Bo meets Lee

In early December I (Bo) had the pleasure to have a long dinner with Lee Freeman-Shor. Lee wrote "The Art of Execution" in 2015, which fellow reviewer Mats Larsson did an excellent review of in 2015.

To quote Mats, *"This might be the most important book on investments that a private investor can read – if he can gather the discipline to follow the advice. It might actually save quite a few professional portfolio managers' bacon as well"*.

During the dinner I had the opportunity to elaborate further on some questions that he rises in the book. The feedback he has received from the people reading the book was about, it can't be this easy, is must be more difficulty to improve results…and I need more help….so Lee is currently working on a new book or workbook.

My very short summary of "The Art of Execution":
The firm LFS worked for (Skandia) had an idea to create a fund that captured the 10 best ideas from a group of the best investors. Initially, the funds were launched with ten investors each contributing their ten best ideas. He was able to track every single trade, and when he did that, he noted that the % winning and losing trades overall was around 50%, and some with bad performance had a high hit ratio and vice versa. Clearly what matters it not just the best idea, but also the execution. He found out a common trait among the best. They cut the losers or materially increased the position if they had decline of 20-35% (he called them assassins when they cut the loss, or hunters when they increased) and they kept winners (he named these the connoisseurs). The bad investors stayed on with losers (these was named rabbits) and sold winners after a quick run (named raiders). Key source to the big outperformance is to hold on to a few winners and be very long term.

With that over to the Q&A.

InvestingByTheBooks: What do you mean by "Feel the pain of the gain"

Lee Freeman-Shor: Lovely quote I believe from Paul Tudor Jones. The best keeps the winners. Value investors tend to sell at a price target (too early). Basic problem with that, is that normally a few outside winners tend to make up most of the outperformance, so you need the big winners to compound. Maybe you can top slice a bit, but then you are at risk falling for the temptation to cut all the position. It's worth repeating, always remember that there are a handful of big winners' responsible success and the key is to compound those. Be a connoisseur. Print out a chart or two of a stock that you sold too early and put it on the wall in front of you to remind yourself.

IBTB: What's the Problem with raider, you don't agree with the saying "you don't go broke taking a profit"?

Freeman-Shor: I had a successful investor that had a high percentage of profitable trades. He was happy taking many small profits, but he still had negative results, as from time to time a stock would lose a lot of money. The small profits failed to offset the occasional big hits. Unfortunately, I think it's typical for short term hedge fund managers or many traders to have that profile whereby many years of steady gains are wiped out in a short space of time.

IBTB: Materially adapt when you have lost money in a position is at the core of your philosophy, please elaborate.

Freeman-Shor: Critical to a good performance is to either get out of losers, or double/treble up.

The decision points come when you should consider taking material action is when the loss is more than 20% but less than, say 35%. Investors (like a trader) should consider using a stop loss. My research showed that stop loss should be wide (loss of more than 20%) otherwise the likelihood is high that you will be whipsawed. Also, you don't want to lose too much money before you act because otherwise you will struggle to recover the loss. A loss of 50% requires a return of 100% to breakeven. Whereas, if you are down say 35% you still need 50% to recover but at least that is doable. Difficult but doable.

At a 20-35% loss, the investor is thus at a key juncture. If the narrative still holds, and there is a willingness to increase, without a doubt, then the investor should do it. If not, sell. If there are a doubt, excuses etc, sell. The decision to either double up or cut the loss, comes naturally to the best investors. I would also note that many value investors tend to be investors when they increase in a stock that has fallen a lot, but also fall for the temptation to be a raider, i.e. sell post a bounce reaching a shorter-term price target. The problem here is that they risk never holding any big winners and therefore will be lucky if they are successful.

IBTB: What can investors do to get better in the heat of the moment?

Freeman-Shor: One alternative is to temporary reduce the position while doing the extra research, to have a clearer head. I had investors do that with good results.

IBTB: Many value investors recommend to "average down", what's your view?

Freeman-Shor: Value investors tend go against the trend of many things, which often leads to further price falls. They often advocate to dollar cost average in a stock. However, they then lose out the ability to potentially increase a lot post a big decline. The best investors can go against the trend, and materially adapt post a major fall. They don't add a little with ever small price fall. They wait until it makes sense. You need to be prepared from the beginning, and size accordingly & not average down. Results tend to come after some time, and a key challenge then is to hold on to the stock as it rerates, not to sell too early; be a connoisseur. But its more common to find good value investors.

IBTB: Ok but I need more input here, please

Freeman-Shor: Ok, so I will share something that is not in the book. I met with a quant manager. I told him to check if sell losing stocks automatically at -20% was a good strategy. I thought it could be but wasn't sure whether it make sense in a systematic fashion. Neither was he. When he ran the numbers he discovered that if you have a concentrated portfolio, with nr of stocks <15, when you cut the loser at 20%, the information ratio shot up. The lesson was clear. The more focused the fund is, the better it is to cut losers and avoid big drawdowns. The more diversified the fund the less it mattered.

Further to this, the best investors, enjoy picking the bottom right. I saw too many to get these calls right to think that was a losing game. There is skill here. The best Hunters increased the position materially.

IBTB: Why can't I hold on to my losses without not doing anything, things will work out….

Freeman-Shor: Facts don't support the rabbit strategy. it's very difficult to recover from large losses, which is what you risk by just sitting on a loser and watching what happens. Like a rabbit, if you dig a hole that is too deep you will never get out of it. The ability to cut losers, and move are crucial. That improves the result dramatically.

The best investors also use a time stop, they tended to avoid holding losing/underperforming positions for a long time.

Important to be a good loss taker. That is skill, which the best investors have. No one of the successful investors was a rabbit.

IBTB: What's the next book about?

Freeman-Shor: After writing the first book, I got many question on how to know when to sell a losing idea. So, I interviewed my network of top investors. I asked them, why did you decide to sell? Was it the valuation, was it some technical or was it lack eps upside? No, the reason was the narrative changed. The initial thesis doesn't hold anymore. But to know this you have to be good at questioning to be able to attack the story, your thoughts, feelings and behaviour.

I will take the results from this and put it together in a workbook that contains lots of useful questions for investors to help them challenge the story in their head and determine whether they should stick with the idea or move on.

One other thing I think is useful, is to construct a pre/post mortem, what can go right and wrong before you go into the investment.

Lee, thanks for your time. I am very excited about the next book, and I hope it's about the art of investing, and not investing in art.

If you want to see and hear him, this interview on realvision is a gem!

Enjoy your Christmas break

Bo Börtemark, December 15, 2019

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