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Hot favourites won't always turn out to be great winners

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Perfect foresight is impossible in the complicated and dynamic world of investing. Even the best investors typically turn out to be wrong – meaning they don't beat a risk-free rate of return – on 30-40 per cent of the investments they make. That's perfectly fine – if your winners on average also go up more than your losers go down, you can build an outstanding record over time.

The fallibility of investment foresight came to mind recently when I revisited a feature article in Fortune magazine that appeared in the summer of 2000 under the ambitious headline "10 Stocks to Last the Decade". As the table (below) indicates, a portfolio of this august group has tumbled 39 per cent since the article ran, versus a meagre, but positive, 3.5 per cent gain for the broader market as measured by the Russell 3000 index.

Stocks to last the decade? Here's how each of the Fortune picks would have fared had you bought on July 19, 2000 and held through September 7, 2007 %	
Broadcom	-78.1
Charles Schwabb	-44.9
Enron	-100.0
Genentech	110.7
Morgan Stanley	-17.2
Nokia	-36.1
Nortel	-97.8
Oracle	-45.3
Univision	-36.0
Viacom	-49.2
Average	-39.4
Russell 3000 (No dividends)	3.5
Source: Value Investor Insight	

Optimists might point out that Fortune was picking stocks to last a full 10 years, and we're only three-quarters of the way there. Fair enough. But this "buy-and-forget" portfolio – Fortune's term – will have to rise 19 per cent a year for the remainder of the decade since the article ran, just to get back to break-even. That’s quite a bit of ground to cover just to notch a 0 per cent 10-year gain.

I raise this not to ridicule Fortune, which is consistently one of the smartest and best-written business publications. Rather, there are many worthy lessons here, of which I’ll point out just a few.

Never underestimate the competition. The main premise of the article was the identification of winners that would capitalise on “four sweeping trends that have the potential to transform the economy”. Charles Schwab was chosen as the prime beneficiary of one such trend, the “boomerisation” of financial services. While Schwab has acquitted itself well as a beneficiary of this clear trend, the profitability of doing so hasn’t been what was once imagined, as competitors have driven trading commissions ever lower.

Valuation matters. Guess what the average price/earnings ratio was of the stocks on Fortune’s list. 30x? 40x? Such ratios were for wimps in mid-2000. How about a nice round 100x? As Jeremy Siegel writes in *The Future for Investors*: “The long-term return on a stock depends not on the actual growth of its earnings, but on the difference between its actual earnings growth and the growth that investors expected.” That’s something to remember every time you buy a stock, especially if you’re betting on “sweeping trends”.

Buy-and-hold isn’t what it used to be. I’d be the last to recommend frequent trading and, in fact, believe some of the greatest inefficiencies in the market result from investors’ collective short-term orientation and tendency to overreact to news. But “buying-and-forgetting” in a world economy roiled by change is an increasingly risky proposition. With its powerful media and entertainment brands, for example, Viacom appeared poised to thrive in an increasingly wired and interconnected world. What was harder to foresee was the havoc new distribution channels would wreak on Viacom’s traditional business models. Now split into two pieces, Viacom and CBS, an investment in the company in the summer of 2000 would have lost nearly half its value.

To this last point on buying and holding, the funds I co-manage have recently sold several long positions, driven by our belief that the odds of a significant market correction over the next year have increased substantially. We’re not predicting Armageddon, but we think the subprime train wreck is in its early stages and could have substantial effects on the world economy and credit markets.

In light of this more cautious outlook we went through our portfolio, analysing each position and asking ourselves, “If our fund were 100 per cent cash today, would we buy this stock?” During times when our outlook is more sanguine, we sometimes hold 80-cent dollars – typically either in stocks that we purchased as 50-cent dollars and are waiting until they reach our estimate of intrinsic value, or in high-quality, growing businesses that are moderately undervalued, which we’re happy to own in lieu of cash at certain times. But in today’s environment, we prefer cash to anything but pound-the-table-with-conviction stocks.

As a result of this exercise, we've closed or reduced positions in great companies such as Microsoft, Costco, Wal-Mart and Anheuser-Busch.

Among the highest-conviction stocks on which we're now more concentrated are: Target, McDonald's, Fairfax Financial and – my personal pick to "last the next decade" – Berkshire Hathaway.

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