By Hugh Dive

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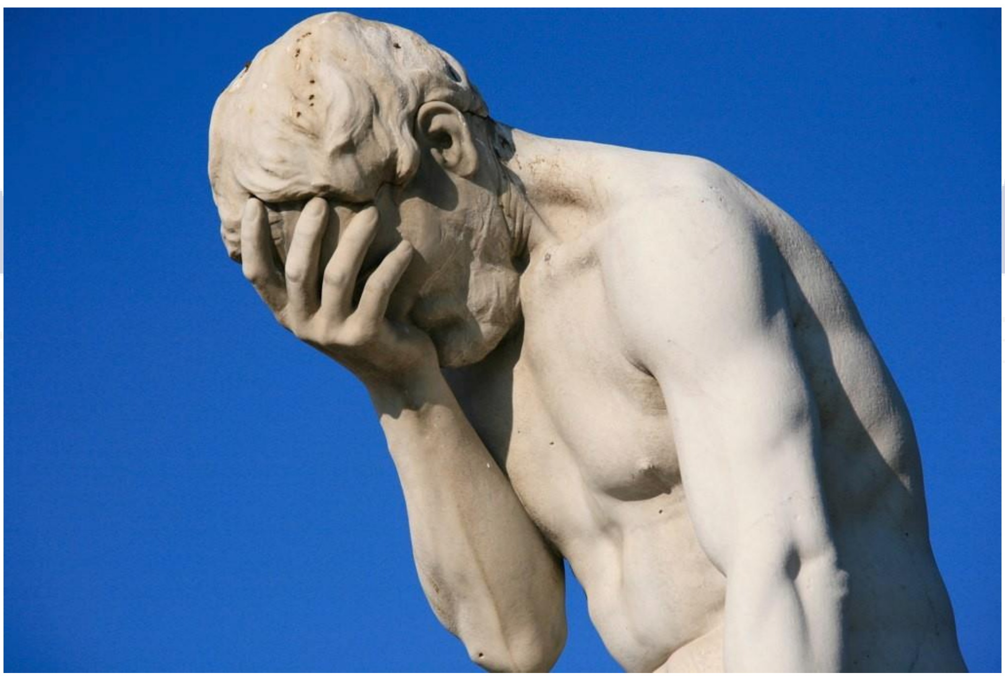
Making Investment Mistakes

A piece of advice that has stuck with me over a number of years has been "*In gaining an education in the stock market, you cannot set either the timing or the cost*". Most articles produced by fund managers focus on great stock picking successes, highlighting brave and courageous decisions made by the fund manager in the face of naysayers and critics. Obviously this is done with the motive of encouraging clients to invest in funds managed by an individual with superior intellect and investment instincts greater than their peers. These articles are always quite easy to write as they conjure up pleasant memories of investing triumphs.

However I am firmly of the opinion that successes don't build investing skills, but rather future outperformance is built on the accumulation of knowledge learned from painful experiences. In this week's piece I am going to look at mistakes that I have made over the past two decades of being a professional fund manager.



"Caïn venant de tuer son frère Abel" by Henri Vidal, Jardin de Tuileries

Asset Rich Companies

This point refers to investing in companies that have a large asset backing, often with a NTA per share (net tangible assets or a company's assets minus liabilities and non-cash intagible assets such as goodwill and patents) higher than its market value. In theory, investors can often buy $1 in cash for 80c by liquidating the company's assets and paying back its liabilities. This is particularly seductive to value investors which has led them into many asset rich industrial companies such as as Arrium that traded for extended periods below its net asset backing. Whilst avoiding Arrium I was involved in making an investment in timber company Gunns, seduced by the 250,000 hectares of land containing $500 million dollars worth of trees.

Ultimately this vast land bank ultimately counted for little when a rising AUD dramatically reduced woodchip sales to Japan and the company's debt load became unsustainable. Gunns became an asset rich and cash flow poor company that was unable to control its own destiny as they were unable to sell off assets quickly enough to pay current liabilities during stressful market conditions.

Lesson: You can't eat assets, cash flow is king

Earnings are reliant on the status quo remaining

One of the weakness all analysts have is extrapolating the future based on the past and assuming that recent conditions will remain so for the foreseeable future. Earlier on in my career I invested in ***Shermag*** a Quebec-based furniture manufacturer. At the time the company was a thriving manufacturer of wood furniture with 90% of their sales going to the USA, where their quality and modern designs allowed the company higher margins than Chinese imports and US domestic furniture manufacturers. At the time I assumed that the currency would remain within historic ranges (CAD/USD between 0.65 and 0.75), however the commodities boom pushed the Canadian dollar to parity with the USD dollar. As Shermag's costs were mostly fixed in Candian dollars, its furniture became 30% more expensive within a short amount of time for 90% of its customer base and at the same time the quality of Chinese furniture improved. The mistake that was made here was that the company was overtly reliant on one set of customers (US furniture stores) and a weak Canadian dollar. The company went bankrupt in 2008.

Lesson: Stress test your assumptions, how robust is the company's business model

The Market can remain wrong longer than you can remain solvent

Unlike owning a stock that is heading in the wrong direction, if you have short sold a stock with the anticipation of it falling and it rises, ever increasing amounts of money are required to be posted to the short seller's margin account. These are funds that are unable to be invested elsewhere and represent a drag on performance. The father of modern macroeconomics Keynes once famously said that "*markets can remain irrational a lot longer than you and I can remain solvent*''. This quote particularly resonated with me after an unprofitable short selling of ***Fortescue*** in late 2007 due to concerns about the over-valuation and debt situation of the company. This trade was put on at $50 per share in late 2007 and then was closed out at $70 four months later as the price continued to rise with no signs of slowing momentum. Whilst our investment thesis was ultimately correct (it fell to $20), we were too early and unable to handle the pain of a steeply rising stock and the associated losses and increasing margin calls.

Lesson: Set firm limits on exit prices and loss limits

Anchoring

Anchoring refers to the investing tendency to rely on the first piece of information offered when making decisions. These pieces of information can range from an entry price to an investment thesis such as growing Chinese demand for iron ore. In this case an investor may say "I bought QBE for $20 and it has declined and I know the business faces more challenges, but it is a blue chip stock and I will wait till it gets back to $20 before I sell it". Here the investor anchors their decision based on a past number, rather than a valuation based on the prospects for the business going forward.

To combat anchoring bias, a range of funds have strategies where if a stock declines by a certain percentage, the position is automatically sold. If the fund manager continues to want exposure to the company in the portfolio, they can re-examine the outlook for the company with much less emotion.

Lesson: The market does not know your entry price, it values a stock based upon future expectations and market emotions

Big Winners

In the mid 2000s ***Incitec Pivot*** went from a sleepy fertilizer manufacturer (at the time 70% owned by now arch rival ***Orica***) who's share price was consistently around $12-$17 to a $100 and then to almost $200 per share company. This occurred due to the combination of a fortuitous purchase of an unwanted phosphate plant from BHP and a dramatic increase in the fertilizer price due to an artificial step change in the demand for corn. This step change in fertilizer prices was fueled by the construction of ethanol plants in the US; designed to both subsidize famers in Iowa and reduce dependency on Middle Eastern oil. Though this time the fund that I was helping to manage owned almost 5% of the company and I was the analyst responsible for overseeing the position.

As the stock rose so did my standing in the firm and in hindsight I became too close to the company's management team as they had made my investors a large amount of money. When the time came to critically evaluate whether to sell the position; I was not as objective as I should have been. The GFC and the development of the US shale gas industry caused the "Dot Corn" bubble to be pricked along with ***Incitec Pivot***'s share price, and culminated in a deeply discounted rights issue being priced at the equivalent price of $50 (adjusted for a stock split).

Lesson: Don't love a stock, as it is not worthy of your affection

Our Take

Every investor makes mistakes, but these mistakes offer more lessons than stocks that went up several hundred percent. Indeed when professional fund managers get together, the talk is rarely about successful investments, but rather situations where we misread the outlook or did not pick up the clues that management were not telling the truth. Like all investors we feel the pain of the downside, more than the gains, mainly because poor performing stock picks require explanations to hostile investment committees and asset consultants. We see that investing is a game of inches where outperformance ultimately comes to those who make the fewest mistakes over time. I believe that some of the mistakes that I have made in the above paragraphs have helped us either avoid or short sell some torpedo stocks over the past few years.

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