of the time that means the best thing to do is nothing. If you can’t control your emotions, being in the market is like walking into a heated area wearing a backpack full of explosives.... The emotional[ly difficult] path is the only reliable way that I know of to succeed.”

I agree with Ellis’s thinking, but he goes too far in the last sentence. Controlling emotions is necessary but not sufficient for investment success. The key, in my mind, is not being better in one of the three areas he cites -- it’s to be better in *all three* areas.

Ellis cites Warren Buffett’s intellect, but Buffett didn’t build the greatest investment track record in history because he’s a lot smarter than average -- really smart people in the investment business are hardly rare. Buffett is also supremely analytical and rational, and -- even at his age, when he could be resting on his laurels -- thinks about investing constantly (at least when he’s not playing bridge). As Charlie Munger noted at the Wesco annual meeting, “Warren spends 70 hours a week thinking about investing.”

Why does Buffett do this? Because he loves it. That’s the final piece of the puzzle that Ellis doesn’t mention. I don’t know any successful investors who don’t love what they do, independent of the money. Forgive me for quoting Donald Trump, but he was right when he said, “The money’s just a way of keeping score.”

Conclusion

As you think about whether you want to be a stock picker, I urge you to do an honest self-assessment. What exactly are your competitive advantages that are going to enable you to beat the smart, “deeply

committed, vastly well prepared” people at the top investment firms in the world? If you can’t come up with good answers, then there’s no shame in investing in a mutual or index fund.

-- Whitney Tilson

Guest columnist Whitney Tilson is Managing Partner of Tilson Capital Partners, LLC, a New York City-based money management firm. Mr. Tilson appreciates your feedback at Tilson@Tilsonfunds.com. To read his previous columns for The Motley Fool and other writings, visit <http://www.tilsonfunds.com/>.