Investing by the Numbers

If you could invest successfully by the numbers, anyone with a computer would be rich. That is not the case at all. Therefore something must be amiss.

Let's play with numbers. Historically, the market has grown by about 12% a year over the long run. In theory, if you get a 12% return on your money, you are an average investor. It makes no sense to work you ass off for an average return if you can get it by buying index funds. To be an active investor you have to set your sights higher, at say, 15% a year. For you to get 15% while the market gets 12% means that someone is underperforming the market. Simple irrefutable logic.

WALDO's theory seems to be that there are bunch of idiot monkeys out there (many of them right here) and that it is a cinch to take candy -- bananas? -- away from them. All he has to do is play the numbers which the monkeys are too dumb to play. His game plan seems to be the following: Split stocks into three groups, undervalued, fairly valued and overvalued and play each group accordingly -- go long on undervalued stocks, neutral on fairly valued stocks and short on overvalued stocks. For whatever reason, he has chosen to play the Telecosmic stocks, but by his own admission, it could have been any other group of stocks. This logic is perfect provided two things come to pass.

1. Your fair value calculation is on the money, and
2. Everyone else is wrong today, but after you take your long or short position, by magic, the monkeys will realize that you were right in the first place and will change the stock price accordingly.

BTW, the second part of the equation is one of the motivations behind the pump and dumpers and the bashers. They are trying to goad the monkeys in the right direction.

How do you calculate fair value? WALDO has given us a formula and Warren Buffett has another one based on the present value of all future cash flows which you can read about in "The Warren Buffett Way" by Robert G. Hagstrom. Warren Buffett does not do it mechanically even if he uses certain fixed parameters. His most important input is an estimation of the growth possibilities of the company. The reason he does not buy technology companies is that he admits that he does not understand their business models and therefore he cannot estimate how they will make money in the future. So he sticks with businesses he does understand, like soda pop, razors, news publishing and insurance. More on insurance later. From the discussion so far, it becomes clear that Warren Buffett does not invest by the numbers alone. He has a big influence on the numbers to be used, his vision of the business, which accounting, even the ones approved by the SEC, the IRS and the mayor auditing firms, do not provide (actually, GAAP can be a mayor hindrance in your understanding of a business and Buffett does some massaging of the numbers before plugging them into his formulas).
The formula for fair value that WALDO has given us is strictly a mechanical one that any computer can follow. Also of note, Peter Lynch, another very successful investor, uses the numbers for confirmation of his other investigations which are mostly of the personal market study type -- sleep in the beds, eat the food, wear the clothes -- done by himself and his immediate family. The Gorilla Game also has some interesting and rather more complex views about Competitive Advantage Period (CAP) and Competitive Advantage Gap (GAP) but no metrics for converting them into a calculated "fair value" number. From all this I conclude that the method of calculation used by Warren Buffett is the preferred one and it is fairly simple.

OK, the fair value calculation is difficult, uncertain but possible. How about the second point, making people change their minds so as to make them buy or sell, as the case may be, to get the price to match our expectations? Long term, stock prices will be governed by earnings, earnings and earnings. People like Warren Buffett and Peter Lynch invest with this truth in mind. But traders need to have the market or particular stocks swing up or down depending on their long or short positions so that they can trade in and out. Jesse Livermore, the greatest speculator of them all, describes in "Reminiscences of a Stock Operator" how to manipulate a stock for bull and for bear but with the caveat that you cannot really fight the tape. You can help it along but not fight it. Our traders could sit and watch the tape until the inevitable, according to them, happens. In other words, until the price matched the fair value, to close out the position. If they are also pump and dumpers or bashers, they will not sit idly waiting for the tape to come to them. They will actively pump and dump or bash to push the monkeys or to herd the sheep to their desired ends.

There is a more respectable crowd out there manipulating stocks. They are called analysts, bankers, brokers and such. How do they work? Let's take a stock which is rising. They notice the rise and decide to take advantage of it. They buy some stock and put out a buy recommendation. This combined action, of course, raises the price of the stock. Based on this good performance, they raise their recommendation from buy to strong buy and buy some more. The stock improves some more. At some point the stock cannot go higher because it has exceeded all reasonable valuations. At this point the analysts downgrade the stock and sell some. As the stock weakens, they downgrade it some more and sell some more. Once the stock reaches rock bottom, the cycle is repeated. Notice the beautiful legality of this system: while they are upgrading the stock, they are buying it and when they are downgrading the stock, they are selling it. Perfectly legal! It's the opposite that's not legal, to pump and sell.

Let's have a look at the bashers. These people are speculators and they have studied Jesse Livermore. They are looking for stocks that are overpriced to play them for bear. This is easiest in a bear market when everything is trending down. Now you know why bashers come out of the woodwork in bear markets. Take any stock with an elevated P/E ratio and it is probably ripe for a bear ride. The people who got in early bought at such a low price that they will not be too bothered by a relatively small (for them) drop in the price. Many of the late comers, on the other hand, bought high. They are ripe for manipulation. As the price drop
they hurt and worry and the more the price drops the more they hurt and worry. Now the basher insults them to get their attention, that is the only purpose of the insults. Once he has their attention, the basher explains how the stock in question, which they bought high, is really a dog with no future and that the tout that got them into it is an unscrupulous idiot who only wants to get rich with some idiotic, high sounding snake oil, for example: Telecosm. Even if the tout was right at some point, "He lost it, man, he lost it!" When you combine the pain of the loss with the pain of being forced to recognize a mistake, is is easy to sell the victim a story. "You my dear pal, are a victim of this unscrupulous snake oil salesman." "Let me help you dump the stock before you lose it all." "I am here to save you." "I am the voice of reason." "I am the voice of sanity." "I am your friend." As the victims dump their stocks for a loss, the price drops some more and the basher can close out his short position at a nice profit.

Up to this point, our victim had bought high, let's call it an unfortunate coincidence. He has now sold low as a result of the basher's efforts. Now what? Some time soon the market has to turn and our victim wants to get back in. But it is not enough for our victim to have an ordinary profit, he also has to make back what he lost on account of the tout. Slow, steady, safe stocks are too boring for our victim, he needs to make a killing. Penny stocks and pump and dumpers come into play. The pump and dumpers buy some very low CAP penny stock, force the price up and go hunting for their victims. "Look at this stock go!" "It has gone up 30% in less than a week and this is nothing." "They have this wonderful product..."

Has anyone seen any pump and dumpers lately on the forum? Of course not, dummy, we are in a bear market! Wait till the bulls start to run and we'll have the pumpers back and the bashers will go into hibernation.

And that is the story of investing by the numbers.

I promised that I would talk about insurance. If you look at Warren Buffett's portfolio you will see several insurance companies. And if you read the book "The Warren Buffett Way," you will find that they are not run like ordinary insurance companies. Their purpose is not so much to make money from insurance but to provide capital for Buffett to invest. In the insurance business you collect a lot of money in premiums, spend some to operate the company, spend some more on agent commissions and keep the rest to pay off the loses your customers will eventually have. But, until you have to pay for claims, you can use the money to invest, and that is what Warren Buffett does. The money you have for investing is called a "float." The really important thing for an insurance business, besides not losing too much money on claims, is to produce the float at a low cost. This money should cost less that what you would have to pay for it in the credit market. Float is good!

Warren Buffett has other ways to produce a float. He also has a company that deals in trading stamps. Blue Chip Stamps provides supermarkets and gas stations with trading stamps which they in turn give to their customers to collect in books and eventually trade in for merchandise. To purchase this merchandise, the supermarkets and the gas stations create a pool of money, or float, which Blue Chip Stamp manages. Of course, until it is needed to redeem
the stamps, Buffett uses the float to buy shares or companies.

The Buffett portfolio also includes banks and savings and loan associations. All of them produce float.

Finally, it is interesting to have a look at Buffett's management style. It is totally hands off. He lets his managers run their businesses any way they like with the exception of capital allocation. This last he reserves for himself. He makes sure that each one of his businesses uses the least amount of capital, just what is necessary to keep them operating profitably. All the rest of the cash is used for investments.

The main reason I have bought to light Warren Buffett's interest in float and investment capital is to stress the importance of cash management for investing. All your cash should be working for you, and not for a bank or for another financial institution. This is the reason I keep saying that a small amount of margin is profitable for your portfolio. It should be clear that there are times when the bear market is so pronounced that actually having cash can be a blessing. But that is the exception.

Happy investing!

Denny

"Demand creates queues. Supply gets rid of them."