US Edition

Inside the Minds of Guru Investors

The secrets of how eight guru investors made a fortune from the stock market.

Inside the Minds of Guru Investors - USA

The secrets of how eight guru investors made a fortune from the stock market

Ben Hobson

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Investing inspiration

As Strategies Editor at the stock market research platform Stockopedia, I'm in a fortunate position. For several years I've had the advantage of spending most of my time reading and writing about what works in the stock market. Most individual investors simply don't have the time to do that.

On my investing journey, I've read a range of academic studies, professional research and investment books. Armed with that insight, it's my job to show individual investors how to turn abstract and unfamiliar ideas into practical, profitable reality. In other words, to build sensible, rules-based investing frameworks that they can live with in good times and bad.

Anyone who has spent time researching the stock market knows that there is a huge amount of information and commentary out there. But for me, the most inspirational sources of knowledge have always been successful investors themselves. There isn't much that compares with the reflections of investors who have fought the market and won.

In eighteen years as a finance journalist I've interviewed hundreds of company owners and managers about what makes a successful business. But to paraphrase Warren Buffett, himself one of the world's most successful investors, great businesses don't always make great investments. For that reason, the suggestions and guidance of successful investors on how to make great investments are incredibly valuable.

In my role, I'm fortunate to be able to access the kinds of guru investors in this book. These interviews have been published as part of the Stockopedia service for our membership. In the case of each investor, they were willing to share their expertise with me,

knowing that I would in turn share it with a much, much wider audience.

But this is only the start. More interviews in more countries are on the way. You can keep up to date with those forthcoming interviews by following me here: https://www.stockopedia.com and here: https://twitter.com/BenJamesHobson.

I hope you find the interviews as useful and entertaining as I do.

Ben Hobson
December 2018

Inside the minds of great US investors

This book is a guide to how some of the most influential investors in the United States succeed in the stock market, and what you can learn from them.

Having compiled a series of interviews with British investors in 2017, it made sense to do the same in the States. After all, America is home to some of the world's most respected investors and it's where some of the most influential investing strategies were conceived. What was uncertain was whether any of the US investors I'd shortlisted would talk to me. Happily, it turned out they were.

During weeks of planning in early 2018 I set up meetings, lunches, coffees and, alarmingly, a gym session with all but one of my target list. Scheduling them into one trip, taking in New York City and Los Angeles, meant there was a lot that could go wrong. Would these people even be there when I turned up in places like Manhattan, Philadelphia, Venice and Playa Vista?

One Thursday afternoon in June, two days before I was due to fly, I got a phone call from a PR lady who was interested to know why I'd been pursuing (to no avail) one of her clients for the past few months.

After a lengthy explanation and a back and forth of emails, we agreed the terms of an interview that I never thought would happen. At 10am the following Monday - less than 48 hours and a transatlantic flight later - I was sitting with the legendary value investor Joel Greenblatt in the boardroom of his New York City office.

That was followed by meetings with a genuine legend of quantita-

tive investing, an investment advisor and finance media celebrity, and several other influential names from an exciting new generation of successful stock market investors.

Learning from the best

While their styles and strategies vary, they all have similarities. Some of these investors focus entirely in quantitative approaches, while others take a more qualitative view. But they all revile the bad behaviour of old-school Wall Street and all put considerable importance on integrity and authenticity. They are focused on low-cost, common sense investing using strategies that are driven by data. By sharing the highs and lows of their journeys, they offer some fascinating insights for anyone with aspirations of building wealth from the stock market.

One of the overarching themes of this book is how investment strategies based on simple principles are often the most effective. With a sound strategy at hand, it's much easier to maintain the kind of discipline needed to stick with it. That's arguably what really sets the most successful investors apart.

The investors in this book include Joel Greenblatt, James O'Shaughnessy, Wes Gray, Barry Ritholtz, Todd Wenning, Meb Faber, Toby Carlisle and Mark Minervini. To varying degrees they all work in the constant glare of one of the most scrutinised industries on the planet. It's where every move is watched, every trade is analysed and return performances are constantly under the microscope. What marks them out is that they are all very aware of the behavioural flaws that can derail investment performance - and the importance of avoiding those errors.

What's in this for you?

Behavioural psychologists have found that humans are often ill-suited to investing. Emotional flaws, biases and cognitive errors can hamper the sorts of cold-hearted decisions needed to win in the stock market. Yet just knowing about these pitfalls can put you on the road to overcoming them.

So reading about the experiences, the strategies, the hopes and fears of successful investors is both entertaining and illuminating. They offer a snapshot of how some of the best investors operate. They illustrate how to build and refine an investment strategy and then apply it consistently. And they show how long-term outperformance can be achieved with commitment, humility and good humour.

Joel Greenblatt - A magic formula for stock market investing

There aren't many Wall Street legends who command respect like Joel Greenblatt. After starting his money management firm, Gotham Capital in 1985, he and his business partner, Rob Goldstein, spent the next decade delivering returns that took Wall Street by storm.

Yet the nature of Greenblatt's strategy meant long periods of super-high returns would be interrupted by spells of underperformance. For him, these periodic drawdowns were simply a mathematical consequence of running concentrated value portfolios. It was a philosophy inspired by his original investing hero, Ben Graham.

While Greenblatt was content to ride these waves with his own money, it was harder to do the same for others. So, in 1994, he wrapped up the first chapter of his investment career by returning Gotham's outside capital.

In the years since, he and Goldstein have continued to pursue their strategy of buying good, cheap stocks and selling expensive junk. They've also built a suite of new long and long/short funds that are less volatile and once again opened the doors to external capital.

While Greenblatt's investing skills have earned him superstar status, he has also spent his career sharing his expertise with individual investors everywhere.

In a series of books – including the hugely popular 'Little Book That Beats the Market' – he outlined an incredibly accessible and intuitive investment strategy based on his favoured principle of focusing on 'good' and 'cheap' stocks. He called it the Magic Formula, and it is arguably responsible for educating a generation of investors about how a blend of value and quality can be used to construct portfolios that outperform on average.

I met Joel Greenblatt at Gotham Asset Management's offices in New York City first thing on a sunny Monday morning in June. We'd only agreed the precise details of the interview the previous Friday. Happily, he seemed to overlook being presented with a slightly flustered British guy and was thoughtful, funny and generous with his time…

As a college student, you were much more influenced by the work of Ben Graham than you were by the academic concepts around efficient markets. How did the way you think about investing begin to take shape at that time?

That's a good question. I would say it really took shape after my junior year, when I read an article in Forbes about Ben Graham's stock-picking formulas. His view was that stocks are either too high or too low at various times, and that markets are somewhat emotional about it. That concept resonated with me immediately. If you looked in the newspaper at that time, there were 52-week high and low lists for pretty much every company. In each case, the high was double or triple the low, but it never made sense to me how that would be accurate and efficient at every point.

In general, I think academic study is about solving the hardest math problem, rather than discovering the most useful thought process to have. I had that epiphany when reading Ben Graham for the first time, and haven't wavered in my opinion since then.

I started reading everything that Graham had written, which led me to Warren Buffett. At the same time, everything I was learning in school really made very little sense when I boiled it down, after I got done with the math. I almost immediately realized that, to me, the teachings of Graham and Buffett made sense, while everything I was learning in school made no sense.

It sounds like you made the decision early on that you were intent to start managing other people's money as quickly as you could. What were the pivotal moments in those early days?

I always knew that I was going to work for myself. I saw what the working world was like and I didn't want to get paid by the hour, I wanted to get paid for my good ideas.

When I was in business school at Wharton, I ended up writing a paper with two of my good friends: Rich Pzena, who is a large value manager and whose board I sit on, and Bruce Newberg. We conducted a study together that actually updated Ben Graham's stock-picking methodology. It was published in The Journal of Portfolio Management and it was our Master's thesis. All this said, I was smitten with money management right away – I knew it was right for me and knew what I wanted to do after first reading Graham.

While you were quick to move into money management, you returned to teach investing classes at Columbia University in New York City. Why has that been so important to you?

From early on, I always wanted to write and teach. That said, I never expected a career in academia, I just thought it would be a fun avocation.

Then, after I returned our outside money at the end of 1994, I began co-teaching a class at Columbia. One of the things that appealed to me about that class in particular, was that it was called 'Security Analysis,' which is the class that Ben Graham taught when he was at Columbia, and the one that Warren Buffett took. Little did I know I would end up continuing to teach that class for five years. I went

on to teach a 'Value and Special Situation Investing' course, which was part of a Value Investing program Columbia launched under Bruce Greenwald. I've been teaching ever since.

When you closed your original fund to investors in 1994, it marked the end of what was really the first chapter in your investing career. What led to that moment and what happened next?

When I got into this business, I was wired as a gambler and my partner, Rob Goldstein, who joined me in 1989, was wired the same. What is good about our partnership is that we are both cynical about businesses. We never did anything that one of us didn't like, and all of our investment decisions were mutual. That was a nice check and a nice discipline to have.

The other discipline we had was managing outside capital. In some sense there's a value to managing other people's money because there is more of a discipline involved. I think it's good to run scared, and other people's money helps you do that because you don't want to lose it.

All in all, during those 10 years, we had success and I really enjoyed it. Before fees, we earned 50% a year returns (30% net of fees). We knew it wasn't going to get much better than that. We thought we'd done well, and well is good enough.

Nevertheless, there were always periods every two or three years where there would be big downward draughts on the portfolio. One of Howard Marks' best quotes is: "Experience is what you got when you didn't get what you wanted." That was the attitude I had when I lost my own money. The draughts never bothered me, but they did bother me when I was managing other people's money.

By 1994, we had done well enough to keep our staff, return outside capital to investors and continue to run our own internal capital. I had felt that it was foolish to be doing what I loved, but not be having as good a time as I could. I was also beginning to grow a family and wanted to spend time with them. So all these things

came together, and I just thought, “Why don’t I set things up the way I’d like?”

The investors weren’t happy when I returned the money, but it just seemed like the right thing to do and I was very happy I did it.

An important feature of all this is that while you were hugely successful in your investing, you were also writing books about it, predominantly for individual investors. What led you to do that?

I had written the book ‘You Can Be a Stock Market Genius’ in 1997, which was really just a series of war stories from our first decade running money. In that book, I looked at the lessons we had learned and what we’d been thinking about at the time.

I had also just begun teaching when that book came out. I’d written it in a friendly style, but I had made some assumptions about what people knew about the market and investing. As soon as I walked into my first day at Columbia, I realised that I had really written it at an MBA level and that it wasn’t fully accessible to readers. Hedge fund managers thanked me for it, but that wasn’t my goal. Like Ben Graham, my goal had been to share what I knew for a broad audience. Unfortunately, I assumed that everyone already knew about the things I was discussing in the book.

Looking back, what led me to writing my books began with the research and testing that I’d done with my friends in college, which boiled down to figuring out what a stock was worth, buying it for a lot less and leaving a large margin of safety. It was what Ben Graham had done. Warren Buffett added a little twist that made him one of the richest people in the world. He said if he can buy a good business cheap, that’s even better. My friends and I had evolved much more towards buying good businesses cheaply.

So, in the same way that we had tested and updated Ben Graham’s work in college, in the early 2000s Rob and I started doing some more computer testing. We wanted to find a more sophisticated

way of doing what I had been teaching my students and what Rob and I had been doing to make money over the years.

The very first thing that we tested – a crude metric for "cheap" and a crude metric for "good" – came out well. It was that very first test that I wrote about in 'The Little Book That Beats the Market;' I thought it was a great proof point that buying cheap, good businesses made sense over time. To be clear, it still wasn't an easy ride, which I view as good, because if the formula worked every day and every month and every year, everyone would use it. But over time, the principles made sense. All in all, if you stuck to the formula over a period of time, you could do well.

When we did those first tests, I said: "Wow." I finally felt I could explain my formula for stock picking very simply to people, and more importantly, that people would understand it. I was excited to write 'The Little Book,' and so, it just came out of me. I combined my years of teaching at Columbia and learning with the test, which demonstrated the basic principles worked, to write the book and share it. While it probably took only a year to write, it really took 20 years of thinking.

Apart from exploring the power of blending value and quality, what do you think the most important ideas in 'The Little Book' really are?

The great thing about the Magic Formula is that when you look over a large number of years, you can see that it worked quite well, yet also examine the pain that happened in that great period of performance.

I wrote another book, called 'The Big Secret for the Small Investor', and I'm always saying it's still a big secret because nobody bought it. In that book, I utilized a study of the best money managers for the decade 2000-2010 to examine who had the best ten-year record. Forty-seven percent – so about half – of those that ended the period with the best ten-year record, spent at least three of those 10 years in the bottom 10 percent of performance. The idea of the book was

to explain simple principles that would carry one through the tough periods of time – the times when one may consider pulling their money rather than sticking it out and riding the losses in hopes of future gains.

I like to use the analogy of a house, where if you're buying a house, and to keep the number simple, they're asking a million dollars for the house and you have to figure out whether it's a good deal or not. So there's a few questions you'd probably ask. The first question you'd ask is, "well if I rented out this house, how much could I get for it?"

So that's the first question we ask for a business, you know "how much cash flow, how much earnings am I going to get for this house relative to the total cost of the house including liabilities, whether liabilities are on balance sheet, off balance sheet, what's my all in cost to buying this business? And what kind of cash flow am I going to get for it." With the house, it's "what's the cost of the house, and how much annual cash flow can I get from it? How much could I rent it out for? "

What's the next question you'd ask if you were buying a house? The next question you'd probably ask is "hey, what did the other houses on the block go for and the block next door and the town next door?" And that's what we do. "How relatively cheap is this company relative to all our current choices?"

In the stock market, however, there are daily quotes and you're getting bombarded by constant news, which can be seen as challenging, but illustrate that the market is possible to beat.

You can take the view that other people don't have a time horizon, they don't have a home base and they don't have a true north. If you have a true north, though, and you can actually value businesses, or in the case of 'The Little Book', you know that on average you're owning good, cheap businesses, that might help you push through. I wanted to share that idea with others.

The Magic Formula was really ahead of its time as a factor

model that individual investors could understand and use when you first introduced it. Tell me about your personal approach to applying value and quality in the stock market?

The results in 'The Little Book' are based on what I call the 'not trying very hard' method. We took crude metrics, a crude database and used crude methods to put those measurements together – and it worked incredibly well.

My partner Rob and I turned to each other and said, 'You know what, we actually know how to value businesses. As opposed to the 'not trying very hard' method, we know how to try, so what if we did that?' At the get go, there was no plan to take outside money, we were just going to develop something for ourselves, so the building of our business was really an evolution.

I'd say there's less than one percent of people who are pretty good at valuing businesses and who are seeking to invest. That's the truth. How we think about valuing businesses is that the value in businesses is the discounted value of future earnings. If you think of a discounted cash flow formula, and you move your discount rate one or two percent, and you move your growth rate one or two percent, you can double or half the value of a business.

Really what we're doing is looking for normalised earnings and whether the growth rate in a business is going to improve. What I always ask myself is, can you beat the risk-free rate? There's no point in investing if you can't beat the risk-free rate. And I use a high one. I think rates are below normal, so in my mind I use a 6 percent risk-free rate. I actually wrote that in the book and I still use it.

If I buy an equity, I have to believe it will beat a 6 percent risk-free rate. That doesn't mean that you can't buy something with an earnings yield of 5 percent, it just means that you better believe it's growing over time in order to beat that 6 percent constant threshold.

So, gauntlet number one is that anything I buy should be expected

to beat the risk-free rate. Once you get past that, what you're really doing is comparing companies against each other. What are the cheapest companies you can buy? You can compare two companies to say, does this one perform better than that one on these scores?

At Gotham, we've assembled a team of 13 researchers who have developed a sophisticated way of balancing risk that hopefully allows us to get to the long-term value with the least amount of pain. At the end of the day, it's really about putting together cheap and good portfolios. We manage both long-only and long/short portfolios. With the long/short, we use leverage, so we have to balance our risk. As a value investor, you can say: "Ah I'm down 30 percent, that's fine." But if you use leverage and you go long/short, that's not fine! Instead, you must have a sophisticated way to balance the risk in your portfolios.

At Gotham, we have a seven-person tech team that supports that effort. Importantly, this team doesn't know anything about investing, and we did that on purpose. We believe that makes them even more qualified to help us look at the kind of risk to take in our long/short portfolio, and figuring out good metrics. All in all, they're crucial to helping us decide how much risk to take in a strategy based on how much leverage we have, how much exposure to the market we have, and whether our exposure is in large-cap equities or all-cap equities. It's a fun project.

People ask me: "Why do you own hundreds of stocks on the long side and hundreds of stocks on the short side when you did pretty well with the methods in 'You Can Be a Stock Market Genius'?"

The answer is that there's nothing wrong with what Rob and I did together for close to 20 years, and what I did for 28 years. There are just different ways to make money. The main difference for our investors is that on our "bad days," we're not losing 20-30 percent of our net worth. Instead, we may be underperforming by 20 or 30 basis points. While there is a clear difference between our past strategy and current strategy, I do not believe one is better than the

other. Rather, one strategy is more appropriate for outside investors and the other is more appropriate for either managers themselves or for very sophisticated investors with a very long time frame, which in this investment world is very rare.

Given the discipline needed to execute a value strategy, and the need to take a long-term view, do you still think it's a viable route for individual investors?

It's certainly been a fascinating ride for me to learn how to take the principles I had used in concentrated portfolios and apply them on a more general basis. But that said, I think there's a place for both strategies I've deployed. I still give some of my money to people who do what I used to do, and I teach my kids those same methods. One's not good, one's not bad, one's not better or worse. They are different ways of applying value principles for different types of risk profile.

I gave a talk at Google a little over a year ago where I mentioned that even Warren Buffett said most people should just index, and I said I agree with him. But then I said, "Hey, Warren Buffett doesn't index and neither do I – how come!?"

If you have an ability to pick stocks, or understand what you're doing, which most people don't, there is an opportunity for long-term value investors. People are very emotional and that's never going to change. I always promise my students on the first day of class, that if they do good valuation work on a business, the market will agree with them, I just never tell them when. It could be a couple of weeks, it could be two or three years or sometimes longer. That's really the way to think about it.

If you have a home base, you can be very selective and pick only the companies you understand and are able to value, you just might have to do a lot of work to find a few names that are undervalued significantly enough to make you want to take that position. You have to be patient, but if you find one good idea every two or three months, you'll have a full portfolio after a little while.

So you think it's important for investors to be really conscious of the extent of their capabilities, both in stock selection and their capacity to ride the rollercoaster of returns?

You know, Warren Buffett talks very appropriately about a circle of competence. You can learn over time what you're good at valuing and what you're not as good at valuing. I always say to my students: "What do you do if it's hard to figure out what the competition will be, whether the new products will work out or what the earnings will be in a few years? How do you approach that?" I always following up by saying: "Skip that one, and find one you can figure out." Buffett calls it 'one-foot hurdles,' and that's what I'm always looking for: easy ones.

I opened 'You Can Be a Stock Market Genius' with a story about my in-laws, who used to live in Connecticut and on the weekends would shop at antique sales and country auctions. If they found a painting, they didn't say: "Hey, is this guy going to be the next Picasso?" They wouldn't ask that because that's a really hard question to answer. What they asked is: "Hey, did a similar painting by the same artist just go up for auction at three times this price at Sotheby's, and can I now get it for one third?" That's a much easier task, and that's sort of the way I look at investing. Look for the easy ones.

Joel, thank you very much for your time.

James O'Shaughnessy - Rewriting the rules of stock market investing

James O'Shaughnessy is one of very few investors who can truly lay claim to having changed the way people approach the the stock market. He's also one of the nicest and most engaging people you could hope to meet.

O'Shaughnessy has spent more than 30 years researching equity market returns. His work has brought to the fore the power of what he calls 'fundamental quant'. His groundbreaking studies became a relentless pursuit of the factors that are most commonly associated with outperformance. And from that he built a fund management business with nearly $7 billion under management.

For most professional money managers, those achievements would probably be enough. But O'Shaughnessy is remarkably altruistic. Despite lucrative offers to keep his research private, he presented it to the world.

As the author of four books, it was the second - What Works on Wall Street - that transformed his career and very likely the fortunes of many others. In four editions published between 1997 and 2012, he set out his findings on how elements of value, quality and momentum combine to work in investing.

What set him apart was a willingness to follow the data, even if it meant tearing up previous conclusions. What he was left with was a set of strategies that he could stick with in good times and bad.

O'Shaughnessy's benevolence - his readiness to share his knowledge - is in his genes. His grandfather built what was once one of the world's largest privately-owned oil company before giving away 95 percent of his fortune during his lifetime. In fact it was the family debates on how the enduring foundation should be invested that first got the 17-year-old O'Shaughnessy into studying markets.

Back then, all he had was a Value Line subscription, a large paper spreadsheet and and a book on the Dow Jones Industrial Average. Some years later - after finishing college and getting married - he returned to those studies. With the help of computers and the advent of Morningstar, he started taking much deeper dives into the market.

Jim told me this story when I met him at a suitably exclusive, yet surprisingly relaxed and rules-free club in New York City. Having recently passed the leading role at O'Shaughnessy Asset Management to his son Patrick, I got the impression that he was very much enjoying a slightly more relaxed life...

Jim, what was the journey that took you from studying markets to actually investing and advising others about them?

I've always loved chamber music; and at the age of 25 I was on the board of the Saint Paul Chamber Orchestra. One of my colleagues was the general counsel of a company called Control Data, which was a conglomerate. It had bought disparate companies and had not yet made redundant some of the pension plans of the companies that it had purchased.

My friend said: "You've talked to me about your research in the stock market. If you start a company, I will hire you as a consultant immediately because we have no idea what's going on with these pensions plans. We have no idea whether the manager is honestly managing the money or not."

So I formed O'Shaughnessy Capital Management in 1987 and I looked at these seven separate pensions. What I did was very straightforward. I took their portfolios - both current and historical - and put them on the database and did what we would today call a factor profile. Then I created a normal portfolio, or clone portfolio, which was like a benchmark on steroids. It not only had similar factors to the underlying manager, it also looked a lot like the manager.

The point of a normal portfolio was to say: How much value is the manager going to add through their buying and selling? My "aha" moment was about one year in, when it became incredibly clear that the clones were killing the managers that they were cloning.

I'm like: "What is going on here!?" So I started doing research into actuarial decision-making versus regular human, or clinical, decision making.

I found a great book called "House of Cards: Psychology and Psychotherapy Built on Myth", by a fellow by the name of Robyn Dawes. He had a chapter in that book that was fabulous; it was all of the studies that had been done of actuarial and clinical approaches. They started these in the '50s, and they thought that what they would see is that the actuarial approach would be a flaw that the human forecaster would soar above. Well, what they found was it was a ceiling that the human forecaster could never touch.

Concurrently I was seeing this happen with the portfolios. My clones were doing so much better because they were not human beings. They were just buying and selling securities based on those factors, and those factors alone. There was no emotional override, there was nothing that would be inconsistent or any shade of grey. It was black and white; if you met the criteria you were bought, if you didn't you weren't. It was that simple.

It's reassuring that professional money managers suffer the same emotional flaws that everyone else does. Have those findings changed over time?

It led to my first book, which Patrick named his podcast after as an 'hommage' - "Invest Like the Best". In it I showed you how to clone your favourite manager. We haven't done it for a long time, but the last time we updated all the clones in that book they were killing the managers they were cloning.

That made me decide: "Okay, number one, I have to move into active management because this is unbelievable." At the same time we moved to New York and I became a consultant to Merrill Lynch, where I designed a popular growth-based portfolio.

At this same time I had convinced the people at Standard & Poor's Compustat to give me access to their database. They'd never given it to an outsider before in its entirety, because they viewed it as the crown jewels. But I convinced them that the only way that were going to be able to sell more of it was to have an outsider prove to the world that it was in fact the gold standard.

I published a piece in Barron's about what came to be known in the US as 'Dogs of the Dow'. I reworked my earlier research and found that simply buying the 10 highest-yielding stocks in the Dow, holding them for a year, rebalancing the portfolio to again holding the 10 highest-yielding stocks in the Dow, did tremendously well over long periods of time.

Merrill had seen that article and they were doing a 'Dogs of the Dow' Unit Investment Trust. They also knew I was writing this book 'What Works on Wall Street', and so they wanted to hire me. So, 'What Works on Wall Street' came out, and literally, and inexplicably, became a bestseller.

You devoted much of your career to discovering what really works in the stock market. Why did you feel compelled to write about it when you could have quite easily kept it to yourself?

That kind of speaks to my fundamental beliefs. I believe that you need to add as much as you can to the public domain in terms of knowledge that allows other people to do better. I'd already kind of turned myself into a dyed-in-the-wool quant, and I knew that

the majority of investors would reject that message. But I’m a huge believer in level playing fields, so that’s why I published it.

After publication, O’Shaughnessy Capital Management quite literally had around $600 million come through the door - and we had no sales people. This is in early 1997, and it was all incoming calls. We went from being a consultant to Merrill, which was a sweet gig in itself, to a $600 million dollar asset manager. We were the fastest-growing Schwab institutional manager in the North East, and we were getting a lot of press at the time. It’s hard to believe now, with the ascendancy of quant and everything, but back then that was really unusual.

I spoke to your friend Ted Seides and he suggested a question that I should ask you. It coincides with this time when your career was taking off. He suggested that I ask you about the time you appeared on Oprah!?

Ted would definitely say something like that! The Oprah thing was really funny. After ‘What Works on Wall Street’ became a bestseller, an agent called me, and the conversation went like this:

Agent: “You are in a very rare club; you are a bestseller. You’ve got to do another book, and we’re going to auction it.”

Jim: “What do you mean? I was writing these books just to advance knowledge.”

Agent: “No, no, no. We have to write a book with mass-market appeal. You know, ‘What Works on Wall Street’ for dummies, for people who don’t know anything about investing.”

Jim: “Alright.”

So we came up with the book ‘How to Retire Rich’, which was a bestseller. Then about four months later one of Oprah Winfrey’s producers calls and says: “Hey, we’d love to have you on the show.” I’m like: “Fantastic.”

I had never seen ‘Oprah’, so I watched a couple of shows just to see what it was all about, and I thought: “I don’t know how they’re

going to have me on this show." But it was devoted to finance, and how people could do better.

So I get to Chicago, and go on Oprah. At the time, the show was shot live, so when a commercial was on you would literally just sit and wait. The green room is very nice, but there's a space between the green room and the studio that is entirely black. It's blacked out because they don't want any light coming in. So we go from a very lovely lit environment to this pitch blackness. I'm surrounded by maybe five producers, and one is saying: "Hey, you're going to be great, and this is going to be awesome."

And then another one says: "Just one thing, Jim..."

Jim: "Yeah, what's that?"

Producer: "If... if you could not be technical that would be really good."

Jim: "What do you mean by that?"

Producer: "Well, don't say things like 'Dow Jones Industrial Average'."

James: "Oh! Okay, alright!"

So I go out, sit down - it's during a commercial break - and Oprah and I are chatting. She's very cordial, and she asks: "So... one line. What is this about?"

I said: "Well, Oprah, the message is: if you can change your focus, you can change your future." And Oprah loved that line. She's all about empowerment, which I think is great, and she loved that line.

So, we come on, and she looks like she's my best friend: "My next guest, he said - I love this - 'If you can change your focus, you can change you future'. You know how much I believe that!?" So we had this great back-and-forth, and I had all of five minutes on the show.

I learned a lot about the book business but after being on Oprah, and I also understood the true power of American media. I'm not

kidding you; I walked out of the hotel in Chicago, and a woman walking on the sidewalk looked at me and said; “Oh, are you Jim O’Shaughnessy!?” I’m like: “Yeah!” She said: “I saw you on ‘Oprah’, you were great!”

It freaked me out. So I get to the airport and walk up to the American Airlines check-in desk, and without missing a beat the woman behind the counter says: “Welcome Mr O’Shaughnessy.”

It’s like a Monty Python sketch. I’m like: “Okay”. She says: “Wait, you’re going to be escorted to the plane.” I say: “It’s okay, I can walk, I’m fine.”

The pilot and the chief stewardess arrive, and the pilot doesn’t know anything about Oprah. But the stewardess is like: “Oh my gosh, will you sign this for me!?”

I got to San Francisco: the same thing. I’m on one of the moving walkways at the airport and all of a sudden I become aware that a woman has been walking - but has stopped walking - right next to me. I’m looking, and she’s just looking at me. And finally, I’m like:

Jim: “Can I help you?”

Woman: “I’m sorry, it’s so rude what I’m doing… but are you Jim O’Shaughnessy?”

Jim: “Yeah!”

Woman: “Oh my God, I saw you on ‘Oprah’, you just made the biggest difference in my life.”

Jim: “Okay.”

Woman: “Will you sign this?”

It was wild. The lesson is that if you control the American media, you can do great things. As long as you don’t ever say ‘Dow Jones Industrial Average’!

Another of your friends, Barry Ritholtz, suggested that I ask you how ‘What Works on Wall Street’ changes the way money is managed in the US?” That’s a big question.

When the CFA journal wrote a review of 'What Works on Wall Street' they said that theoretically its impact on the American money management industry would be immense. It wasn't immense but it certainly created a new niche for what I call fundamental quant.

If you go and talk to Cliff Asness, or you talk to the guys at LSV, all of those are PhD quants who manage money very differently than we do. We are hyper-fundamentalists, we're Ben Graham on steroids. Their alpha is better than smart beta, but a low tracking error and high information ratio are very important to them. What was more important to me was alpha. So it created a niche of discipline, evidence-based investing that has only grown in the US by leaps and bounds.

I have written an article with the title: 'Mistakes Were Made (And, Yes, By Me.)', which goes over some of the big mistakes that I made. One of the biggest mistakes was when ETFs were brand new and Gary Gastineau approached me, and he said he wanted to do an ETF for every one of the best strategies in 'What Works on Wall Street'." I said no because at the time no-one even knew what an ETF was. I would have had to have put up a lot of money to do it and I decided not to do it. But I should have done it.

I think that the effect that 'What Works on Wall Street' had on American money management was it helped to create what is now a very robust category. I'm very proud of that. I became aware in the mid-2000s that there was an enormous amount of money being managed according to 'What Works on Wall Street', that I knew nothing about. I got a call from somebody at the Bank of Ireland, and this was the conversation:

Bank executive: [by Jim in a perfect Irish accent] "I love your book you know, it's grand and everything, but we've got some questions."

Jim: "Why?"

Bank executive: "We're running a decent-sized portfolio around it."
Jim: "Ah, okay..."

Then I found that there were some other banks in the US and other parts of Europe doing the same, which I was totally okay with. If you have the guts to use the formulas, you're the ones taking the risk. There are a whole host of O'Shaughnessy screens printed by AAII, the American Association of Individual Investors. I think that's great for people who can actually use them. But what I also wanted to get into was the idea than innovation and constant research is absolutely required. And that brings me back to 'Dogs of the Dow'.

In the third version of 'What Works on Wall Street', I started doing much broader tests, testing a lot more variables. One that I was really enamoured with was shareholder yield, which is dividend yield plus buybacks. We found categorically that shareholder yield was better than dividend yield in the US.

So in the book, I said not to use dividend yield, and to use shareholder yield instead. But there was pushback on that because people had got familiar and bought into dividend yield. That really illustrates nicely for me the power of narrative, the power of a story. We are a story-telling creature; all of our original histories, poems and plays were an oral tradition before we developed writing.

It's in our genes that we want things a) to make sense, and b) to be something that we can say: "Oh yeah, I understand why that works." With 'Dogs of the Dow', buying the 10 highest dividend-yielding shares made sense. "Of course! If I'm buying the company that has a two percent higher dividend yield, I'm going to do better than the company that has a deficiency there. Plus cash makes sense; I'm getting paid actual money. What's the whole buyback? I don't know what that is?"

It really underlined for me, the idea that people get stuck in their beliefs. This is true everywhere - it's not just in the stock market, it's everywhere.

I found that really interesting; the reticence to accept new research from the same person that you believed the first time around. But

if you compared our original models, from Market Leaders Value to the way we do it now, the foundation is absolutely the same. We are still concerned with value, we still are concerned with quality, with financial strength, with shareholder yield, but now we use composites.

One of the really fascinating aspects of 'What Works on Wall Street' is how you constantly re-assessed your conclusions. That was particularly the case when you switched from advocating a single factor to composite factors. What drove you to do that?

I believe in the truth above all else. That means that if I am wrong, I will change what I think. I told you about the piece I wrote, 'Mistakes Were Made (And, Yes, By Me.)' It was a rookie error in the first version of the book to declare one of the ratios the king; that was the price-sales ratio. That was naïve, because if you look, if you're time frames are different, it's going to be something else.

To say: "This is the right one, and here's why!" just seems so foolish. What I've found, and what the data tells us, is that it's a horse race, and it depends on when you start that horse race and when you end that horse race, which horse is going to win.

One thing we noticed that's very interesting is the single factor that's doing well suddenly has a bunch of academic papers being written about it, with everyone saying why this one's so much better. That almost always happens right as it slips and loses its crown, and another takes its place.

I actually got the idea from a paper that somebody had written about me, saying: "We think price-sales is good, but when it's combined with P/E it's even better - and here are the results."

I'm like: "That's a good idea." So, we ended up testing a variety of composites, and we found that composites were vastly better, they gave you a much better real sense for value, for example.

A colleague, Travis Fairchild, just published a piece about price-

to-book called 'Veiled Value', in which he documents the fact that price-to-book is broken. It's broken not because of its faults, it's broken because the economy is completely different than it used to be. There's trillions of dollars being invested based on price-to-book, including the Russell indexes.

We are not afraid of challenging any of that and we think we're doing a service to investors. That has been our message. Certainly I made it my message with the fourth version of 'What Works on Wall Street'. Anything where we can innovate, where we can challenge, where we can improve; that's our mandate.

I don't think I'm being too boastful to say that OSAM probably has the sharpest definitions of the factors of any of the quants out there. We have that because we have a team that is intensely curious about this sort of stuff, and drills down, and then drills down, and then drills down further.

It's our mission to improve this way of investing. People always say: "This is a secret, so why would you?" The answer is that you could shout this from the rooftops, and no-one's going to believe you. If you have a really good idea, you're going to have to cram it down their throat. People are just naturally hostile to new ways of doing things.

To what extent do you think human behaviour and self control have a bearing on successful investing over the long term?

I gave a talk at Google, and I actually wrote a piece that's on 'What Works on Wall Street' (the blog), called 'Successful Active Stock Investing is Hard']. One of the studies I found was done by two researchers in Sweden, where they looked at the portfolios of identical twins. Obviously identical twins share 100 percent of their genome; they're copies of each other. The takeaway of this study was that up to 45 percent of investment choices are genetic, and you can't educate against them.

Isn't that true in so many different aspects of the world? People have heuristics and rules of thumb because we'd go crazy if we

didn't have them. We only take in under one percent of the external stimuli that is currently around us. That's because our brain filters it all out, because we'd go mad, we wouldn't make sense of anything. It does it naturally, and we come with the code preinstalled.

We have interns at OSAM every year. I do lunches with them, and I talk to them, and they ask me: "What shall I study?" I say: "Evolutionary biology and psychology", and read the books A, B and C. The numbers are the easy part. If you really want to understand how to be good at this, how to be a success at this, it's the steadiness of the hand. My proudest thing is that I have not a single documented time when I ever overrode one of our models because of emotion or volatility, and that's hard.

Finally, the work you have done and the strategies that you have built presumably give you confidence in good times and bad? How do you handle difficult periods in the market?

I am not a religious person, but I read a lot of Taoist thought and a lot of Buddhist thought, and I think that I most closely identify with that. It's very helpful. The Roman Stoics are also fantastic because they taught me the lesson of "worry only about what you can control".

There's no use, no benefit, and no good comes out of worrying about something that is out of your hands. I've really applied that. Then there is the story of the king who wanted the wise men to write something that was always true and it could only be a single line. The wise man who came up with the winning sentence, wrote: "This too shall pass." That really guides the way I think.

I've been very lucky because this has been my entire adult life. I started very young, and this is part of me, it's part of my DNA.

On CDOs I was so incredibly bearish, anyone who knows me knows that I spent 2006 walking around, saying: "If I could short my house, I would." Had I not had such a quantitative approach to investing, I would have done my homework and said: "Oh, I can short my house!" I would have done it because, again the data was

overwhelmingly compelling that leveraging illiquid, complicated derivative instruments forty to one is going to bankrupt you, always. Not sometimes. Always."

But I didn't do that, because I didn't have a 25-year stream of data that told me empirically that I could. There are upsides and there's downsides, but as far as the horrible times go, my wife has always remarked, and my parents remarked, that oddly I am at my best in a crisis. I get calm when everyone else goes crazy. I don't know why but I do.

I guess I've just mercifully been designed by nature that those kind of things just don't affect me. Maybe that's because I love to read, and I've seen this happen, the same play, different players. As long as we've had markets we've had these things happen. They happen all the time; they will happen in the future in a different set of circumstances, a different set of companies, same result. People will panic, stocks will decline precipitously, people will sell at the bottom, and the show goes on.

Jim, thank you very much for your time.

Wes Gray - Factor strategies and common sense quant for everyone

Wes Gray runs his boutique investment firm Alpha Architect with the determination you'd expect of a former US Marine. In a competitive industry dominated by big names, his small team of 'quant ninjas' are endeavouring to make themselves unkillable.

They're doing it by bringing factor strategies and quant investing to regular investors. There's no black box or secret sauce, and there's no flashy office. Instead they're leading on education - with blogs, books and research - to show how factor premiums can deliver long term outperformance - even though they'll make your life hell at times.

Alpha Architect is based at Wes's home on the outskirts of Philadelphia. Standing among the desks and monitors in the kitchen is an eight foot stuffed grizzly bear. Walk through to the back and it opens into a huge space, with more large stuffed animals - including a leopard. The house was once owned by a game hunter but Gray (typical for a classic value investor) bought it in a distressed sale - and the stuffed animals came for free. Now it's a symbol of his efforts to offer transparent, marketing-free, win-win 'achievable alpha' with strategies that most investors can't stomach on their own or can't find anywhere else.

Wes and his team currently manage nearly a billion dollars of client

money, half of which is spread across their range of exchange-traded funds. They include US and international versions of Quantitative Value and Quantitative Momentum plus a crossover Global Value Momentum Trend strategy that was launched in 2017. The ETFs are concentrated and regularly refreshed to keep them as closely aligned to the value and momentum factors they aim to profit from.

I went to visit Wes and his team and spent three hours talking about football, finance and the epic battle they are preparing for in their mission to take quant to the masses…

Wes, tell me about how you got into investing and your journey from being a value stock picker to a quant-driven factor junkie?

Ben Graham was my first intro to investing. I grew up on a farm in Colorado and I came into a little money early on. My grandmother was a huge, old-school, value stock-picker and she was the only one in the family who even knew what investing was. So when we started asking about finance, my dad was always like: “Go talk to Grandma Jenny.”

She literally sent me that damn book; I got Buffettology and I got Intelligent Investor. I thought it was an interesting idea that when you buy stocks you’re buying a business. You want to buy it cheap, you want to buy it with a margin of safety and you want to be rational about it. Price shouldn’t matter, momentum shouldn’t matter; it’s all about the fundamentals and figuring out what something’s worth and buying it for less than that.

For a lot of people, that’s not intuitive for some reason. But for other people, whether it’s to do with culture or genes or something, it just clicks.

For me it seemed so obvious, but I was like the cliché. You go from there, and then you find this Warren Buffett guy, and he’s doing what Ben Graham did, so and you try to learn some of his lessons. But for some reason the Warren Buffett thing didn’t click with me. Ben Graham is all about buying cheap sh*xx*. But Buffett’s about:

"Hey, cheap but focus on quality, it's all about the integration." But for me, Ben Graham's classic net-nets strategy is what I want to do: buy the totally distressed turds.

So I was just a stock picker trying to be a hero, and I was doing that right around the internet bubble. In 1998 we were going into the teeth of all this chaos and I just got lucky; I didn't get caught in the tech stuff. I was so in tune with value that I was focused on the cheap stuff that everyone hates.

At the time I was a Wharton undergrad and we'd have all these speakers come in. They were like: "Well, if you actually figure out the present value of all the internet stocks, and you map out how many sales they have to achieve to justify those valuations, it's more than 100%. So, clearly this is a fu*xx*ing bubble."

Obviously it blew up a few years later and I missed it completely, and then after that we had the small cap value rebound. Anyone with half a brain bought any stock that was small and cheap and if you didn't make 50 percent returns you were an idiot.

A lot of people made careers in hedge funds - so-called 'geniuses' - because they just happened to be value investors, which tend to be small value guys. But it wasn't because they were smart, it's because they were in the most epic bull ever in those factors. I happened to be in that crowd too. I rode it all the way towards the end before I started getting my ass handed to me towards the '08 crisis.

Another good luck event was being on a PhD programme and getting exposed quantitative, systematic strategies where I realised: "Oh, I can just go buy all small value names, and I get the same return I did when I was beating my head against a wall. This seems like a smarter way of going about it."

So I had all these different events happen. Having done the stock picking thing, it's insane and you get emotionally involved. I just naturally gravitated towards the quant stuff, doing stock picking ideas. That's what started Quant Value, which is really a system of

what was in my stock-picking head. Then eventually we branched into momentum, and ideas that were "off-religion" at the time. Everyone has their religion in investing, and then you've got to move off that somehow… but it's hard!

You've done the in depth research, studied and tested all the data and read every academic paper on what works in the stock market over time. That's put you in a group of investors who pretty much agree on which factors drive returns, right?

I think If you set out to find the intellectual truth and to really understand what works and why - which is the culture of academic and quant research - in the end we all agree on the same stuff. So in a way it's boring. You talk to Cliff Asness and he likes value and momentum. You talk to James O'Shaughnessy and he likes value and momentum. You talk to anyone who's been doing this for too damn long, and unless they've got a bias, that's what they say.

Value and momentum are the big cahoonas, and they have always been. But now we have the issue of the factor zoo, which is perfectly correlated with computing power. I can go get a machine and look at a million strategies in five minutes, and I can tell you which one is going to backtest the best. But unless you understand: "Do we do out-of-sample? Do we try different countries? Do we try to understand the economics of how or why this works in the first place?" it quickly gets boiled down to what we call the "open secrets".

Then we're just arguing about our algorithm versus O'Shaughnessy's algorithm versus Joe Blow's algorithm. The reality is that they're all probably going to be around the same in the end. Someone gets lucky, someone gets unlucky, but ex-ante, the distribution is that they're all about the same.

The other big fight here is about how concentrated you are. Some factor people are like: "Oh you want to run a thousand stocks, and just slightly tilt away to get a little bit of value and a little bit of momentum." So you never deviate too far from the index, but

you may have a good shot at beating it in some designated time. Whereas we're like: "Fu*xx* that, we just want to make money. I don't want to be beholden to benchmark hugging because I may make suboptimal decisions. But if I want to just compound wealth, the best odds over the long haul - and the data is pretty clear on this - is if the factor works then it's going to work when it's more concentrated. It makes sense that the pure version of it should work even better. But the downside of it is you're going to get more whipping around the index. O'Shaughnessy and us are in total agreement on that, but most people in the industry are not like that.

In your research of the value and momentum premiums, what did you conclude about why those factors are so powerful and predictable?

With any of these really good premiums, they are going to be a proxy for risk at some level. So you've got to ask questions like: "Why is the other guy at the table giving me extra returns?" That's the equilibrium way of thinking about factors or quant or any investing. In the end, if I'm going to make extra money, I've got to understand one of two things: Am I eating more risk? Probably, because the market is pretty damn efficient. And, if I'm exploiting mispricing, because I think I know more than the other guy, I'd better damn well understand why the other smart guys haven't already done it.

You've got to have a reason why other smart people - the hedge fund and high-frequency guys - aren't already doing this. Because if I've accounted for extra risk and I see mispricing, I'm thinking this is free money. But both of those are fake. They're gone or they're fleeing. Structural excess return is going to come from real risk - i.e. because it has risk to it - and if there's mispricing that sucks to exploit, like value. Just because you know value works, that doesn't mean prop shops do value investing, because it could take you five years and you could burn out before you win.

So why does value work? Well, typically, if you buy cheap sh*xx* it's

because it's got extra risk. Right now you buy things that are in Amazon's path. There's a real risk, even with the margin of safety, that things will blow up, because you're buying fu*xx*ing Best Buy, and Amazon is probably going to eat their lunch. But at a certain price, even that could still be good value, but there's risk.

The second part is the value premium associated with what I call "throw the baby out with the bathwater." Obviously it's risky, obviously it sucks, obviously it's not the best business in the world. But, if it's priced so low, it could still be a good investment. So the investing public threw the baby out with the bathwater. Obviously it's bad, but they're pricing it too bad, and that's the mispricing component.

So you know there is extra risk and you know there is this mispricing component that Graham talks about. You know it's hard to exploit, because it's not just like buying cheap stocks is an easy life. You know there's a reason that the mispricing is there, and there's a reason that mispricing is not being exploited by every hedge fund guy that charges two and twenty, because it sucks to hold stocks that don't track the market and are harder to hedge.

So value makes a ton of sense; but then we think about momentum. With momentum, the risk-based explanation is a bit harder to understand, because frankly it doesn't exist in spades like it does in value.

In momentum it's a little bit harder to identify true, systematic macro risk that's associated with that premium. You can do it a little bit, because it has skewness to it. With momentum names in general, when sh*xx* hits the fan they really hit the fan. They've got a high beta component to them, so arguably there is some risk element there. But the big one with momentum is obviously the behavioural component.

There's tons of mispricing there arguably, but it's also mispricing that's really, really hard to exploit. To do momentum right requires high-frequency turnover, a ton of trading, so you've got to make

sure you can do that in a way that's not going to destroy you. And when you look at real momentum strategies done the way that gives you those historical premiums, those portfolios are fu*xx*ing hair-raising. They've got like 25% volatility, they don't hug the index at all, they're totally insane. They're basically just a great way to say 'I'm fired'.

It's like what Greenblatt always talked about: the career risk component. He talked about it in the context of value, but in momentum it's arguably three times worse.

So in all these things, the question is where's the risk and where's the mispricing that's hard to exploit? In value, you can argue it's more even-keeled; there is a lot of risk and a lot of mispricing that's hard to exploit. In momentum, there is a little fundamental risk, but tons of this idiosyncratic behavioural risk that's just hard to exploit. It will still be there forever, because it's really hard to hold momentum portfolios frankly. And again, it's not like prop traders and two-and-twenty guys are going to fall out of their chairs to do momentum strategies.

So in my mind, momentum falls into the same framework of risk and hard-to-exploit mispricing. With pretty much every strategy we do, if I can fit it to that framework, and know why I'm earning some premium or some benefit, it makes sense because I'm doing stuff that sucks. And I should be getting paid for that. That's what gives me confidence that certain things will probably work in the future.

What I'm talking about is not pure quant. Pure quant is like: "Let's get our machine learning algorithm and pump 10,000 variables through it and just try to outsmart the other computers." But then there are also fundamental, common sense people that use quant to pull away the human problems. We're still fundamentally thinking about equilibrium in a market with other humans. So I guess the term would be 'common sense quant'.

Having done all this research, are you still as curious about

other potential factors and anomalies?

We started Quantitative Value on live money about six years ago and we haven't changed any of our algorithms since. But we're always looking for new ideas and testing new concepts and our clients are usually our best brains because most of them are pretty sophisticated. They're like: "Hey, why don't you try this?" or "Joe Blow said this; why don't you take a look at that?" But we've honestly never found anything that has enough robustness, given what we've already got.

The marginal bar to change something at this point has got to be super, super high because we've also got to discount away data mining and optimisation bias. We've just never found anything, and it makes sense because we spent so much time thinking about this up-front. The idea that we could somehow magically uncover some rock we didn't think about is pretty low. I'm not saying it's not there, but we just haven't found it.

The only thing that's changed is that we've embraced ideas that we used to think were bullsh*xx*. We had a long-time client who said: "Hey, why don't you guys look at managed futures?"

Now, I'm a Fama school guy, so I was brainwashed in efficient markets. Momentum is bad enough but but now you're telling me that there is something in trend following and all this market timing crap? It's just not what we're predisposed to. But, he was like: "You guys are killing it. I'm not smart enough to study this, but you guy have all the capability. There's something here, I'm telling you!"

So we finally got past our own religion problems and started studying it. Now we've embraced it - trend following in managed futures is a great idea for a lot of the same reasons that value and momentum were great ideas in stock picking. So we've made changes in expanding our horizons to try to understand good ideas that maybe we would never really have considered, but now we do.

What about the pain that comes with these strategies? What kind of misery do investors have to face and how do you deal

with that as a firm?

The good thing about value investors is that they've got a religion. I'm kind of weird since I can go across religions pretty easily. I understand the religion because I used to be them, so I know how they think. But I also know about this other stuff, so I can go between the worlds. It's easy to offend them, but the one thing I like about value investors is they do have a kind of humility culture. You have to have humility to be any good at it - because you're used to getting your ass handed to you.

With value investors or momentum investors or any of these people, you're always dealing with pain and anguish. Once you start thinking about it through that lens, these "simple" ideas start making a lot of sense because they're simple but they're not easy.

You're always in pain situations, and most people would be willing to give up a few percent to not have to deal with this all the time. It's just the plight of investing; stuff works for a reason. It's not because you're so smart, it's usually because you're doing stuff that sucks but you just haven't realised it yet. So that's the message that you want to bring to people. Firms like us are just making it transparent now.

Our mission, and our whole business model, revolves around this idea of saying: "Hey, nobody has a magic wand, but what we're going to do is inform you about the facts of why this works and how it works, and be upfront with you about why it's going to suck." But, to the extent that you understand that, you're going to be a better investor, and you're going to actually be able to exploit this stuff. This is why our mission is not: "We're PhDs, we're smarter than you, and hire us because we're alpha generators." Our mission is: "We're going to make you smart in order to make sure you can actually stick to the strategy we're about to tell you, because it's going to work. It's going work on paper, but when you actually have to live through what we're delivering, you're going to hate us."

That's why investors have got to know what they're getting into. Everything we do revolves around our beliefs: we're transparent, we're not black box. In the old days, it was always about selling black box, how smart you are and how awesome your research is. If you do well and have a good run you'll raise a ton of money. But the reality is if you were winning it's not because you were that smart, it's because you were probably taking some unique risk, or you were exploiting the mispricing which sucks to exploit. Eventually it stops working, and all those clients you told that you had a secret sauce are like: "Wait a second...", and they're out.

That's great for product hawkers but we've moved past that. That was old-school Wall Street. New-school Wall Street is the internet, it's transparency, it's education. We're going to do the same that the hedge fund guys did, but we're going to tell you what we're doing and why.

Right now, three out of our four funds are like number one in the universe over the past 12 months. We're like: "Listen, you know if you've been hanging around long enough that the year prior they were 99th percentile. So don't get excited about any of this. Understand the process, and how and why it works. And when the thing kicks ass a lot, you shouldn't feel any different than when the thing gets its ass kicked a lot. You're just following a process that exploits these hard-to-arbitrage risk premiums. Stick to the process, don't worry about the returns."

So we're transparent, evidence-based and we're not going to sell stories. We're going to make systems, and it's not going to be how Wes feels today about the markets. It's going to be about what the fu*xx*ing computer says do, because it's a lot smarter than we are.

Finally, to what extent does your approach reflect the view that finance and investing needs to do more to serve the customer, not just the money managers? And how do you set yourselves up to compete in such a ruthless industry?

We're not a marketing shop, we're an inbound shop. For us, our

products are only bought, not sold. We run all our own money on our own stuff, so our incentive is to think: “Hey, what would I want to do if I were an actual investor?” We don’t think about targeting advisors and minimising tracking error, we don’t do anything traditional like that.

It might take us forever to build this business but doing it this way gives us structural edge. We don’t have sales people, we’ve cut them out of the equation. We’re running nearly a billion dollars and it’s all inbound. We fulfil our mission with the website; we go out there and educate and write blogs and, lo and behold, people like transparency, integrity and authenticity. And there are like, eight of us.

I think the world will be a lot better in terms of financial advice and products in 10 years, but it’s rough right now. Who knows? It’ll be an exciting world and we feel like we’re on the trend.

As you get bigger and better, everyone knows who you are. Like the US military, everyone knows they’re going to kick your ass, and so they’re all going to be ready for you. So you’ve always got to be tough to kill and figure out how to do more with less. We’ve got a balance sheet that is like iron and I don’t ever want to get a real job ever again. So I will live on ramen noodles and go pitch a tent out here if I have to; they ain’t killing us.

The big issue in asset management is that it’s such a high operating leverage business. People get blown out because there’s huge competitive pressure. They get monster fixed costs and they create a hedge fund culture with fancy offices. Then when something bad happens, they’re stuck at a high operating leverage, they die and someone comes in and sucks them up. We want to be the opposite; like, when things get crazy, we’re going to buy you, because we’re ready for World War 10.

Wes, thank so much for your time.

Barry Ritholtz - One of America’s favourite investment commentators

Barry Ritholtz is one of the most widely followed investment commentators in America. He’s also the chairman and chief investment officer of one of the country’s fastest growing wealth advisers.

Over the past twenty years Ritholtz has forged a reputation for his no-nonsense views on finance and markets. He’s an advocate for low-cost, rules-based investing - and he’s also not afraid to call out bad industry behaviour when he sees it.

Apart from being a prolific writer, Ritholtz hosts Bloomberg Radio’s *Masters in Business* show, where he’s interviewed some of the most influential names in finance and beyond.

Five years ago, he switched from a career in broking and analysis and set up Ritholtz Wealth Management. Together with Josh Brown (The Reformed Broker), Chris Venne (The Certifiable Planner) and Michael Batnick (The Irrelevant Investor), they tore up the existing rules for how wealth managers communicate with the outside world.

To build their business, they embraced blogging and social media. They shunned complexity and took a more personable, authentic approach to talking about investment and financial advice.

In an industry with a habit for obfuscation and still on the ropes reputationally, 10 years after the financial crisis, Ritholtz and his team have found a successful formula. Their growing advisory team doubles as some of the most widely followed investment writers around. Among them are people like Ben Carlson (A Wealth of Common Sense), Blair DuQuesnay (The Belle Curve), Tadas Viskanta (Abnormal Returns) and Nick Maggiulli (Of Dollars and Data).

I met Barry Ritholtz at his office on Bryant Park in Midtown New York City. I'd been in the city for less than 24 hours and just arrived from interviewing Joel Greenblatt (whom Ritholtz had interviewed for *Masters in Business* a couple of weeks earlier). This set the scene for a what turned into part-therapy, part-interview training, and part trying to get an interview out of Ritholtz, who, he said himself, is pretty hard to interview...

Barry, tell me about your writing. You were a commentator who rose up the ranks and now your interviews and opinions are some of the most followed in finance. How did that happen?

I started writing publicly back in the late 1990s. I should say I was writing quasi-publicly because nobody was actually paying attention. At the time, I was writing sporadically on Yahoo! GeoCities, which is hilarious to mention. I wanted to become a better writer, so I started reading other really good writers, and then writing for about an hour or so every day.

At the time of 9/11 my firm had an office in Two World Trade. That morning I called our head trader and took copious notes as he gave me a running narrative of everything that was going on. He was on Broadway heading up towards the Brooklyn Bridge when the towers collapsed. I posted it that night, and it was one of the first

non-media descriptions of what happened to be posted online. It went insanely viral.

So what started out as a very sporadic set of posts became a daily thing, and then it became a twice-daily thing. Then it was my morning overview, followed later in the day by a chart you should see. Then I started doing the reads and the links of the 10 or 20 things you should see each day.

I've been doing that stuff for 15 years. There was a time when there weren't a lot of people writing every day. I think I put out some interesting, quality things and that I was more right than wrong about a lot of big issues. Now it's a firehose of everything from Twitter to LinkedIn to Facebook. I don't think the same opportunity exists today that existed when I started, so I got a little lucky. I was interested in writing, and doing it in a very public venue. It was a wonderful opportunity that I don't think anybody imagined would lead to all the places it's lead to.

You often hear that there is way too much noise in investing. But do you think the kind of writing and content out there now is much improved on what used to be available?

When I started, most of the economics blogs were professors at colleges. There really were no financial blogs. The closest thing was when TheStreet.com first launched in the mid 1990s. Todd Harrison was Jim Cramer's head trader at his hedge fund and he started writing about his trading posture. He used the metaphor of putting on his bull costume or his bear costume. "I have two legs in my bull costume", he would say, or "I'm adding my third leg in my bear costume", to reflect how bullish or bearish he was. That was the first time someone was talking about what they were trading in real time on the internet.

The professional financial media today has gotten much more sophisticated that it once was. But it was shockingly naïve and occasionally incompetent in the way it did its job.

Take the prediction business. There would be a parade of people

coming on making predictions. Every article had a prediction - "so-and-so has said this is going to happen". They never stopped to ask "how do you know, what's your track record of making these forecasts and why should anybody listen to you?" That's how I eventually came to the conclusion that all forecasts are just marketing.

How did you get started in the investment industry?

I started as a trader, which I loved because it was so much fun. But you make a ton of money one month, you lose it, and you make it back the following month. At a certain point my wife said: "Listen, if you want to be a trader that's fine, but it can't be up 100, down 100 each month."

So I made the decision to go into the research side. I joined a guy named Lawrence Hart at a firm called Prime Charter, which was later bought by Oppenheimer. He'd been a software analyst at Bell Labs in the '50s and he understood technology like nobody's business - but nobody understood him.

I remember one of the retail brokers coming up to me and saying: "Look, we love Larry, but we don't understanding a word the guy says." He goes: "Do me a favour… I don't need the technical explanation… just pick your two favourite recommendations from him and write it up in a way that we can understand."

So I picked two: one was AOL, the gateway to the internet for middle America, which was five or six bucks at the time. It was a one-pager on why you could buy it from $6 to $15… and it could even go to $20! Obviously it ran up insanely. The other one was EMC, which I think was even cheaper.

The joke was my money was no good in any bar within a five-block radius. Every broker in that place that bought AOL and EMC at single digits, and they all went up 10x or 20x or 30x. You know, that's a great start for a portfolio.

From there I become a strategist. I ended up at Maxim Group, which

was a $7.5 billion firm formed by the merger of Herzog, Royce, Ernst & Co. and the big South African bank Investec. I was there for a couple of years. But at a certain point you come to the realisation that if you're just in research, and not accumulating your own assets, you're a cost not a revenue generator. I got tired of hearing that because it really doesn't recognise what I think is the proper way to run a business.

You've been at the centre of the US investment industry for the last 20 years. When you look back now, what lessons do you think have been learned?

In the 1990s you had all these rumours, tips and mayhem, and then the dot-coms collapsed. Then you had the analyst scandals, the accounting scandals, the housing boom and bust and then you had the commodities run up, which collapses.

My pet theory is that about a decade ago, following the financial crisis, the individual investor in America turned around a said: "Hey listen, this whole market is rigged, so rather than play your game I'm just going to find a low-cost index fund. Here's Vanguard. Here's BlackRock. One is $6 trillion and the other is $5 trillion. I'm going to give them my money for the 30 or 40 years until I retire, and I'm not going to waste my time playing your game. Does it makes sense to spend a lot of time, energy and effort picking active fund managers or selecting individual stocks rather than owning a broad, globally diversified index of low-cost assets, rebalanced once a year for 30 or 40 years?"

Do you think that idea is now becoming more mainstream?

I've been saying the same thing for decades, it's what we believe and it's what we've always done. When I was at a firm that had a really interesting, quantitative methodology of stock selection, it was never a case of saying all your money should be in it. If you want to have a portion of your portfolio in something that is a little more juiced, and has the possibility of greater returns, first recognise that you're taking on more risk and accepting the

possibility of weaker returns. But if you want to have the slug of your portfolio in something active, I don't have a problem with it. As long as the bulk of your money is in low-cost, global indices, no matter how much you mess around with everything else, you're going to insure your retirement or your generational wealth transfer, or your foundation, is safe.

Tell me about Ritholtz Wealth Management. How did it get started?

It started with me, and then I brought in Josh, and then we brought in Chris and Mike: the four partners here. When we were first setting up, we took over a portfolio that was kind of abandoned. It had a dozen mutual funds in it and we slowly started replacing them with our own selections.

I met Josh about seven years ago at a conference, and I was impressed by him. He's a funny guy, he's very sharp and he writes really well. So I said to him: "Why are you on the sell side?" He said: "I hate the sell side; I'd love to be in the buy side. What do I need to do?" I said: "Cut that mullet, come over to us and it will be a great thing."

He started working with me, and a couple of months later he's says: "Dude, you have to stop turning down this money coming your way, it's ridiculous." I said: "The problem is the day-to-day operations are not my strength. That execution, dealing with the clients and the back office - I hate that stuff. Managing the money, the market analysis, the communication: I love that." That's basically how our partnership formed. We then went out and got Kris Venne, who runs the financial planning side, and Mike Batnick, who does the research, and that became the core nexus for us launching our own firm.

I knew we wanted to be fiduciaries from day one, but we spent a solid year thinking about what we wanted the firm to look like.We began to think about ways we wanted to run the firm, what we wanted to do, how we wanted to press it forward. I

had a philosophy in terms of what our portfolio should look like. You're constantly adjusting what you're doing to conditions, but we launched and had a flow of new money come in.

Presumably you've been on a steep learning curve?

You very quickly learn that success and failure are surprisingly linked. When Visa became public and was trading at around $60 a share, we started buying it for our clients. As new clients came in we'd give them the standard portfolio. As the first year went by the stock went to $80, $100, $120 and eventually it went over $200. At this point you say: "Wait, this isn't an asset class it's a single, speculative stock.

If one client paid $100 and another client paid $200 and if I'm selling it at $180, it's a big winner for one and it's a big loser for the other. That doesn't make any sense. But with an asset class you can count on some reasonable range of returns, no matter when a person is in it.

So going from being a specific trader and an abstract strategist to actually managing money was a pretty big change. When we launched the firm five years ago, setting up the portfolios in a way that was sustainable and not dependent on stock picking, was a priority.

You've taken a slightly different approach...?

I'd like to think that this is not your normal finance firm. Notice that there's nobody on the phone. Our clients find us. We've built a model based on the idea of going out and saying to people: "Look, everything you think you know about investing is wrong - here's what's right. You can do it yourself but you have to be disciplined, you have to work hard, you have to understand what you're doing and you have to keep your emotions in check. If you don't want to, or don't think you can do that, we can do it for you." That's really a very subtle message.

I guess it needs to be subtle because human behaviour and emo-

tion can have a very negative bearing on investment returns, right?

I've spent 20-plus years reading and writing about it. It's probably the single most important aspect of managing assets. You you can have the greatest stock selection in the world, but if your own behaviour has you panicking out in March '09 and not getting back in, your stock-picking prowess is irrelevant. I got emails from people in 2010, '11, '12, saying: "Look I followed you out of the market in '08, but when you said you were going back in in March '09 I thought you were crazy." After you get enough of those emails, you think "maybe we should really get into this asset management thing?"

So we built this from scratch. There was no legacy business that we had to preserve. Most people in finance spend their days chasing clients. They need new assets, they need new accounts, they need new clients in order to generate revenues, commissions, transaction fees or whatever. So if you are spending your whole day chasing clients, then how much can you develop an expertise in anything to actually serve those clients? So I consider it our privilege. There's no-one pumping the phones and it's not the usual mania. You get to step back and think a little bit, and actually consider what is in the clients' best interests, as opposed to being on that treadmill of more clients, more assets, more commissions.

But alongside the wealth management business your media work is obviously still really important, especially Masters in Business. You've built some strong relationships with some of those interviews, right?

It's the most fun I have all week. When I sit down with Jack Bogle, Ray Dalio, Howard Marks, Cliff Asness…it's insane.

With Cliff Asness I'm constantly charmed by him, even though he busts my chops. When I write anything, every now and then I'll get: "That's a pretty good column". But usually it's like: "Here's why you're an idiot who doesn't know what you're talking about."

But having a guy like that read your stuff and basically explaining why you're wrong... that's a privilege.

Howard Marks of Oaktree Capital, who's another superstar, tells a story of his chairman's letters. He's been writing these letters for more than 20 years. For the first 10 years, he's writing these letters, and they're literally folding them up, sticking them in envelopes and mailing them to all their clients. They would send out a few thousand, but there was not a peep from anybody. Imagine doing something with so much conviction but nobody responds, and you just keep doing it for a decade. So the fact that someone like Asness is busting my balls about something I wrote... I consider that a privilege!

Which have been your favourite interviews?

We're over 200 interviews now. With most of them I normally get a sense that it was "good", "very good" or "okay". On rare occasions you'll think, "oh my god this is a disaster" or "this interview is fantastic". The Ray Dalio interview was really amazing. For a bunch of reasons I was in the right headspace, I knew his work and we chatted beforehand. So that was a fun interview that hit all my expectations. The same was true for Bill McNabb of Vanguard, Howard Marks and Cliff Asness. The one that was a giant surprise was Ken Feinberg, the Special Master of the September 11th Victim Compensation Fund. That was just horrifying and fascinating; he he told stories I've never heard before. So that was the one which was the most surprising because there are tons of stories that he just hasn't shared publicly. It was an astonishing conversation.

Who would you most like to interview?

Charlie Munger would be fascinating... and I don't know what questions are left to ask Buffett that haven't been asked. Although you could have said the same thing about Jack Bogle, and that was a fascinating conversation. He comes into the room, a little hunched over. But he sits down, puts on the mic and... boom! He's just full voice, full strength for 90 minutes, it was astonishing.

The other white whale I have is Mike Bloomberg. I keep telling him that the series is incomplete without him. But he's like: "No, no, I prefer to own the station."

Did you notice that I didn't look at my questions at all? I was taking a tip from you - I read that you just let your interviewee take the lead.

Those are the best interviews. My best interviews are when the ratio of asked questions to prepared questions is very low. But as for me, I'm an unruly interviewee, I'm not easy, and I'm over-caffeinated today.

Todd Wenning - Hunting for moats, brands and killer businesses

Eight years ago Todd Wenning was living in London and writing hundreds of articles for the investment website Motley Fool. Today he's back on home territory in the US and working as a senior investment analyst at the San Francisco-based management firm Ensemble Capital.

In the intervening years Todd has built a following on both sides of the Atlantic for his work on one of the investment industry's holy grails - company moats. The term "economic moat" was originally coined by Warren Buffett to describe firms with durable competitive advantages that can compound high returns over long periods. His metaphor stuck and the world was gifted a new way of thinking about stocks.

It was while Todd was at Morningstar - which has its own methodology for rating company moats - that he took this qualitative approach to heart. At Ensemble Capital he now spends his days looking for businesses that have the moat-like characteristics that can deliver premium returns.

Todd has been a friend of ours at Stockopedia for some time and he offered a lot of moral support ahead of my road trip to the States this year. With that in mind, it would have been daft not to press him on the reasons why moats are such a powerful way of thinking about businesses. So when we met up, this is what he said...

Todd, tell me about your investing journey and how you started to specialise in analysing business moats?

My moat approach really began to take shape when I joined Morningstar in 2011. They have a very established moat methodology that spells out how you look at a company and what you look for. Whether it's network effects, switching costs or intangible assets like brands, if you can't figure out which bucket a company's advantage goes to, it doesn't have a moat.

But it's important to define what a moat is. In capitalism, high profit margins and high returns on invested capital should naturally be competed away. But some companies - when you look at the track records of Coca-Cola, Procter & Gamble and so on - for decades they were able to generate high returns on capital, well above the cost of capital, and create substantial economic value.

So what was it about those companies that enabled them to do that? It had to be one of those moat factors, something that gave them a structural, durable advantage that kept competitors from beating away their margins over time.

So I think it's very important, especially for a dividend investor, to think that what a moat really does is to protect cashflows over time. If you're a dividend investor and looking 10 years out, and you want to grow your dividend stream by six, eight, 10 percent a year you have to demand a competitive advantage from the companies you invest in. It's hard to do and it's more qualitative than quantitative.

We're seeing this more and more today and I think the reason is that when I first started looking at moats the idea was to screen for companies with 15 percent ROEs, profit margins of 10 percent and above, or whatever it might be. These were the typical signs of a moat company. But that is changing a bit because you have a lot of companies like Amazon, who don't have great financial ratios but nonetheless have a moat. So it becomes very difficult. If you just screen for those metrics you're going to miss out on a lot of these newer companies with perhaps emerging moats. So there are a lot

of changes happening in the moat world right now - if the 'moat world' is a real phrase! I'm endlessly fascinated by the competitive dynamics happening with businesses today.

It's an interesting idea that classic traits of a moat might be changing and that killer businesses can look quite different to what you might expect.

You're seeing that with the platform businesses, which are reinvesting to get scale. The idea for investors is that they'll eventually produce large cashflows. But the aim for the businesses is to get as many nodes in the network as possible as fast as possible, which makes it really, really hard for anyone new to come along and mimic it. Look at Facebook. It's much harder today for someone to compete with Facebook on a social media platform than it was to compete with Friendster, MySpace or any of the predecessors because they ramped up the scale so fast. To get someone to change from Facebook to another network is very difficult.

But fast growth can have pitfalls, right? Facebook is obviously successful but it has made quite serious errors at times. Similar errors in other businesses could have been terribly damaging, right?

Capital allocation by management is extremely important with moats. Warren Buffett has a line where he says that if a management team is retaining so much in earnings every year to reinvest, within a couple of years they have allocated 70 percent of the company's total capital. In other words, it really matters a lot. You can get a poor management team and a great moat and they can destroy that moat very quickly by taking their eyes off the ball and by chasing growth.

One of the key concepts that I have picked up over the past two years or so is the idea of legacy moat versus reinvestment moat. A legacy moat is a business that has a moat but its advantages are rooted in existing assets. So the incremental dollars that they're reinvesting in the business may not be getting 15, 20, 30 percent

return on invested capital. Whereas a reinvestment moat is the opposite. Look at Facebook. Every dollar they invest in the business they're getting a dollar fifty out, or whatever their return on invested capital might be. So their return on incremental invested capital is much higher. Today, the businesses that are in danger are the legacy businesses with the legacy moats. The likes of Procter & Gamble again. They have struggled to keep up with the pace of innovation happening in the market.

If you look at capital availability in the 60s, 70s and 80s even, it was either very expensive or it was hard to come by for a start-up. Sam Walton of Wal-Mart and Phil Knight of Nike talk about how it was very difficult in the early days for them to get capital to fund their businesses. That was a barrier to entry. But now, there is plenty of capital. If you've got a good business idea you are going to get funded. The barriers to entry have come down substantially. Now you have social media advertising that allows you to target key demographics and mimic the reach of a Unilever or Reckitt Benckiser, for example. If you've got a niche product you can go after one of their products as an alternative relatively cheaply.

I think there's more and more evidence that consumers will pay up for niche alternatives to mass-market brands. You see it all over the place.

Yes, and it also comes down to the way the next generation of consumers wants to shop. The younger cohort, the 20 year olds, don't go to physical stores nearly as much as older generations, they order everything online. They also tend to be more travel oriented and they put experiences above things. They want to eat healthier and a lot of times they associate bigger brands with their parents or their grandparents, and they want to be unique and different. So there are a lot of things happening at once. The technology is there, the consumer behaviour is there and there are a lot of factors at play that are challenging the old guard.

I wrote a blog post recently talking about how the dividends are

at risk at a number of consumer packaged goods companies. If you think that they are paying out 60, 70, 80 percent of their earnings and their moats are in danger, that's not a good mix.

But do you think those those businesses can change?

Well another point I think is really important is culture. If you started your career at a large consumer packaged goods company, a blue chip CPG company, your job was basically to be innovative but not to take a lot of risk. You can have a very good career if you stay there for 40 years and don't change anything. So I think there is a lot of bureaucracy and cultural issues at those companies that makes it difficult for them to truly innovate and grab on to changes that are happening in the market. They almost need to be willing to destroy themselves to rebuild again, which is very difficult for a company to do.

Five or seven years ago you could have looked at Google versus IBM. IBM being the bureaucratic tech company and Google not so much with a strong culture of innovation. If you're a young, talented software programmer, where do you think you're going to want to go? So that also becomes a factor. You think about the virtuous cycle of the talented labour going to certain places at the expense of others.

Against the backdrop of changing consumer trends, can you always rely on a big name brands to have the moat-like characteristics that you might think they do?

There is still opportunity for brands to be moats but they have to add value in some way. Certain brands in grocery stores are just search cost brands. By that I mean if your wife sends you out to get a box of cereal, you're going to quickly grab the one you know. What's one we both know? Let's say Cheerios. But now people are online and they are taking their time, they can research a lot more and they have information in their hands that they didn't have before. So they can be a lot more choosy, and there is no real apparent added benefit of having Cheerios over a private label.

It doesn't make you feel anything, it doesn't satisfy something beyond just taste.

But Johnny Walker scotch is very different. There is something associated with Johnny Walker scotch that goes beyond scotch whisky. There's a status that comes with it. So I think there is room for brands to remain moats but if the product doesn't separate itself in some way, if it doesn't tell a story and if it doesn't bring out emotion, I don't know that you can call it a moat.

We've been talking a lot about brands, but moats of course can exist in what at first seem like the most unremarkable industries you can think of. Packaging, tins and cardboard spring to mind…

I would argue that moats are more prevalent in low asset growth industries. If you were a venture capital firm you'd be super excited to build the next Facebook but you wouldn't be super excited to build the next cardboard business. Capital doesn't seek out these businesses as readily. People coming out of college aren't thinking that they want to get into cardboard. But nonetheless, they are some very, very good businesses.

In the cardboard industry in the US, there are basically four players that control 75 percent of the supply. They all have solid, mid-teen ROICs, and that's steady. Some of the plants are economically irreplaceable. It may cost a billion dollars to build a new one because of the environmental issues, the sourcing and the different costs that come along with building what's called a virgin fibre plant, which is taking the trees and turning them into pulp and turning it into cardboard. That's one of the reasons why it's so hard to build a new virgin fibre plant.

There are a lot of companies like that. There is a company here called Alamo Inc that does lawn mower attachments for tractors to help maintain roadsides. It's a great moat business that has done very well over time. You can find moats in all different areas. Peter Lynch talks about this in One Up on Wall Street. Boring businesses

are super interesting because they don't attract massive amounts of capital.

If we flip this around and look at it from an investor perspective, how does the stock market tend to treat moat-like stocks? Why should investors consider taking this approach?

The market tends to be very sceptical. It tends to believe that companies that currently have strong performance will revert to the mean. They have a 15 percent ROIC today but they'll trend closer to the market average of eight percent over the next 10 years. The market is sceptical of the durability of the moat. A lot of times there is good reason for that. But if you are right in your analysis and you say you think the company will generate consistent 15 percent ROICs over the next 10 years while the market thinks it will fall to eight, that difference is your alpha. Eventually the market will have to re-rate higher as expectations are reset - and that is where the opportunity is.

How about valuation? How does the market tend to value firms with moats?

I think the market consistently undervalues great businesses, and that's something Nick Train has talked about. If you could have assigned the right PE ratio to Coca-Cola in 1980, it would have been something like 80 times earnings. The business was so strong and the market underestimated it year after year after year. Look at Amazon, which has been around for more than 20 years now. They are gobbling up businesses left and right and the stock continues to surge and take people by surprise. It's a great business that the market just can't get its head around. Especially with those businesses, I don't think there's a great base case, there is no precedent for those companies, which also makes it hard to value them.

One of the things I look for is idiosyncratic companies. These are companies that are categorised inappropriately. For example, there is a bank called First Republic Bank and they pride themselves

on customer service. Their customer service ratings are up there with the best department stores, the best customer experience businesses. But banks in the US tend to have very low customer satisfaction ratings. So there is a virtuous cycle that happens in that business. You have these happy high net worth customers who tell their friends. But First Republic is constantly analysed by bank analysts who do a regression analysis and say "on a price to book basis this stock looks extremely expensive." The analyst isn't stupid, they recognise that there is a differentiated business model, but their valuations can't begin to fully appreciate the added value. So any time I find a business that is mis-categorised I take interest.

We've talked a lot about finding moats in businesses, but as an investor there is always the risk that what you believe to be a strong moat is an illusion. How do you deal with those situations?

What you want to do is find three to five variables that you think account for the majority of the moat. If one of those becomes questionable you have to start wondering what's wrong. I would say moat-focused investors like myself are probably slow to acknowledge but I think that's okay. Over a large number of ideas, waiting is the right strategy but being slow to react can be a negative sometimes. You want to give companies time to fix things but sometimes it doesn't work that way. Sometimes they are on the wrong path, and there is nothing that's going to stop that from happening. It's hard to come to the realisation that you've messed up.

A healthy dose of scepticism is always a good thing to have when you are looking at companies - especially companies with great stories. It's easy to get caught up in them so you need to constantly check yourself. The story might be great, and it might be true. But you need to question yourself, especially if you are feeling 90 percent confident.

It's important to seek out the bear case. If you can explain the

bear case better than the bears, you're in a good position because you're through a lot of the risks and you've reduced your potential downside. Plus, by recognising those risks you can also tell earlier, hopefully, when things are going badly.

So let's say you have a luxury brand that caters to the high end, relies on scarcity and has gross margins of 70 percent plus. All of a sudden they decide to go down market to pick up volume on lower price items. It might be temporarily good but it kills the brand long term. So understanding where the downsides are is really important.

Finally, give me a summary of the approach at Ensemble Capital?

I'm constantly turning over rocks and looking at different businesses. Initially we're trying to find a moat or the sign of a moat. We'll discuss it between ourselves and when we think we've got something we'll start digging into it and building the model, talking to the company and doing more research. It's labour intensive and it takes a lot of time. It can be frustrating too, when you don't have anything attractive in the pipeline. Keeping at it is the hardest part.

We're primarily domestic and we tend to be mid- to large-cap, and that's a competitive space. But we have a different approach with the moat focus. We're not casting a lot of bets, we're trying to focus our efforts on the best 15 - 30 opportunities at any given point in time, and we think we have a good philosophy. That might be 30 percent consumer, 30 percent tech, overweight sectors or certain business types but if our conclusion is that's the place we want to be, we're okay with that.

Todd, thanks so much for your time.

Todd Wenning, CFA, is a senior investment analyst at Ensemble Capital Management in the US. As of the date of publication, clients invested in Ensemble Capital Management's core equity strategy own shares in Nike, Alphabet (Google), and First Republic. These companies represent only a percentage of the full strategy. Mr.

Wenning personally owns shares in Berkshire Hathaway, Diageo, and Amazon

Meb Faber - Leading a new generation of factor investors

Meb Faber is one of the most popular figures in America's new generation of quant-driven factor investing specialists. He runs Los Angeles-based Cambria Investments which oversees a suite of funds and ETFs and manages over $1 billion of client money.

Meb is about as far away from the traditional profile of a money manager as it's possible to get. He's an engineer-turned-finance-quant who built the exposure of his firm by regularly publishing research, articles, blogs and tweets and, latterly, a long-running podcast series.

It's this transparency and Cambria's commitment to driving down management costs to zero on its range of funds that sets Meb apart. I met him at Deus Ex Machina in Venice, LA, for coffee and a conversation about the drive for lower costs and higher integrity in the US investment industry.

Meb, tell me about your background and your investment journey?

In the late 1990s I was an engineer, I was a biotech guy, an undergrad with full intentions of going and doing a PhD. But then we had this fun bubble in internet and biotech stocks. I had taken a year off and was working at a biotech mutual fund while also going to grad school at night. It was the year 2000 and it was a

fascinating time. I said that one year would maybe become two because I wasn't quite ready to go back to grad school for however long it takes to get a PhD. Two years became three and the next thing you know, my career became my hobby and vice versa.

I kept gravitating more towards quant and further away from biotech, and now biotech is no more than a passing interest. We may launch a biotech fund at some point but in general, like a lot of the randomness of everyone's lives, these little decisions you make when you're in your twenties end up becoming careers. I was working for a research firm in the traditional commodity trading / advisor world. A lot of the ideas that we've since built out here, such as trend following had some of their origins there.

We started Cambria 10 years ago without really knowing what we wanted to do. It took a lot of bootstrapping, blood, sweat and tears. We've done a dozen academic papers, five books and two more that I've curated. In addition there are more than 2,000 blog posts, although the blog has shifted more towards the podcast now. It's now split between white papers and podcasts.

A lot of the ideas and research was certainly front loaded. The first three or four years was very heavy on the research side. But that doesn't mean we don't still do research, because we keep coming up with crazy ideas and it's an ongoing process. The evolution of the firm was that it went from a two-person start-up to a boutique asset manager and now that we're over $1 billion we're getting into the next stage of transitioning into a sustainable institution. The research is my love, it's what I like doing. So I try to optimise my day so I can spend more time doing that and less time signing forms and dealing with compliance.

How has that transition from doing research to running money been for you?

The phrase we use is related to a lot of young people that want to get into our world. They watch Billions and they see the romance and seduction of asset management and they see how much money

they can make. You see this pot of gold but you have to make the distinction between managing money and the business of money management. The business of money management is dealing with government regulations, dealing with upset clients, dealing with all the operations. Being good at one doesn't mean you'll be good at the other. But like any firm, you learn to grow, to allocate responsibilities as you go from a single digit headcount firm to a much bigger one.

There is a big debate in the US about the pros and cons of active versus passive investing and the associated costs for investors. Where do you stand on this?

It has become very muddled and this topic drives me nuts. Historically, passive specifically meant one thing, and that was market-cap weighting. That is the default passive portfolio, where you literally do nothing. There's like five percent turnover and the only thing you react to is corporate actions. That then became, "well, we have an index for that and we'll follow the index". Over the past 50 years the word index has come to mean anything. The assumption that passive and indexing are the same thing has totally gone away.

The assumption is that 'active' equals high fee, terrible tax efficiency and passive is low fee, index, incredibly tax efficient. It's a safe generalisation but it's actually very different. You have indexes on crazy double, triple leverage funds, you have indexes on small cap, leveraged marijuana ETFs - it makes no sense.

I side more with the Vanguard view. A lot of people see them as the king of indexing and passive. But while they have more assets in the passive funds, they actually have more active mutual funds than passive, which always surprises people.

I'm a firm believer that all that matters is return after all fees, expenses, taxes and costs. But that means a lot of different things. If you have some esoteric strategy that invests in Peruvian farmland and you are really good at it and you earn a 25 percent return a year, hey, if you charge two percent a year, I understand that that's

possible and it's great. So I'm not solely against high fees, but all that they do is to set the bar a lot higher.

How have you endeavoured to position Cambria funds to try and set yourself apart?

We've launched one, and we'll launch some more of what we call these investable benchmarks. The first one we did was Global Asset Allocation, where all we earn is 30 basis points. It says this is the global market portfolio and we have tilts towards value and momentum, so it's factor based, but if you just want to buy the world, here's what it is.

If you're an institution or an endowment or a foundation or a pension plan, this is the bogey you have to beat. Otherwise people will invest in this, and it's tax-efficient. So if you can't beat that, what are you even doing? We've written a series of articles called: Should Harvard's Endowment be Managed by a Robot and Should a Robot be Managing CalPERS Portfolio?, meaning that so many people in the investment world want complexity for complexity's sake. They believe that in so many other fields, the harder you try the more complex it is, and often that equates with success and better outcomes. But with investing that's not necessarily the case.

We'll eventually launch a series of those kinds of funds so that you can look around the world and start to say, hey, if you can't beat Cambria's fund what are you doing? But the big caveat on all that is that I still firmly believe that active management is possible but the world is quickly going in this barbell where exposure to asset classes is essentially now free. So what can you get away with charging for? It's going to have to be concentrated and different from so many of these closet indexers where an active manager is charging one percent or two percent and their performance is literally just the same as the S&P because they are not making big enough bets.

Closet indexing has been a long term criticism in areas of active management. Is it still a problem?

All the time. Not only that, there are straight-up out-of-the-closet indexers, including a bunch of S&P mutual funds that charge one, one-and-a-half, two percent and they are literally investing in S&P 500 stocks. But you can get the exact same thing for five basis points - it makes no sense. But it's people that have either been sold that, they've been marketed to, they don't know, they're lazy, they forgot or they died - which is probably not an insignificant amount.

Then there are the closet indexers that think they are doing something different. They say: "Our approach is this and we're robust and we do active management." The guys at Alpha Architect, Wes Gray - he's awesome, crazy, and insane person - they have a tool on their website where you can type in an ETF or a portfolio and it will show you the active share or factor exposure, and so many are basically the S&P. So why am I paying you so much if you're just going to give me that exposure?

Most of the funds we offer are very concentrated and specific. The reason a lot of firms don't do that is because when they get to scale there is career risk - if they do poorly they'll lose all their assets. That's because once they get to scale, that fee business is an amazing business. If you're managing $10bn plus, why not mail it in and become a closet indexer? Because that money is much more sticky. So they eliminate the downside outcome, but it defeats all purpose.

What drives your thinking when it comes to strategy?

The goal with our strategies when we launched them was, one, the strategy had to not exist currently, or it was something we could do a lot better or cheaper. If you look at our fund line up, all the funds fit into that category. Global Asset Allocation is one of the cheapest asset allocation funds in the world.

The second criteria is that there has to be a lot of practitioner or academic research that supports the theory, hopefully both and ideally something we have done as well. In some cases it is only us that has published it. But in general a lot of the ideas go back

on ideas that have been around for 100 years. Value investing goes back well over 100 years. It's the same thing for momentum and trends.

Thirdly, it has to be something I would put my own money into. So you're not going to see us launch a lot of these weird funds that are just asset gatherers. I know I could launch a bitcoin ETF and raise a billion dollars. Is is something I'd put my own money into? No.

The hardest criteria of the four is whether it's actually something that anyone wants? That's hard for me because there are a lot of ideas that feel like the best idea ever. I can't wait to get this out and then… nothing. We have a lot of ideas and we have one that, on paper, if you presented it to any logical person, they should agree with it, it's just maths.

We say, look for how many hundreds of billions are there in high dividend funds. People love dividends, it's the most sacrosanct concept on Wall Street. High dividends… income, and retirees love them. The fact of the matter is that if you do the maths, especially with taxable accounts, they underperform the S&P 500. In a retirement account, maybe it's okay. The problem right now is that a lot of the holdings have gotten very expensive over the past 10 years. So my solution is the Shareholder Yield strategy but there are other ideas such as ones that avoid high dividend yield or those that target value, which is theoretically a much better approach, particularly in a taxable account. But trying to market a low-yielding fund is probably not going to raise any money. We also like staying in business!

What are your longer term plans?

We have built this business quite differently to how most asset managers, financial planners and wealth management shops are built. It has been on the back of content, and that's just our personality. I think we're the only asset manager to my knowledge that has crowd-funded an equity raise.

Was that a positive experience?

Yes, it has been great. We opened it up to our followers, people who liked our mission and what we're doing. You had to be accredited but we avoided all the platforms because they are expensive - they take either high fees or carry. So we did two within two years of each other and raised $3.8 million. That has really helped to get us to where we are today. Now we're profitable and over a billion dollars

As far as the future goes, we love doing what we do. The big difference between us and most Wall Street firms is that they've been built on the back of distribution and sales, particularly in the mutual fund world where funds are sold, not bought.

One stat is that the average financial advisor in the US that has been around for 20 years owns 200 mutual funds. That's the most nonsensical thing I've ever heard. When you think about why, it's because people come into your office and sell you a shiny fund and you put it in an account and forget about it. Fast forward 10 years and you have what Josh Brown of the Ritholtz group calls mutual fund salad. The portfolio becomes a nonsensical collection of random funds.

But there are different business models. Ken Fisher built his based on publishing magazine articles and direct mail. We tried to do a local mailing, just to my neighbourhood, because I said, "man, I don't think anyone knows that we're here. Let's send out this post card just so people know." We must have sent out 5,000 postcards and we only got one response, and it was someone who mailed the postcard back to us and written "Don't ever mail me again". That was our one experiment with advertising! So we'll stick to podcasting, I think.

Part of it is personality. The good news about the world today is that the internet has enabled everyone to have a megaphone and a soapbox, for better or for worse. If you have some great things to say it can reach hundreds of thousands and even million of people.

Meb, thanks so much for your time.

Tobias Carlisle - A deep value approach to stock market profits

Toby Carlisle was born and raised in a small village in the Australian outback. He went on to study business and law, and his first day as a mergers and acquisitions lawyer came just as the dotcom boom was unravelling.

In his job he got to witness boardroom decision-making first hand. He saw how company executives can wrong-foot investors by manipulating the truth about their firms. He also learned how corporate acquirers like private equity firms, look beyond market value when it comes to seeing a profit in the wreckage of stricken firms.

Toby moved to California in 2004 and has since become part of a new generation of money managers to embrace deep value investing.

He runs Carbon Beach Asset Management in Los Angeles and has written two books, including Deep Value and The Acquirer's Multiple. In Deep Value, he explores value strategies and the ways they cross over into shareholder activism. In The Acquirer's Multiple he doubles down on his own flavour of value, and shows how the 'Acquirer's Multiple' can reveal much more about the value of a company than it might first appear.

Toby's deep value approach was inspired by the work of Ben

Graham. Like Graham, he's interested in finding what he calls "treasure hidden in plain sight on corporate balance sheets". The Acquirer's Multiple does this by comparing the enterprise value, or total cost of a business, to the operating income flowing into it. These firms can be deeply unloved, in trouble and overlooked by most of the market. That can make them prime targets for activists and takeovers. Bought with enough margin of safety, these stocks can produce impressive profits for value hunters.

I met Toby in Los Angeles, where we talked about the challenges and opportunities of being a deep value investor.

Toby, tell me about the journey you've been on that has taken you from being a corporate lawyer to running an investment firm.

I went to law school in Australia and after that I joined a firm with a corporate practice. I was a research associate in April 2000, which was obviously the very pinnacle of the dotcom boom. I walked into a rough market for what I'd been hired to do, which was IPOs and things like that. When the market is high, corporate advisory involves doing lots of IPOs and capital raising work. But when the market is crushed, it becomes an M&A market, so I was doing M&A from the start.

A new type of investor emerged in this odd market that had been a dotcom boom and where companies had raised a lot of cash. They had no business to speak of and they were all basically burning cash and trying to figure out what they were going to do. They all had a domain and an idea that they were going to destroy some industry with the internet. But they didn't quite know what they were going to do and they were just burning cash in the interim. When the stock market crashed there was no possibility of that continuing and you had these companies that were trading below net cash.

I had read Ben Graham's Security Analysis and Buffett's letters at the time and I was used to the idea of finding high returns on invested capital and an attractive valuation. I was watching these

young guys with small hedge funds go after these busted dotcoms and get control of them. Often we were doing defence against these kinds of activists because we had big clients. We call them activists now, but at the time we were like: 'what are these guys doing? Why would you want one of these things?'

Of course I figured out after a while that they were trying to get hold of the cash. At less than the value of the cash you get a listed company with cash in it. It's an easy thing to stop the business from burning cash: you just stop the business and all of a sudden you've got a cash box for raiding and you've got shares you can issue to do more raiding. So they'd get control of these things to liquidate them or to get control of other companies.

It made me realise that there was much more to value investing than what you might describe as Buffett's view of value investing, which was the only one I knew at the time.

So do you think that environment was showing you a practical illustration of how deep value investing can work?

I knew about net-nets from Ben Graham's Security Analysis. In it he talks about how to calculate the liquidation value of a company from an equity perspective. He also looks at the function of the directors in managing companies and what they should do - are they acting on their own behalf or are they acting on behalf of the shareholders? Those two together are what make Graham great at corporate raiding and activism.

I was lucky that I was working in an area where I was seeing it happen in real life, so it was the real thing. I had read about the theory of it and it was a happy coincidence that the two came together.

I realised later on when I became an investor in my own right that my skills aren't in understanding business strategy and selling products into new markets to generate high returns on invested capital. The thing I can do, and it's a pretty simple thing, is to figure out the balance sheet value and a very conservative estimate

of what a business is worth. Then I can look at it in the context of a transaction if there was an activist involved or potentially an activist involved from a private equity firm or something like that.

That's basically what the Acquirer's Multiple does. If a financial acquirer was to get control of this, rather than a strategic acquirer, what kind of valuation would they want? Where would they want to try and buy it?

That then goes in two directions. One is quantitative, which is just about buying deep value portfolios. They tend to work out over time because people don't like owning scary companies. But they either recover or activists show up and create an event. The second is a special situations type context, where there might be a bidder or they might recapitalise themselves, pay a special dividend or buy back stock, that sort of thing. It tends to be outside the experience of the average investor so it creates an opportunity for someone who understands those transactions.

What led you to set out on your own and how have you managed the challenges of being a value investor during a period when the strategy has come under pressure?

I started my own firm in April 2010 and if you look at the performance of deep value - that was basically the start of the underperformance of deep value! It has been a really rough, long eight years. It gets a good run every now and again - 2015 was a bad year, 2016 was a really good year, 2017 was a flat year and it has tracked the market in 2018. It's a strategy that needs a big shakeout before it starts working in a consistent, year-on-year, compounding way.

Value had a very very good run from 2003 to 2007 in the States. The market had fallen and started recovering through 2007 and value was up every single one of those years, very substantially. You could be a long-only equity investor and be up in a market that was falling, which is pretty rare. Usually you're pretty tightly correlated to the market if you're a long-only equity investor. That's because

it had performed so badly in the late 1990s. Valuations of value stocks had fallen so far from the dotcom stocks and the spread was massive between them.

After the crash, 2009 was a really big year for value guys but the spread had really tightened up to almost nothing by 2010, and value really needs a spread for it to work. So since 2010 it has either tracked the market or slightly underperformed. If I look at the data, I'd say that was a classic harbinger of something nasty coming. But I would have said the same thing in 2016, and it didn't happen.

In the current context, everybody knows that US equities are massively overvalued. Nobody would disagree with that proposition and nobody would have disagreed with that proposition from 2012 onwards. Yet here we are, up 100 percent or something since 2012.

How do you structure you value approach and then apply the strategy in the market?

I've written a book called Deep Value so I'm always going to be a deep value equity guy. I'm always going to be US domestic. I do it in a long/short way. I'm 100 percent long, and a long/short that's 30/30 and I try to apply the reverse of the rules on the short side. I think you can find a lot of junk companies that deserve to be shorted that have got no momentum.

Basically the two strategies are knitted together. The question is whether extending the 100 percent long by 30 percent will outperform the 30 percent short? The answer is not every year, not all the time, but over the long run it absolutely will. The two portfolios are like night and day. One is filled with really junky, cash-burning, share-issuing companies. The other one is filled with pretty high quality companies.

On balance, you are much more focused on value rather than quality. Why do you think quality is a harder factor to profit from?

I'm a deep value guy so I'm not looking for high returns on

invested capital. Joel Greenblatt's Magic Formula uses high return on invested capital, and I like his quantitative approach to what Warren Buffett does, and it works really well. But my own bias is that there's no way that return on invested capital helps. I've tried to do that and it doesn't work.

The key to what Buffett does is sustainable high return on invested capital. If you read Buffett's letters, all he talks about is competitive advantages. But you can't do it scientifically. Michael Mauboussin tried to do it scientifically and you can't find the thing that predicts which companies will retain a high return on invested capital into the future. It seems like it's random, which is what you'd guess because if anybody finds a company earning lots of money from the money invested in it, you'd want to compete with them. It makes simple sense. So you really need some way to stop those guys from being able to compete with you and there aren't very many real competitive advantages.

Things like brands used to be a really big competitive advantage. You'd go into the supermarket and buy Johnson & Johnson Band-Aids, but I think the market is shifting a little bit now. With social media you can become a little bit better informed and that has eroded the power of some brands. It's an interesting thing and I don't know how it will play out.

What are the biggest challenges of using a quant value strategy - both for you and for buying a value ETF or fund?

There is a learning process for getting people used to the fact that they're not necessarily going to understand what each stock is in the portfolio and what it does. If I can remember the tickers, that's a good thing, but I also know that looking at the portfolio all the time is a behaviourally bad thing to do. That's because you look at the the tickers and you're nervous about the stuff that you're long and you're nervous about the stuff that you're short - and you should be. That's why they have fallen to this position or risen to that position, because everyone knows what the tickers are - they're

either the really nasty businesses or the really popular, glamorous businesses to be in.

It's a well known behavioural thing: the more you learn about something, the more certain you become that you're right, because you're just finding new information to prove that you are right, and not really further examining it. You make the decision after the first two or three bits of information, and everything after that is for the "why I'm right" file.

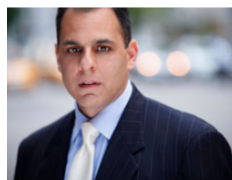
So it's a trap. I think of myself more as a value investor than a quant, but I meet value guys who know the CEO's son and who he is married to, and they've worked out the line of succession. I'm not joking. They've tried to make friends with the son, who will take over eventually. They want to be in a position to know what is going to happen, they want some insight. But it's a trap and you get too concentrated in something just because you know it really well.

There are lots of good reasons why quant is a good method of investing. But it's very hard to persuade somebody because that behavioural error that you're trying to capitalise on is also something that impacts your investors and impacts other people too. They like the idea that there is this steady hand on the tiller, digging into all the information even if it hurts their performance.Think about the big value funds - Ackman, Einhorn, Buffett - they're all about having a steady hand on the tiller. The thought that it's just a computer that's picking the stocks is just anathema to most people.

Toby, thank you very much for your time.

Mark Minervini - Achieve superperformance like a stock market wizard

When you're trying to interview a man with a deadline to write a book, finding a convenient time isn't easy. When that man is Mark Minervini, whose hectic days were split between trading and finishing his hotly-awaited new investing guide – *Think and Trade Like a Champion* – the pressure's even worse. When I finally managed to catch him - after the market close in New York - he was generous with both his time and his views.



For more than three decades, books have played an important part in cementing Minervini's reputation as one of America's most closely-watched traders. 2017 saw the follow up to his popular guide, *Trade Like a Stock Market Wizard: How to Achieve Super Performance in Stocks in Any Market.* That was written 10 years after he was profiled in Jack Schwager's hugely popular *Stock Market Wizards.*

So what's his appeal? Minervini started trading with very little capital in the early 1980s. After several years of losses, he took his strategy back to basics and got scientific with what was working, and what wasn't. It was a turning point that transformed his results.

In 1997 he was named U.S. Investing Champion after smashing the contest with a gain of 155 percent. It served to prove the effectiveness of his strategy even under the most competitive conditions. Since then, he's won a huge following and built an

education business on the back of it.

In essence, Minervini is a growth investor. He made his name shooting for big gains in fast moving stocks with a strategy that blends fundamentals, technicals and strict risk management. The process is carefully laid out in his first book, with a particular focus on getting the timing of trades absolutely right.

But what comes across when speaking to him is that the precise strategy is very much a personal decision. What's more important is the belief and mindset to stick with it, and an unswerving discipline to avoid big losses.

Mark, tell me about how you've evolved and developed your strategy over time?

My strategy developed very simply because I had a small amount of money and I wanted to turn it into a large amount of money. So I had to find a way to trade the markets and be able to very rapidly compound my capital.

In the beginning I couldn't do short-term trading or swing trading like you can nowadays. Back then, commissions were more than $175 per trade. With a small account back in the early 1980s, with a few thousand dollars, I couldn't pay that much commission trading in and out. You had to pick up the phone and call your broker, and he called someone that called someone else on the floor, and it was a much lengthier process to make a trade.

Back then we would look for big moves in stocks. But now you can trade for pennies and have instant liquidity so there is a lot more in-and-out trading, swing trading and day trading. Over the years I've refined it more and more to the point where I've got down to pretty much a science. It's still an art, but the science takes out as much guesswork as possible.

Your strategy is very much focused on growth companies. In terms of fundamentals, what sort of profile are you looking for in a stock?

My books spell everything out much better than I can explain in a brief interview, but from the fundamentals side, if you're investing in growth companies you're obviously looking for signs of growth. It doesn't necessarily mean that just because a company is showing decent earnings, say earnings are up 30 percent over the past few quarters, it's attractive. It's really a matter of asking whether it's doing better than it was previously.

For instance, if you have a company that's growing at 30 percent annually, but prior to that it was growing at 80 percent or 90 percent, that's not very good because the growth has slowed. That's what you saw at Dell Computer in the 1990s. Dell was growing at a rapid rate but it decelerated towards the end of the decade and the stock topped.

But if you take a stock that was previously losing money but is now growing at 10 percent or 15 percent, that's a big improvement from where it was. That could actually do better than a stock with a higher growth rate that's actually slowing down.

Sometimes that confuses people, but it's really the change in growth rate that you're looking for. Wall Street likes it when things are going better than expected, and when a company suddenly shows that its growth is accelerating faster than anticipated.

So I'm looking for big quarterly earnings growth. But sometimes you'll get big fundamental changes that aren't apparent in the earnings. Maybe you'll have a company that has got approval for a new drug and you might not see it in the earnings. So it depends on the situation and the category a company falls in to.

I treat various industries and different types of companies differently. That's why I break it down into four or five basic categories. You have Market Leaders, Top Competitors, Institutional Favorites and Turnaround situations. Those are the four that I usually concentrate mostly on. Then you have Cyclical stocks, which I tend to avoid, and anything involving mergers I tend to avoid most of the time as well.

What advice do you have for investors when it comes to honing a strategy and developing a trading style?

One of the problems for the average investor, particularly for those that are new to trading, is that there is so much information out there; information overload is common. There is more than one way to skin a cat, and my way isn't the only way. It just happens to be the way that I know really well, and I've focused on for so many years that I'm good at it.

You can have a value player buying stocks that I wouldn't touch, and they do very well. Whereas I'm buying growth stocks with P/E ratios that are higher than a value investor would ever think of buying, but we can both do well. The key is to really know your strategy.

But you have to narrow it down and come up with something that makes sense to you and then commit to it. You're not going to be good at a lot of different strategies. You have to make a commitment to one area and spend time learning it so you become really good at it, rather than just dabbling with different styles. You want to be a specialist, not a jack-of-all-trades.

If you're going to day trade, that's a lot different from being a long-term investor. There are going to be different rules to follow - but it's important to have a set of rules and a process.

It took me a lot of years of course, being successful didn't happen overnight. I didn't do very well for almost six years but over time it started to click for me. Nowadays you have access to information that can help shorten the learning curve. When I first started trading, I had to go to the library. I was reading books that were old and outdated, and it wasn't as easy to get access to good information like it is today.

The investment environment has changed a lot since you started trading. Do you still believe that individual investors have an edge despite new developments like algorithm-driven, high-speed trading?

Absolutely! If you'd asked the average investor in 1930 if it was too complicated and whether the big, rich investors and institutions had the edge, they'd have said yes. If you'd asked them in 1950, 1980, 1990 it would always be the case. It's always the case that people feel it's a rigged game and that the big guys have the edge. Actually, it's quite the opposite; the big guys don't have the edge. They have a handicap because they have to move big amounts of money and their process is very slow and lethargic.

The individual investor can move very quickly and has a huge advantage. The smaller you are and the smaller your portfolio, the bigger advantage you have. Nowadays, you also have the exact same tools as almost any professional. You have access to the same information, and laws have been changed to level the playing field as far as the information flow. All your tools, your quotes, your execution are as good as anybody else's. So it's a great time to be a stock trader and it's going to just get better and better.

Your approach has some of the hallmarks of other trading legends like Jesse Livermore and Stan Weinstein. Who have been the big inspirations in your trading, and what have you learned from them?

I met Stan Weinstein back in 1990 at a big investment event in New York City. He was a very colorful, fun guy and he really impressed me with his passion for the market. That's when I began to fold-in the trend work. It really got crystallized for me after I met Stan.

One of my biggest influences early on was Richard Love. He wrote a book called Superperformance Stocks. Richard Love and William Jiler are the two who really are the backbone of the fundamentals side and the technicals side. Jesse Livermore would also be one of my big influences. I would say that I am a modern version of those four traders and I've combined and refined the best of each.

Paul Tudor Jones is also someone who I modelled a lot of my trading after, particularly on the risk management side. As commissions came down and I was able to trade quicker and cheaper, I started

applying the types of rules that futures traders were using. That meant being much more aggressive with trading stocks, and taking a more mathematical approach and mitigating the risk quickly like if I were a highly-leveraged futures speculator.

Risk management is clearly a major part of your strategy, and particularly cutting losses early. Where do most traders go wrong with this, and why?

Most traders go wrong because they usually don't have a good strategy to begin with. For most, their egos are more important than making money, and they don't figure out how to differentiate the two. When a stock goes down, they don't want to be wrong so they wait until it comes back. The loss gets worse and before you know it, a big chunk of your capital is gone. They hit what we call the 'uncle point' where your arm is twisted so far that you can't take the pain any more. Do that enough times and you start thinking about throwing in the towel; and when your confidence is damaged, then you're doomed.

Maybe then they'll read a book like mine and decide that cutting losses sounds like a good idea. They try it, the stock goes down and they sell it and then it turns around and goes back up and takes off and they think: "my god, I'll never do that again, that was stupid".

So you have to realise that you're not going to be right all the time, in fact you'll likely be correct only about 50 percent of the time. You have to manage the risk, that's the most important thing. There is a lot of risk in trading stocks. All stocks are risky and that has to be managed. The goal of stock trading is to make more money on your winners than you lose on your losers - it's not to be right all the time.

For some, it takes a while to shift their thinking, but you have to focus on avoiding big losses by embracing smaller losses.

Selling at a small loss is one challenge, but knowing when to sell for a profit is another difficult subject. What's your advice

on how to run winners and how and when to exit a successful trade?

In my new book what I've done is to try and cover all the things I didn't cover in the first book because I ran out of room! It covers all my rules and the types of things that you should look for when it comes to deciding whether you should hold the stock longer for a larger move. But also when you should reduce or sell the stock even before it hits your stop loss. There's a whole chapter on selling and a chapter on what I call "violations".

The main thing is that you have to have rules. Without them you're just going to be operating from your emotions, your hunches and the seat of your pants. It's never going to turn out good when you do it that way. So those rules should be based on a sound philosophy, which means sacrificing. Let's say you are going to be a swing trader for instance, and you buy a stock at 20 and it goes to 30 and you sell it. If the stock takes off and triples you can't be upset that you weren't in it because you already accomplished your goal.

Take day trading as another example. A day trader goes flat to cash every night and is out of the market. They'll go in there and scalp the stock for sometimes a few pennies, or a nickel or a dime or half a dollar. They're not getting upset when they sell the stock and take 50 cents profit on it if the next day it gaps up 5 points. It's not part of their business plan.

It's the same thing if you're a long-term investor and you buy a stock at 20 and it goes up to 25. You're trying to play it for a much bigger move and it comes back down and stops you out at 18 or 19 dollars. Now you're a Monday morning quarterback and thinking you should have sold it at 25. Again, if you're playing for a larger move, you're going to have to sacrifice the shorter move. If you're going to play for the shorter move, you're going to sacrifice the larger move.

You must define your trading. You have to learn to sacrifice and focus on a particular style, which is all based on having a

framework that you operate in. The whole idea of this scientific approach is to remove as much of the emotion and as much of the luck factor.

There are still going to be intuitive decisions to be made: What to buy? When to buy? How much to buy? When to sell? There are always decisions to be made and you're never going to be truly scientific, it's still going to be an art. But that's the beauty of it. If it was purely scientific then you'd be able to put it into an Excel spreadsheet or computer program and let it run, and humans wouldn't be needed and the edge would be gone. But that's the beauty about trading, there's an art to it. That's the challenging part but it's also what makes it so rewarding.

What was your best trading year, and what was your performance?

One standout year was 1995, when I was up 412 percent, the 1990s were good, of course. I was out in 2000 and came back in 2004 and had some big triple digit years. Since then I've done very well and been very consistent. I haven't had any down years in perhaps 20 years. Early on, I had a lot of volatile periods when I'd do well and then blow myself up in a few months of bad trading. These days I trade more conservatively and without my whole net worth on the line as I did in my initial years when I was trying to build my capital.

When you look back, is there anything the stands out as being a key moment in your trading?

As far as any one trade, not really, because I've traded hundreds and hundreds of thousands of stocks and it's not like I had one big winner that accounted for my success. My returns have really been produced through consistency and a lot of trading year after year.

When I look back in time, back in the 1980s and early 1990s I was more of an investor holding for larger moves out of pure necessity. As a result, I got some really big movers. The names that I was buying back then, if you look at them today you'd say "oh, of

course" - Amgen, Dell Computer, Microsoft, Costco, Home Depot, Gap Stores, etc. But at the time few investors had even heard of those companies, they were all small-cap, underfollowed names. After that, it became sort of a blur because it was a lot of trading and the stocks just became symbols that I was trading on a daily or weekly basis.

Over time, how have your ambitions and the focus in your life changed?

I've come to realize that my calling hasn't just been trading but it is also helping others. My editor told me I was a natural born teacher. I didn't realize it was something I was good at and it wasn't really something I planned on doing.

Back in the late 1990s I got in the public eye after winning the U.S. Investing Championship and I was on TV a lot. As a result, I was offered a lot of money by publishers to write a book, but I didn't because I didn't want to give away the "secret". I was advising some very big institutions and I never saw myself dealing with individual investors or having a retail product or doing seminars. To me, I was a just a trader and I wanted to avoid all that. The reasons why I started trading in the first place was that I could be in a room by myself and be responsible for my own success.

But that all changed as I started thinking about passing the torch. When I wrote my first book I was not sure if anyone would even like it. Then I did a seminar and that turned into a big success and I've been doing it ever since. So it feels like my ultimate calling is to be an educator; it feels really good when people tell me that I've helped them improve their lives.

One of the things that I always tell stock traders is that while you can read about the mechanics behind the big returns from superstars, it's probably not going to get you the same sort of success unless you feel that you can do it and it's possible and you believe in your own abilities.

A big part of me writing a book and doing workshops is to empower

people to help them understand that not only can they do what I have done, but with the benefit of my knowledge, they can do even bigger and better than what I've done. Ultimately, a belief in your own abilities is more important than the strategy.

Mark, thank you very much for your time.