LESSONS FROM THE TRENCHES:
VALUE INVESTING,
ENTREPRENEURSHIP & LIFE

THE BEST OF VALUE AND GROWTH: MAKE MONEY INVESTING

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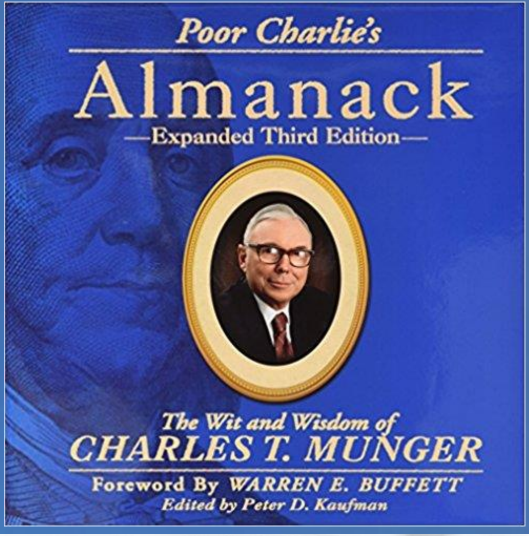
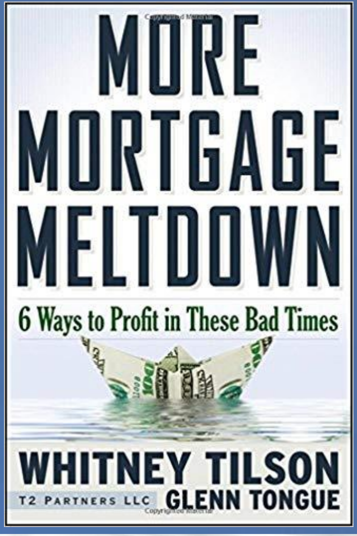
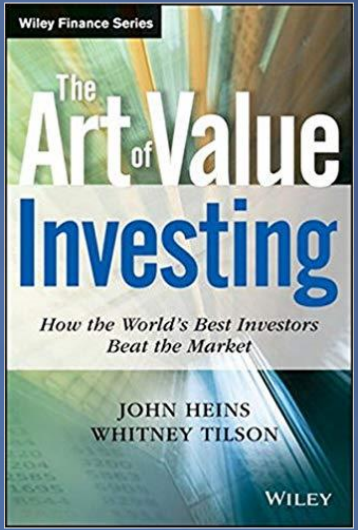
BOOTCAMP

I WAS AN OLD-SCHOOL VALUE INVESTOR

- I pray in the church of Graham, Dodd, Buffett and Munger
- I've been to the last 21 Berkshire Hathaway annual meetings
- I've co-authored three books on value investing:







I BOUGHT CHEAP STOCKS

- As a value investor, I mostly owned stocks that were trading at low multiples of sales, earnings and/or book value
- In most cases, the stocks were cheap because the companies were performing poorly
- I cared about businesses' quality and future growth prospects, but this was secondary to whether their stocks were cheap

THE FOUR MISTAKES OF VALUE INVESTORS

My focus on cheap stocks led me to frequently make four mistakes that are common among value investors:

1. Investing in low-quality businesses whose stocks were value traps because the businesses' fundamentals continued to decline
2. Failing to buy high-quality businesses whose stocks were fabulous long-term compounders
3. Selling the stocks of great companies way too soon because they'd risen and didn't appear as cheap
4. Failing to understand/appreciate powerful new technologies/trends

HOW A COMPANY PERFORMS OVER TIME IS MORE IMPORTANT THAN CURRENT VALUATION

- I estimate that 75% of what matters in terms of a stock's performance over time is how the company performs vs. only 25% the valuation at the time of purchase
- For my entire career, I had this backwards

This was a terrible mistake that cost me and my investors dearly!

THE FOUR MISTAKES OF GROWTH INVESTORS

So the message is: "Just buy the stocks of great growth companies irrespective of valuation"? Not so fast…

Growth investors frequently make four mistakes:

1. They overestimate future growth, forgetting the powerful force of reversion to the mean, driven by technology changes, new competitors, size acting as an anchor to growth, etc. <u>Trees don't grow to the sky</u>
2. They pay too high a price for a stock, such that even if the business performs well, the stock doesn't
3. They fall in love with great companies and fail to sell when they should
4. They get sucked into "story stocks"

I'M NOW A MAKE MONEY INVESTOR

- I now combine the best aspects of both value and growth investing to maximize my returns as a make money investor
- I want to teach you how to become one as well

LESSON #1: STOCKS TEND TO FOLLOW EARNINGS

SO FOCUS PRIMARILY ON BUSINESS QUALITY AND GROWTH, BUT BEWARE OF EXTREME VALUATIONS

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HIGH VALUATIONS HAVEN'T MATTERED FOR CERTAIN STOCKS

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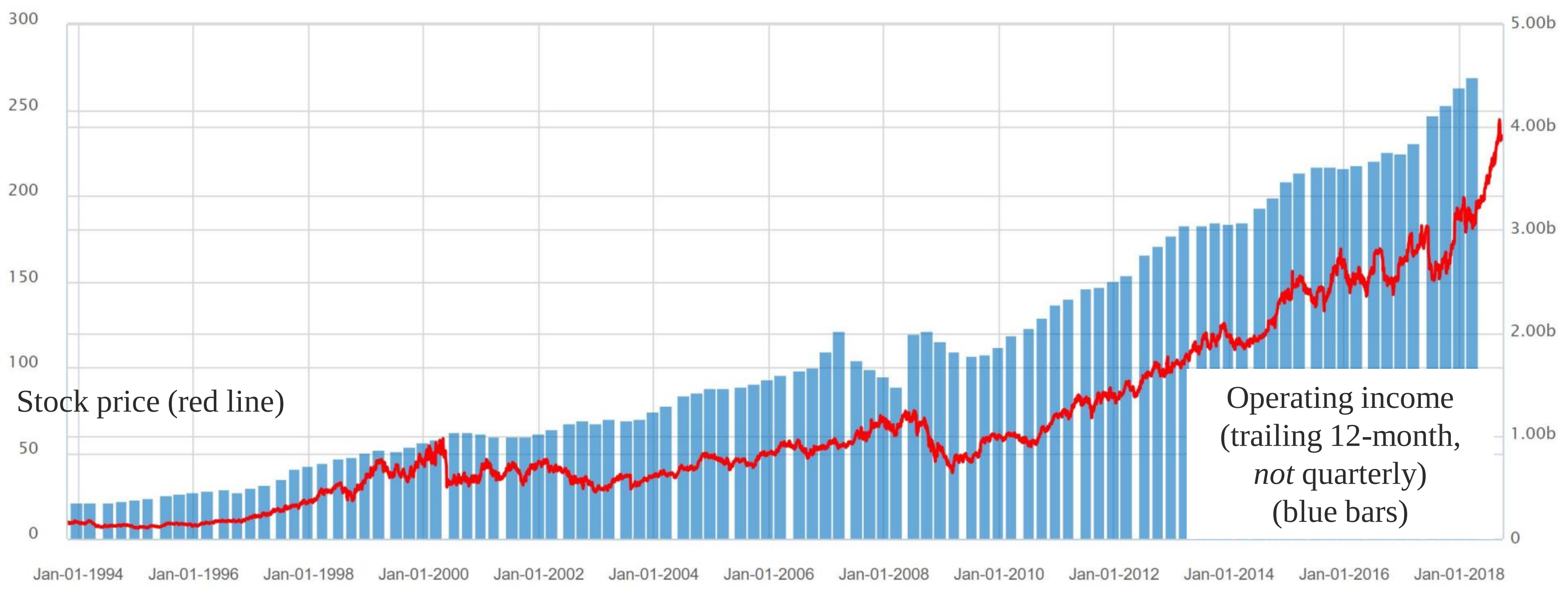
CASE STUDY: COSTCO

A 25-bagger since 1994, driven by extraordinary profit growth



 Source for all charts in this presentation: CapitalIQ

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HOWEVER, EXTREME VALUATIONS CAN OFFSET EVEN ROBUST GROWTH

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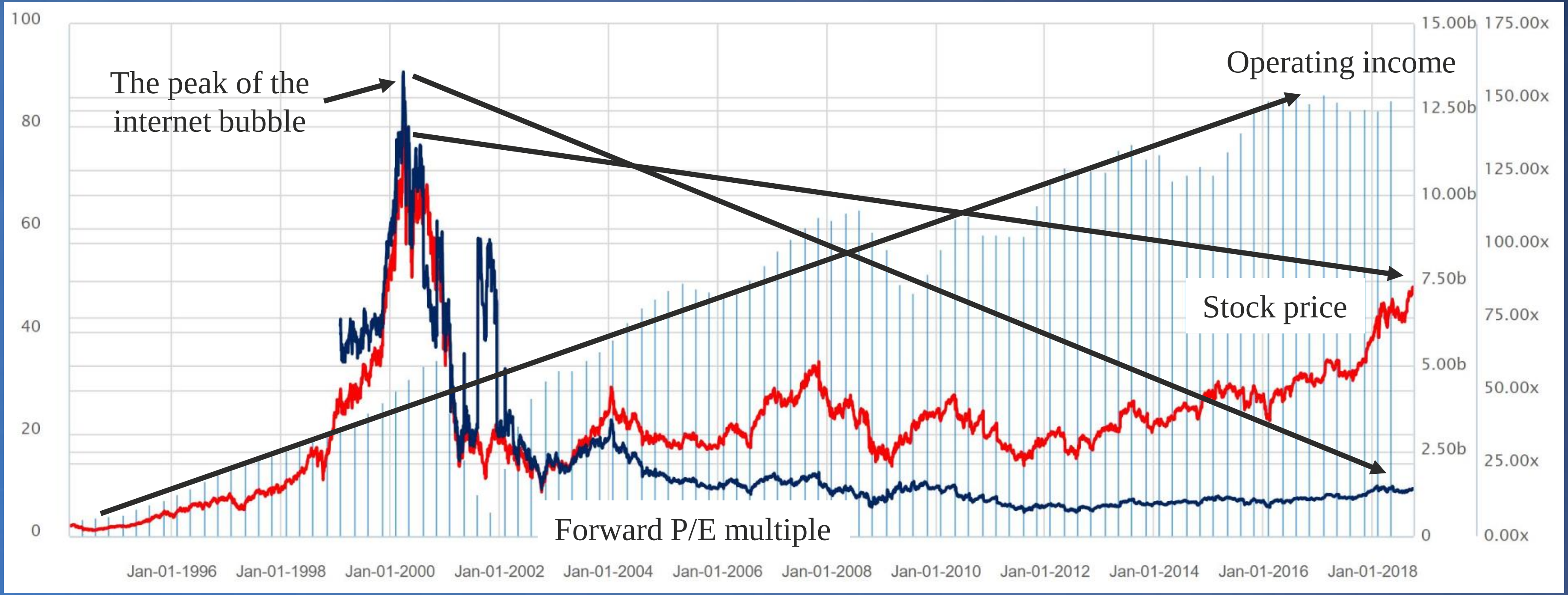
CASE STUDY: CISCO

After briefly becoming the most valuable company on the planet, the stock is still down nearly two decades later



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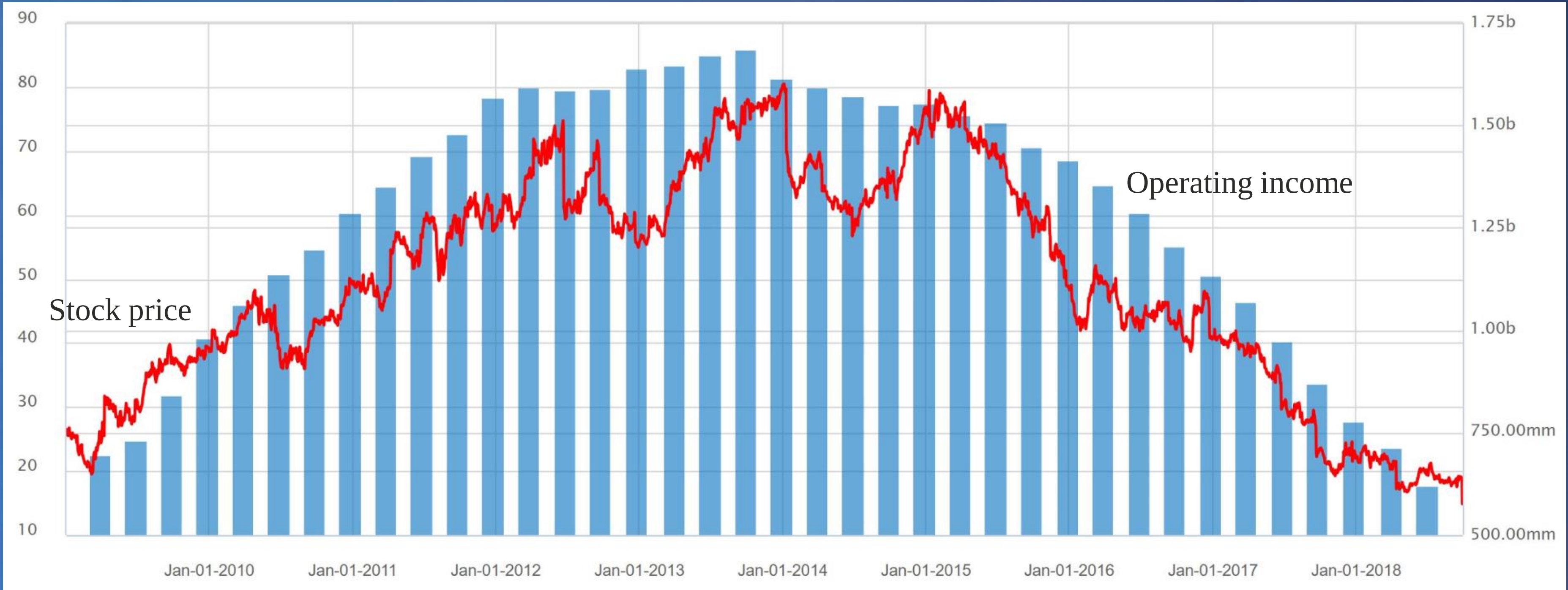
BE ESPECIALLY CAREFUL OF VALUE TRAPS:

COMPANIES WHOSE EARNINGS DECLINE AND DECLINE

- These value traps suck in value investors because they appear cheap all the way down
- Is it extremely difficult to make money on a stock, no matter how cheap it is, if the businesses’ fundamentals steadily decline

CASE STUDY: BED BATH & BEYOND

A round trip of both earnings and the stock over the past decade



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LESSON #2:
TRY TO IDENTIFY INFLECTION POINTS

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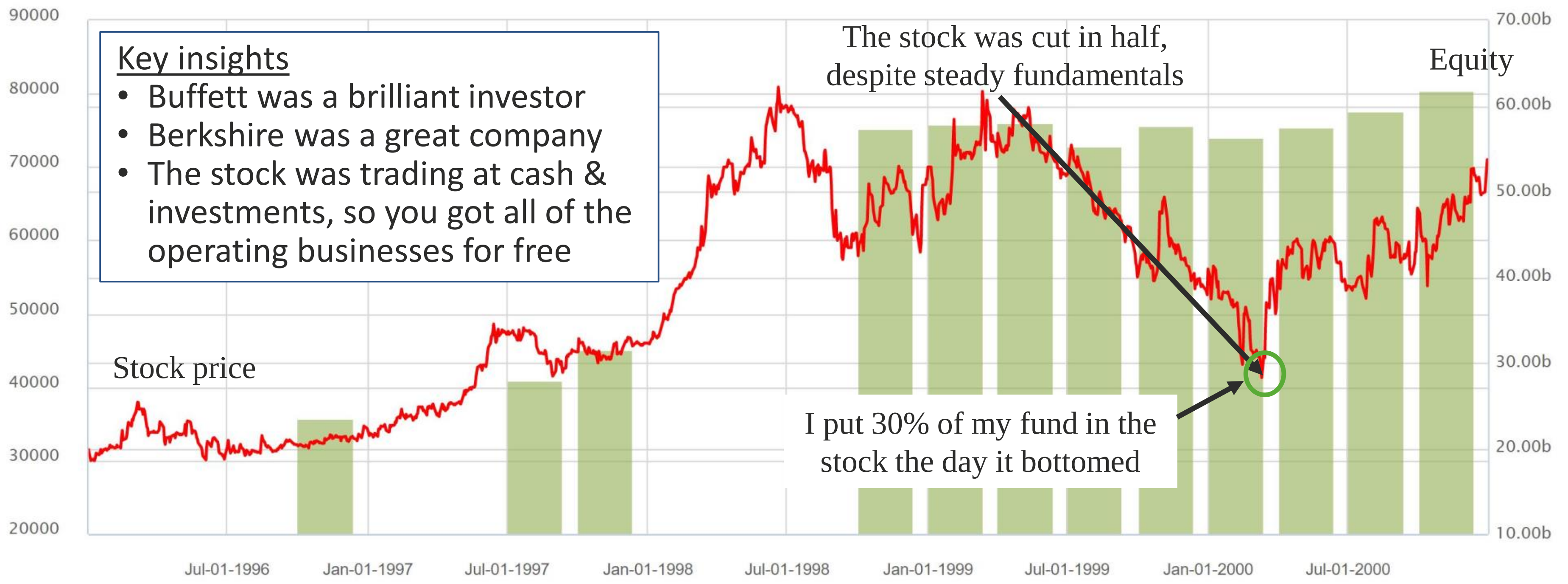
THE BEST OF BOTH WORLDS: COMBINE VALUE AND GROWTH APPROACHES

- If you correctly identify great companies that grow strongly and buy their stocks at anything but the most extreme valuation, you'll do well
- But if you *really* want to make a lot of money, buy the stocks of such companies when they're out of favor and the valuations are reasonable (if not downright cheap)
- If you catch an inflection point, there's a double tailwind for the stock: earnings grow and the multiple on those earnings expands as well
- <u>I am not talking about waiting for a market correction</u> – 90+% of the time, you should ignore the market
- I'm talking about *individual stock* corrections, which are typically driven by changes in sentiment toward the company or sector, or the company experiencing a short-term hiccup

CASE STUDY: BERKSHIRE HATHAWAY

A wonderful buying opportunity at the peak of the internet bubble in March 2000



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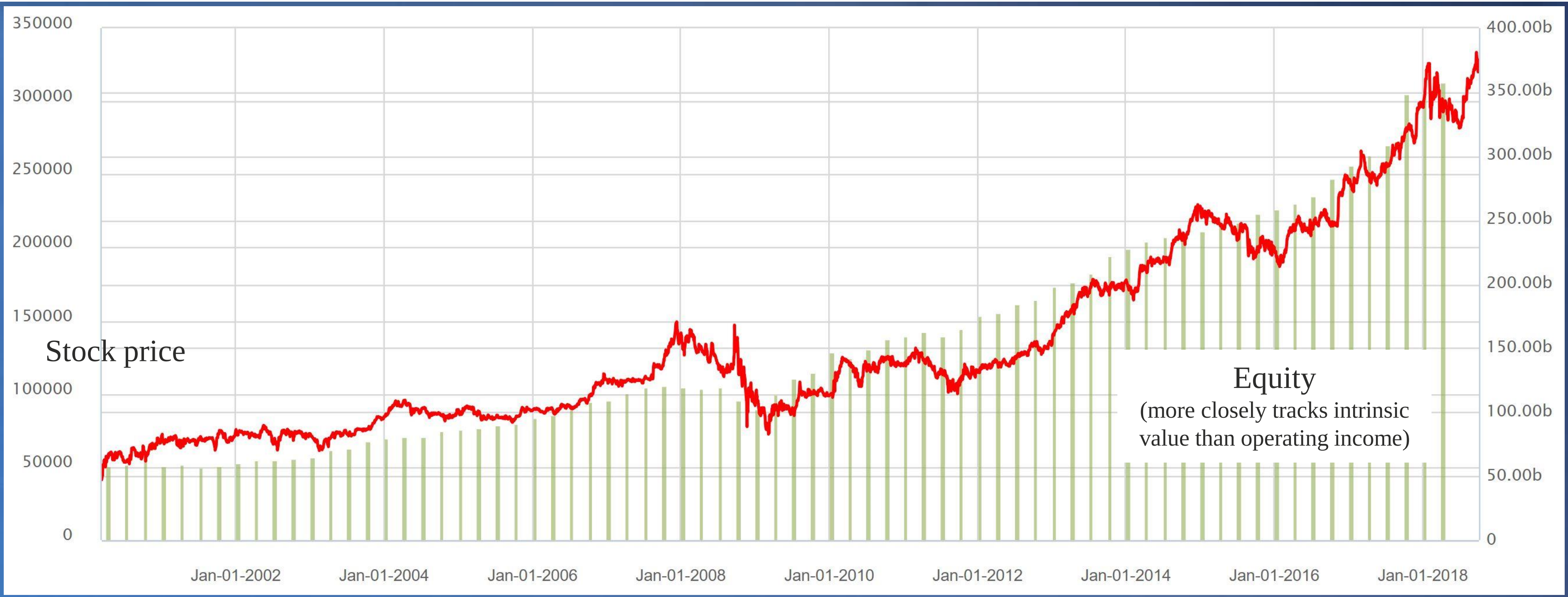
BERKSHIRE'S STOCK IS UP 8x SINCE THEN



HOW TO IDENTIFY INFLECTION POINTS

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INFLECTION POINT = VARIANT PERCEPTION

- An inflection point in a stock occurs when the consensus view is that the company will continue to stagnate/decline, but instead it grows
- They are very difficult to identify – but you don't have to be exactly right
  - "It's better to be roughly right than precisely wrong"
- If you believe a company/stock is at an inflection point, then you have a variant perception – a belief that a company will perform much better (or worse, if you're shorting) than most investors expect
- But having a variant perception is easy – you must also **be right**!

WHAT TO DO WHEN A POSITION IS RUNNING AGAINST YOU?

- This is so hard!
- No wonder mismanaging this has blown up some of the world's smartest investors
- It's especially hard for value investors, for whom it is ingrained that a lower price means "buy more!" (or a higher price means "short more!")
- Classic value investors are going to screen a lot of value traps as attractive
  - We will probably buy some of them
  - Performance will be enhanced by recognizing mistakes on value traps and getting out quickly instead of digging in stubbornly

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LESSON #3: LET YOUR WINNERS RUN

ONCE YOU BUY A GREAT STOCK, HOLD ON

AS LONG AS THE STORY REMAINS INTACT

(IT'S OK TO TRIM TO MANAGE RISK/POSITION SIZE)

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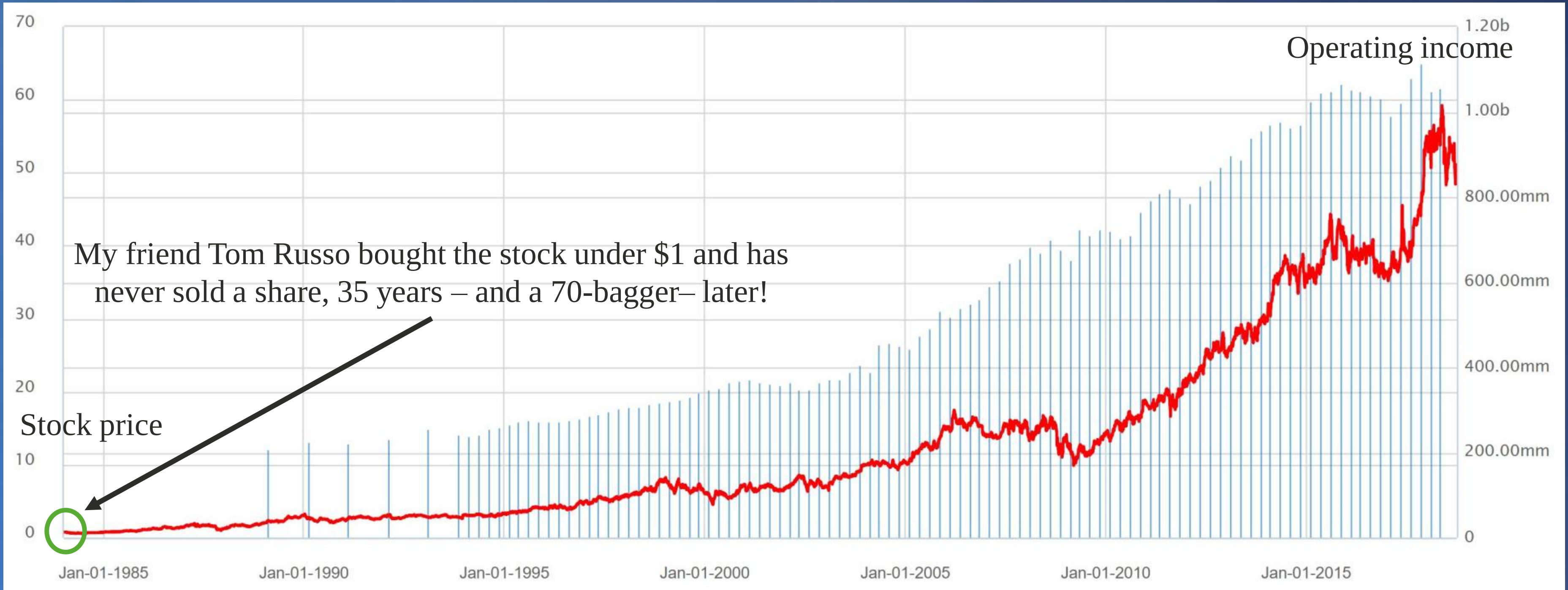
CASE STUDY: BROWN-FORMAN

Maker of Jack Daniels and other spirits



I SOLD FOUR OF THE GREATEST GROWTH STOCKS OF ALL TIME

- I not only owned but publicly pitched four of the greatest growth stocks of all time – Apple, Ross Stores, Home Depot and Netflix – and then sold them *far* too early

THE THREE MOST DANGEROUS WORDS IN INVESTING: I MISSED IT

- The four most dangerous words in investing are: "This time is different"
- The three most dangerous words are: "I missed it"
- The many case studies in this presentation highlight a critically important point: just because a stock has moved up – even doubled or more – doesn't mean it's expensive and shouldn't be bought
- Value investors like to buy stocks trading at or near 52-week (if not multi-year) lows – it makes us feel like we're getting a bargain
- I've lost count of how many times I've looked at the stock of a great company and failed to buy it because it's moved higher and I said to yourself, "I missed it. Maybe I'll buy it if it pulls back" – but it rarely does
- Lesson: ignore where a stock has been and focus exclusively on where it's likely to go

YOU MUST SELL IF THE GROWTH STORY FALLS APART

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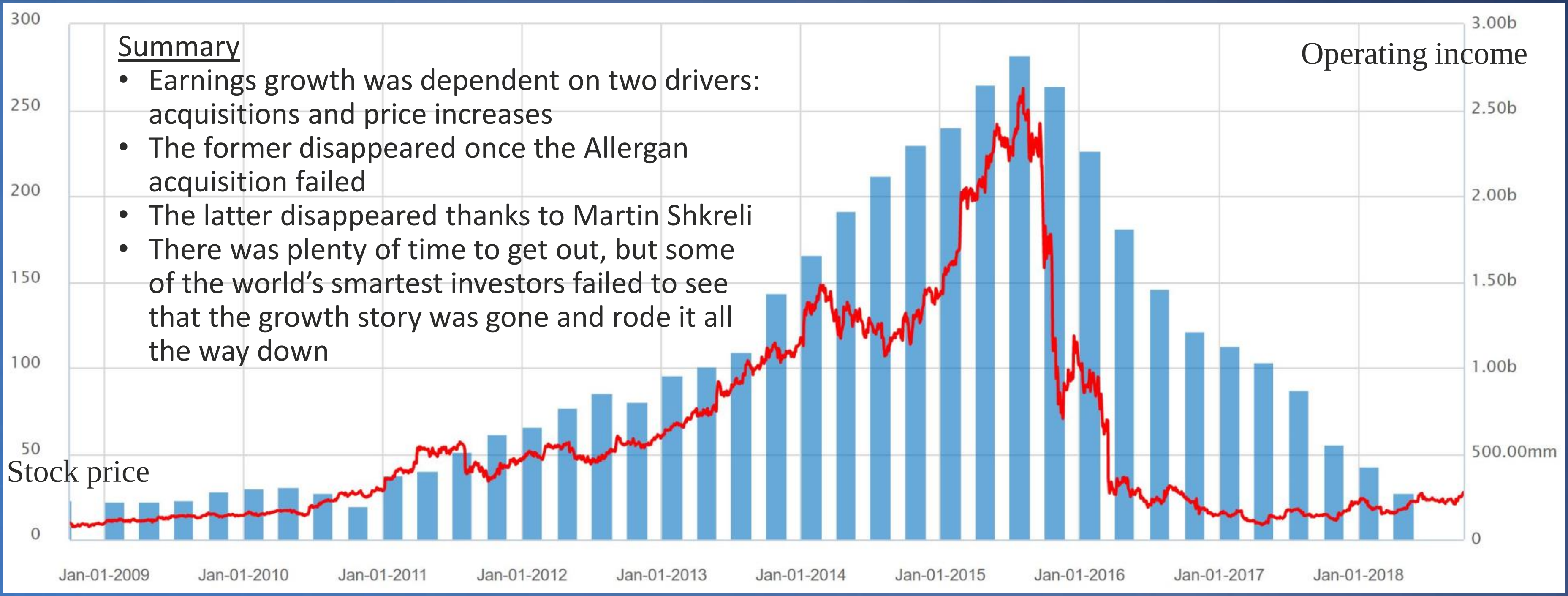
CASE STUDY: VALEANT

Earnings rose 11x, driving the stock up 20x – before it fell by 97%



<u>Summary</u>

- Earnings growth was dependent on two drivers: acquisitions and price increases
- The former disappeared once the Allergan acquisition failed
- The latter disappeared thanks to Martin Shkreli
- There was plenty of time to get out, but some of the world's smartest investors failed to see that the growth story was gone and rode it all the way down

 (Valeant has been renamed Bausch Health Companies – BHC)

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STOCK IDEA #1: ALPHABET (GOOGLE)

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STOCK IDEA #2: FACEBOOK

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STOCK IDEA #3: HOWARD HUGHES

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PS: A FEW THOUGHTS ON BITCOIN

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BLOCKCHAIN IS REAL, BUT CRYPTOCURRENCIES ARE A SCAM

- Like all great bubbles, the cryptocurrency one is rooted in something legitimate, blockchain, which is real and important technology
- But cryptocurrencies will never gain widespread acceptance because there is nothing backing them and they are instruments of speculation, so their values swing widely
  - Think about it: would you ever accept payment in bitcoin (or any other cryptocurrency) if you had to hold it for more than a day?
  - The U.S. dollar, while not backed by gold, is backed by a $19 trillion economy and the government's power to tax it
- The sector, not surprisingly, has attracted every form of promoter and fraudster

I CALLED THE TOP OF THE BITCOIN BUBBLE TO THE DAY

In my investing email to ~6,000 subscribers on Dec. 16, 2017, when bitcoin peaked at $20,000, I wrote:

Subject line: I'm calling the top of the bitcoin/cryptocurrency madness

In the past week, I've been asked about bitcoin by a parade of the least-knowledgeable investors imaginable – and the only times such foolishness has happened before in my 18-year career were at the peak of the internet and housing bubbles, so **I'm calling a top right now**.

Blockchain technology is real in the same way that the internet was real back in 1999 and housing prices tend to go up in the mid-2000s – in other words, a good idea taken to absurd extremes is NOT a good idea!

That said, the greed and speculative nature of humans is inherently unpredictable, so for all I know bitcoin could go to $1 million.

But I do know the ultimate outcome: smoldering rubble, a lot of finger-pointing (where were the regulators?!), and a lot of tears and empty bank accounts, especially among those who can least afford it.

SINCE THEN, BITCOIN IS DOWN 67%

Other cryptocurrencies are down far more

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PPS: THE CANNABIS STOCKS ARE IN AN EXTREME BUBBLE AS WELL

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