Selected Published Columns

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Summary of Each Column

1. **A 2004 Report Card** (1/14/05). I summarized the performance of my picks (+32% on average) and pans (+11% on average) during my 2004 columns. While I'm proud of the stock picks and pans I documented in this column, this is one of my favorites because of the conclusion, in which I summarized the timeless, basic principles of sound investing (with links to my columns on each of these topics). I also shared some stories about my recent trip to Ethiopia and Kenya.

2. **Traits of Successful Money Managers** (7/17/01). I argued that successful long-term money managers share 16 traits, divided equally between personal characteristics and professional habits.

3. **Thoughts on Value Investing** (11/7/00). I shared my thoughts on what value investing is -- and isn't.

4. **The Arrogance of Stock Picking** (1/3/00). I wrote that "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."

5. **Valuation Matters** (2/7/00). Back in early 2000, arguing that one should think about valuations when purchasing stocks was heretical, but I wrote: "I believe investors in [the hottest] sectors are setting themselves up for a fall, not because they're investing in bad businesses, but because the extreme valuations create a highly unfavorable risk-reward equation. I suspect many are not investing at all, but are simply speculating in a greater fool's game."

6. **The Last Bull on Berkshire?** (2/14/00). With Berkshire Hathaway and other value stocks falling and tech stocks skyrocketing virtually every day, it was hard to be a value investor in the spring of 2000. In this column, I analyzed my largest holding at the time and concluded: "I think it is highly unlikely that Berkshire Hathaway has turned into a dog of a business or that Buffett, after more than 40 years of investment genius, has become a fool -- yet that's how the stock is being priced today. I don't know when, but Buffett will be vindicated, and I intend to profit from it."

7. **Perils and Prospects in Tech** (10/9/00). I said that the tech "bubble hasn't finished bursting yet" and argued "that it is a virtual mathematical certainty that [Cisco, Oracle, EMC, Sun, Nortel and Corning], as a group, cannot possibly grow into the enormous expectations built into their combined $1.2 *trillion* dollar valuation." I concluded: "Investing is at its core a probabilistic exercise, and the probabilities here are very poor. If you own any of these companies and, for whatever reason (such as big capital gains taxes; hey, I don't like paying them either) haven't taken a lot of money off the table, be afraid. Be very, very afraid."

8. **Cisco's Formidable Challenge** (10/23/00). I elaborated on *Perils and Prospects in Tech*, showing why Cisco was almost certainly overvalued and arguing that a terribly out of favor stock like Apple was a better bet due to the extreme discrepancy in their valuations.

9. **Valuation STILL Matters** (2/20/01). With stocks down a year later, I argued that focusing on valuations was even more important.

10. **The Perils of Investor Overconfidence** (9/20/99). In the first column I ever published, I discussed the many ways in which people's emotions can undermine their investment decisions and performance.

11. **A Little Perspective** (4/17/01). I have a soft spot for this column, in which I shared my experiences from a trip to visit my parents in Ethiopia.

A 2004 Report Card

At the turn of each year, Whitney Tilson owns up to his advice from the previous year. Bad calls? He's made a few. Great picks? He's had those, too. Today, he files his 2004 report card -- and shares some stories about his recent trip to Ethiopia and Kenya.

By Whitney Tilson
Published on the Motley Fool web site, January 14, 2005
(http://www.fool.com/news/commentary/2005/commentary05011407.htm)

One of the reasons I like writing on the Web is that, while it sometimes comes back to embarrass me, there's a high level of accountability: Every column I've ever written is still posted online. In that spirit, at the beginning of each year I like to review the stocks I discussed in my columns during the previous year.

While I will review my stock picks and pans, keep in mind that I strongly discourage anyone from buying or selling based on what I -- or anyone else -- recommends. My goal is to help my readers think sensibly about investing and develop the tools to make good decisions *on their own* (keeping in mind that the best decision for many people is to avoid picking individual stocks altogether; there's no shame in mutual funds -- or better yet, given the many scandals in the mutual fund industry, index funds).

In my experience, last year was the toughest year *ever* to find bargain stocks, so I only recommended three stocks in all of my columns during the year. Not surprisingly, I found it far easier to find stocks to pan, which I did on 18 occasions (in a few cases, I panned the same stock at two different times during the year). On average, my picks were up 32%, and my pans rose 11% -- a good performance, given that I was quite bearish in a year in which all of the major indices rose. I've posted the entire list, with performance information, on the Fool News and Commentary discussion board.

Comments on picks
In January, I wrote that I owned and still liked **McDonald's** (NYSE: MCD) and **Yum! Brands** (NYSE: YUM), which have risen 21% and 31%, respectively, since then (in fact, McDonald's was the best performing stock in the Dow in 2004). I haven't sold a single share of either stock, as I believe both are roughly 80-cent dollars. Two months later, in a column on Bullish Options Strategies, I highlighted a pick from one of my Superinvestor friends, January 2006 $30 LEAP calls on **Laboratory Corp of America** (NYSE: LH), which is up 44% (he still owns and recommends the position).

Superinvestors' picks
In addition to my own stock picks, in Top Picks from Money Managers I wrote about six stocks recommended by some of the Buffettesque Superinvestors I'd profiled in my previous column. Led by **Doral** (NYSE: DRL), which has risen 48%, those stocks are up an average of 9% vs. 4% for the S&P 500 over the same period.

Blue-Chip Bargains?
In my October column, Blue Chip Bargains?, I profiled the 10 largest market cap U.S.-based companies whose stocks were within 5% of their 52-week lows. While I didn't recommend any of them, I concluded that "I believe it's highly likely that these 10 companies, as a group, will

substantially outperform the S&P 500 over any period longer than a year." Three months later, they are up 3%, nearly keeping pace with the S&P's 4% rise over the same period (given their above-average dividend yield, however, I'll call it a dead heat). The best performer has been **Sysco** (NYSE: SYY), up 26%, while **Pfizer** (NYSE: PFE) has lagged, falling 16%. I haven't changed my opinion that these 10 companies will beat the market.

Comments on pans
I started the year by reiterating my bearishness on **Farmer Mac** (NYSE: AGM), which has fallen 28% since then, and warning investors about overvalued tech stocks, specifically disclosing that I had made bearish bets on the **Nasdaq 100 tracking stock** (Nasdaq: QQQQ) and the **Semiconductor Holders Trust** (AMEX: SMH), which are flat and down 31% since then, respectively.

In February, I wrote negatively about **Juniper Networks** (Nasdaq: JNPR), **Research in Motion** (Nasdaq: RIMM), and **Sirius Satellite Radio** (Nasdaq: SIRI) -- my worst calls of the year, as they are up 1%, 64%, and 123% since then. So am I ready to admit I'm wrong on these stocks? Heck no! Just give them a little more time. I looked pretty dumb for quite a while on **Krispy Kreme** (NYSE: KKD), which I warned investors about shortly after its IPO, before being vindicated...

Late in the year, I bashed another group of overvalued stocks, writing:

> "...there are plenty of pockets of absurdity. I recently looked at a list of the most heavily traded stocks, and all sorts of nonsense jumped out at me: **Travelzoo** (Nasdaq: TZOO), having risen in the past year from $5 to above $90 and valued at 344 times trailing earnings, is the most extreme example, but let's not forget the Travelzoo of six months ago, **Taser** (Nasdaq: TASR) (which has fallen only 27% from its all-time high -- there's a lot more to go), and some fine, yet highly overvalued companies such as **Yahoo!** (Nasdaq: YHOO), **Research in Motion** (Nasdaq: RIMM), **Broadcom** (Nasdaq: BRCM), and **eBay** (Nasdaq: eBay). The company with the *lowest* trailing P/E among these six stocks is Broadcom, at 60. (And I'm not even considering the impact that expensing options will have.) As a group, these stocks are sure to significantly underperform."

Since then, these stocks are down by an average of 5%, while the Nasdaq has risen 2%.

Advice going forward
After 175 columns for The Motley Fool over more than five years, I can't think of any new advice, so allow me to summarize the timeless, basic principles of sound investing (with links to my columns on each of these topics):

- Before you start picking stocks, make sure you have the three Ts -- time, training, and temperament -- and the Traits of Successful Money Managers.

- Don't speculate. The key to Avoiding Investment Traps is to invest in solidly profitable companies with strong balance sheets.

- If a company is universally acclaimed, its stock is 100 times more likely to be overvalued than undervalued, so Go Against the Grain, Don't Chase Performance, and instead apply The Cocktail-Party Test.

- Never pay up for a stock, no matter how much you like the company. Only buy when you're Trembling With Greed. If you can't find something smart to do, *don't do anything*! There's a certain Joy of Cash.

- Try to invest in high-quality businesses. Can you recognize The Perfect Business?

- The single greatest advantage an individual investor has is size, so Think Small Companies and make sure that you have an investment edge.

- If you've made a mistake, recognize that it's Never Too Late to Sell, dump the turkey and move on. (Also see To Sell or Not to Sell?) However, be careful not to panic: Don't Sell at the Bottom.

- Finally, don't get too caught up with investing. Be sure to have A Little Perspective and count your blessings. We all have much to be thankful for (see below).

An update and appeal
My family and I just got back from a wonderful two-week trip to Ethiopia and Kenya, visiting my parents and sister, who live in Nairobi and do development work in education and public health. I wrote about my last visit to Africa nearly four years ago in one of my all-time favorite columns, A Little Perspective, in which I profiled two wonderful Ethiopian charities, the Cheshire Home and the Addis Ababa Fistula Hospital. Many readers were inspired by these two organizations and made contributions, so many years later, I'm back with an update, photos, and stories from two additional worthy charities, and an appeal to join me in supporting all four of them (contact me at *Tilson@Tilsonfunds.com* for further information).

The Addis Ababa Fistula Hospital is an amazing, inspirational place that for more than 30 years has been healing women suffering from a terrible childbirth injury called an obstetrical fistula. Shortly after my visit four years ago, I joined the board of the Fistula Foundation and am pleased to report that we've raised a great deal of money from thousands of generous Americans, which has allowed the hospital to expand its work and helped ensure its long-term future. Click here to see my Web page from my recent visit to the hospital.

The Cheshire Home, just outside Addis Ababa, heals children crippled by polio so they can walk again. We got lost on the way there so unfortunately we didn't visit it on this trip, but here are two Web pages with photos. The children are beautiful and want so much to walk!

In Kenya, I visited a school in the remote northern part of Kenya inhabited by the nomadic Samburu tribe. Its aim is to significantly increase the primary school enrollment among Samburu children, which is currently less than 10%. As the Samburu increasingly come into contact with modernity, their beautiful culture could be wiped out -- as has happened to so many other indigenous peoples -- unless more of them achieve at least basic literacy. Click here to see my pictures and learn more about this wonderful school.

We visited another school in Kenya run by Homeless Children International, which helps street children in Nairobi. I've posted my web page from our visit here.

Lest you think we spent our *entire* vacation visiting amazing charities, here are some pictures from our three-day safari in the Masai Mara.

Whitney Tilson is a longtime guest columnist for The Motley Fool. He was long McDonald's and Yum! Brands, was short Farmer Mac and Taser, and owned puts on the Nasdaq 100 tracking stock and the Semiconductor Holders Trust at press time, although positions may change at any time. Under no circumstances does this information represent a recommendation to buy, sell, or hold any security. Whitney appreciates your feedback. To read his previous columns for The Motley Fool, as well as other writings, click here. The Motley Fool is investors writing for investors and has a full disclosure policy.

Whitney Tilson's picks and pans in his 2004 Motley Fool columns
Posted at http://boards.fool.com/Message.asp?mid=21907235
Links to all columns are at www.tilsonfunds.com

Notes: Prices are as of market close 1/13/05
Link to picks and pans in 2003: http://boards.fool.com/Message.asp?mid=20020595
Link to picks and pans in 2002: http://boards.fool.com/Message.asp?mid=18393768
Link to picks and pans in 2001: http://boards.fool.com/Message.asp?mid=16344843
Column on picks and pans in 2000: http://www.fool.com/news/foth/2000/foth001226.htm

PICKS

Stock	Date	Price Then	Price Now	% change
McDonald's	1/9/04	$25.50	$30.89	+21%
Yum! Brands	1/9/04	$34.54	$45.38	+31%
Lab Corp Jan 06 $30 calls (.YZFAF)	3/5/04	$13.30	$19.10	+44%
AVERAGE				**+32%**

SUPERINVESTORS' PICKS

Stock	Date	Price Then	Price Now	% change
American Financial Realty	2/6/04	$17.90	$15.30	-15%
Aon	2/6/04	$24.50	$22.72	-7%
Del Monte	2/6/04	$10.88	$11.17	+3%
Doral	2/6/04	$32.85	$48.70	+48%
Lab Corp of America	2/6/04	$40.88	$48.18	+18%
Washington Post	2/6/04	$848.75	$903.00	+6%
AVERAGE				**+9%**

BLUE-CHIP BARGAINS?

Stock	Date	Price Then	Price Now	% change
Citigroup	10/8/04	$44.76	$47.60	+6%
Pfizer	10/8/04	$29.99	$25.33	-16%
Coca-Cola	10/8/04	$40.12	$40.74	+2%
Merck	10/8/04	$30.98	$30.65	-1%
Eli Lilly	10/8/04	$59.56	$56.42	-5%
Anheuser-Busch	10/8/04	$50.47	$49.11	-3%
Liberty Media	10/8/04	$8.72	$10.41	+19%
Colgate-Palmolive	10/8/04	$44.41	$49.90	+12%
General Motors	10/8/04	$41.54	$37.32	-10%
Sysco	10/8/04	$28.98	$36.42	+26%
AVERAGE				**+3%**

PANS/SELLS

Stock	Date	Price Then	Price Now	% change
Farmer Mac	1/9/04	$30.79	$22.19	-28%
Semiconductor Holdr (SMH)	1/9/04	$44.82	$30.92	-31%
QQQQ	1/9/04	$37.98	$38.07	0%
iShares Biotech index	2/20/04	$77.50	$71.98	-7%
Juniper Networks	2/20/04	$25.95	$26.30	+1%
Sirius Satellite Radio	2/20/04	$2.90	$6.46	+123%
Research in Motion	2/20/04	$45.70	$75.16	+64%
QQQQ 1/06 $38 put(.YWZML)	2/20/04	$4.30	$2.80	+35%
Dell	7/16/04	$34.87	$40.29	+16%
Semiconductor Holdr (SMH)	7/16/04	$32.68	$30.92	-5%
QQQQ	7/16/04	$35.07	$38.07	+9%
Google	7/30/04	$131.67	$195.33	+48%
Travelzoo	11/5/04	$91.77	$79.27	-14%
Taser	11/5/04	$23.41	$20.80	-11%
Yahoo!	11/5/04	$37.66	$35.33	-6%
Research in Motion	11/5/04	$88.08	$75.16	-15%
Broadcom	11/5/04	$27.34	$31.71	+16%
eBay	11/5/04	$100.87	$103.21	+2%
AVERAGE				**+11%**

Note: When I warned investors about the technology sector in general, I use QQQ as a proxy for this recommendation.

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
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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

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Thoughts on Value Investing

Why will investors wait for a better deal on a car, but not a stock? Whitney Tilson discusses the elusive but vital topic of value investing in his first Fool on the Hill column, trying to hammer down not only what it is -- but what it isn't.

By Whitney Tilson
Published on the Motley Fool web site, 11/7/00
(www.fool.com/news/foth/2000/foth001107.htm)

With the suspension of the Boring Portfolio, I'll now be writing in this space every Tuesday. Since many Fools may not have spent much time in the backwaters of the Bore Port, I'd like to use this, my first Fool on the Hill, to introduce myself. (I don't have much space here, so I've included links to many of my favorite articles below; links to all 45 Motley Fool columns I've written over the past year are on my website.)

Unlike pretty much every other writer for the Fool, I don't work for the Fool. I'm a money manager in New York City, though I'm about as far from the fast trading, Wall Street stereotype as you can get. I've been a consultant and entrepreneur (many times over), and have an MBA, but have never worked for a financial firm. In fact, not too long ago I was an individual investor just like you. I taught myself how to invest my reading voraciously, then began to manage my own money, then some for my family, and eventually started my own firm.

What is value investing?
I am a value investor, though if you looked at my portfolio, you might scratch your head and wonder. I'd like to use the rest of this column and the next one to share my thoughts on value investing, especially as it applies to the New Economy.

Very simply, value investing means attempting to buy a stock (or other financial asset) for less than it's worth. In this case, "worth" is not what you hope someone else might pay for your stock tomorrow or next week or next month -- that's "greater fool investing." Instead, as I wrote in Valuation Matters, "the value of a company (and therefore a fractional ownership stake in that company, which is, of course, a share of its stock) is worth no more and no less than the future cash that can be taken out of the business, discounted back to the present."

Buying something for less than it's worth: What a simple and obvious concept. Charlie Munger said it best at this year's Berkshire Hathaway annual meeting: "All intelligent investing is value investing." Bargain hunting is pretty much what everyone tries to do when buying anything, right? How many people walk into an auto dealership and say, "I want to buy your most popular car, and I don't care about the price. In fact, if the price has doubled recently, I want it even more."? Conversely, why would someone be deterred from buying if the dealer had recently marked down the price by 25%? And how many people would buy a car based on a stranger's recommendation, without doing any of their own research?

So why do so many people behave like this when buying stocks? The answer lies in part, I suppose, in the realm of human psychology -- the assumption that the crowd is always right, and the comfort of being part of the herd. Also, there's the thrill of gambling and the hope of a big score. (I intend to return to the topic of behavioral economics -- the subject of my first Motley Fool column, The Perils of

Investor Overconfidence -- in future columns.) Another factor is that valuation is tricky -- it's hard to develop scenarios and probabilities to estimate a company's future cash flows. But that's no excuse. As I argued in perhaps my most controversial column, The Arrogance of Stock Picking, if you don't have the three T's -- time, training and temperament -- that are the basic requirements for successful stock picking, then you're very likely to be better off in mutual funds (or, better yet, index funds).

As I noted in my follow-up column, More on The Arrogance of Stock Picking, "I think it's a sign of the times that this [point of view] 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."

I think my arguments largely fell on deaf ears during the madness earlier this year. With the unfortunate pain many unsuspecting investors have experienced since then, maybe now there will be a more receptive audience.

What value investing is NOT

Many people think that value investing means buying crummy companies at single-digit P/E ratios. Ha! While some value-oriented investment managers have fallen into this trap (the subject of my column, Should Warren Buffett Call It Quits?, which compared Warren Buffett with the Tiger Funds' Julian Robertson), I'm skeptical that there's much genuine value in companies trading at low multiples but with poor financials and weak future prospects. Buffett agrees. In his latest annual letter, he wrote: "If the choice is between a questionable business at a comfortable price or a comfortable business at a questionable price, we much prefer the latter. What really gets our attention, however, is a comfortable business at a comfortable price."

Nor does value investing rule out taking risks. If the potential payoff is high enough, even the risk of total loss is acceptable. For example, every value investor I know of would jump at the chance to invest at least a small portion of their assets in a coin toss, where heads would pay 5x, but tails would yield a total loss. (I make similar calculations when I make venture capital investments.) Unfortunately, however, as I argued last month in Perils and Prospects in Tech, many people take tremendous risks -- often unknowingly -- by buying high-flying stocks in the belief that they are making such a bet, when in fact the odds are far worse.

This does not mean that value investing excludes all companies with high P/E ratios (though I would argue, as I did in Cisco's Formidable Challenge, that very few businesses of any size are likely to be undervalued if they trade above 50x earnings and certainly 100x). For example, I bought Intel early last year at approximately 25x trailing earnings. That may not sound like a bargain, but I felt that this exceptional company would generate enough cash over time to justify its price. Despite its recent hiccups, my opinion hasn't changed and I'm still holding.

As this example shows, I don't believe that value investing precludes buying the stocks of technology companies. While Buffett is famous for his aversion to such stocks (the subject of my column, Why Won't Buffett Invest in Tech Stocks?), he does not deny that there can be wonderful bargains in this arena. He simply says:

"I don't want to play in a game where the other guy has an advantage. I could spend all my time thinking about technology for the next year and *still* not be the 100th, 1,000th, or even the *10,000th* smartest guy in the country in analyzing those businesses. In effect, that's a 7- or 8-foot bar that I can't clear. There are people who can, but I can't. Different people understand different businesses. The important thing is to know which ones you *do* understand and when you're operating within your circle of competence." (1998 annual meeting)

I urge you to think about *your* circle of competence. Understanding it -- and not straying beyond it -- is one of the most critical elements of successful investing. Another critical element is a firm grasp of Sustainable Competitive Advantage.

Conclusion
Value investing is very simple in concept, but very difficult in practice. The market, for all its foibles, tends to be quite efficient most of the time, so finding significantly undervalued stocks isn't easy. But this approach, done properly, offers the best chance for substantial long-term gains in varied markets, while protecting against meaningful, permanent losses.

Next week I will continue with some thoughts about why, despite being a value investor, I embrace rather than shun the tech sector.

-- Whitney Tilson

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The Arrogance of Stock Picking

By Whitney Tilson (Tilson@Tilsonfunds.com)
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(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

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Valuation Matters

By Whitney Tilson (Tilson@Tilsonfunds.com)
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"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. For the investor, a too-high purchase price for the stock of an excellent company can undo the effects of a subsequent decade of favorable business developments."
-- Warren Buffett, 1982 annual letter to shareholders

"We submit to you then, Fool, that valuation isn't half so important as quality and the durability of the business model. At least when you're building a Rule Maker Portfolio. In fact, we'll go so far as to say that the quality of the company is fully 100 times more important than the immediate value of its stock price."
-- The Motley Fool (Step 7 of the 11 Steps to Rule Maker Investing)

I believe in The Motley Fool's core investment philosophy of buying the stocks of quality companies (or index funds), holding for the long run, and ignoring the hype of Wall Street and the media. But if I were to level one general critique of the Fool, it would be that there is not enough emphasis on valuation. I agree -- and I'm sure Buffett would too -- that the enduring quality of a business is more important than today's price, but 100 times more important? C'mon! The experience of the past few years notwithstanding, that "pay any price for a great business" attitude is a sure route to underperformance.

For a number of years now, we have been in a remarkable bull market where valuation hasn't mattered. In fact, I believe that the more investors have focused on valuation in recent times, the worse their returns have been. But this hasn't been true over longer periods historically, and I certainly don't think it's sustainable. While the laws of economic gravity may have been temporarily suspended, I do not believe that they have been fundamentally altered.

Don't get me wrong -- I'm a big believer in the ways that the Internet (and other technologies), improved access to capital, better management techniques, etc., have positively and permanently impacted the economy. Nor am I the type of value investor who thinks that anything trading above 20x trailing earnings is overvalued. I simply believe in the universal, fundamental truth that the value of a company (and therefore a fractional ownership stake in that company, which is, of course, a share of its stock) is worth no more and no less than the future cash that can be taken out of the business, discounted back to the present.

I find it hard to believe that this type of thinking is present in the hottest (mostly emerging, technology-related) sectors of the market today. The enormous valuations imply phenomenal growth and profitability for numerous companies in each sector. That's a mathematical impossibility. Sure, a few of these companies might become the next Ciscos and Microsofts, but very few will. They can't *all* achieve 80% market share! I believe investors in these sectors are setting themselves up for a fall, not because they're investing in bad businesses, but because the extreme valuations create a highly unfavorable risk-reward equation. I suspect many are not investing at all, but are simply speculating in a greater fool's game.

Well, if that doesn't trigger a flood of hate mail, nothing will. But before you flame me, consider this: I own some of today's hottest stocks. But I bought them at much lower (though still high, to be sure) valuations, when I felt confident that their future cash flows would justify their valuations at the time. Now, while I am not as comfortable with their valuations and am certainly not buying more, I am determined to stick to my long-term investment strategy and hang on to these stocks as long as the underlying businesses continue to prosper.

Overview of Valuation

If the future were predictable with any degree of precision, then valuation would be easy. But the future is inherently unpredictable, so valuation is hard -- and it's ambiguous. Good thinking about valuation is less about plugging numbers into a spreadsheet than weighing many competing factors and determining probabilities. It's neither art nor science -- it's roughly equal amounts of both.

The lack of precision around valuation makes a lot of people uncomfortable. To deal with this discomfort, some people wrap themselves in the security blanket of complex discounted cash flow analyses. My view of these things is best summarized by this brief exchange at the 1996 Berkshire Hathaway annual meeting:

Charlie Munger (Berkshire Hathaway's vice chairman) said, "Warren talks about these discounted cash flows. I've never seen him do one."

"It's true," replied Buffett. "If (the value of a company) doesn't just scream out at you, it's too close."

The beauty of valuation -- and investing in general -- is that, to use Buffett's famous analogy, there are no called strikes. You can sit and wait until you're as certain as you can be that you've not only discovered a high-quality business, but also that it is significantly undervalued. Such opportunities are rare these days, so a great deal of patience is required. To discipline myself, I use what I call the "Pinch-Me-I-Must-Be-Dreaming Test." This means that before I'll invest, I have to be saying to myself, "I can't believe my incredible good fortune that the market has so misunderstood this company and mispriced its stock that I can buy it at today's low price."

Conclusion

Since I've been quoting Buffett with reckless abandon, I might as well conclude with another one of my favorites, from his 1978 annual letter to shareholders (keep in mind the context: Buffett wrote these words during a time of stock market and general malaise, only a year before *Business Week's* infamous cover story, "The Death of Equities"):

"We confess considerable optimism regarding our insurance equity investments. Of course, our enthusiasm for stocks is not unconditional. Under some circumstances, common stock investments by insurers make very little sense.

"We get excited enough to commit a big percentage of insurance company net worth to equities only when we find (1) businesses we can understand, (2) with favorable long-term prospects, (3) operated by honest and competent people, and (4) priced very attractively. We usually can identify a small number of potential investments meeting requirements (1), (2) and (3), but (4) often prevents action. For example, in 1971 our total common stock position at Berkshire's insurance subsidiaries amounted to only $10.7 million at cost, and $11.7 million at market. There were equities of identifiably excellent companies available -- but very few at interesting prices. (An irresistible footnote: in 1971, pension fund managers invested a record 122% of net funds available in equities -- at full prices they couldn't buy enough of them. In 1974, after the bottom had fallen out, they committed a then record low of 21% to stocks.)

"The past few years have been a different story for us. At the end of 1975 our insurance subsidiaries held common equities with a market value exactly equal to cost of $39.3 million. At the end of 1978 this position had been increased to equities (including a convertible preferred) with a cost of $129.1 million and a market value of $216.5 million. During the intervening three years we also had realized pretax gains from common equities of approximately $24.7 million. Therefore, our overall unrealized and realized pretax gains in equities for the three-year period came to approximately $112 million. During this same interval the Dow-Jones Industrial Average declined from 852 to 805. It was a marvelous period for the value-oriented equity buyer."

It is clear that Buffett's unparalleled investment track record over many decades is the result of buying high-quality businesses *at attractive prices*. If he can't find investments that have both characteristics, then he'll patiently wait on the sidelines. That's what's happening today. As in 1971, Buffett has again largely withdrawn from the market, refusing to pay what he considers to be exorbitant prices for stocks. This is a major reason why the stock of **Berkshire Hathaway** (NYSE: BRK.A) has been pummeled. And Buffett himself is ridiculed as being an out-of-touch old fogey (you should read some of the e-mails I get every time I write a favorable word about him). Only time will tell who is right, but I've got my money on Buffett.

Next week, I will take this discussion of valuation from the theoretical to the practical by analyzing **American Power Conversion's** (Nasdaq: APCC) valuation.

--Whitney Tilson

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The Last Bull on Berkshire?

By Whitney Tilson (Tilson@Tilsonfunds.com)
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(www.fool.com/boringport/2000/boringport000214.htm)

Berkshire Hathaway (NYSE: BRK.A), the Boring Port's largest holding by a significant margin (it accounts for 25% of the portfolio), has continued to decline. After last year's 19.9% drop, it has fallen another 19.4% this year (through last Friday's close at $47,200), and has now plunged 46.2% from the all-time high it reached a year and a half ago. As if that's not bad enough, the S&P 500 has risen nearly 30% over this period (and let's not even talk about the Nasdaq). It's been a painful ride for investors, myself included. For this stock anyway (to quote our President), I feel your pain.

Does that mean I'm selling? Heck no! While it's no fun getting in too early, I love beaten-down stocks if (and this is a big if) I have confidence that the company will rebound. In the case of Berkshire Hathaway, my confidence in Warren Buffett and the company is unshaken. As the stock drops farther and farther below what I believe to be its intrinsic value, I become more and more bullish about its future potential, and thus I am continuing to buy.

Am I being stupidly stubborn, or am I going to make a lot of money on Berkshire Hathaway? Only time will tell. But let me explain why I'm betting on the latter.

Berkshire Hathaway's Wealth Creation Drivers
Berkshire Hathaway has been one of the best performing stocks of all time: It is worth 1,100 times more than its 1969 price of $42/share (that's 26.4% annual growth for 30 years). Of course, the only thing that matters is the stock's future, not its past, but it helps to understand what accounted for Berkshire Hathaway's success in order to evaluate what its future is likely to be.

Obviously, Buffett's investing acumen has been a major factor, but that's only part of the story. Most companies that are successful in the long run are able to invest capital at high returns -- substantially higher than their cost of capital -- and increase the amount of capital they are able to invest at these high rates over time. The beauty of Berkshire Hathaway is not only that Buffett has invested increasing amounts of capital very wisely, generating compounded returns consistently greater than 20% over many decades, but also that the company's cost of capital has been very low -- even negative in many years -- due to its primary source of capital, insurance float.

What's Gone Wrong?
In the past year or two, the fundamental drivers of Berkshire Hathaway's wealth creation engine were impaired, at least temporarily, and some other factors have also hurt the stock. Here are some of the things that have happened:

- Berkshire Hathaway's major stockholdings did poorly in 1999. On a weighted basis, the seven largest positions (in descending order of size: Coca-Cola, American Express, Gillette, Freddie Mac, Wells Fargo, Disney, and the Washington Post) were flat versus a 21% increase in the S&P 500 (they're down another 5% so far this year, approximately matching the S&P). Despite the decline, these positions alone are worth $30.2 billion today (not including the unrealized capital gains tax obligation).

- Due mainly to high valuations in the market, during 1999 Buffett did not make any major stock purchases (that have been disclosed anyway), and only made one acquisition of consequence: MidAmerican Energy Holdings (click here to read about it). You can imagine the market's lack of enthusiasm for the acquisition of a utility. Hence, low-return cash and bonds have accumulated to $36.0 billion on Berkshire Hathaway's balance sheet. For perspective, that's approximately twice as much as the cash and short-term investments Microsoft has, and represents half of Berkshire Hathaway's $71.7 billion market capitalization.
- The cost of Berkshire Hathaway's insurance float rose sharply. Overcapacity in the worldwide insurance industry and subsequent price competition have hurt results at a number of Berkshire Hathaway's insurance subsidiaries, especially General Re. There have also been higher-than-expected claims. Finally, GEICO is growing explosively -- approximately 20% annually -- but is forgoing current profits to do so (a strategy I endorse).
  Poor results on occasion should not be a surprise, as Buffett does not try to manage earnings so that they increase smoothly and steadily. In fact, he highlights the fact that one of the company's competitive advantages as an insurer (especially when writing super-catastrophe policies) is that Berkshire Hathaway, unlike its publicly traded competitors, is willing to accept the risk of periodic large claims in exchange for a higher level of overall profitability over a long period of time.
- Interest rates have been rising, which tends to hurt the value of stocks in general and stocks of financial companies like Berkshire Hathaway in particular.
- Given Berkshire Hathaway's size, there are questions about how quickly it can grow going forward.

In addition to these factors affecting the company, there are also a number of unique things about the stock that make it vulnerable to a significant decline:

- Berkshire Hathaway has very long-term-oriented investors. The average holding period of its freely traded shares is 15 *years*, more than double the average holding period of the next-longest-held company among the 100 largest American companies. Because it is so thinly traded, relatively few buyers and sellers set the price, which can lead to large price swings.
- Wall Street barely covers the stock because Buffett does not try to promote it, refuses to play the quarterly earnings game, and has little need for investment banking services. Also, the stock's high price and low turnover discourages brokers from promoting the stock since their commissions are based on the number of shares traded.
- The high price of Berkshire Hathaway's shares (even the B shares trade at more than $1,400 each) has a psychological effect that intimidates many buyers. In addition, the increasing number of small investors may not be able to purchase even a single B share and still maintain as much diversification as they would like.
- There may still be residual selling from General Re shareholders who are frustrated with the stock's underperformance since they have owned it.
- In a market increasingly enamored with technology stocks, Buffett's avoidance of this area -- where he correctly believes he has no competitive advantage as an investor -- has caused many investors to abandon Berkshire Hathaway.

All of these factors would give me pause were I looking to buy the stock for a short-term pop. But I'm focused on the long term.

Implicit in Berkshire Hathaway's depressed stock price today is the assumption that the company's ability to grow profitably has been materially and permanently damaged. I don't believe it. Over the long term, do I expect Berkshire's current stock holdings -- businesses of exceptional quality -- to continue to trail the market? No, though I'm not expecting dramatic outperformance either. Do I expect the poor pricing environment and high claims in the insurance industries in which Berkshire competes to improve? Yes, as they always have, though I don't know when this might happen. Do I expect that Buffett will be able to wisely invest the company's growing insurance float and cash flow? Absolutely, though this might take a while as well.

I believe what happened to Berkshire Hathaway in the past year or so was the equivalent of a 100-year storm -- pretty much everything that could go wrong did go wrong. Yet even under these circumstances, the company remained enormously profitable. I am steadfast in my opinion that Berkshire Hathaway is still a gem of a business.

Valuation
Berkshire Hathaway is a complex company. As such, it is very difficult to understand and value. That's one of the reasons why I think a generally efficient market is significantly mispricing this stock. At some point I plan to write about the company's valuation, but right now I don't spend a lot of time thinking about it. Why? For the same reason that I no longer get carded when I buy a bottle of wine. The person behind the counter doesn't know how old I am, but you only have to look at me to know that I'm older than 21. Similarly, it doesn't take more than a few minutes of back-of-the-envelope calculations to figure out that Berkshire Hathaway is worth a lot more than it's trading for today. How much more? I don't know for sure, but of the dozens of valuations I've read and those I've done myself, I've never seen a figure lower than $60,000/share -- and I think it's worth quite a bit more.

Dale Wettlaufer, the former manager of the Bore Port, did some nice valuation work a year ago, which you can read by clicking here.

Conclusion
I think it is highly unlikely that Berkshire Hathaway has turned into a dog of a business or that Buffett, after more than 40 years of investment genius, has become a fool -- yet that's how the stock is being priced today. I don't know when, but Buffett will be vindicated, and I intend to profit from it.

--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.

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Perils and Prospects in Tech

Technology stocks have declined significantly this year, as the market has corrected some outrageous valuations. Yet a number of "blue-chip" tech stocks still trade at very high prices and are ripe for a fall. There are, however, some good companies in the sector whose prices have become very attractive during the shakeout.

By Whitney Tilson
Published on the Motley Fool web site, 10/9/00
(www.fool.com/boringport/2000/boringport001009.htm)

What we are witnessing today in the technology sector is a speculative bubble bursting. I believe the process is still underway, which has important implications for investors, especially those still clinging to the few blue-chip tech stocks that are still relatively unscathed. But one need not abandon this sector entirely -- in fact, there are wonderful bargains available to courageous investors with a time horizon beyond a quarter or two.

Turmoil in the tech sector
As evidenced by the Nasdaq's 17.4% decline this year (and a 33.4% fall from its peak on March 10th -- all figures as of Friday's close), technology stocks have been hit hard recently. We're all familiar with the demise of the dot-com sector, which I touched on in my column, Twelve Internet Myths. Leading Internet companies like **America Online** (NYSE: AOL), **Amazon** (Nasdaq: AMZN), **eBay** (Nasdaq: EBAY), and **Yahoo!** (Nasdaq: YHOO) have been whacked badly, and lesser companies are being obliterated (deservedly so by and large). Nor has the carnage been limited to dot-coms. Highly profitable stalwarts such as **Microsoft** (Nasdaq: MSFT), **Dell** (Nasdaq: DELL), **Intel** (Nasdaq: INTC), **Qualcomm** (Nasdaq: QCOM), **Worldcom** (Nasdaq: WCOM), and **Lucent** (NYSE: LU) -- plus a host of solid second-tier companies like **Apple** (Nasdaq: AAPL), **Lexmark** (NYSE: LXK) and Boring Port holdings **Gateway** (NYSE: GTW) and **American Power Conversion** (Nasdaq: APCC) -- have all been taken out and shot due to various hiccups (or worse) in their businesses.

Many of these companies were and still are outstanding, but they were bid up to valuations ranging from very rich to utterly preposterous by naïve or cynical investors -- a frenzy cheered on by Wall Street and the media. These stocks were priced for perfection -- but perfection, for most, proved impossible to achieve. This should not have come as a surprise, given the ferociously competitive and unpredictable nature of the fast-moving technology sector.

A bifurcated market
Curiously -- this is why I think the bubble hasn't finished bursting yet -- some stocks have remained relatively unscathed, with their enormous valuations intact. In part, this is because these companies are in exciting sectors and have continued to deliver outstanding results. But I suspect it is also because investors have been conditioned for too long that tech stocks are the only way to make money, so instead of fleeing the sector entirely, they -- like those caught in a flood where the waters are continuing to rise -- have crowded onto a small handful of islands, a few blue-chip tech companies, that offer the illusion of safety.

But these stocks are not safe at all. In fact, they are extraordinarily risky. Not because there are problems with the companies -- these are exceptional businesses with marvelous economic characteristics and bright future prospects -- but because of the nosebleed valuations caused by all the investors piling into them.

Examples of the companies I'm talking about (I'm bracing myself for the hate emails) include **Cisco** (Nasdaq: CSCO), **Oracle** (Nasdaq: ORCL), **EMC** (NYSE: EMC), **Sun Microsystems** (Nasdaq: SUNW), **Nortel Networks** (NYSE: NT), and **Corning** (NYSE: GLW). What do these six have in common? As the chart below shows, they are very richly valued by any measure, in part because they have not been hit as hard as many stocks in the tech sector. They are also large companies -- the smallest has $5.6 billion in trailing sales -- which is important because size will almost always act as a brake on high percentage growth rates. (That's why I didn't choose to highlight much smaller companies like **JDS Uniphase** (Nasdaq: JDSU), **Juniper Networks** (Nasdaq: JNPR), **Palm** (Nasdaq: PALM), **Veritas** (Nasdaq: VRTS) and **Brocade** (Nasdaq: BRCD), which have even higher valuation multiples, but which have the potential -- that doesn't mean it's likely -- to grow at very high percentage rates for a long period of time.)

Consider the following data on the first six companies I mentioned:

Company	Price	% off peak	Sales (TTM$B)	Market Cap($B)	P/S (TTM)	P/E (TTM)	P/E (Future)
Cisco	$56.19	31%	$18.9	$396	21	156	75
Oracle	$67.63	27%	$10.4	$190	18	87	68
EMC	$89.19	15%	$7.6	$194	26	156	87
Sun	$107.50	17%	$15.7	$173	11	99	81
Nortel	$62.31	28%	$26.5	$185	7	88	64
GLW	$90.44	20%	$5.6	$80	14	144	67

Note: Prices as of Friday's close. Oracle's and Nortel's TTM (trailing 12-month) EPS are adjusted to exclude one-time events. Future P/E based on consensus analyst estimates for the fiscal years ending 5/01 for Oracle, 6/01 for Sun, 7/01 for Cisco, and 12/01 for the others.

The *lowest* P/E multiples among these six are 87 times trailing earnings and 64 times (very optimistic) estimated earnings for next year. Where, pray tell, is *any* margin of safety? Such an antiquated notion! What an old fogy I am, and still in my 30s!

Beware of tumbling tech titans

To some extent, this is an unfair chart. I could have included growth rates, margins, returns on capital, etc., and the picture would appear much brighter. I didn't because I don't question that these are great companies -- the only issue is whether the stocks are attractive at today's prices. I would argue, absolutely not! In fact, I'll go so far as to say that it is a virtual mathematical certainty that these six companies, as a group, cannot possibly grow into the enormous expectations built into their combined $1.2 *trillion* dollar valuation. That doesn't mean they're all going to crash -- in fact, one or maybe two of them might end up being decent investments -- and I make no short-term predictions. But long term, even if the companies perform exceptionally well, their stocks -- in my humble opinion -- are likely *at best* to compound at a low rate of return, and there's a very real possibility of significant, permanent loss of capital.

Investing is at its core a probabilistic exercise, and the probabilities here are very poor. If you own any of these companies and, for whatever reason (such as big capital gains taxes; hey, I don't like paying them either) haven't taken a lot of money off the table, be afraid. Be very, very afraid. (And please, if you disagree with me, that's fine, but don't spam me with hate emails accusing me of trying to push the stocks down because I'm short any of them. I've never shorted *any* stock.)

Opportunities
If the few remaining tech stalwarts left standing are taken down, it will probably ripple through the entire sector. That being said, if I can find particular companies that I think are very attractively priced today, I'm certainly not going to hold off on buying them because of my predictions -- or anyone else's -- regarding the sector they belong to.

This schizophrenic market is offering wonderful bargains everywhere I turn. One example of a stock I've been buying recently is **American Power Conversion** (Nasdaq: APCC), which is now down 64% since an earnings warning a few months ago. This company is a market leader in its niche, has enormous margins, a pristine balance sheet, and has been growing like gangbusters for more than a decade (and, I believe, will continue to do so in the future, despite a weak second half of this year). I wrote about the stock in July after it had been cut in half after an earnings warning. At that time, with the stock above $25, I said "it's not quite cheap enough." Since then, the company has not announced any change in guidance, yet the stock has fallen another 31% to $17.50. Trading at 12.3x next year's earnings, it's plenty cheap enough for me now.

An even cheaper stock I just bought for the first time this week is **Apple** (Nasdaq: AAPL). The company has a market cap of $7.2 billion, $3.8 billion of cash and $300 million of long-term debt, for an enterprise value of a mere $3.7 billion. Over the past four quarters, Apple has generated $807 million of free cash flow (cash flow from operations minus net cap ex) -- and that isn't an aberration either: free cash flow for the four quarters before that was a comparable $886 million. So, Apple today is trading at an enterprise value to trailing free cash flow multiple of 4.6. That's absurdly cheap. Think about your downside protection this way: with its net cash on hand, Apple could buy back nearly *half* of its outstanding shares right now.

Sure, Apple's recent earnings warning could be the sign of tough times to come, but at today's price, I believe that anything except a total meltdown scenario will result in returns that are at least satisfactory and possibly exceptional. And I think a worst-case scenario is quite unlikely. It's not as if Apple preannounced a huge loss -- just that sales would be weaker than expected for at least one quarter, leading to earnings per share of $0.30-$0.33 -- in line with the $0.31 in the same quarter last year -- rather than the expected $0.45. And let's not forget what an innovative company Apple is, the new products that are hitting the market (did anyone read Walter Mossberg's rave review of the new G4 Cube in *The Wall Street Journal* recently?), and the company's pipeline of forthcoming new products.

I think American Power Conversion and Apple represent very high probability bets for investors with a time horizon beyond a quarter or two.

-- 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.

Cisco's Formidable Challenge

Given its high valuation, Cisco must deliver truly spectacular performance over many years for its stock to be a winning investment. Anything less, and its stock is likely to be a disappointment. With a modest upside even in a best-case scenario and enormous downside if Cisco so much as hiccups, there are other investments with a higher probability of success.

By Whitney Tilson
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(www.fool.com/boringport/2000/boringport001023.htm)

In my column two weeks ago, I argued that **Cisco** (Nasdaq: CSCO) and other richly valued large-cap technology stocks were low-probability investments, but suggested that beaten-down stocks such as **Apple** (Nasdaq: AAPL) might be worth a look. (Now you see why I don't try to make a living predicting short-term stock movements.) In last week's column, I began my analysis of Cisco and Apple with a quick overview of the two companies. Today, I'd like to continue with an analysis of Cisco, and cover Apple next week.

Please note that my arguments against buying Cisco apply to pretty much any stock with an extreme valuation -- let's define that as 100x trailing earnings per share (EPS) or more. This still leaves quite a large universe of stocks -- mostly technology stocks -- that I think are very unlikely to provide a satisfactory long-term return. I've chosen Cisco to make my point because it's so widely known and owned, *not* because I think Cisco is particularly ripe for a fall. In fact, the opposite is the case: I used to own Cisco, think highly of the company, and, were I to buy a richly valued tech stock, Cisco's would be among the first I'd snap up. Thus, when I conclude that Cisco's stock is a bad bet, you can safely assume that I feel similarly, if not more strongly, about dozens of other companies that have extraordinary valuations.

To think sensibly about the returns from Cisco's stock over, say, the next five years, it helps to develop some scenarios for what the future might look like. This will help us think about the range of possible outcomes. Then, we can assign probabilities to each scenario and calculate an expected return. Keep in mind that this exercise is more art than science -- the future is inherently unpredictable -- so I encourage you to develop your own scenarios and probabilities if you disagree with mine.

Scenarios
There's little doubt that Cisco is priced for perfection. To its credit, the company has consistently achieved perfection for many, many years, so let's start with this scenario: Cisco continues to grow like gangbusters and achieves the very high EPS growth that analysts are projecting over the next five years. For the next 12 months ending July 2001, Cisco is projected to earn $0.74 per share, 40% higher than the last 12 months (pro forma). The next year, analysts project $0.96 per share, a 30% increase. Let's be aggressive and assume 30% growth for the three years after that, which translates into EPS of $2.11 in five years. This means net income would be $20 billion (if we assume that shares outstanding grow at 5% annually, to 9.5 billion shares). For perspective, $20 billion is 64% more than the net income earned by the most profitable U.S. company today, **General Electric** (NYSE: GE), which has trailing 12-month earnings of $12.2 billion.

This supercharged EPS growth likely implies even higher revenue growth, given Cisco's declining margins and increasing share count. Over the past eight years, Cisco's gross margin has fallen every year except one, from 67.6% to 64.4%. Of greater concern, operating margin has fallen every year over the same period, from 40.6% to 26.5% (pro forma, which excludes intangibles and in-process R&D). That's a big drop.

Keep in mind that Cisco's margins have become increasingly inflated due to the enormous option grants the company makes to compensate employees, the cost of which doesn't appear on the income statement. If it were, according to estimates in Cisco's 10-K, net income last year would have been 41.9% lower than reported. Two years ago, net income would have been 26.5% lower; three years ago, 19.3% lower. The problem is rapidly getting worse. This reminds me of three questions Warren Buffett asked in his 1998 annual letter to shareholders: "If options aren't a form of compensation, what are they? If compensation isn't an expense, what is it? And, if expenses shouldn't go into the calculation of earnings, where in the world should they go?"

The impact of all these options may not be immediately obvious, but they cost shareholders dearly in the form of dilution -- and will make it even tougher for Cisco to meet analysts' EPS projections. Cisco's diluted shares outstanding have increased an average of 3.7% annually since 1991, with increasing dilution in recent years (6.1% from 1998 to 1999 and 5.3% from 1999 to 2000). (Note that the increasing share count is also due to dozens of acquisitions, a strategy that has been very successful.)

My goal in pointing out the declining margins and increasing share count is not to bash Cisco -- after all, over this period, Cisco has been one of the greatest stocks of all time. Rather, they simply must be factored in to our future scenarios by assuming that Cisco's EPS growth will be at least five percentage points lower than its revenue growth. Thus, to meet the EPS targets noted above, Cisco's sales would have to grow 45% in the next year and 35% annually for the four years after that, resulting in revenue jumping almost fivefold, from $18.9 billion to $91.0 billion. Only four U.S. companies -- **Exxon Mobil** (NYSE: XOM), **Wal-Mart** (NYSE: WMT), **General Motors** (NYSE: GM), and **Ford** (NYSE: F) -- have sales greater than this. (Cisco is currently ranked No. 84.)

Of course, Cisco's growth will eventually slow and its P/E ratio will decline to reflect this, so let's assume that Cisco's P/E ratio, if all goes well, will be 75x trailing EPS in five years. This is an aggressive estimate based on Cisco today trading at 77x next year's earnings and GE -- surely one of the best-run, most-profitable businesses in existence -- trading now at "only" 42x trailing EPS.

So, in the most optimistic scenario imaginable, Cisco stock will be at $158.25 ($2.11/share x a P/E of 75) in five years, representing 22.5% annual growth. At this price, assuming diluted shares outstanding grow at 5% annually, Cisco's market cap will be $1.5 *trillion*. To give you a sense of how big that number is, the entire U.S. Gross Domestic Product last year was $9.3 trillion.

As improbable as all this may sound, this is the perfection scenario, so let's go with it. Thus, the beginning of our scenario chart looks like this (CAGR = compound annual growth rate):

Scenario	5-Year CAGR
Perfection	23%

What about other scenarios? Based on the experiences of **Intel** (Nasdaq: INTC) and **Home Depot** (NYSE: HD), among many others, we can guess that if Cisco so much as stubbed its toe, its stock would fall at least 25% instantly. And heaven forbid it should run into more serious difficulties along the lines of **Microsoft** (Nasdaq: MSFT) or **Lucent** (NYSE: LU). Without going into the details of each additional scenario, here is my optimistic assessment of Cisco's future scenarios (as I noted earlier, I encourage you to come up with your own estimates):

Scenario	CAGR	Assumptions	Price in 5 Years
Perfection	23%	$2.11 EPS; 75 P/E	$158.25
As expected	9%	$2.11 EPS; 42 P/E	$88.62
Stumbles	0%	$1.64 EPS; 35 P/E	$57.40
Big trouble	-10%	$1.13 EPS; 30 P/E	$33.90

Probabilities

Now, let's assign probabilities to each scenario. How likely is Cisco to achieve perfection? The company has certainly earned the benefit of the doubt, but it's already quite large, technologies are moving rapidly, and there are countless established and emerging competitors. I'm willing to be wildly optimistic and give Cisco a 40% chance of achieving perfection. Here's the rest of my chart, again being very optimistic:

Scenario	CAGR	Price in 5 Years	Probability
Perfection	23%	$158.25	40%
As expected	9%	$88.62	20%
Stumbles	0%	$57.40	20%
Big trouble	-10%	$33.90	20%

Multiply all this out and the result is Cisco at $99.28 in five years, which represents growth of 11.6% annually. I don't know about you, but I can think of many stocks that I believe will compound at a higher rate -- using conservative assumptions, rather than highly optimistic ones.

Conclusion

It's easy to identify great companies with fabulous economic characteristics, strong management teams, and bright future prospects. So many investors end their analysis there and start buying, forgetting the final question: *At what price*? If the price you pay fully discounts even the most optimistic scenario, then you are virtually certain to do poorly. And a long investment horizon won't help -- in fact, it will work against you. In the short term, momentum might carry even an overvalued stock still higher, so you can make money if you sell quickly, but given enough time the laws of economic gravity will always prevail.

Though the bull market of the past few years has persuaded many to the contrary, I believe that the only way to consistently make money in the stock market will be the same in the future as it's always been over long periods of time in the past: Buy stocks that are undervalued. In other words, stocks that are being misunderstood and mispriced by the market. Thus, the most important question to ask yourself when you're considering buying a stock is: "What is the market underestimating about this company that is causing its stock to be significantly undervalued?" If you can't come up with a good answer, don't buy the stock.

Getting back to Cisco, many people emailed me after my last two columns to detail the company's many strengths and future opportunities, but my response remains: "What part of your argument is not widely known, and can you explain to me how, at today's valuation, the company is underappreciated?" Too often, the answer is, "Well, the stock's gone up for many years and I've made a lot of money on it, so I'm betting that it will keep going." This is the fallacy that Warren Buffett wrote about in his brilliant article last year in *Fortune*:

“As is so typical, investors projected out into the future what they were seeing. That’s their unshakable habit: looking into the rearview mirror instead of through the windshield.”

I agree that anyone looking into the rearview mirror would want to own Cisco today, but I also argue that one would reach the opposite conclusion after a careful, unemotional look through the windshield. For Cisco to be a good investment going forward, absolutely everything must go right. It’s possible, but the probabilities are unfavorable. In short, it’s a bad bet.

A number of people emailed me to point out that I could have made similar arguments as recently as two years ago, and the stock has nearly quadrupled since then, but Cisco was a much better bet at that time. Its trailing sales were $8.5 billion, not $18.9 billion, making high rates of future growth more likely. It also had higher margins, fewer competitors, and, most importantly, a trailing P/E ratio of 48 versus 108 today (based on pro forma EPS).

While the most widely followed, universally loved, highly valued stocks sometimes prove to be undervalued, I believe -- and there is abundant evidence to back me up -- that such stocks in general do not represent high-probability investments.

-- 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.

Valuation STILL Matters

Are companies such as Siebel Systems the best bet for the Rule Maker Portfolio? Whitney Tilson is wary of tech stocks that are priced to perfection, and fears that focusing on everyone's favorite stocks -- at the expense of valuation -- is a sure path to underperformance. He likes the idea of identifying dominant businesses with strong franchises, but prefers to wait until the price is just right.

By Whitney Tilson
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Almost exactly a year ago, I wrote a column called Valuation Matters. In it, I said:

"I believe in The Motley Fool's core investment philosophy of buying the stocks of quality companies (or index funds), holding for the long run, and ignoring the hype of Wall Street and the media. But if I were to level one general critique of the Fool, it would be that there is not enough emphasis on valuation... The experience of the past few years notwithstanding, [the] 'pay any price for a great business' attitude is a sure route to underperformance."

Since I wrote those words on February 7, 2000, here's what has happened:

Portfolio/Index	% change
S&P 500	-9%
Nasdaq	-44%
Rule Maker	-48%
Rule Breaker	-45%
Berkshire Hathaway	+36%

My goal in showing these figures is not to gloat, but to make a point that I've made over and over again: valuation really does matter.

Regular readers might think, "You're beating a dead horse, Whitney. After the events of the past year, everyone already understands and agrees with you." I'm not so sure.

As evidence, consider that in a survey TheStreet.com conducted recently to determine which stocks its readers wanted more articles about, 47 of the top 50 were tech stocks. The Fool's own Rule Maker portfolio has dedicated three recent columns to a potential purchase of **Siebel Systems** (Nasdaq: SEBL) -- an exceptional company, but also one whose stock is trading at either 126 or 264 times trailing earnings per share (depending on whether you use the company's adjusted figures or actual GAAP numbers) and 85x analysts' (very optimistic, in my opinion) estimates for 2001.

Siebel is almost certainly overvalued
My answer to the question posed by the title of the Rule Maker's most recent column on Siebel, "Is Siebel Overvalued?," is "Almost certainly, yes." In my mind, Siebel falls into the same category of stocks I raised questions about in a column last October. That column named some of the most poplar tech stocks at that time -- **Cisco** (Nasdaq: CSCO), **Oracle** (Nasdaq: ORCL), **EMC** (NYSE: EMC), **Sun Microsystems** (Nasdaq: SUNW), **Nortel Networks** (NYSE: NT), and **Corning** (NYSE: GLW) -- and claimed:

"It is a virtual mathematical certainty that these six companies, as a group, cannot possibly grow into the enormous expectations built into their combined $1.2 *trillion* dollar valuation... Even if the companies perform exceptionally well, their stocks -- in my humble opinion -- are likely *at best* to compound at a low rate of return, and there's a very real possibility of significant, permanent loss of capital. Investing is at its core a probabilistic exercise, and the probabilities here are very poor."

I received more hate emails from that column than any other -- which should have been a clue that I was on to something. Less than five months later, here's how these stocks have performed:

Stock	**% change**
Cisco	-50%
Oracle	-29%
EMC	-39%
Sun	-57%
Nortel	-68%
Corning	-64%
Average	**-51%**
Nasdaq	**-28%**

These numbers certainly highlight the dangers of investing in the most popular stocks that are priced for perfection -- like Siebel.

Does valuation still matter?
One might argue that with so many stocks so far off their highs, perhaps one needn't focus as much on valuation today. I think the opposite is true. A year ago, you could argue that even if you bought an overvalued stock, it didn't matter since someone would come along and buy it from you at a higher price. As silly as that argument might sound, a rapidly rising stock market over the previous few years had lulled many into believing it. But today, with the market psychology broken, I don't think a reasonable argument can be made that the "greater fool theory" of investing is likely to be very rewarding going forward.

My kind of Rule Maker: IMS Health
So am I rejecting Rule Maker investing? Not at all. I wholeheartedly agree with the strategy of buying and holding for many years the stocks of exceptionally high-quality companies. But I won't pay any price. In fact, I will only buy a stock when I think it is so undervalued that I'm trembling with greed. Let me give you an example: a stock I bought last summer and still own, **IMS Health** (NYSE: RX).

IMS Health is the world's leading provider of information solutions to the pharmaceutical and healthcare industries. Its core business -- in which it has built approximately 90% market share over the past half-century -- is providing prescription data to pharmaceutical companies, which use the data to compensate salespeople, develop and track marketing programs, and more. More than 165 *billion* records per month flow into IMS databases worldwide.

The company has offices in 74 countries, tracks data in 101 countries, and generates 58% of sales overseas. IMS Health has a near-monopoly and there are very high barriers to entry. As a person I interviewed at one of the largest pharmaceutical companies (who is in charge of its relationship with IMS) said, "There will be no more entrants into this market."

Due to its powerful competitive position, IMS mints money: It has a healthy balance sheet, very high returns on capital, huge 19% net margins, and solid growth. Revenues in the first three quarters of 2000 (IMS reports Q4 00 earnings after the close today) increased 14%, or 16% in constant currency, and net income rose 16%. With large share buybacks -- in the latest quarter, shares outstanding fell 7% year-over-year -- EPS grew 25% in the first three quarters of 2000 and is projected to grow 19% in 2001. (All figures are pro forma, as IMS has spun off a number of entities.)

At Friday's close of $25.45, I don't think the stock of IMS Health is cheap enough to buy at this time, but it sure was last July when I bought it for $16, equal to approximately 16x estimated 2001 EPS. It was cheap because management was widely disliked by Wall Street, due in large part to an ill-conceived merger that was subsequently called off.

While I wasn't thrilled with the management team either, I figured this was already reflected in the stock price, and I could not find a single element of weakness in IMS' financials. I couldn't see much downside to owning the stock and, over time, if the business continued to grow strongly, I suspected that management and Wall Street would smooth out their differences. This is exactly what happened. Even better, new management is now in place.

This was my kind of Rule Maker: a company with a bulletproof franchise that meets most of the key Rule Maker criteria, but which is priced very attractively due to the market overreacting to a short-term issue.

-- 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 IMS Health at the time of publication. Whitney appreciates your feedback at Tilson@Tilsonfunds.com. To read his previous columns for The Motley Fool and other writings, visit www.tilsonfunds.com.

The Perils of Investor Overconfidence

By Whitney Tilson (Tilson@Tilsonfunds.com)
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NEW YORK, NY (September 20, 1999) -- Hello, fellow Fools. Dale is away this week and he invited me to be a guest columnist today, Wednesday, and Friday in his absence.

First, by way of introduction, when I began investing a few years ago, I tried to educate myself by reading everything I could find on the topic (click here for a list of my all-time favorite books on investing). Being an early user of the Internet, I soon discovered The Motley Fool, which I have enjoyed and learned from immensely.

The topic I'd like to discuss today is behavioral finance, which examines how people's emotions affect their investment decisions and performance. This area has critical implications for investing; in fact, I believe it is far more important in determining investment success (or lack thereof) than an investor's intellect. Warren Buffett agrees: "Success in investing doesn't correlate with I.Q. once you're above the level of 25. Once you have ordinary intelligence, what you need is the temperament to control the urges that get other people into trouble in investing."

Numerous studies have shown that human beings are extraordinarily irrational about money. There are many explanations why, but the one I tend to give the most weight to is that humans just aren't "wired" properly. After all, *homo sapiens* have existed for approximately two million years, and those that survived tended to be the ones that evidenced herding behavior and fled at the first signs of danger -- characteristics that do not lend themselves well to successful investing. In contrast, modern finance theory and capital markets have existed for only 40 years or so. Placing human history on a 24-hour scale, that's less than two seconds. What have you learned in the past two seconds?

People make dozens of common mistakes, including:

1) Herding behavior, driven by a desire to be part of the crowd or an assumption that the crowd is omniscient;
2) Using mental accounting to treat some money (such as gambling winnings or an unexpected bonus) differently than other money;
3) Excessive aversion to loss;
4) Fear of change, resulting in an excessive bias for the status quo;
5) Fear of making an incorrect decision and feeling stupid;
6) Failing to act due to an abundance of attractive options;
7) Ignoring important data points and focusing excessively on less important ones;
8) "Anchoring" on irrelevant data;
9) Overestimating the likelihood of certain events based on very memorable data or experiences;
10) After finding out whether or not an event occurred, overestimating the degree to which they would have predicted the correct outcome;
11) Allowing an overabundance of short-term information to cloud long-term judgments;
12) Drawing conclusions from a limited sample size;
13) Reluctance to admit mistakes;
14) Believing that their investment success is due to their wisdom rather than a rising market;

15) Failing to accurately assess their investment time horizon;
16) A tendency to seek only information that confirms their opinions or decisions;
17) Failing to recognize the large cumulative impact of small amounts over time;
18) Forgetting the powerful tendency of regression to the mean;
19) Confusing familiarity with knowledge;
20) Overconfidence

Have you ever been guilty of any of these? I doubt anyone hasn't.

This is a vast topic, so for now I will focus on overconfidence. In general, an abundance of confidence is a wonderful thing. It gives us higher motivation, persistence, energy and optimism, and can allow us to accomplish things that we otherwise might not have even undertaken. Confidence also contributes a great deal to happiness. As one author writes (in an example that resonated with me, given the age of my daughters), "Who wants to read their children a bedtime story whose main character is a train that says, 'I doubt I can, I doubt I can'?"

But humans are not just robustly confident-they are wildly overconfident. Consider the following:

- 82% of people say they are in the top 30% of safe drivers;
- 86% of my Harvard Business School classmates say they are better looking than their classmates (would you expect anything less from Harvard graduates?);
- 68% of lawyers in civil cases believe that their side will prevail;
- Doctors consistently overestimate their ability to detect certain diseases (think about this one the next time you're wondering whether to get a second opinion);
- 81% of new business owners think their business has at least a 70% chance of success, but only 39% think any business like theirs would be likely to succeed;
- Graduate students were asked to estimate the time it would take them to finish their thesis under three scenarios: best case, expected, and worst case. The average guesses were 27.4 days, 33.9 days, and 48.6 days, respectively. The actual average turned out to be 55.5 days.
- Mutual fund managers, analysts, and business executives at a conference were asked to write down how much money they would have at retirement and how much the average person in the room would have. The average figures were $5 million and $2.6 million, respectively. The professor who asked the question said that, regardless of the audience, the ratio is always approximately 2:1.

Importantly, it turns out that the more difficult the question/task (such as predicting the future of a company or the price of a stock), the greater the degree of overconfidence. And professional investors -- so-called "experts" -- are generally even more prone to overconfidence than novices because they have theories and models that they tend to overweight.

Perhaps more surprising than the degree of overconfidence itself is that overconfidence doesn't seem to decline over time. After all, one would think that experience would lead people to become more realistic about their capabilities, especially in an area such as investing, where results can be calculated precisely. Part of the explanation is that people often forget failures and, even if they don't, tend to focus primarily on the future, not the past. But the main reason is that people generally remember failures very differently from successes. Successes were due to one's own wisdom and ability, while failures were due to forces beyond one's control. Thus, people believe that with a little better luck or fine-tuning, the outcome will be much better next time.

You might be saying to yourself, "Ah, those silly, overconfident people. Good thing I'm not that way."

Let's see. Quick! How do you pronounce the capital of Kentucky: "Loo-ee-ville" or "Loo-iss-ville"? Now, how much would you bet that you know the correct answer to the question: $5, $50, or $500? Here's another test: Give high and low estimates for the average weight of an empty Boeing 747 aircraft. Choose numbers far enough apart to be 90% certain that the true answer lies somewhere in between. Similarly, give a 90% confidence interval for the diameter of the moon. No cheating! Write down your answers and I'll come back to this in a moment.

So people are overconfident. So what? If healthy confidence is good, why isn't overconfidence better? In some areas -- say, being a world-class athlete -- overconfidence in fact might be beneficial. But when it comes to financial matters, it most certainly is not. Overconfidence often leads people to:

1) Be badly prepared for the future. For example, 83% of parents with children under 18 said that they have a financial plan and 75% expressed confidence about their long-term financial well being. Yet fewer than half of these people were saving for their children's education and fewer than 10% had financial plans that addressed basic issues such as investments, budgeting, insurance, savings, wills, etc.

2) Trade stocks excessively. In Odean and Barber's landmark study of 78,000 individual investors' accounts at a large discount brokerage from 1991-1996, the average annual turnover was 80% (slightly less than the 84% average for mutual funds). The least active quintile, with average annual turnover of 1%, had 17.5% annual returns, beating the S&P, which was up 16.9% annually during this period. But the most active 20% of investors, with average turnover of more than 9% monthly, had pre-tax returns of 10% annually. The authors of the study rightly conclude that "trading is hazardous to your wealth." Incidentally, I suspect that the number of hyperactive traders has increased dramatically, given the number of investors flocking to online brokerages. Odean and Barber have done another fascinating study showing that investors who switch to online trading suffer significantly lower returns. They conclude this study with another provocative quote: "Trigger-happy investors are prone to shooting themselves in the foot."

3) Believe they can be above-average stock pickers, when there is little evidence to support this belief. The study cited above showed that, after trading costs (but before taxes), the average investor underperformed the market by approximately two percentage points per year.

4) Believe they can pick mutual funds that will deliver superior future performance. The market-trailing performance of the average mutual fund is proof that most people fail in this endeavor. Worse yet, investors tend to trade in and out of mutual funds at the worst possible time as they chase performance. Consider that from 1984 through 1995, the average stock mutual fund posted a yearly return of 12.3% (versus 15.4% for the S&P), yet the average investor in a stock mutual fund earned 6.3%. That means that over these 12 years, the average mutual fund investor would have made nearly twice as much money by simply buying and holding the average mutual fund, and nearly three times as much by buying and holding an S&P 500 index fund. Factoring in taxes would make the differences even more dramatic. Ouch!

5) Have insufficiently diversified investment portfolios.

Okay, I won't keep you in suspense any longer. The capital of Kentucky is Frankfort, not "Loo-ee-ville," an empty 747 weighs approximately 390,000 lbs., and the diameter of the moon is 2,160 miles. Most people would have lost $500 on the first question, and at least one of their two guesses would have fallen outside the 90% confidence interval they established. In large studies when people are asked 10 such questions, 4-6 answers are consistently outside their 90% confidence intervals, instead of the expected one of 10. Why? Because people tend to go through the mental process of, for example, guessing the weight of a 747 and moving up and down from this figure to arrive at high and low estimates. But unless they work for Boeing, their initial guess is likely to be wildly off the mark, so the adjustments need to be much bolder. Sticking close to an initial, uninformed estimate reeks of overconfidence.

In tests like this, securities analysts and money managers are among the most overconfident. I'm not surprised, given my observation that people who go into this business tend to have a very high degree of confidence. Yet ironically, it is precisely the opposite -- a great deal of humility -- that is the key to investment success.

--Whitney Tilson

P.S. If you wish to read further on the topic of behavioral economics, I recommend the following (I have drawn on heavily on the first two in this column):

- Why Smart People Make Big Money Mistakes, by Gary Belsky and Thomas Gilovich.
- "What Have You Learned in the Past 2 Seconds?," paper by Michael Mauboussin, CS First Boston.
- In May and June this year, David Gardner wrote four excellent columns in The Motley Fool's Rule Breaker Portfolio: The Psychology of Investing, What's My Anchor?, Tails-Tails-Tails-Tails, and The Rear-View Mirror.
- There's a great article about one of the leading scholars in the field of behavioral finance, Terrance Odean (whose studies I linked to above), in a recent issue of *U.S. News & World Report*: "Accidental Economist"
- The Winner's Curse, by Richard Thaller.
- The Undiscovered Managers website has links to the writings of Odean and many other scholars in this area.

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A Little Perspective

Guest columnist Whitney Tilson recently visited Ethiopia, where he saw startling human poverty and adversity firsthand. Away from cell phones and stock quotes, he came away with a renewed appreciation for his good fortune.

By Whitney Tilson
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I live, eat, and breathe investing, in part because it's my job, but mostly because I love it. Even when I'm on vacation, I typically have a cell phone and laptop with me and I'm regularly checking the market and keeping abreast of developments -- often to the annoyance of my family.

Thus it was an unusual experience for me to disconnect from the stock market for the past two weeks and visit my parents, who live in Ethiopia. Tonight, I'd like to share a few stories from my trip and how it has affected my perspective on investing.

Ethiopia
In the span of a day, I went from my parents' home in the Ethiopian capital of Addis Ababa to my home on the Upper East Side of Manhattan. I lived in Tanzania and Nicaragua for a good part of my childhood, so I've seen third-world countries, but it was still a striking, sobering contrast. I probably don't need to tell you much about the Upper East Side -- overpriced stores, luxury apartments, and the highest income census tract in the United States, with an average income of over $300,000 annually -- so let me instead tell you about Ethiopia.

I really enjoyed the country, which has friendly, proud people, a wonderful climate, and a fascinating history. It used to be the kingdom of Abyssinia and is the only African country never colonized. Yet Ethiopia is desperately poor, with average annual per capita income just above $100, among the lowest in the world. Roughly speaking, the average American earns in one day what the average Ethiopian earns in an entire year.

Such poverty means that Ethiopians are subject to famine, diseases, and other misfortunes unheard of in developed countries. Remember "Do They Know It's Christmas?" and "We Are the World" in 1984 and 1985? Those pop-star fundraising crusades came about because of terrible famines in which hundreds of thousands of Ethiopians perished.

Income per capita is a pretty dry number, so let me give you some examples of what real poverty is all about.

Dereje
Dereje is 19 years old and works full-time for my parents, caring for their horses, accompanying them riding a few times a week, and doing other miscellaneous tasks. He's handsome, intelligent, athletic, and has a warm and compelling personality. Kids, mine included, love him.

He lives in the tack room at the stable, not because my parents require him to but because it's better than the single small room in a dilapidated hut the other six members of his family share. Until my parents found his brother a similar job, Dereje was supporting his entire family on the salary he earned from my parents, which is 50% higher than the going rate for this type of work.

So take a guess at how much Dereje earns. Nope, lower. How about $44. Not per day, not per week, but per *month*. The cost of living in Ethiopia is low -- a bottle of Coke, for example, costs 20 cents -- but seven adults living on $1.50 per day is tough no matter where you are. Yet Dereje considers himself fortunate, and he is, especially compared with the people I met at two charities my parents support, the Cheshire Home and the Fistula Hospital.

Cheshire Home

When was the last time you saw someone crippled by polio? Probably never, as an inexpensive vaccine has eliminated it in the developed world. But in Ethiopia, many awful diseases such as polio -- which strikes children and generally causes terrible deformities -- are still common. With few people able to afford wheelchairs, Ethiopia's polio victims have to pull themselves along the ground in crablike fashion. When even healthy people struggle to survive, imagine how hard life must be for those crippled by polio.

The Cheshire Home helps polio-stricken children walk again, albeit with special braces and crutches. It's a long and painful process, usually involving multiple rounds of surgery in which doctors cut tendons in the children's legs so they can be straightened. Between surgeries, the legs have to be in full-length casts so they don't curl up again.

I've posted a Web page with eight pictures of the Cheshire Home. (Dereje is in the first picture.) Look at those kids' legs, yet also at their faces. It'll make you cry and smile simultaneously.

Fistula Hospital

Life in Ethiopia is very hard for most everyone, but it's especially hard on the women. Like women in most of the developing world, they tend to do the most difficult, dirty work, yet generally do not have access to the few opportunities that exist for an education and a good job. Many are married off at a young age -- sometimes as young as 10 -- and often start bearing children by their early teens. Childbirth rarely occurs with a qualified attendant, much less at a hospital. If there's a problem during delivery, common given the lack of prenatal care, the babies often die and the mothers can suffer injuries.

A common injury is called an obstetrical fistula, which occurs when the baby tears a hole into the bladder and/or rectum, causing the mother to become permanently incontinent and constantly smelly. When this happens, the husband almost always abandons his wife, who returns to her family, often to be rejected again. These women have lives of unspeakable misery. One didn't leave her bed, much less her family's hut, for *nine years* before making her way to the Fistula Hospital.

The hospital specializes in the relatively simple surgical procedure that repairs the fistulas, allowing the patients to return to normal life and even bear children again. It heals more than 1,000 women annually, at a total cost of a mere $400,000 -- a pittance by Western standards, but a fortune in Ethiopia.

Changed perspective

The last two weeks affected my perspective on investing in two ways. First, simply being away, unable to constantly check my portfolio and receive news and messages, was strange -- but good for me. Given my passion for investing, I find that it's easy to get caught up in the day-to-day gyrations of the market, which can affect my mood and judgment. (Based on the dozens of emails I receive weekly from readers, I know that I'm not alone in this regard.)

This isn't healthy. The last thing I need is more stress, and it's likely to hurt my investment performance as well. As I've written many times in the past, one of the keys to successful investing is tuning out short-term noise. I don't believe it's a coincidence that Warren Buffett has built the greatest investment track record in history from Omaha, which is about as far away from the foolishness of Wall Street as one can get in this country.

The last two weeks have also given me -- how do I say this without sounding corny or trite? -- a greater appreciation for how damn lucky I am. After seeing the tremendous hardship and obstacles facing Dereje, the children of the Cheshire Home, and the young women of the Fistula Hospital, I more than ever thank my lucky stars that I was born in the richest country in the world and have been fortunate enough to accumulate long-term assets to invest.

-- Whitney Tilson

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