Intelligent Investing Panel

Don't Catch Falling Knives

Michael Maiello and David Serchuk 03.24.09, 4:00 PM ET

At the end of last year, Bill Miller, manager of the Legg Mason Value Trust lamented that he had purchased Citigroup at what he thought was a bargain price, only to see its shares drop lower as the banking crisis worsened. Miller found the experience troubling to say the least. Was the market signaling a depression in the works? Had he missed liabilities on Citi's books? Was the market irrational? If so, could Miller stay solvent enough to outlast it?

Barry Ritholtz of FusionIQ said that he'd consider buying Citigroup stock under $5 a share. But when the bank's stock got there, Ritholtz decided not to pull the trigger. He told Steve Forbes: "Yeah. We didn't buy it. We said Citi at around 10. And I said assuming there's no more revelations, under $4, $5, Citi could be an interesting thing. So, we watched it, and we just didn't have the nerve to pull the trigger. And now, Citi is on the dollar menu."

Two experienced investors made two opposing decisions. For the moment, Ritholtz looks to have made the right decision and Miller has committed the old Wall Street error of trying to "catch a falling knife." But how do you tell in advance?

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Research and clarity are key. Miller is an expert analyst of financial stocks. This is the manager who, after all, came out of the Savings and Loan Crisis on a tear. He watched and invested with the big financial companies as they became conglomerates. Few investors have such intimate knowledge of how these companies are put together as Miller. But look at Ritholtz's caveat: "Assuming there's no more revelations…" It seems the stocks that Miller knows extraordinarily well now hold surprises.

Ken Shubin Stein, of Spencer Capital Management, believes that most individual investors won't be able to tell if they're being handed a blade or an opportunity because they have to be able to fully understand a company's liabilities and, most importantly, what might cause its customers to flee. It's easy for a simple business like Hershey, he says, but more difficult or technology and financial businesses.

Here's a rule of thumb from Shubin Stein: If you can't honestly make it through the company's annual report without your eyes glazing over and your attention wandering toward less arcane subjects, you're not qualified to judge the stock and are just speculating or following hunches.

P. Brett Hammond, chief investment officer of pension giant TIAA-CREF, warns that: "Our equity analysts have a sector. And they spend 60 hours or more a week looking at that sector and the firms in it. And that's all they do. And from that, what they're trying to do is pick the two winners, and the two losers to overweight and underweight. And the ability of any individual to do that, to devote that kind of time to it is far diminished from our equity analysts."

Marc Lowlicht, an adviser with Further Lane Asset Management says, "I could probably do taxes from my background. I never would, because the guy who does it all day is 10 times better at it than I am. Just like the guy who analyzes financial statements is going to be 10 times better at it than I am."

For the investor determined to go it alone, there is some hope: just stick to the companies you're best able to understand and use expendable amounts of money. Remember also that the balance sheet is king. Debt, especially in the current environment, can make hash of the best forecasts. The safest value stocks will have a well diversified lot of customers and little or no debt on the books.

Avoid Falling Knives.

Ken Shubin Stein: I think people should follow [Warren] Buffett's advice of knowing which of the two buckets they want to be in. Either they should think to themselves that "I'm a know-nothing investor." In which case, they should buy funds and

not pick individual stocks. And then, you know, those people will do very well in life by avoiding major pitfalls.

Or, Buffett recommend the Jack Bogle approach of index investing. But certainly, there are good managed funds out there as well that you can research. Or, they're going to buy individual stocks. They really need to put time and effort in to do it in a way that's thoughtful and careful.

And they need to understand exactly what they're buying. Which means, you know, printing out the 10K (annual report), and reading it, and making sure they understand everything in it. And that takes a lot of work. And people, you know, it's a patience issue or a discipline issue. But if people want to buy individual stocks, they should be willing to put the work in or realize they're speculating.

Forbes: What are Ken's tips for people who feel like they're up to the task of putting in the work? What is the homework you would recommend that intelligent investors should do?

Shubin Stein: It's a good question. I get that question all the time from doctors that I'm friends with. What I would say is, it's important to know who you are. And if you don't, the market will tell you over time.

People should ask themselves, "How much time am I willing to devote to this? And am I trying to speculate because it's intellectually stimulating and fun to do this with a small amount of money?" They can satisfy that craving with a very small amount of money. Or, are they making decisions with significant portions of their net worth or their savings, rather than hiring a professional planner, a financial planner or a wealth adviser?

If they're going to individually manage their stock portfolio with significant parts of their wealth and their net worth, then they should be willing to devote a very significant amount of time to it. Because they're trying to do something that most people fail at over time. And I think people should be aware of that going into it.

Forbes: Ken, you talked about reading 10Ks. Are there a couple of other pointers you can give?

Shubin Stein: Sure. They should, first and foremost, make sure they really understand what the company does at a very simple level. So, for example, who buys from the company? Why does a customer buy from this company? Why does a customer fire this company and buy from a competitor?

And vice versa: Why do they fire a competitor and move on to buy from this company? If we took a company like Hershey's Chocolate, you'd be able to answer that question very easily. If we took a company with complicated software or business processes or other things that maybe aren't clear to people who aren't in that field, it is less obvious, right? So, first and foremost, I think people need to have a very good basic understanding of why it is that the company exists and what customer base do they serve?

And what do they offer that customer base that their competitors don't? Trying to get to the concept of, what is this company's competitive advantage? And if you can't define very simply what this company's competitive advantage is, I think that's really a qualifying first step. I would say that a thorough evaluation is the other important part of that.

P. Brett Hammond: I like your point that you've got to spend an enormous amount of time each week to do this. And we, you know, what I keep thinking about is our equity analysts have a sector. And they spend 60 hours or more a week looking at that sector, and the firms in it. And that's all they do. And from that, what they're trying to do is pick the two winners and the two losers to overweight and underweight. And the ability of any individual to do that, to devote that kind of time to it is far diminished from our equity analysts. And so, I just think that the hurdle to overcome there is so enormous.

Shubin Stein: And the other hurdle I don't hear people talk about too often, but it's very true, you know, that this is an accretive business. The longer you do it, the more you learn, the better you get at it. Because you see more things. We see more cycles, we see more industries, we learn more business models. We learn how more business models fail. And all of us in business tend to get better as we get older at it. And in investing, that's very true. You know, the reason the banks are failing today is not so different in the broad terms from the reason that lending institutions have failed in the past.

Forbes: What are those reasons?

Shubin Stein: Well, you know, they have an asset and a liability side of the balance sheet. And if they gear up their balance sheet too high--so you were talking about having firms who were levered 20, 30, 40 times to one--and we have this whole shadow banking system because of derivatives … But as long as the debt is recoursed, then it's leveraged the balance sheet, right. And it's risked the equity part of the balance sheet. So, lending institutions have perfectly time-proved methods of failing. I mean, banking institutions have perfectly time-tested methods of failing.

And Buffett, in the early 2000s, said, that he sold his stakes in the GSEs because he started to not be able to understand their balance sheets well anymore. And I think that's a really good test for everybody--just to say, do I really understand what this company does? And if you can understand what it does, that's a good starting point. And then, you have to be able to value it. You know, you're buying an earning stream or an asset value when you're buying a company. The price you pay is one thing and the value you get is another, as Buffett's quote goes.

But you have to understand, what price are you paying? If you want to look at it as a bond, you could say, OK, what yield am I getting for my investment? And there are a lot of ways to look at that. We could look at just what dividends I'm getting out of the corporation. Or, what is the earnings yield?

The after-tax earnings yield of the corporation? And just trust that if they retain it, they're going to do something at least reasonably sensible with it. But it's really important to be able to value an asset. And if you don't know what they do, and you don't know how to price the appropriate earnings yield for it, it's hard to do. It's hard to buy it.

Forbes: So, this is a quick follow-up, I hope. You were talking about the element of experience, the longer you do, for example, what all of you are doing, the better at it you become. More like novelists, less like rock musicians, you get better at it with time. I mean, is that element actually large in our financial meltdown?

Shubin Stein: No, it's not. It's because one of the things you can easily point out is where the people who ran these investment banks spectacularly failed, and a lot of them are extremely smart and have been in the business a long time. And that speaks to the perversion of agency and the combination of the severe greed and envy that drive Wall Street.

And somebody before was saying that the pressure to perform and keep up with the other guy really moves firms in the wrong direction. We saw this during the tech bubble. The people who competed with Enron, and the people who competed with WorldCom, ended up doing bad things also. And a lot of them said, "Well, we kept getting out-performed by our direct competitor. And we kept looking at the numbers, and not knowing how they did it. And that moved us toward trying to make, you know, more aggressive decisions in one way or another, to try to keep up."

And I think that focus on short-term perform and the agency issues, and other issues, are a part of what's driven Wall Street. But as investors, and my comment about it being sort of it being an accretive business, is really focused just on being an investor. As an investor, I believe in investing as an accretive business. You keep an open mind, keep trying to learn, stay humble and keep trying to learn from your mistakes and other people's mistakes. And focus on what worked well and do more of that, it tends to do well over time.

Marc Lowlicht: And I would also look at it as an individual investor, you have to be informed and understand why things are being done. But at the same time, I think the best decision you can make as an individual is to surround yourself with people who are smarter than you. And the best corporations have CEOs who hire people with the ability to do things to their best ability.

The best presidents are the guys who surrounded themselves with people smarter than them. Individual investors, like Ken said earlier, don't have 60 hours a week to go through financials. You know, individuals don't have the ability, like myself and Brett, to really understand and look deeper into why managers are investing a certain way vs. another. And understanding how much income you're going to need at retirement and amassing it. And you know, understanding trusts, wills and everything else.

I surround myself, and I would assume and I'm pretty sure that Brett does the same thing. I have on retainer, attorneys and accountants. I could probably do taxes from my background. I never would, because the guy who does it all day is 10 times better at it than I am. Just like the guy who analyzes financial statements is going to be 10 times better at it than I am.

I think it's very important for individual investors to be educated and understand why their plan works the way it does. And there's nothing, it's like, again, when you go to the doctor, it's very wise to know everything he's telling and researching it. But it's also very wise to have the best doctor put you on the best course to being healthy.

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