How to Lose Money: Top Five Mistakes of a Value Investor

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In my article *How to Lose Money in the Stock Market: The Top 5 Mistakes*, I sought to teach you what not to do when investing by answering the following question: What is the most certain way to lose the most money investing in stocks?

As a refresher, the five most certain ways to lose money in the stock market that I identified were:

1. Invest in Bad Businesses
2. Invest with Bad Management Teams
3. Invest in Companies with Too Much Debt
4. Pay Too High a Price
5. Focus Only on the Short-Term

Now, I want to share with you my own mistakes in each of these categories from my 15+ years of professional investing experience that have taught me valuable lessons. My hope in sharing these with you is to help you avoid making these mistakes yourself.

Avoid Investing in Bad Businesses

About fifteen years ago, as a young equity analyst, I recommended that the large investment firm that I worked for invest in a company's stock. It was a cyclical business, and I carefully analyzed the past financial statements and made what I thought was a well-reasoned estimate of the future mid-cycle earnings power of the company. Over a decade hence and with the full benefit of hindsight, I realized that I had been off… by a factor of 10x!

> How is it possible to be off by so much? Well, it turned out that the future was quite different from the past that I was relying on in my analysis. While this is always a risk, the magnitude of the deviation from past financial results was driven by the low quality of the business – its operations were in tough industries in which it had only very marginal, if any, competitive advantages. This made it unable to cope with the negative changes that the industry experienced after my investment recommendation, and caused the earnings of the business to permanently collapse.
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> The lesson learned? A business with no competitive advantage can have future economic characteristics that are drastically different from those it had in the past. What is worse, the direction of any unexpected changes in profitability is likely to be negative. This can make estimating the value of such unpredictable businesses an exercise in overconfidence and futility, and is thus better avoided barring extremely unusual circumstances.

Avoid Investing with Bad Management Teams

While managing the Focused Value strategy at my last firm prior to founding Silver Ring Value Partners, I came across a small consumer goods company. The stock was very inexpensive relative to historical earnings and cash flow, and the business seemed to be good enough, with decent niche brands that had high market share within their categories. As I studied management's communication and actions over the years, I became somewhat concerned by the lack of focus on maximizing value per share, and instead a focus on growing the business. I put aside that concern, in part because I saw that the two brothers who were the main executives at the firm owned a very large amount of stock. This gave them a fair amount of control over the company, and I thought it would also align their incentives to act rationally. Unfortunately, I was wrong. Management kept underperforming operationally, and what's worse, it started deploying capital into large acquisitions. Management openly admitted after the last of these deals that they didn't have any idea what the return on the investment would be. I was forced to reassess the value of the company, and this caused me to sell the stock. Fortunately, the low initial purchase price resulted in this being essentially a break-even investment as opposed to a big loss, but that was still a poor outcome.

> The increase in profits that I anticipated never materialized. Looking back on this investment today, the earnings of the company are far lower than I originally thought they would be when I made the purchase, and also lower than the company's historical profit levels despite a healthy economic environment. The stock is currently ~ 15% lower than when I sold it, despite the overall market increasing substantially during the intervening two years.
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> The lesson learned? The best predictor of management's future behavior is its past behavior. When a management team shows lackluster capital allocation skills in the past, it is unlikely to become good at capital allocation in the future. What's more worrying is that if the business encounters any challenges, the management's lack of acumen can cause substantial value destruction for the company. While large stock ownership is an important means of aligning incentives with the shareholders, it alone is insufficient to guarantee a management team capable of and interested in maximizing long-term intrinsic value.

Avoid Investing in Companies with Too Much Debt

Also at the beginning of my investing career, I was recommending purchase of another stock. This company had a somewhat stretched balance sheet, but not so much so that I thought it was going to be a problem given that the then current credit metrics were OK. Right before Christmas, the company pre-announced a major earnings disappointment due to weakening demand trends, suspended its dividend, and announced that its expectations for next year's results were now substantially below last year's profit levels. With this revised view, the credit metrics were no longer OK at all.

> That night, I woke up in the middle of the night very agitated, and I kept repeating just one word: "EBITDA! EBITDA!" (Earnings before Interest, Taxes, Depreciation and Amortization.) As I fully woke up, I remembered the dream that I was having – the bank group which had lent this company money was considering forcing it into bankruptcy due to non-compliance with the loan covenants, and I had been arguing with them for forbearance based on the company's future levels of profitability.
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> The lesson learned? When the balance sheet of a business with no competitive advantage carries what seems like an appropriate amount of debt in a benign business environment, it leave no

margin of safety for adversity which can quickly impair the company's profitability and cause the balance sheet to become unhealthy quite rapidly.

Avoid Paying Too High a Price

Three years ago, while managing the Focused Value strategy at my last employer, I came across a company with a very strong brand in the apparel space. The stock had already declined by a meaningful amount, and was now trading at a low ratio relative to its historical profits. As I did additional work, it became apparent that some of the reasons for the decline in profits were not temporary and were the result of structural industry changes and company-specific brand challenges. Management was trying to implement a plan to turn the business around to restore past profitability, and was well incentivized to maximize long-term value. That stock was not yet cheap on the then-current earnings, but I judged it to be substantially undervalued if the turnaround materialized.

I made a small investment in the stock, as the combination of business quality, management quality and a strong balance sheet led me to believe that it was undervalued relative to my range of intrinsic values for the company. Unfortunately, fundamentals continued to deteriorate, and the turnaround has failed to materialize thus far. When I left my prior employer to start Silver Ring Value Partners in 2016, I reassessed all of the investments with a fresh perspective, and this led me to not include this stock in my new portfolio. So far, this has been a good decision as the company has fired its CEO, fundamentals continue to track below expectations, and the stock is down substantially despite the overall market being up.

The lesson learned? Had I been more patient initially and waited for a stock price that was low not just relative to an outcome that I thought was likely, but also low relative to the current trajectory of the business without a turnaround, I would have had a higher margin of safety. This would have allowed me to lose less money even in the scenario where the likely turnaround that I was expecting failed to materialize. Price is the only variable a passive outside investor can fully control, and it is very important to be extremely patient to wait for one that offers a large margin of safety relative to the company's intrinsic value.

Focus on the Long-Term, not on the Short-Term

When I started investing in my own account while studying at MIT, I came across a brokerage report about a company of a then well-known branded apparel manufacturer. The report highlighted the short-term prospects for sales growth, and the likely upward direction this was going to result in for the stock price. This was shortly before I had the opportunity to listen to Warren Buffett speak on campus and became a value investing convert. Back then, I didn't really know what I was doing, and I quickly became excited about the company and bought a small number of shares.

The short-term sales growth that the brokerage report touted never materialized, and the business continued to weaken. Its brand became less relevant with customers, and it lost market share and retail shelf space. As a result, its profits declined, and the stock declined as well.

Lesson learned? Thinking about where the business is heading long-term is more helpful when investing in the stock market than trying to anticipate short-term trends. Additionally, I learned never to rely on the work of others, and always do my own research to validate the attractiveness of an investment

One of my favorite sayings is: “When a man with money meets a man with experience, the man with money leaves with experience and the man with experience leaves with the money.” My hope in sharing some of my mistakes and the lessons that I learned from them with you is that these insights will help you be a better investor and avoid making some of the same errors that I had to learn how to avoid through painful experience. Value investing can be very rewarding when implemented properly, but it is far from easy to do so. Hopefully reading this will help you improve as an investor.