

“Trying Too Hard”

Keynote Speech

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The title Marshall mentioned, “Trying Too Hard”, comes from something that happened to me a few years ago. I had just completed what I thought was some fancy footwork involving buying and selling a long list of stocks. The oldest member of Morgan’s trust committee looked down the list and said, **“Do you think you might be trying too hard?”** At the time I thought, “Who ever heard of trying too hard?” Well, over the years I have changed my mind about that. Tonight I am going to ask you to entertain some ideas whose theme is this: We probably are trying too hard at what we do. More than that, no matter how hard we try, **we may not be as important to the results as we’d like to think we are.**

But I also hope to persuade you that’s not all bad. Sure, we get an uncomfortable feeling when we question the value of some of the things we’ve thought we’re supposed to do . . . but the rest is pure good news. Complete with more time to do the thing we’re well-suited for, greater efficiency in own companies and, probably, better results for our customers.

Here are the ideas I’m going to talk about: **the first is an analogy between physics and investing.** With apologies to anyone who knows anything about physics—or about investing, for that matter- let me put it this way: The foundation of Newtonian physics was that physical events are governed by physical laws. Laws that we could understand rationally. And if we learned enough about those laws, we could extend our knowledge and influence over our environment. That was also the foundation of most of the security analysis, technical analysis, economic theory and forecasting methods you and I learned about when we first began in this business. There were rational and predictable economic forces. And if we just tried hard enough. . . . **If we learned every detail about a company.** . . .If we discovered just the right variables for our forecasting models...Earnings and prices and interest rates should all behave in rational and predictable ways. **If we just tried hard enough.**

In the last fifty years a new physics came along. Quantum, or subatomic physics. The clues it left along its trail frustrated the best scientific minds in the world. Evidence began to mount that our knowledge of what governed events on the subatomic level wasn’t nearly what we thought it would be. Those events just didn’t seem subject to rational behavior or prediction. Soon it wasn’t clear whether it was even possible to observe and measure subatomic events, or whether the observing and measuring were, themselves, changing or even causing those events. What I have to tell you tonight is that the investment world I think I know anything about is a lot more like quantum physics than it is like Newtonian physics. There is just too much evidence that our knowledge of what governs financial and economic events isn’t nearly what we thought it would be.

The second idea I am going to ask you to think about is that most of us spend a lot of our time doing something that human beings just don’t do very well. **Predicting things.** What earnings will be in a few years. When interest rates will peak. What inflation will be. **One of the most consuming uses of our time, in fact, has been accumulating information to help us make forecasts of all those things we think we have to predict.** Where’s the evidenced that it works? I’ve been looking for it. Really. Here are my conclusions: Confidence in a forecast rises with the amount of information that goes into it. But the accuracy of the forecast stays the same. And when it comes to forecasting—as opposed to doing something—a lot of expertise is no better than a little expertise. And may even be worse. The consolation prize is pretty consoling, actually. It’s that you can be a successful investor without being a

perpetual forecaster. Not only that, I can tell you from personal experience that one of the most liberating experiences you can have is to be asked to look over your firm's economic outlook and to say, "We don't have one."

In the advance material you were sent, I noticed some words that smiled at me like the Mona Lisa: "It is generally recognized that growth stocks produce a superior risk-adjusted rate of return. However, this is only true for stocks that are expected to grow in the future, and **correlations between past growth and future growth are low**". As Gomer Pyle would say, "How true, how true". I've concluded this about growth stocks: There is no such thing as a growth stock. **Only passing phases of growth in almost every company's life.** Phases whose beginning and end usually appear in disguise.

If there is a reliable and helpful principle at work in our markets, my choice would be the one the statisticians call "**regression to the mean.**" The tendency toward average profitability is a fundamental, if not the fundamental principle of competitive markets. It is an inevitable force, pushing those profits and their valuation back to the average. It can be a powerful investment tool. It can, almost by itself, select cheap portfolios and avoid expensive ones. Its plain English equivalent is that something usually happens to keep both good news and bad news from going on forever.

I started by saying that you and I probably aren't as important to the results as it would be fun to think we are. I meant that in the same spirit that Leroy Jolley meant it when he said, "The more I am around horse racing the more I think that the most underrated thing is the horse and that it is us trainers and jockeys and owners who are overrated". There are some qualities you and I can bring to the races. But I think it is one of those cases where less is more. Here they are:

SIMPLE APPROACHES.

Albert Einstein said that "...most of the fundamental ideas of science are essentially simple and may, as a rule, be expressed in a language comprehensible to everyone." The first time I heard that I thought, "Sure, that is easy for him to say." But as long as there are people out there who can beat us using dart boards, **I urge us all to respect the virtues of a simple investment plan.**

CONSISTENT APPROACHES

Look at the best performing funds for the past ten years or more. Templeton, Twentieth Century Growth, Oppenheimer Special, and others. What did they have in common? It sure wasn't their investment philosophies. It was that whatever their investment plans were, they had the discipline and good sense to carry them out consistently.

A very special tolerance for the concept of "nonsense", or what the Zen call "Beginner's Mind". I could have saved myself a lot of time if I hadn't been so quick to label as "nonsense" a lot of ideas I now accept as good sense. **Expertise is great, but it has a bad side effect. It tends to create an inability to accept new ideas.**

The last idea I'm going to ask you to consider is that it may be to our advantage to come at our jobs from a totally different orientation. How are most of us organized? To gather information and use it to make

predictions. We have security analysts. We get research reports from brokers. We get forecasts about the economy, interest rates, the stock market. We process that information and act on the basis of it. For all of that to make any sense, **we all have to believe we can generate information which is unknown to the market as a whole.**

There is an approach which is simpler and probably stands a better chance of working. **Spend your time measuring value instead of generating information. Don't forecast. Buy what is cheap today. Let other people deal with the odds against predicting the future.**

Let's go back to the beginning. I began by talking about physics and investing. I remember a conversation Dean LeBaron and I had a few weeks after I joined Batterymarch. It was the first really serious talking we'd done about investment philosophy. He said, "You might as well know that I have some fundamental biases about investing." I sat forward in my chair. Primed and ready. "...and a lot of them are contained in these two books." Which he put on the table in front of me. I looked at the books. They were the *Tao of Physics* and *The Dancing Wu Li Masters*. I can literally remember thinking, "Maybe this is some kind of test. Maybe he wants to see if I will say the first thing that pops into my head. Like....'Are you kidding me?' Or a southern colloquialism meaning the same thing. I kept my views to myself, though, and took the books home. The analogy between the investment world you and I deal with and the molecular world of quantum physics I began about was evident almost from the first page.

How many times have we all identified a pattern in past numbers and watched as it predicted one market turn after another right up to the time we got involved by trying it with real money? Or, have you ever had the feeling that a stock that just sits there month after month . . . ugly . . . lifeless somehow knows when you sell it? And picks the very next day to turn from a frog to a Prince?

A couple of months ago you may have noticed an article in the *Wall Street Journal* called "The Books That Businessmen Are Reading." The author had asked the chief executives of a number of companies what books they had enjoyed recently and why. I was surprised to see that *The Dancing Wu Li Masters* was one of the three books mentioned by Richard Fontaine, the President of B. Dalton Books. He said it had made him aware of "**how little we really know.**" A good starting point. Like those who study quantum physics, we should be more content with probabilities and admit that we really know very little.

The next idea we talked about was that maybe the ability to see into the future wasn't one of the things the Creator had in mind for us. It would be an advantage in our line of work, to be sure. So it is definitely a game worth winning. **The question is, are the odds against forecasting well so great that it may not be a game worth playing?**

The most readable treatment of that question I have seen is by a Wharton professor named J. Scott Armstrong. About a year ago he published an article in *Technology Review* called "The Seer-Sucker Theory". He collected studies of experts' forecasts in finance, economics, psychology, medicine, sports and sociology. The summary of the evidence he found is that expertise beyond a minimal level is of little

value in forecasting change. His recommendation probably is drawing fan mail from consultants everywhere: “Don’t hire the best expert. **Hire the cheapest expert.**”

Armstrong catalogs studies of market forecasts and stock picking ability from as early as 1902. He tells about the work of Alfred Cowles, who went through nearly thirty years of forecasts which had been published in the Wall Street Journal, only to find that 50% had been right and 50% wrong. Compared with most academic papers, the way Armstrong words his theory stands out like a hoagie on a plate of watercress sandwiches: “**No matter how much evidence that seers do not exist, suckers will pay for the existence of seers.**”

Those of you who watch pro football on television will join me in reminding professor Armstrong that, no matter what the facts are, it was talk like that that got Brent Musberger a punch in the nose from Jimmy the Greek.

Ray Devoe, the market writer, makes a claim which I let stand, no questions asked. It is that he has collected several examples of graffiti from walls of ladies restrooms. One, in particular, struck a sympathetic note with me. It was apparently written by a woman who had concluded, after years of dealing with men, that it just wasn’t worth the bother and who needs ‘em anyway. It was, “A woman without a man is like a fish without a bicycle.” **Give life a try without forecasts.** You might even decide, as I have, that a portfolio manager without a forecast is also a little like a fish without a bicycle.

The next idea we mentioned was the deceiving simplicity of investing in growth stocks. Like most ideas, it is not a new one. Let me read this to you from the 1938 annual report of a mutual fund called National Investors Corporation:

“The studies by this organization afford evidence that the common stocks of growth companies.—that is, companies whose earnings move forward from cycle to cycle and are only temporarily interrupted by periodic business depressions—offer the most effective medium of investment on the field of common stocks. We believe that this general conclusion can be demonstrated statistically and is supported by economic analysis and practical reasoning.”

That made a lot of sense then and it still does. If you believe that a stock is worth the present value of its future earnings, you have to be attracted to the idea of owning the ones whose earnings will go up the most. And study after study has confirmed that: **Over most periods, earnings growth rates and investment returns are highly correlated.**

There are some problems, though. The one we talked about earlier was is there really such a thing as a growth company? In “Marketing Myopia” Theodore Levitt said, “Every major industry was once a growth industry. Some that are now riding a wave of growth enthusiasm are very much in the shadow of decline. Others, which are thought of as seasoned growth industries, have actually stopped growing.”

In recent years, some growth companies have been the ones that could raise their prices the fastest. Before that it was the ones that sold more and more of everything from Pringles to instant film to lipstick. Before that it was the ones that understood the math of offering stock at forty times earnings to buy companies selling at twenty times earnings. Before that it was life insurance and, believe it or not, electric utilities. And before that, steel and automobiles and railroads.

The point is that growth—for those companies that enjoy it—is usually only a phase between the early years and the maturity and loss of leadership that probably will be in every company's future. Like life itself, it has to be appreciated in its own time.

Another problem is knowing ahead of time who is going to grow fast and who isn't. As early as a dozen years ago Benjamin Graham said, **"In our view security analysts as a whole cannot estimate the future earnings pattern of one of more growth stocks with sufficient accuracy to provide a firm basis for valuation in the majority of cases."** When your advance material said that correlations between past growth and future growth are low, it wasn't kidding. It was referring to one of the most original pieces of research ever done in our field. It was by an Englishman named Ian Little. He called it *"Higgledy Piggledy Growth."*¹ Its conclusion was, don't expect past growth rates to give you much help in predicting future ones.

The final problem probably is the most important one. **It is how do you keep from paying too much for a growth stock when you don't have much confidence about its future growth rate.** That was what Benjamin Graham meant. It wasn't just that he thought it was hard to estimate earnings far into the future. It is that he didn't think it could be done accurately enough to value those stocks properly.

We talked about a helpful principle called **regression to the mean**. Aside from the intuitive good sense you and I can see in not expecting anything to go on forever, that is increasing evidence that this principle is alive and well in our markets. There are studies showing that differences in multiples among companies tend to disappear or even reverse over time. And that high and low returns on capital do the same thing.

That is the reason so many studies show that **if you are going to manage money mechanically**, a good rule is: Buy the stocks with the lowest multiples. Imagine two portfolios. One has stocks we all agree are the "best: companies, with the best prospects for growth. And they are priced that way. To justify those prices they all have to meet your expectations. But we know that *some* of them won't. **They will disappoint us.** The other portfolio has all the companies we don't like or don't care about. They are priced on low expectations. But we know that *some* of them will surprise us and do well. **And since we haven't paid for the expectation that any will do well, that is the portfolio with the odds in its favor.**

Next, we talked about some qualities you and I can bring to our jobs a tolerance for nonsense, "Beginner's Mind", simplicity, and consistency. The first sentence in *The Dancing Wu L Masters* is, "The importance of nonsense can hardly be overstated." Again, the analogy between physics and investing came through to me: In general, physicists don't deal in nonsense. Most of them spend their

¹ Please see Appendix on page 9

professional lives thinking along well-established lines of thought. The ones who establish the established lines of thought, however are the ones who aren't afraid to venture into what any fool could have told them is pure nonsense."

Werner Heisenberg, the physicist of an earlier generation, talks about coming up against his concept of nonsense: "I remember discussions with Nils Bohr, which went through many hours til very late at night and ended almost in despair. And when, at the end of the discussion, I went alone for a walk in the neighboring park I repeated to myself again and again the question: Can nature possibly be as absurd as it seemed to use in these atomic experiments?" I can imagine Ian little saying the same thing to himself as he stared at his results showing that earnings growth rates looked like a random walk. And I can guarantee you that was what went through my mind the first time I heard that institutional portfolios had earned lower returns than the market averages themselves. So, like the Woody Allen character in "Sleeper", who came back to life after fifty years to discover that science had proven that the real health foods were now cotton candy and jelly doughnuts, let's be open to any possibility.

"Beginner's Mind" is a Zen concept which says that, "It is not difficult to attain enlightenment, but it is difficult to keep a beginner's mind. In the Beginner's mind there are many possibilities, but in the expert mind there are few." When we think about tall that has been said over the years by experts and accepted by other experts, only to be proven wrong by events, beginner's mind seems too important to be left to beginners.

The reason for dwelling on the virtue of simple investment approaches is that complicated ones, which can't be explained simply, may be disguising a more basic defect. They may not make any sense. Mastery often expresses itself in simplicity. Werner Heisenberg, the physicist we met when we were talking about nonsense, said, "Even for the physicist, the description in plain language will be a criterion of the degree of understanding that has been reached."

My favorite paper on this subject was also written by our leg-pulling friend J. Scott Armstrong. It is called "*Unintelligible Management Research and Academic Prestige*." I couldn't possibly improve on his words, so I will read the first page to you:

"Dr. Fox was an actor who looked distinguished and sounded authoritative. He was provided with a fictitious but impressive biography and was sent to lecture about a subject on which he knew nothing. The talk, "Mathematical Game Theory as Applied to Physician Education", was delivered on three occasions to a total of 55 people. One hour was allowed for the talk and 30 minutes for discussion. The audiences consisted of highly educated social workers, psychologists, psychiatrists, educators, and administrators. The lecture was comprised of double talk, meaningless words, false logic, contradictory statements, irrelevant humor, and meaningless references to unrelated topics. Judging from a questionnaire administered after the talk, the audience found Dr. Fox's lecture to be clear and stimulating. None of the subjects realized that the lecture was pure nonsense.

"If an unintelligible communication is received from a legitimate source and if this communication claims to be in the recipient's area of expertise, recipients might assume that they are wasting their time because they receive no useful knowledge. In terms of knowledge, they would be wasting their time.

But their involvement in this activity may lead them to try to justify the time spent. Furthermore, the greater the unintelligibility, the greater the need to rationalize about the time spent (e.g., if you cannot understand a paper, it must be a high-level paper). This might be called the Dr. Fox hypothesis: An unintelligible communication from a legitimate source in the recipient's area of expertise will increase the recipient's rating of the author's competence. "

He then goes on to conclude that, "Overall, the evidence is consistent with a common suspicion. Clear communication of one's research is not appreciated. His final advice is "Lack of clarity is especially helpful when content is poor. **Because there's maybe two billion dollars in fees at stake in our business, we can be tempted to avoid simple investment methods, which can be simply explained to our clients.** Dr. Fox is not a good role model for us.

The last of the mental qualities we talked about was consistency . . . and how it seemed to be present in nearly all outstanding investment records. You are familiar with the periodic rankings of past investment results published in *Pension & Investment Age*. You may have missed the news that for the last ten years the best investment record in the country belonged to the Citizens Bank and Trust Company of Chillicothe, Missouri. *Forbes* magazine did not miss it, though, and sent a reporter to Chillicothe to find the genius responsible for it. He found a 72 year old man named Edgerton Welsh, who said he'd never heard of Benjamin Graham and didn't have any idea what modern portfolio theory was. "Well, how did you do it?" the reporter wanted to know. Mr. Welch showed the report his copy of Value-Line and said he bought all the stocks ranked "1" that Merrill Lynch or E.F. Hutton also liked. And when any one of the three changed their ratings, he sold. Mr. Welch said, "It's like owning a computer. When you get the printout, use the figures to make a decision--not your own impulse." The *Forbes* reporter finally concluded, "**His secret isn't the system but his own consistency.**" EXACTLY. That is what Garfield Drew, the market writer, meant forty years ago when he said, "**In fact, simplicity or singleness of approach is a greatly underestimated factor of market success.**

The final idea we talked about was that there are two ways we can try to gain an edge over the market. The one that most of us choose is to try to generate superior information. To know more than anyone else. The other choice is to be better at measuring value than others and not to care very much about what other investors think they know. **To hold cheaper securities by today's standards and to let the future speak for itself.**

For all of his reputation as the father of security analysis—which he was—Benjamin Graham was skeptical of anyone's ability to generate information unknown to the market or to forecast future earnings. His view of portfolio management wasn't information and it wasn't forecasts. **It was buying a diversified list of statically cheap stocks.**

He gave an interview shortly before his death. He said, "I am no longer an advocate of elaborate techniques of security analysis in order to find superior value opportunities. This was a rewarding activity say, forty years ago when our textbook *Graham and Dodd (Security Analysis, 1935)* was first published. But the situation has changed a good deal since then. In the old days any well-trained analyst could do a good professional job of selecting undervalued issues through detailed studies. But in light of

the enormous amount of research now being carried on, I doubt that in most cases such extensive efforts will generate sufficiently superior returns to justify their costs.” I think he may have been asking us all, in the same gentle spirit that the question was first put to me”Do you think you might by trying too hard?”

Appendix

I.M.D. Little did an extensive analysis of hundreds of British companies in a pioneering 1962 study of whether **“past growth behavior is some sort of guide to future growth.”**

. . . . It is useless to try to predict future earnings from any single past earnings growth ratio, or from dividend cover, or from asset size. None of these factors should influence the price of a share except insofar as a high dividend cover probably on average results in a higher than average future dividend performance. But a share’s price is only loosely tied to its earnings. Mr. Scott has found a correlation between past earnings and the future share price (for up to a year after the last results) This is explicable insofar as future dividends and past earnings growth are related: but, probably, the main reason is a naïve belief that past growth tends to continue.

Mainly for Economists

1. I wrongly expected that I would be able to find some correlation of future and past growth (in relation to the average for the industry), primarily on the view that some continuity of good and bad management would establish such a correlation. If a good management is one that earns a higher rate of profit on equity capital than the average for the ‘industry,’ and which maintains this rate on new money for a period of, say, 5-8 years or more, then good and bad management is extremely rare. Statistically speaking, Marks and Spencer does not exist. Evidently, much too high a standard was being expected. Not only may luck play so big a part that steady success or failure is more improbable, but also the forces of competition may operate to prevent above average returns being maintained.
2. It was noted that the variance of the growth distributions had greatly increased since 1955. This can be equated with an increase in uncertainty, which may be associated with a growth in the freedom and competitiveness of markets.
3. The tentative conclusion of the lack of significant correlation between plough-back and growth is disturbing. **It shows that among those firms which plough back relatively heavily, about as many decline in relation to the average as grow.** It is, of course, possible that the new investments of those which decline are just as profitable as those of the rest, the whole of their relative failure being accounted for by the declining profitability of old assets. Even so, if the heavy ‘plougher-back’ contained only their fair share of declining profitability of old assets, one would still expect the group as a whole to grow faster than the average. The lack of correlation could be accounted for by the hypothesis that firms with declining profitability tend to plough back more as a kind of insurance ((possibly buying mainly financial assets). But this we know to be in general false, since it is a fact that rapid growth induces a relatively high plough-back. One seems to be left with the conclusion that those which retain a relatively high proportion of profits select relatively unprofitable investments. . . .

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