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## The Catch- 22s of Investing

We all know that P/E is quite meaningless because it is being manipulated by management to influence journalists and analysts. But we also know that lots of people ignore this manipulation and use P/E as a principal investment tool. Warren Buffett likes to talk about the risks of high P/E stock and when Buffett talks lots of people listen. So Catch-22 -- P/E is useless but it still rules investment decisions.

Brian Arthur points out that positive feedback and not negative feedback<sup>(1)</sup> is what controls economics. Classical economists hate the thought because, with positive feedback, the economy is not predictable a la Isaac Newton and gravity. We, as investors, even if we have read Arthur and believe in his ideas about economics, we still try to forecast the price of stocks some time in the future. So Catch-22 -- forecasting is impossible but it still rules investment decisions.

Discounted Cash Flow is the best way to evaluate the "fair" value of a stock but the source of the data for doing the calculations is GAAP or "pro-forma" accounts, both modern forms of sanctioned lying. So Catch-22 -- the data for calculating DCF is not available but DCF still rules investment decisions.

Stock price charts have in them the history of the investing community's mood changes over time. Our problem is that we really don't know how to read these charts in a meaningful way. So Catch-22 -- we don't really know how to read stock price charts but some people still invest by them so technical analysis becomes a self fulfilling prophecy.

What to do?

The object of investing is not to be right but to make money. We have to examine what successful investors do. Two of my favorite (and rich) investors, Warren Buffett and Peter Lynch, use very simple systems. Both insist that they have to understand the business before they go any further. Before you say that this is passé, remember what [The Gorilla Game](#) requires of you to become a gorilla investor: "You have to understand the technology and you have to understand

investing." I think we can accept that as rule number 1:

**"Understand the business of the company you plan to invest in."**

As far as I remember from reading [One up on Wall Street](#), Peter Lynch does look at Financial Statements in an abbreviated manner and he does look for free cash flow but he does not do convoluted calculations. He tries to find companies that don't have to spend much on R&D, that don't need expensive assets to produce a profit. That, of course, leaves out most high tech companies from his portfolio.

Warren Buffett does calculate discounted cash flow but he too simplifies things. He uses the 30 year treasury rates and does not add a risk premium figuring that the companies he is evaluating don't present extra risk. If they did, they would have been dropped by the time he gets around to DCF calculations. Basically, Buffett guesstimates future cash flow from data in the financial statements. But he also has close access to top management which the rest of us will never have. For a more complete analysis of Buffett's calculation methods, please read [The Warren Buffett Way](#) by Robert G. Hagstrom or [Buffettology](#) by Mary Buffett, his ex-daughter in law.

The Gorilla Game does talk about more complicated things like CAP and GAP but there are no formulas for calculating them. Instead, Moore relies on the mantra: "Open Proprietary Architecture with High Switching Costs" and the book goes to great lengths to explain why this mantra should produce extraordinary returns for the gorilla investor. The mantra is supported by Moore's specialized knowledge of high tech marketing as described in [Crossing the Chasm](#) and [Inside the Tornado](#). So, once again, we have someone with an intimate knowledge of how certain businesses are run producing a winning investing strategy.

Rule number 2 deals with our ability to quantify the risk/reward ratio offered by companies whose business we understand:

**"Do some form of discounted cash flow calculation on the investment candidates that you like."**

Many Wall Street types don't want to know about how to run a business. All they want to know is what stocks to buy. These people rely on technical analysis as their main investing tool. Before you skip this part in disgust, let me tell you that

stock price charts have in them the history of the investing community's mood changes over time. Our problem is that we really don't know how to read these charts in a meaningful way. Jesse Livermore, one of the most colorful stock operators of his time, started his career as a quotation-board boy in a stock brokerage office. He tells us in his autobiography, [Reminiscences of a Stock Operator](#):

"I noticed in advances as well as declines, stock prices were apt to show certain habits, so to speak. There was no end of parallel cases and these made precedents to guide me. I was only fourteen, but after I had taken hundreds of observations in my mind I found myself testing their accuracy, comparing the behavior of stocks to-day with other days. It was not long before I was anticipating movements in price. My only guide, as I say, was their past performance. I carried the 'dope sheets' in my mind. I looked for stock prices to run on form. I had 'clocked' them. You know what I mean."

Unfortunately for us, Jesse never said what his secret method was. But it does lead to rule number 3:

**"Find good entry and exit points for your stocks based on what the market is doing."**

In the near future I will be working on rules number 2 and number 3. Actually, I have worked out a discounted cash flow method that seems satisfactory at first glance but I would like to test it against reality before writing up the details. Regarding rule number 3, I have been working on a mechanical trading system that relies solely on price fluctuation to make its buy and sell decisions. I have to give it a stock universe to work on. In the experiments that I have carried out so far, when the trading system was working on a group of known well performing stocks based on 20-20 hindsight, the results were spectacular, they left Warren Buffett in the dust. On the other hand, when the system was working on a random selection of stocks, it produced a small loss more or less equivalent to the commission costs of the trading. What this means is that the system must be fed winners and those winners must be selected according to rules number 1 and number 2.

Stay tuned!

Denny

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

[Software Times](#)

(1) Negative feedback is what keeps systems in equilibrium. When a system, for any reason, leaves the equilibrium state, negative feedback bring it back to equilibrium. In classical economics, supply and demand tend to equilibrium., they tend to balance each other out. The easiest way to picture negative feedback is to think about the "governor" on James Watt's steam engine. It consists of two iron balls attached to a rotating shaft by hinged arms. As the engine speeds up (too much steam or too little power usage), the faster rotation swings the balls outward. As the engine slows down (too little steam or too much power draw), the slower rotation lets the balls fall and move in. This in and out movement is transmitted to a valve which allows more or less steam to enter the condenser regulating the speed of the engine.