The Templeton Way by Lauren C. Templeton (Book Synopsis)

(Also, read ***Templeton's Way with Money: Strategies and Philosophy of a Legendary Investor***) Jonathan Davis & Alasdair Nairn

If you want to have better performance than the crowd, you must do things differently than the crowd. John Templeton.

Invest at the point of maximum pessimism.

You are trying to buy a share at the lowest possible price in relation to what a corporation is worth. There is only one reason a stock is being offered at a bargain price: because other people are selling; there is no other reason. To get a bargain price you must look where the public (institutions) are most fearful and pessimistic.

To buy when others are despondently selling and to sell when others are avidly buying requires the greatest of fortitude and pays the greatest ultimate rewards.

Bull markets are born on pessimism grow on skepticism, mature on optimism, and die on euphoria. The time of maximum pessimism is the best time to buy, and the time of maximum optimism is the best time to sell. J. Templeton Sept. 2007.

Eternally optimistic. Doing well by doing good.

Do something where you are performing a real service for people.

Some readers may think harder about the benefits of this physical and mental separation when they remember that WEB lives in Omaha.

Poker helped him take advantage of folly. The game requires acumen in probability, risk-taking, and, most important, psychology. The ability to not act foolishly is critical.

You need to understand the motive or driving force behind the actions you are witnessing. If a stock is trading at an exorbitant level in comparison to its measures of prospective earnings, cash flows and the like, the price of the expensive stock will fall when investors realize that they are holding a pair of threes and not a full hand.

Judgment is the difference.

His famous poem is "IF" by Rudyard Kipling.

Chapter 2: The First Trade in Maximum Pessimism.

Bull markets are born on pessimism; grow on skepticism, mature on optimism, and die on euphoria. The time of maximum pessimism is the best time to buy, and the time of maximum optimism is the best time to sell –Sir John Templeton, February 1994.

The underlying values of the companies did not decline at the same rate as prices during the 1930s.

Buy things for less than they are worth. Identifying a discrepancy between what an asset is worth and the price.

Forget stories, focus on facts.

Avoiding the most popular and most richly priced stocks will help you improve performance.

When there is a dramatic change in price, you must be an active processor of information.

Avoid poor judgment and emotional decisions.

Sir John made his career by taking advantage of people with less than clear thinking, purchasing the stocks they recklessly sold in haste, often on the basis of emotion.

Overreacting to a situation is the way people are wired. As a bargain hunter my goal is to buy stocks that people are desperate to sell and sell them the stocks they are desperate to buy. The accumulation of experiences had made spotting bargains in the stock market second nature for him. The key is to distinguish small problems from large, intractable problems.

Small problem, big over-reaction means take advantage of price below value. A delay in plant construction.

Understanding the history of the market is a huge asset for investing. This is the case not because events repeat themselves exactly but because patterns of events and the way the people who make up the market react can be typical and predictable.

People bring their money and opinions into the stock of a specific company and then bid the price of that stock up and down on the basis of events that unfold in front of them.

1. Rely on your own judgment.
2. Study the situation ahead of time.
3. There is no substitute for doing your own homework ahead of time.

It is absolutely necessary to understand a business thoroughly before you buy its stock: how it works, what stimulates its sales activity, the types of pressures it faces to sustain profits, the fluctuations if its results over time, how it fares against its competition. Having this information is the best way to create psychological fortress for decision making on a stock.

Sir John studied previous wars like the Civil War and WWI to understand how WWII would affect economic activity.

He had an asymmetrical perspective on the future because of his ability to focus longer-term prospects and disregard the prevailing current views. This ability to fixate on probable future events rather than react on the basis of current events creates a deep divide between successful investors and mediocre investors.

He borrowed $10,000 to buy as many stock under $1 on the NYSE. The least efficient business would be revived by the economic stimulus of the war. Of the 104 companies that he purchased in these transactions, 37 were already in bankruptcy.

Diversification can change with the circumstances.

	Norfolk & Western		*Missouri Pacific*		*Norfolk & Western*		*Missouri Pacific*	
	Sales ($MM)	**Sales Growth %**	**Sales ($MM)**	**Sales Growth %**	**Net Income**	**NI Growth %**	**Net Income**	**NI Growth**
1939	93		83		30		-30	
1940	105	12.9	87	4.8	32	6.7	-13	56.7
1941	120	14.3	111	27.6	28	-12.5	4	69.2
1942	140	16.7	178	60.4	22	-21.4	31	675

The key instance (excess profits tax) made buying the "weaker" company the better investment during improving conditions.

Comparison of Successful and Unsuccessful Companies

Company with frequent losses before 1940	Five-Year Return in Stock Price, %	Company with no losses before 1940	Five year Return in stock price, %
Century Ribbon			

- Why it pays to know history,
- think outside the box and
- Look at the stocks of companies that everyone else refuses to consider.

Volatility is our best friend in trying to buy bargains.

Where is the outlook most miserable. Search everywhere in the world.

Extreme cases of mis-pricing.

Global Investing: Chapter 3

Sir John was always led by an intense process of examining stocks at the company level.

Your edge as a bargain hunter is to have conviction that you did your homework up front and that time is on your side. The market eventually will recognize what you already know. Every great investor will eventually underperform the market in spite of their long-term ability to outperform the market.

A good example of these information gaps and a working example of how Uncle John tackled them comes from his purchase of *Telefonos de Mexico* in the mid 1980s. He counted the number of telephones in the country and multiplied by what people were paying.

The **doctrine of the extra ounce**—the only hurdle is your unwillingness to work just a bit harder than the next guy or gal to get the answers.

Focus on just a little more effort than the next guy.

Look at low P/Es. Apply conservative assumptions for a margin of safety.

Currency trends tend to last for years. Buy the least risky. Study currency devaluations.

Avoid excess spending by the govt. Socialist governments.

Read Adam Smith's Wealth of Nations.

Try to find out why stocks are mispriced.

The First to Spot the Rising Sun

Sir John was led to Japan by the low P/E ratios and high growth rates that the stocks and their companies carried in the 1950s and 1960's.
The people embodied thrift, hard work and focused determination.

In the early 1960's Japanese stocks trade under 5 xs vs. 19 xs in the US. Japan's economy growing three times as fast.

Why the discrepancy?

1. Fluctuations in stock prices are too extreme.
2. There is not enough information.
3. Bias against Japan based on ignorance.

Welcome to the world of neglected stocks. Korea in the 1990s and 2000. **Avoid social proof.**

Neglected stocks reward patience.
Replace your bargains with better bargains.

Hitachi seemed to trade at 16xs but when you consolidated all of its equity holdings it was trading at 6 xs.

Bargain hunters should not run from misinformation but embrace it and seek the truth. Ignoring details can lead to mistakes in either situation: passing over Japan or investing in Enron.

If a company is growing, avoid paying for the growth.

Comparison shopping.

Sir John always said that there are 100 yardsticks of value that an analyst can use to judge the worth of a stock, but this is one of the techniques that he employed over and over.

<u>Continuously search for better bargains</u> so as to not get swept up in euphoria. This should push you toward bargains and out of harm's way.

The investors who continued to pile into Japan during the late 1980s were paying more and more and getting less and less as the decade wore on.

Document events and learn from the experience of others. Harness experiences.

Chapter 5: The Death of Equities or the Birth of a Bull Market.

The death of equities looks like an almost permanent condition. Business Week, August 1979

The market moved sideways for a decade in the 1970's. Returns were much better in tangible commodities.
Bargain hunters in the stock market should have taken the magazine cover and the views that supported it as a point of maximum pessimism.

"The masses long ago switched from stocks to investments having higher yields and more protection from inflation. Now the pension funds—the market's last hope—have won permission to quit stocks and bonds for real estate, futures, gold, and even diamonds. <u>The death of equities</u> looks like an almost permanent condition—reversible someday, but not now.

This introduction to the article is a great study in the elements to look for when you want to buy at the bottom. Wise bargain hunters should view the article's message as a bullish indicator, rather than a bearish one. The first clue comes in the opening sentience: "The masses long ago switched from stocks to investments having higher yields: First and foremost, bargain hunters are not looking to follow the masses anywhere, period. Instead bargain hunters go exactly where the masses are not because that is the best place to spot a bargain. The next great clue lies in the words: death of equities look like an almost permanent condition." Sir John was asked about finding the point of maximum pessimism, and his advice was to wait until the ninety-ninth person out of a hundred gives up.

From that point the only buyer left is you. Moreover, there was good evidence in this excerpt that the market was approaching a point of maximum pessimism: “Now the pension funds—the market’s last hope—have won permission to quit stocks and bonds for real estate, futures, gold and even diamonds.

The last holdouts are ready to sell.

If you study market manias over time, there is a certain ideology that inevitably rears its ridiculous head in every instance. We are not sure what causes these people to be so outspoken in their views, but they appear like clockwork whenever the market gets carried away in one direction or the other. More often you see this stuff when the market is extremely overpriced or in a bubble. It has been shown, however, that the stock market’s pessimism drives prices down at least as much as it drives them up during a fit of euphoria.

The statement contains the misguided notion that the financial paradigm has changed and the market has entered a new period in which stock prices and company values are no longer relevant. “We have entered a new financial age. The old rules no longer apply.

If and when you read these statements in the future, they should activate every alarm, bell, and whistle in your bargain hunting soul. These words and the myopic concepts that back them are the antithesis of bargain hunting. Statements like these crop up from time to time in cases off extreme moves in market prices over a prolonged period. Usually they appear as an attempt to justify paying too much for an asset. In this case the pundits were defending a “new age” of investing in real estate and commodities.

Long term history of P/E—the lowest in history was 1979 where it was 6.8 vs. a long term average of 14.2. 1950 was 7 P/E.

Many different buy signals—sentiment, valuation, history. The market was dirt cheap.

Sir John’s approach to bargain hunting always involved being able to apply one of the “100 yardsticks of value” that were available to a securities analyst. There are two good reasons for taking this approach. The first and perhaps more important is that if you are limited to a single method of evaluating stocks, you periodically will go through times, even years, when hour method does not work.

All the stock selection methods that have proved to be successful over time become universally adopted and eventually cease to work when everyone practices them in unison.

If you have only one method of selecting bargains like net/nets then you may miss obvious opportunities elsewhere.

Accumulate findings of your findings from different methods. If you can see that a stock is a bargain on five different measures that should increase your conviction that the stock is a bargain. Raising your conviction level is an important psychological asset as you face the volatility of the stock market.

In late 1970 and early 1980s, stock prices of market values had become thoroughly depressed relative to the asset values listed in the financial statements of different companies. P/BV.

A low P/BV ratio reflects low expectations for the business.

This ratio has been around forever, but in the late 1970s and early 1980s a peculiar phenomenon was occurring in the U.S. economy runaway double-digit inflation that eclipsed investing. The presence of double digit inflation altered the conventional nature of the price/book ratio and uncovered extra value for investors.

The replacement value of the assets was much higher than the stated cost on the books. So if the historical costs of a steel plant are $10 million but steel prices have been increasing for 15% for five years, then the replacement value is $20 million.

In late 1982, stock prices relative to the replacement values of assets were at all-time historical lows.

The last time besides 1979/82, prices were below book value were 1932. That year was the low point for the Great Depression. However, during the Depression the economy experienced falling prices, known as deflation, versus the rising prices of the late 19670s and the early 1980s.

So in the 1930s, it would have cost firms 20% to replace their assets due to the falling prices.

Stocks were 40% cheaper on a replacement basis than just looking at price to book value in 1982.

Table 5-2

Comparison of Price/Book Ratios

DJIA	1932	1982	DJIA with Adjusted BVs	1932	1982
Book Value	81.8	881.5	Replacement value	65.4	1,498.6
Index Price	64.6	884.4	Index Price	64.6	884.4
Price/book value	0.79	1.0	Price/replacement BV	0.99	0.59

Always be an active interpreter of financial ratios. The casual observer could have discovered easily that the price/book ratio for the Dow Jones Industrial Average in late 1982 was approximately 1.0, and of course this is a low ratio in a historical conte4xtt. However, only an active interpreter of the numbers would have taken the time to process intellectually the fact that the historical costs of assets listed on the balance sheet carried values that were far understated in relation to current prices.

The practice of looking deeper into the numbers goes back to the doctrine of the extra ounce.

Note that Sir John made adjustments to the earnings of Japanese holding companies to include their subsidiaries and equity investments. Always adjust to economic reality.

Casual observers tend to gloss over accounting treatments and often are led astray by the way business activity is recorded. Bargain hunters are active interpreters of the data and dig deeper to interpret accurately what is being presented to them in accounting terms and then compare and contrast the data with what they see as the real world economic reality of the situation.

Adopt many yardsticks of value. Even though stocks appeared to be bargains on a P/E basis, but they were screaming bargains on the basis of the ratio of price to replacement value.

Another clue was the large numbers of corporate takeovers at the time. Spend nearly as much time researching the company's competitors as they do researching the company itself. A company's competitors are often on the lookout to absorb capable competitors into their own businesses. They seek to adopt the competitor's advantages as their own and eliminate weaknesses.

As takeovers began to accelerate and the bids were 50% to 100% above the market prices, he took that as a good sign the market was undervalued. Another yardstick of value. Big share buybacks; an overwhelming amount of cash on the sidelines. Pension funds would need to enter the market.

With the market trading at 800 in 1982, Sir John thought stocks were the best values of his lifetime.

If corporate profits grew at their long term average growth rate of about 7 percent and inflation remained at an expected run rate of around 6 to 7 percent, overall profits would increase approximately 14% a year. If those 14 percent gains compounded annually, the values of the stocks w2oule nearly double over the next five years, and if that held up, they would double again in the next five. This corporate earning activity alone would not require the stock market to assign a higher P/E multiple in order to double. However, with the Dow's P/E ratio at around 7x compared with the long term average of 14x, it was reasonable to see the index getting a lift from a return to the average P/E ratio was well. Then, with all the money sitting on the sidelines and not being invested by institutional buyers, he believed that there was latent firepower to be deployed that would help drive the index higher. Practice of looking for bargains where others refuse to look and then having the strength to stand alone on an island is a basic recipe for sustained success in value investing.

Sir John had a willingness to walk into a situation that had been deemed hopeless by all others, examine it with an open mind, and then have the conviction to follow through on his finding and go against the crowd.

It is a perverse reason that when stocks go on sale, no one will buy them.

If you take your market outlook from observers, friends and the news, you will not purchase during unfavorable times.

Be independent minded and focus on the numbers versus public opinion, you can create a virtuous investment strategy that will endure in all market conditions.

Chapter 6: No Trouble to Short the Bubble.

Study all past bubbles.

Note the similarity between the automaker boom of 1900-08 and the dot com boom of 1994-2000. The early automobile producers were really assemblers of parts rather than large scale manufacturers, just as many early dot-coms simply had an idea and could build a Web site. In either case it did not require much capital to start-up a business. Similarly, the public did not require much capital to start up a business. Similarly, the public did not seem to contemplate the fate of the initially large number of players, and only the sheer force of competition eventually separated the winner from the losers.

The public usually grossly overestimates the industry at the outset. Once competition forced the companies to survive on their own about to make money rather than by raising money from investors.

For every GM there are several New Era Motors Inc. and for every eBay there are several Webvans.

Note one sided views underlying assumptions of continued fast and furious growth.

Distinguish between the stock price and the company the stock represents.

One characteristic accompanies speculative manias is the wealth-consumption effect. New found wealth is spent. Consumption and higher stock prices.

Naysayers are disliked. On Dec 27, 1999 Barron’s ran a cover story title “What’s Wrong with Warren?

One of the unfortunate features of asset bubbles is the unscrupulous figures that emerge to cash in on the unsuspecting public.

Whenever you see an IPO, your bargain hunting instincts should warn you to stay away.

Sir John researched the lockup periods of insiders in technology stocks. When the insiders could sell, the catalyst was in place to pressure the stocks. He put $2.2 million into 84 stocks or $184 million into his short selling strategy.

The point of maximum optimisms reached when there were no more buyers left in the market, and the sellers were about to take control. That point was reached on March 10, 2000.

The WSJ as the NASDAQ peaked, that was title "Conservative Investors Warm Up to Idea That Tech Sector Isn't a Fad."

This is the kind of pressure you can expect to feel when your bargain hunting methods are out of style, as they will be from time to time, and the urge to jump into what is working at the moment grips you like an anaconda. We know that is exactly the wrong time.

The very last buyers had come into the market.

Remember that the path from euphoria to pessimism takes time, at least months but more often years, just as the path from pessimism to euphoria can also take months if not years.

Sir John had a preset level to cut his losses. The market can stay irrational longer than you can stay solvent. In the same vein, a bargain hunter should elect to take profits on a predetermined basis. For instance, when Uncle John sold short these NASDA shares, he established guidelines for that aspect of the trade also. In this case, he elected to take profits when the stock price lost 95% of its value after he sold it short or should the stock fell below a price/earnings ratio of 30x based on trailing 12 months' earnings per share. These rules for taking profits are almost as important as the ones for taking losses as they prevent you from reaching too far or becoming greedy.

Chapter 7: Crisis Equals Opportunity.

The best time to buy is when there is blood in the streets.

One way to think about the strategy of purchasing shares in the wake of a crisis is to relate the current crisis to the same strategies that a bargain hunter employs on a daily basis in common market.

To summarize, bargain hunters seek volatility in stock prices to find opportunities, and panicked selling creates the most volatility, usually at historically high levels. Bargain hunters seek misconception, and panicked selling is the height of misconception because of the overwhelming presence of fear. History shows that crises always appear worse at the outset and that all panics are subdued in time. When panics die down, stock prices rise;

Buy when the situation looks bleak.

History of recent crisis pg 77

Pick up assets from “motivated sellers.”

Japanese companies trade at a lower p/e than global equities but their ROE remains at roughly half the level achieved by firms in the rest of the world. (Mar. 2008)

ROI are 50% higher in the IS than in Japan.

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