Have Your Cake and Eat It Too Investing

Relative Strength at Work, Vol. 4: Learning from Ted

May 24th, 2017

It was the summer of 2000 and I stood anxiously at Ted and Julie's front door. I had just met Ted earlier that week while cold-calling on 30 year bonds (paying 8% no less!), and he had expressed an interest. So there I was, ready to meet Ted and go over the details of the potential bond purchase in person.

Ted and Julie were retired, in their mid-70's, and lived in one of those comfortable gated communities in a middle-class suburb. I noticed the slightly used Mercedes in the driveway, and hoped as most brand-new advisors do that this meeting with Ted and Julie would develop into a great long term business relationship.

Ted opened the door and greeted me warmly. After chatting briefly and sharing a cup of tea, we got down to business.

Or so I thought.

You see, I thought I was there for Ted to buy a bond. I figured out later that Ted's true purpose for inviting me to his home was to talk about Technology stocks. Remember the dot.com boom in the late 90's? Ted was all over it – and he had made a fortune.

A funny thing about investor behavior is that people love to talk about their winners - evidence of their superior intellect maybe, or the time they outsmarted the experts. Whatever the reason, as time passed over the next hour it became clear to me that Ted really had no interest in bonds… he simply wanted to share his great success with someone whom he thought would appreciate it.

Ted proceeded to show me his home office where he had his computer and all his research. Thick, well-used binders clearly labeled by year all in an orderly row above his desk. Stacks of research reports took up half the space on his big oak desk. A huge pile of old Wall Street Journal's sat waist-high in the corner of his room.

"You see Jeff, I don't really have a need for investment advice or for your bond. I've been doing it myself for years, and I own all the big names in tech – Cisco, Applied Materials, Nortel, Qualcomm, JDS Uniphase, Lucent, and a few more. I've made so much money it's ridiculous. And when I've had other advisors like you talk to me about managing my money, they always talk about selling! I'd bet if I had followed their advice it would have cost me about a million bucks!"

Ironically, Ted had a valid point. Diversification and balanced portfolios and all that traditional investment advice is designed to provide investors with a smooth ride, dampened volatility, and the least risk of being sued. They are widely used because without a completely different set of risk management tools (like relative strength), they ensure middle-of-the road results. There is safety in living in the middle of the bell curve.

The advantage of Ted's approach was that he had identified the biggest winners in the market early on ('96) and he poured all his money into those stocks. And it worked, because the trend in technology and dot.com stocks continued to surge year after year.

The disadvantage of Ted's approach is that he bought into the story of the internet theme and perpetual earnings growth. He took on a high level of risk by concentrating his money into one sector of the market, and because it kept working, making huge profits year after year, he began to believe he wasn't taking high risks at all. Ted likely recognized the risks he was taking in '96 but (correctly) deemed the potential rewards were worth the risk. But after four years of massive success he had morphed into a 'true believer'. His results were so good for so long he couldn't accept the possibility that his risk of loss was just as great (or greater) than when he started.

You see, it is a natural behavioral evolution for investors to find reasons or justifications to own investments (stocks, gold, oil, real estate) where their past personal experience was very positive. The best investment decision Ted ever made was to focus all his money into technology stocks in 1996. At the time, he was likely very conscious of the risks and likely had a price at which he would get out and abandon his positions to protect his capital. But after four years of stratospheric gains, I could tell that right there in his office surrounded by the weight of evidence of his research (but more so, the profits), there was no way on earth he would sell even one iota of stock.

He had become the most dangerous of investors – a disciple of Cant. "The fundamentals are so strong it Can't go down." "I've made so much money I Can't sell because of the taxes I'd have to pay." "It's already down 20%, I Can't sell now. I'll sell when it bounces back." "The analysts who are the experts say it's still a buy. They Can't be wrong!"

When I was at Ted's home back in the summer of 2000, he told me he had made over $2M in that handful of stocks. I do remember meekly asking him about valuations at the time, as someone somewhere had told me that stocks with price to earnings ratios (p/e) over 100 were typically deemed to be 'expensive' or 'risky' (and all these stocks were easily 100-200x p/e). He brushed it off. He knew that.

"They're expensive because of their massive future earnings potential Jeff! They've been expensive for years, and they keep going up, they keep making me money. Anyone who says they're too expensive is just bitter because they missed the move."

That was the last time I met with Ted. I don't know if he eventually capitulated on his beloved stocks… I hope he did. Two years after that summer meeting if he didn't take action his $2M would be worth about $200,000. A number of those companies went bankrupt.

Now some of you reading this will see this as a clarion call for diversification and avoidance of aggressive or high-flying stocks.

Maybe.

But if you think about it, if Ted had a traditional diversified portfolio with a sector limit of around 20% technology, he never would have made the $2 million in the first place! He would be lucky to have made $400,000. So avoiding high-flying stocks will avoid the downside, for sure, at the cost of avoiding most of the enormous upside stock markets can produce at rare occasions.

How about instead of trying to 'out-smart' the market, Ted might have been better off admitting his own limitations and been wise enough to say to himself, "I will stick with my concentration in aggressive stocks while the trend continues higher, but when the trend changes because I acknowledge the high level of risk I will not hesitate to sell."

> "I will take the tax hit.
>
> I will sell 20% or 30% below the all-time highs instead of waiting for the rebound which may never come.
>
> I will ignore the reassuring opinions of experts telling me to buy more.
>
> I will accept the possibility that these stocks might indeed bounce back, but I stick with the odds and the odds tell me to sell."

In this case, Ted would likely have made it out with about $1.6 Million. Better than the wipeout down to $200k while he waited for the rebound (that never came). Better than the making the $400,000 in the diversified portfolio and then losing 80% of that portion, too, because when investors believe they are diversified adequately it somehow absolves them from managing sector risk or market risk (i.e. going to cash when markets are crashing).

What Ted did to make his fortune (despite the fact he didn't know he was doing it) was **relative strength investing**. He stuck with what was working, and put zero money into things that weren't. He concentrated his money into investments with the highest odds of making above-average profits. Companies in the 'sweet spot'.

What Ted did to lose his fortune was the **opposite of relative strength investing** – he stuck with what wasn't working, while it was dropping, hoping or believing in an eventual recovery (assuming he stayed committed to his beliefs). If Ted stayed in the 'pain zone' he would have lost nearly all of his life's savings.

Ted would have been far better served to recycle all that paper and learn to interpret and follow price. Price is objective, free from opinion, hope or blind faith, uncluttered by greed or fear. If Ted simply followed the price trend in his beloved tech stocks, he would have made great money and kept most of it.

In effect, ***relative strength at work***.

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