

Learn from your own investment mistakes

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Published: February 16, 2007

<http://www.ft.com/cms/s/4326d066-bdd8-11db-bd86-0000779e2340.html>

Investing is a game of averages: nobody bats 1,000 but, if your analysis and judgment are solid and your winners generally go up more than your losers go down, you can build an outstanding record. The key is not picking big winners; it is avoiding big losers.

That's why learning from mistakes is so important – ideally, as Warren Buffett says, others' mistakes rather than your own. In that spirit, here are 10 traps I've identified – many times the hard way – that are likely to lead to bad investment outcomes:

- **Declining cash cows.** There can be a fine line between opportunity and trouble when a once-strong business goes into permanent decline. One can profit if the market overestimates the speed of the decline or underestimates management's ability to transform the business. But this is a hard way to make money. Generally speaking, a business in decline – even a cash cow business – is a painful, drawn-out affair. Investors in newspaper stocks in recent years have seen this first-hand.
- **High and rising debt.** Value investors are naturally drawn to companies in trouble – that's what makes stocks cheap if the difficulties prove to be temporary – but beware of high and rising debt levels. Even if a company is positioned to benefit from improving conditions over time, equity holders won't benefit if its debt levels trigger a bankruptcy or a massively dilutive refinancing in the near term.
- **Unions and legacy liabilities.** When betting on a turnaround, it's critical to understand the flexibility the company has – or doesn't have – in implementing painful but necessary changes. Poor union relations can prevent such changes, and legacy healthcare, pension and environmental liabilities can serve as the same drag on a company's prospects as too-high debt.
- **Weak or erratic cash flow.** Operating cash flow, because it adds back depreciation and amortisation to net income, should be higher than reported profits. If it's not, figure out why. Are there unusual items consuming cash? Are inventories or accounts receivable ballooning? In the 11 quarters ending in the second quarter of 2000, Lucent reported pro-forma profits totaling \$9.4bn. Over the same period, it had a free cash flow deficit of \$7bn. This should have been a tip-off for investors, who suffered as the stock plunged from more than \$70 to less than \$1.
- **Over-reliance on one customer.** In my experience, one of two things happen to companies that derive a large portion of sales from a single customer: at some

point, the company loses the customer or the customer renegotiates the deal – either of which is devastating to the company and its stock.

- Consumer fads. Famed short-seller James Chanos put it well in a *Value Investor Insight* interview explaining why fad-driven companies often become great short ideas: “Investors – typically retail investors – use recent experience to extrapolate ad infinitum into the future what is clearly a one-time growth ramp of a product. People are consistently way too optimistic and underestimate just how competitive the US economy is in these types of things.”
- Deeply cyclical industries. Fortunes can be made by investing in cyclical businesses if you have a deep understanding of the industry and you’re buying at maximum pessimism. If neither is the case, discretion is often the better part of valour. Just ask those attracted to the ostensibly low multiples of subprime mortgage lenders before last week’s revelations of deteriorating loan-portfolio credit quality.
- Focus on earnings before interest, taxes, depreciation and amortisation (ebitda). Used properly by those who understand its limitations, ebitda can be a useful measure. But too often it’s used by unscrupulous management, investment bankers or analysts to make a stock appear cheap – a stock’s ebitda multiple is always lower than its p/e multiple – or to deceive investors about the true nature of a company’s capital requirements. It’s not a coincidence that many big frauds, such as WorldCom, were touted using ebitda metrics.
- Serial acquirers or mega-acquisitions. Given the research showing that two-thirds of all acquisitions are failures and a wide range of accounting shenanigans that can occur when one company acquires another, it’s remarkable how often investors get excited about big acquisitions or roll-up stories. While my funds own Tyco today as a discount-to-the-sum-of-the-parts story as it sheds its conglomerate structure, we fortunately avoided it when it was a serial acquirer.
- Aggressive accounting. Grey areas in US Generally Accepted Accounting Principles (GAAP) leave management with tremendous leeway in how aggressively or conservatively it represents company operations. I have difficulty thinking of a single instance in my entire career of a company that blew up in which there were not signs of aggressive accounting.

Mistakes are inevitable but every savvy investor should at least try to make original ones. Recall the proverb: “Fool me once, shame on you. Fool me twice, shame on me.”

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