Unconventional Wisdom in the Investment Process
(What I Have Learned Over The Last 40 Years As An Investor)

by Bill Woodruff

- A stock price is rarely the same as a company's value because the valuation process is flawed. Stock prices are heavily affected by market dynamics and by investor emotion, and emotions swing wildly from pessimism to optimism.

- Many investors buy stocks with the intention of holding them for 1 to 5 years based upon information that really applies to a short-term time horizon. If people invest in a company based on current information, they have to be prepared to act on any changes in that information in a much shorter time frame than most investors are prepared to do.

- Some sectors or industries are much greater beneficiaries of secular changes than others. Why hold stocks of companies in sectors and industries with a poor outlook? Do not diversify for the sake of diversification. Look for companies in a favored sector, with a strong market position, and an improving outlook.

- An investment manager must adapt to new concepts ad ideas. Many investors find comfort with money manager who say that they have rigid discipline that they have adhered to consistently. Those managers may be making decisions without the full benefit of the rapidly changing technology that is available today. I have learned that you must be able to do things differently from most other investors. Many investment managers follow investment paradigms and this could lead them to mediocre result.

- <u>Paradigm Myth #1 - "Buy low, sell high"</u> – best known of all.
  I believe more money can be made buying high and selling at even higher prices. I try to buy stocks that have already had good price moves and are often making new highs and that have positive relative strength. These stocks are in demand by other investors. The risk obviously is that I am buying at the top. But I would much rather be invested in a stock increasing in price and take the risk that it may begin to decline than invest in a stock that is already in a decline and try to guess when it will turn around.

- <u>Paradigm Myth #2 - "Just buy stocks in good companies and hold onto them, that way, you do not have to pay close daily attention"</u>.
  I would say the same but add "until there are unfavorable changes". Closely monitor daily events because they will provide the first clues of long-term change. Remember, just as the business value does not equal the stock price, things are always changing and yesterday's good company may not be today's great investment.

- Paradigm Myth #3 - "Do not try to let home runs make you a lot of money than better singles"
  I could not disagree more. I believe you can make the most money hitting home runs. But you also need a discipline to avoid striking out. That is my sell discipline. I try to cut my losses and let my winners run. This may be a paradigm too, but it is one that works.

- Paradigm Myth #4 - "A high turnover strategy is risky"
  Most people believe high turnover is risky, again, I think just the opposite. High turnover reduces risk when it is the result of taking small losses in order to avoid larger losses. I do not hold on to stocks with deteriorating fundamentals or price patterns. For me this kind of turnover makes sense. It reduces risk.

- Paradigm Myth #5 - " An investment process must be very systematic"
  Most people believe that an investment process needs to be rigidly systematic. I believe a good process involves discipline, but must be flexible enough to respond to changing market conditions. Example: At the end of Nov'91, DJIA was trading at 2895. The market PE was 23, P/B was a lofty 2.7 and the market yield was only 2.8% in a much higher interest rate environment than we have today. A rigid systematic value based process would have told you to get out of the market; after all, the market was higher relative to those valuation measures than it has been 90% if the time on a historical basis. But, I believed that there were other relevant factors that suggested the market could go much higher. This was not a time to rigidly adhere to valuation disciplines. People who stayed fully invested benefited – from Nov'91 to Dec'93 the market advanced 30%. Do not invest because of what you think should happen. Invest because of what is happening.

- Paradigm Myth #6 - "You must have a value based process"
  Often people I have spoken to recently tell me they like to see a very systematic value based process. They think that each stock should be submitted to some type of disciplined, precise and uniform evaluation. But the real world is not that precise. I am convinced there is no universal valuation method. In the short run valuation is not the key factor. Each company's process is unique to that company's place in the market environment and to its own phase in its development.

- Paradigm Myth #7 – "The best measure of investment risk is the standard deviation of return"
  Volatility only measures risk over the short run. I am talking about long-term objective. For most investors a major long-term risk is portfolio underperformance due to insufficient exposure to a higher return more volatile asset class. In my opinion, investment vehicles that provide the least short-term volatility often embody the greater long-term risk.

- Paradigm Myth #8 - "It is risky to place your money with a star system manager"
  In any industry, performance is achieved by the stars. Great ideas, inventions and works of art have always been created by individuals, not groups or committees. This is also true of the investment business. Good long-term results have been achieved by talented individuals, most often surrounded by a great team.

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