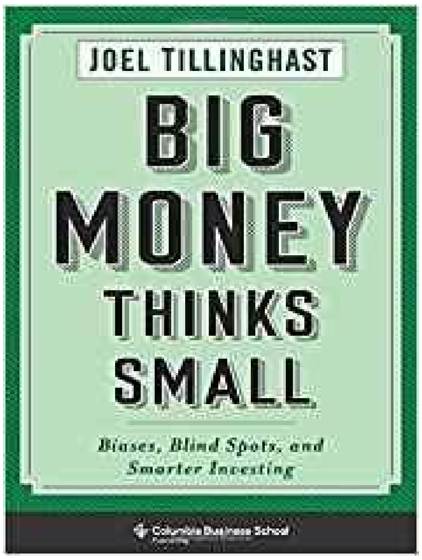

My Take on Joel Tillinghast's Recent Book

by Stéphane Préfontaine

Professional money management requires to regularly take a step back from ongoing short-term news flow and external pressures. Delving into an in-depth topic helps to put things in perspective.

Anyone who beats his benchmark stock index (here the Russell 2000 and the S&P 500) by 4% annually over nearly 30 years as Joel Tillinghast did deserves to be read.

This brings me to an important observation for individual investors: we put far too much emphasis on short term returns and not enough on long periods. Returns over 3 to 5 years should not be enough to form a definitive judgment on a manager and especially not to justify paying high management fees; statistics show that very few "super" results over 3 to 5 years persist over the next 10 to 20 years, more significant periods for individual investors. It's important therefore to seek to understand what characteristics in managers help generate lasting outperformance.

Joel Tillinghast has managed a fund mainly of small capitalization stocks at Fidelity since 1989 (29 years), in the tradition I would say of Peter Lynch, with about 800 stocks in the portfolio. A Lesson I draw from this book is that there isn't only one way to invest successfully in the long run. One should start with one's own goals, intellectual abilities, interests, and psychological makeup, i.e. one's temperament.

Thinking Small

The title of the book refers to the fact that higher returns can be achieved by investing in small and medium-sized businesses, which makes no doubt statistically. However, investors must accept more volatility and be more patient because in general there is more uncertainty on smaller companies' future cash flows, and reduced stock trading volumes can increase price fluctuations. It is necessary investors compensate by a solid knowledge of each company, its business model, outlook and risks and develop high conviction on the quality and integrity of the leadership team; it's also important to avoid companies with too much debt relative to the stability and predictability of their cash flows; finally, I suggest investors in small stocks shouldn't look at the stock price too often once a full position is taken. "Thinking Small" for Tillinghast also refers in some ways to reducing the number of variables where one can go wrong by keeping it simple, not trying to predict macroeconomic trends and focus on businesses that are easy to analyze and stable.

Reading this book exposes us to remarkable encyclopedic knowledge of the economics of several industries. We detect through this book a flexible, open and creative mind, a person who also can recognize his mistakes. Key to success in investing according to Tillinghast is to act cautiously, be patient, avoid excessive trading and look for easy to understand safe bets rather than strong emotions and home runs. The longer our investment horizon, the more advantage we have over other stock market participants ("time arbitrage").

Avoiding common mistakes

The author wants to help us avoid investing mistakes, especially those he has committed in his career. He classifies investment errors into five categories: 1. Acting too impulsively or emotionally, i.e. being subject to a series of psychological biases; 2. Overestimating ourselves as investors; 3. Investing in poorly managed businesses; 4. Investing in businesses prone to failure due to obsolescence, excessive competition or excessive debt; 5. Paying too much.

Psychological biases in investment have been the subject of extensive literature since the '80s and Tillinghast offers us a good summary. For instance, he talks about the recency bias, where we tend to extrapolate the distant future based on the very recent past; or the confirmation bias, a form of cognitive dissonance where we tend to look for statistics that confirm our initial (often emotional) point of view on a subject rather than looking for facts and arguments that might refute it.

The section on the qualities and integrity of senior management of companies is fascinating. His numerous examples of fraud and deceptive accounting remind us of the importance of understanding senior managements' incentives structure and getting a sense of the culture of the companies in which we invest.

The section on quality and sustainability of business models is also filled with informative examples and provides us with an historical perspective of different industries. Tillinghast gives us numerous examples of well-known bankruptcies and helps to elucidate their most common causes.

Valuation

Finally, the section on valuation teaches us different concepts and techniques to help avoid overpaying for a stock. Tillinghast usually begins his analysis with a low price/earnings ratio, coupled with a high return on capital, and brings to it numerous refinements. Proper valuation depends on a solid understanding of the economics of the company and its industry. Valuation is not an exact science and a range of estimates should cover different scenarios, taking good care to distinguish the facts that are more certain from those more unreliable. His checklist to determine if there is undervaluation includes four points: 1. Low price/earnings ratio; 2. competitive advantages reflected in a high return on capital; 3. Sustainability of the business model; 4. Predictability and stability of finances (cyclicality, volatility, uncertainty of revenues and earnings).

In conclusion, I would say students of investments should seek to identify who are the best investors in the world over several decades and avidly read all they can about these people. Tillinghast is just one example. Maximizing our exposure to the brightest people is key to developing a solid intellectual framework. Then I believe it is necessary to learn about ourselves and learn to control our emotions by practicing investing real money, starting with small risks, in order to gradually build our self-confidence.