Understanding the Foolish Strategy to Success in Investing

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Abstract

What makes for a successful investment? I investigate stocks suggested by the Motley Fool in their Stock Advisor weekly stock recommendation service. It has boasted a +428.5% return with successful picks such as Netflix, Amazon, and Priceline. How do they achieve such a successful return? Why are the stocks they choose so successful? Can we learn from their picks and improve on their success? I explore the stock recommendations made in Stock Advisor to understand their success.
Keywords: *Stocks, Investing, Motley Fool, David Gardner*

1 Introduction

The Motley Fool is an online investment advice company run by David and Tom Gardner. They provide Stock Advisor, where they have given a weekly stock recommendation since 2002. Many of these recommendations have become successes such as Netflix, Amazon, and Priceline leading to +428.5% average return. Netflix is by far their largest winner, with a 243,687% return since they recommended it in 2004.

I wanted to understand their success, when it's said that 95% of hedge fund managers can't beat "the market", which refers to the S&P 500, a collection of the 500 largest companies. To do this I posed 7 questions to investigate.

1. **What Performance did David and Tom Gardner Achieve?**
2. **Which of David or Tom Gardner was more Successful and Why?**
3. **Should you Continue to Buy Your Winners?**
4. **What Role does Market Cap Play in a Stock's Success?**
5. **What Role does the CEO Play in a Stock's Success?**
6. **What are the Traits of the Best Performers?**
7. **What Stocks could be Strong Performers?**

2 Questions

2.1 What Performance did David and Tom Gardner Achieve?

To answer this question, I simulated the following scenario: I would put $1000 in each of David's 135 recommendations, $1000 in each of Tom's 106 recommendations, and $500 in the S&P 500 for each of the 241 times they recommended a stock. Doing this, we get:

- A total investment of $135,000 over 18 years or $7,000 a year, in David's picks would have turned into **$1,602,496**. This nearly 12x's your money!
- A total investment of $106,000 over 18 years or $5,900 a year, in Tom 's picks would have turned into **$510,392**. This nearly 5x's your money.
- A total investment of $120,500 over 18 years or $6,700 a year, in the S&P 500 would have turned into **$263,469**. This 2x's your money.

It is clear to see both David and Tom beat the market. But David beat the market with a crazy 12x return on your money. How did he do it? This leads to our second question.

2.2 Which of David or Tom Gardner was more Successful and Why?

We've answer the question of which of David or Tom showing David was wildly more successful with a 12x return of your money. But why was he so much more successful?

One hypothesis is his breakout picks overwhelmingly pay for most of his return. To see this we can look at what are his best recommendations.

	TICKER	REC DATE	TEAM	RISK	ADJ REC PRICE	RETURN	S&P RETURN
221	NFLX	2004-12-17	David	11.0	1.85	243.687	2.580
222	NFLX	2004-10-01	David	11.0	2.33	193.491	2.794
236	AMZN	2002-09-06	David	8.0	15.31	173.723	3.981
213	NFLX	2006-09-15	David	11.0	3.25	138.790	2.136
215	NFLX	2006-06-16	David	11.0	3.87	116.111	2.323
226	BKNG	2004-05-21	David	9.0	23.71	67.617	2.949
238	DIS	2002-06-07	David	9.0	7.35	62.288	3.351
218	NVDA	2005-04-15	David	5.0	6.55	55.580	2.721
231	ATVI	2003-02-07	David	10.0	8.61	46.839	4.325
235	DIS	2002-11-08	David	9.0	11.81	38.394	3.961

Figure 1: For percent returns, subtract 1 and times returns by 100x. For example, David's recommendation of Netflix on 2004-12-17 had a percent return of 242,687%.

From David's most successful recommendations, we can see Netflix makes 4 out of the top 5 recommendations, and each makes outsized returns. For example David's recommendation of Netflix returned 242,687% in 2004-12-17, and 192,491% in 2003-10-01. We can see this when we compare David and Tom's final portfolio.

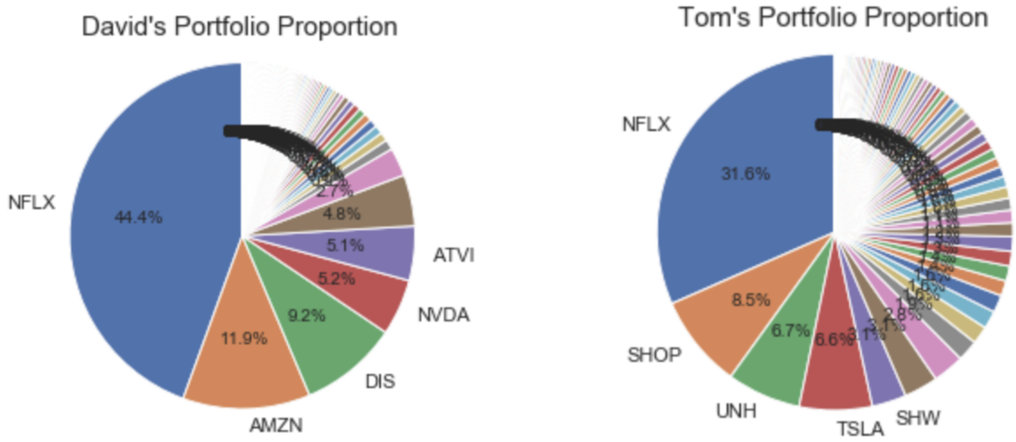


Figure 2: David and Tom's final portfolio from 2002 to 2020.

For both David and Tom, Netflix was an outlier winner that led to the monstrous wins for both David and Tom. David was more consistent, choosing to reinvest in Netflix six times from 2004 to 2019, while Tom picked Netflix once in 2007.

One might imagine finding a company like Netflix would be an incredibly difficult task, with thousands of different possible companies. However, David and Tom have picked companies 120 different times, and their few major successful pay for the majority of their portfolio.

David was also more successful at picking Amazon, Disney, and Nvidia, while none of Tom's picks before 2010 were as successful. If we look at recommendation post 2010, $1000 in each of David's picks would return $249,674, while $1000 in each of Tom's picks would return $241,525.

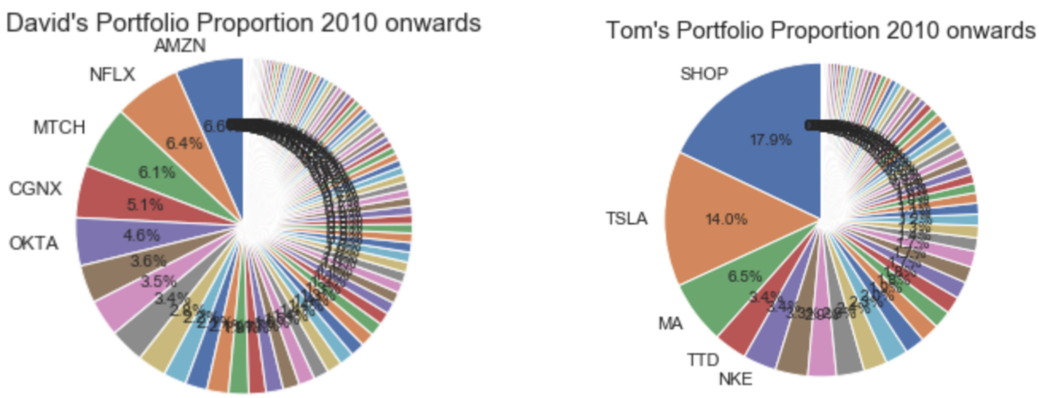


Figure 3: David and Tom's final portfolio from 2010 to 2020.

While David still takes the lead with companies like Amazon, Netflix again, and Match

Group, Tom does perform well with Shopify and Tesla.

Overall, **David's picks tend to be stronger**. David tends to pick strong growing consumer brands with loyal customers and strong leadership while Tom picks high growing and disruptive companies that can shape new industries. David also reinvests in his winners, which often continue to outperform and compound value.

2.3 Should you Continue to Buy Your Winners?

We've seen one reason David was successful was because he reinvested into his winner? Why is this effective?

If we look at David's rerecommendations, we see he invests in:

1. Netflix and Disney 6 times
2. Activison Blizzard 4 times
3. Apple, Amazon, Nvidia, and Cognex Corporation 3 times

Tom biggest recommendations are:

1. Mastercard and Shopify 4 times
2. Markel Corporation, Berkshire Hathaway, and Chipotle Mexican Grill 3 times

David tends to rerecommend more and rerecommend in better stocks.

One issue with rerecommend have usually performed very well since the first time they were recommended. It's common to see people complain they missed out on a stock and say it's too expensive. We can investigate these claims on David's two biggest rerecommendations, Netflix, and Disney.

2.3.1 Netflix

David's 5 recommendations in Netflix are 2 in 2004, 2 in 2006, 1 in 2007, 1 in 2013, and 1 in 2019.

	TICKER	REC DATE	TEAM	RISK	ADJ REC PRICE	RETURN	S&P RETURN
14	NFLX	2019-11-21	David	11.0	311.69	0.456	0.010
148	NFLX	2013-06-21	David	11.0	30.99	13.643	1.246
213	NFLX	2006-09-15	David	11.0	3.25	138.790	2.136
215	NFLX	2006-06-16	David	11.0	3.87	116.111	2.323
221	NFLX	2004-12-17	David	11.0	1.85	243.687	2.580
222	NFLX	2004-10-01	David	11.0	2.33	193.491	2.794

Graphing Netflix from its IPO in 2002 to 2020, it's clear to see Netflix has had an outstanding performance.

However, if we graph only the first two recommendations in 2004, it looks like Netflix was an overvalued stock that is underperforming. When put into perspective of the top graph, this apparent underperformance is just a blip that doesn't even show up.

Now if we include David's 2013 rerecommendation of Netflix, it's pretty clear it has been a winner since the original picks in 2004. By David's rerecommendation in 2013, the original recommendation of Netflix in 2004 would have been an outstanding 1,228% return. Most investors would have been happy to take profits, especially with Netflix's deep dip in 2011. However, if we put the 2013 rerecommendation into the larger 2002 to 2020 perspective, it again had huge room to grow. David's 5th rerecommendation of Netflix in 2013 returned another 1,364% while the original returned 19,349%. Even the crash in 2011, where Netflix lost more than half it's value is tiny compared to its current 2020 value.

And yet again David had stuck to his investing principles and rerecommended Netflix for the 6th time in 2019. While it might seem Netflix is at near record highs, one could image a graph to 2040, where even this near record high recommendation is an insignificant blip.

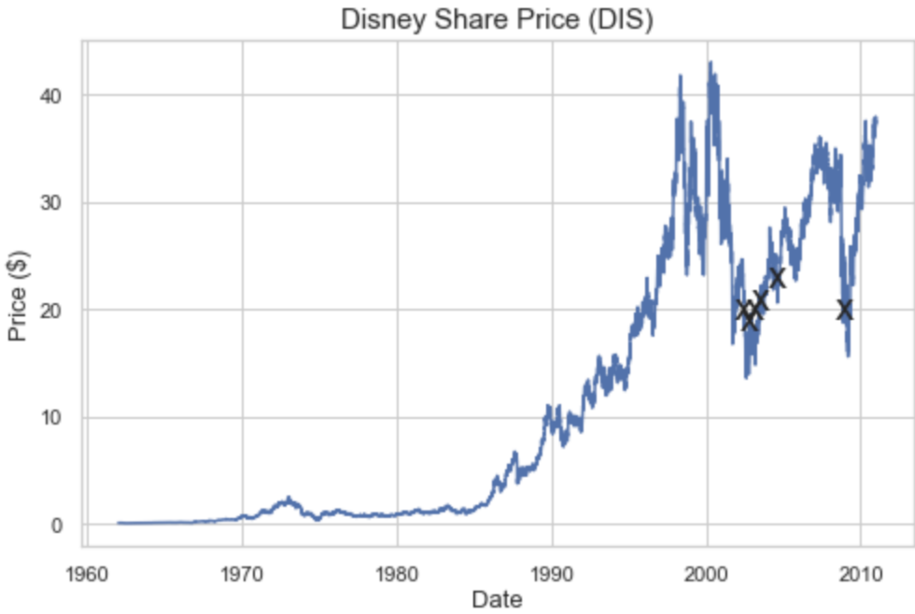
2.3.2 Disney

David also recommends Disney 6 times, twice in 2002 and 2003, and once in 2004, and 2008.

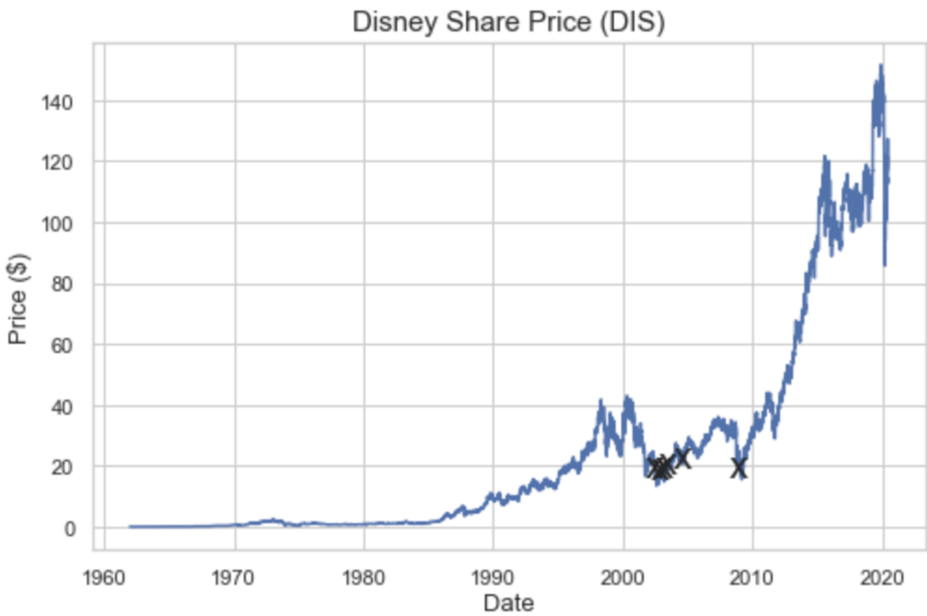
	TICKER	REC DATE	TEAM	RISK	ADJ REC PRICE	RETURN	S&P RETURN
200	DIS	2008-12-19	David	9.0	61.88	6.515	3.448
223	DIS	2004-08-20	David	9.0	29.58	14.724	2.915
228	DIS	2003-07-11	David	9.0	57.27	8.507	3.392
230	DIS	2003-03-07	David	9.0	44.86	11.137	4.320
235	DIS	2002-11-08	David	9.0	11.81	38.394	3.961
238	DIS	2002-06-07	David	9.0	7.35	62.288	3.351

If we look at Disney from 2000 to 2010, it would appear to be massively underperforming from its 2000 highs.

Yet if we look at it from its IPO in the 1960s, it would appear to have been a vastly successful investment for someone in the 60s to 80s, but would like near the top without that much room to grow. Most people would take the multi-thousand percent return as profit.



Yet again, in the full perspective from the 1960s to 2020s, Disney's volatility in the mid 2000s is just a tiny blip in the grand scheme.



Continuously reinvesting in your winners hugely important factor in success. Usually these companies have strong businesses, large moat, and effective executives that have earned trust to grow and adapt to changing markets.

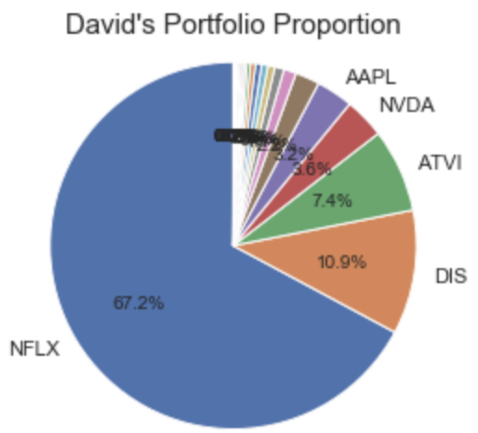
For example, Netflix was able to grow even bigger by making the shift from DVD rentals to online streaming. This leds to hiccups as can be seen in the 2011 drop, but the leadership of CEO Reed Hastings was able to execute leading to their success and dominance in online streaming. Netflix again had to adapt to rising streaming competitors such as Amazon and Disney as well as contracts for beloved shows ending such as Friends. Again the leadership was able to execute, experimenting with original content creation like House of Cards, and double down on it as an effective strategy to survive through competition. Even in 2020, the business and leadership is strong as ever as they focus on original content creation and growing massively in international markets.

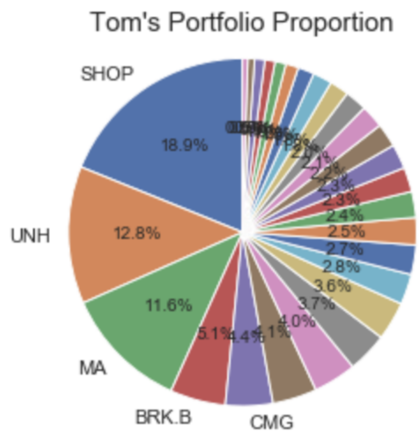
2.3.3 Simulation Investing in Rerecommendations

One way to analyze how effective investing in rerecommendations is to simulate investing when David or Tom rerecommends a stock. In these simulations, we do not invest the first time the stock is picked, as there is no prior evidence for how well it will perform, making it indistinguishable from the 200+ stocks David and Tom pick that are not like Netflix.

Running these simulations we get:

- A total investment of $134,995 or $3,118 (instead of $1,000) in each of David's 35 rerecommendations would have turned into **$2,972,328**. This would be a 22x of your money compared to 12x by investing in all of David's picks.
- A total investment of $106,012 or $3,857 (instead of $1,000) in each of Tom's 34 rerecommendations would have turned into **$264,440**. This would be a 2.5x of your money compared to 5x by investing in all of Tom's picks.





If we look at their portfolios, David's proportion of Netflix balloons to 67% instead of 44% originally. This helps explains his outsized returns of 22x instead of 12x. Tom's proportion of Netflix disappears to 0% instead of 31.6% originally. Tom recommended Netflix once so investing in Tom's rerecommendations excludes Netflix entirely. This shows picking only rerecommendations is not fool proof as Tom's portfolio underperforms with 2.5x returns instead of 5x originally.

Overall, it is a good idea to continually **reinvest in your winners**. While a good portfolio should be balanced with different stocks including new investments, "sometimes the best stock is one you already own."

2.4 What Role does Market Cap Play in a Stock's Success?

Another hypothesis to explore is what role does the market capitalization of a company play in its success. One theory is that companies with larger market capitalization tends to have smaller growth as there is not a lot more room for these companies to grow. Small capitalization companies would have a lot more room to grow, but are more difficult to identify.

In current times though, large and mega capitalization companies such as Apple, Microsoft, Amazon, Google have outperformed the market, still able to maintain high growth.

To investigate these factors, I created two metrics to compare, **return over days to present**, to normalize returns from compounded old recommendations, and **market capitalization percentage of largest market capitalization** to measure market capitalization normalize to the market value at that time.

For example, Tesla's market capitalization is 253 billion, compared to the largest market capitalization Apple's 1.65 trillion. This would give Tesla a market capitalization percentage of 15%.

If we look at the largest return over days as of 06/20/20 we get this.

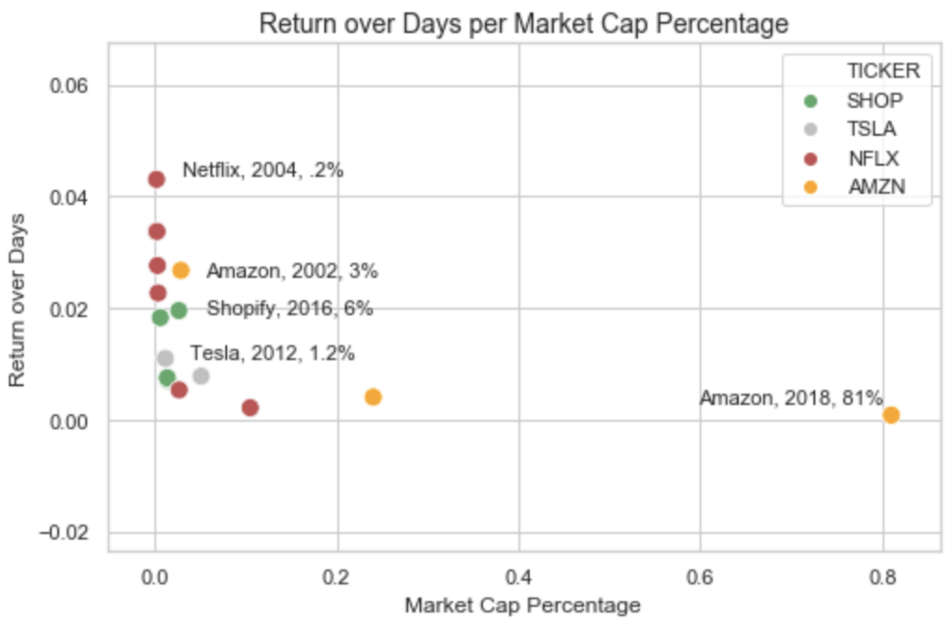
	TICKER	REC DATE	RETURN	Return over Days
221	NFLX	2004-12-17	243.687	0.043024
222	NFLX	2004-10-01	193.491	0.033703
208	NFLX	2007-06-15	160.138	0.033685
213	NFLX	2006-09-15	138.790	0.027609
236	AMZN	2002-09-06	173.723	0.026739
215	NFLX	2006-06-16	116.111	0.022687
5	SHOP	2020-04-02	1.544	0.019544
94	SHOP	2016-07-15	26.259	0.018286
226	BKNG	2004-05-21	67.617	0.011511
155	TSLA	2012-11-16	30.435	0.010975

Netflix, Amazon, Shopify, and Tesla are interesting companies here with multiple recommendations so I focused on investigating those companies.

Next I collected the market capitalization of the largest companies in the years those companies were recommended.

YEAR	COMPANY	MARKET CAP (B)
2002	MSFT	264.00300
2004	GE	382.23300
2006	XOM	446.94300
2007	PTR	723.95200
2010	XOM	368.71150
2012	AAPL	500.61070
2013	AAPL	504.77080
2016	AAPL	617.58849
2018	MSFT	1091.00000
2019	AAPL	1305.00000
2020	AAPL	1560.00000

Using this, we can calculate and graph return over days and market capitalization percentage.



As we can see, there is a cluster around 0-6% market capitalization. **This shows that for the most successful, outsize returns investments, the market capitalization does have to be small.** At the original Netflix recommendation in 2004, Netflix was only .2% of the largest company Microsoft. In more recent years, the recommendation for Shopify in 2016 was 6% of the largest company Apple.

This leads to a difficult point then. To have out sized returns, the market capitalization of a company must be small. However, there are thousands of small cap companies compared to large cap companies and most will not outperform. Second, we have shown it is important to reinvest in winners, which occurs when a company has grown and is at a much larger market cap. In our graph, Amazon was a rerecommendation in 2018, with a large market cap at 81% of Microsoft.

To address this the best action to take is to invest a small amount into several well chosen small cap companies ready for breakthrough. When these companies grow, some will become clear winners, and one should reinvest at these clear winners. This will create a diverse power curve portfolio, where there will be hundred of different stocks, but a select few that have proven themselves which will make up a majority of the portfolio. This is what David and Tom's portfolio's look like, but has a larger factor in reinvesting in winners, which is the factor that compounds out sized returns.

2.5 What Role does the CEO Play in a Stock's Success?

In addition to reinvesting in winners and investing small amounts into small market capitalization stocks, the Motley Fool says the leadership in the number one determining a stocks success. The leadership of a company is a force multiplier in years of growth and is the glue that can hold companies strong and vigilant during difficult periods. A visionary CEO can innovate new markets and products, like Steve Jobs and the iPhone, Elon Musk and electric cars, and Reed Hastings and online streaming.

To investigate this hypothesis, I selected twelve companies that were major successes, rerecommended multiple times and stuck out to me. These were Netflix, Amazon, Shopify, Tesla, Zoom, Okta, The Trade Desk, Match Group, Activision Blizzard, Apple, Nvidia, and Zynga. For these companies, I collected who their CEO was, what their Glassdoor approval rating was, and whether they were mentioned in the stock recommendation report. This could give insights into the quality David and Tom Gardner look for in a CEO as well as how it factors into their recommendation.

	CEO	GLASSDOOR RATING	MENTIONED IN REC
TICKER			
NVDA	Jen-Hsun Huang	0.99	True
ZM	Eric Yuan	0.98	True
OKTA	Todd McKinnon	0.96	True
ZNGA	Frank Gibeau	0.95	True
TDD	Jeff Green	0.93	True
AAPL	Tim Cook	0.92	False
NFLX	Reed Hasting	0.89	True
SHOP	Tobias Lütke	0.88	True
MTCH	Mandy Ginsberg	0.87	False
AMZN	Jeff Bezos	0.86	True
TSLA	Elon Musk	0.71	True
ATVI	Robert Kotick	0.48	False

Most of these CEOs hold high glassdoor ratings with Elon Musk of Tesla and Robert Kotick scoring the lowest. Some are exceptionally well rated like Jen-Hsun Huang of Nvidia and Eric Yuan of Zoom.

Most CEOs were mentioned in the article. Tim Cook was not as the recommendation for Apple was before Tim Cook became CEO. The reports did mention Steve Jobs and described him as a visionary with products.

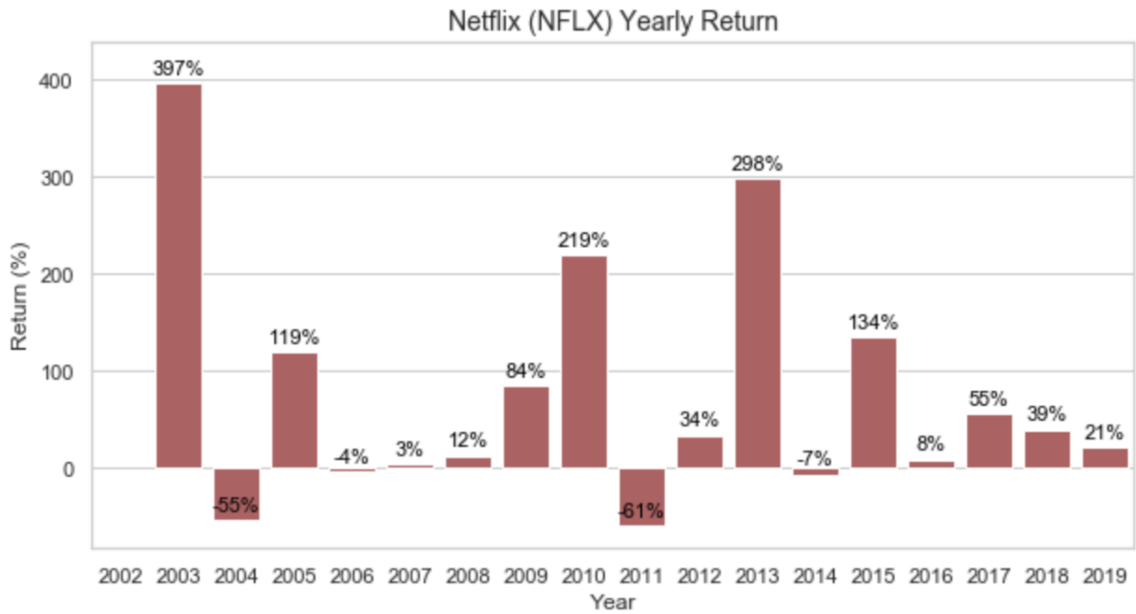
In the reports, many of the leaders of these companies were described as "visionary" including Steve Jobs, Elon Musk and Jeff Bezos. Another common trait was that they were successful in other companies, where Todd McKinnon was a vice-president at Salesforce, Eric Yuan was a vice-president as Cisco, and Jeff Bezos was a vice-president at DE Shaw. This would give them executive experience valuable in running a company. Other had successfully creating other companies, Reed Hasting with Pure Atria, Elon Musk with PayPal and SpaceX, and Jeff Green with AdEcn. Finally, others like Tim Cook of Apple held esteemed roles inside their company before becoming CEO.

Strong Leadership is important but inconclusive if it's the most important factor. Strong leaders do allow a company to perform over time through good and tough periods.

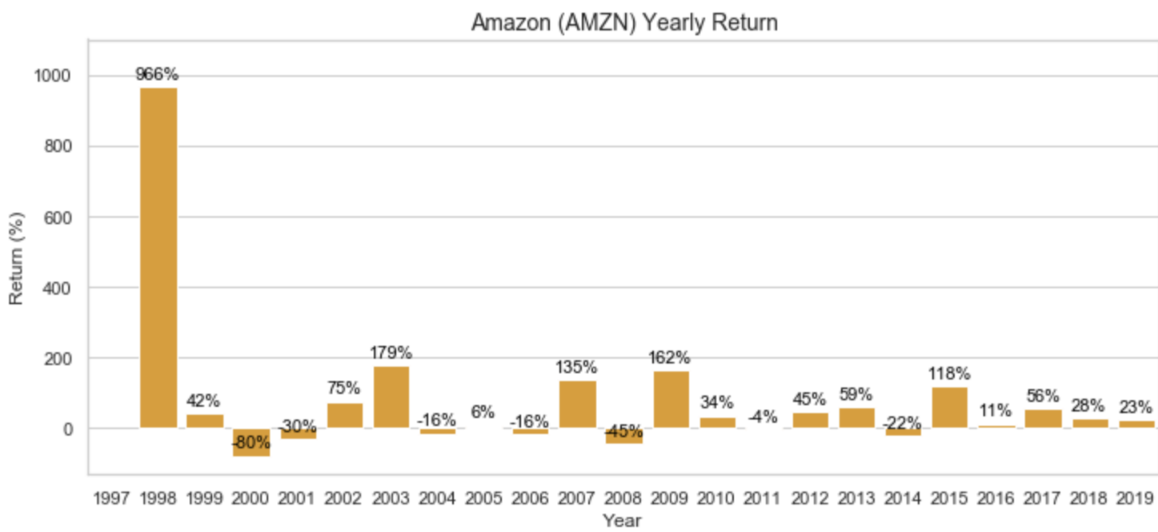
2.6 What are the Traits of the Best Performers?

If strong leadership isn't the catch all to a company's success, what other factors are critical?

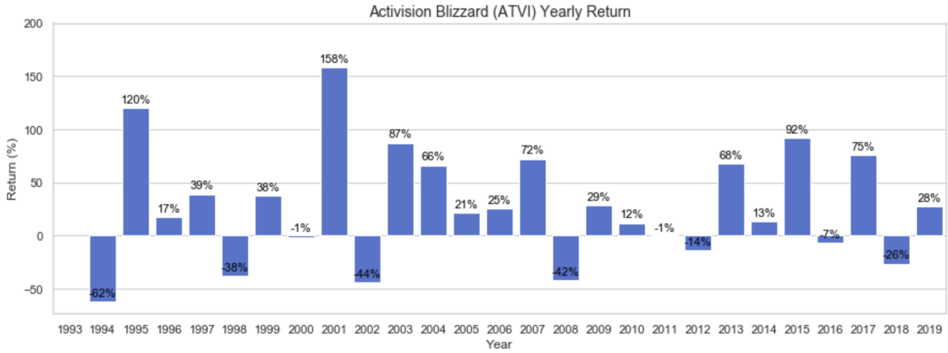
The first thing I looked at was the yearly performance of successful stocks David and Tom Gardner picked. I wanted to see if a breakout stock's success happened in bursts after breakout events, or was growth consistently over time.



Netflix does have huge spikes such as 2003, 2010, and 2013. Netflix also grows fairly stably but its largest drop is in 2011 facing a rough experience transitioning to online streaming from DVDs.

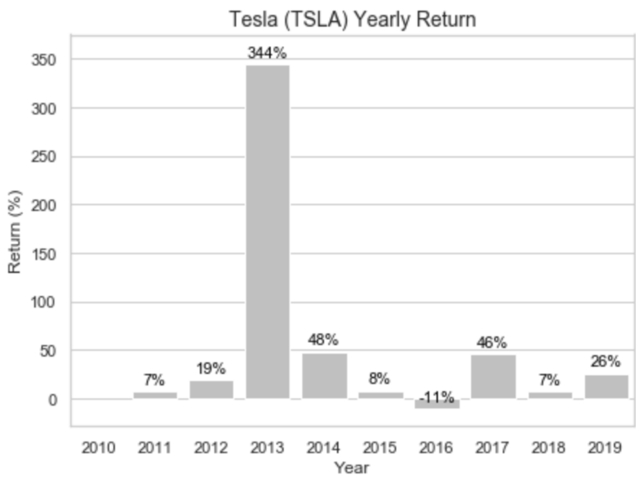


In Amazon, the first thing you notice is the dot-com bubble. Other than that, Amazon grows consistently and stably, but does have spikes as well.



Activison Blizzard is the most volatile so far. It has huge spikes but more draw downs than Amazon and Netflix.

Shopify has shown consistent growth but is too new to tell.



Tesla clearly has a spike in 2013. Other than that, it has consistent growth and few draw downs.

It's difficult to generalize but consistent growth, few draw downs, and some spikes seem to be how these companies grow into successes. This gives the idea that these companies are "priced to perfection, but perform to perfection". The draw downs are when the company underperforms it's high valuation, but does gain back and re-perform at expectation.

Finally, I read the stock recommendation reports to see common themes in the companies noted before: Netflix, Amazon, Shopify, Tesla, Zoom, Okta, The Trade Desk, Match Group, Activision Blizzard, Apple, Nvidia, and Zynga. Reading these reports, some things stuck out.

1. **Growth** - Several of these successful companies were growing at rapid rates, 30-50%, sometime 100%+ a year. They invented new markets and/or were part of new growing markets.
2. **The Company is Considered Expensive** - This could be seen in Apple, Netflix, and Amazon. All of these companies were expensive, had high PE ratios, priced to perfection. Yet they were all able to grow and exceed expectations.
3. **Unconsidered Potential Factors** - In the Apple report, David mentions the potential of the iPhone, even when most of Apple's sales were from Macs and iPods. Early in Netflix, streaming was a considering to their DVD business, and David believed as the market leader, they would be the best to execute on it.
4. **Strong Leaders** - Both brothers show conviction and trust in their leader. Reed Hasting was successful in his company before Netflix. Elon Musk, Jeff Bezos, Steve Jobs were described as visionary. Tobias Lütke and Eric Yuan are scrappy and convicted to their mission.
5. **Under-rated by Wall Street** - David talks a lot about this. Zynga was believed to be dead by everybody, but has been chugging along. Wall Street didn't get the business model and potential of Netflix.
6. **Strong Business Models** - Netflix's subscription business model provided it consistent revenue. Apple subsidised their phones with AT&T plans, and created the App Marketplace with a 30% cut. Tesla created a luxury car brand, then used that to built consumer affordable cars.

To summarize the lessons to learn, **successful companies have tremendous consistent growth. Successful companies will seem and be objectively expensive. The companies have strong, convicted, scrappy, visionary leaders that can adapt to competition, build new markets, and provide strong leadership in tough times**.

2.7 What Stocks could be Strong Performers?

This is probably the question everybody has been waiting for! You have probably guesses, but it is the stocks that have been analyzed and noted before!

1. **Netflix**. Their leadership is incredible strong and have proven themself time over time again. They have shown to make data driven decisions, bold bets, and adapt to changing markets. They have huge opportunity for growth internationally.

2. **Amazon**. Amazon has proven itself in its strategy to continuously reinvest in itself. It isn't afraid to take bold bets and invest into them, creating huge winners like AWS. Jeff Bezos has shown himself to be visionary and stays true to his 1999 principles of customer obsession, and continuous investment for the future.

3. **Shopify**. Shopify is the enabler of online stores and e-commerce marketplace. One could imagine them as the next Amazon, or even overtake Amazon as Amazon did to eBay in 1999. Tobias is young and scrappy, ready to build the future of e-commerce.

4. **Tesla**. One could imagine this as the Amazon of energy. Electric cars on the road. Solar panels and battery stations everywhere. Advanced robotics and manufacturing. SpaceX, Hyperloop. Even gaining market share in the automobile industry will be highly profitable. Elon Musk is crazy, but dutifully convicted in his mission.

5. **Zoom**. A small video chat app, that has taken the world by storm. It just works. It has mind-share in the public and can leverage that to gain market share in businesses. It can use that to grow consumer products and become the defacto online communication platform. Eric Yuan is determined, it took him 9 times to get a Visa to come to the US. He will leverage his position to grow Zoom into a successful giant.

6. **Okta**. As businesses go online, cloud security becomes increasingly important. Okta is a major player in IAM management for businesses, and holds a high margin SAAS business. Their leadership come from Salesforce and have huge success building SAAS businesses.

7. **The Trade Desk**. Online Ads is a hugely profitable business. The Trade Desk makes this fairer by focusing brining business to ad buyers and signing percent deal contracts instead of arbitraging between buyers and sellers like other ad providers like Google. Jeff Green has been successful in the ad business for a long time. He sold his first ad startup to Microsoft and is hungry and back for more with The Trade Desk.

8. **Match**. Underrated by Wall Street, Match has a strong high margin ads business. Match can leverage itself as the platform for online dating and grow the market for online dating. They can continuously refine their business model, targeting demographics, locations, and extract consumer surplus to become a highly lucrative business.

9. **Activision**. Gaming as a Service is a new business model that's highly lucrative and sticky for customers. Activision Blizzard has done a phenomenal job leveraging this with Overwatch and Heartstone. On Twitch, Call of Duty: Modern Warfare is the 2nd most popular game.

10. **Apple**. Apple is in an incredible place in its position. It's new strategy is building the Apple ecosystem, the iPhone, the Macbook, Airpods, iPod. Their products are expensive, but they build high quality products and have loyal customers that continue to buy their quality products. Tim Cook has shown he is able to grow the company and build great products.

11. **Nvidia**. Nvidia will power the future of deep learning and AI. Data center computing is highly lucrative and Nvidia is growing massively in that market. Nvidia holds a monopoly on GPU technology and will continue to become increasingly important in the technology of the future.

12. **Zynga**. Zynga again was underestimated by Wall Street. Mobile app gaming is highly profitable with ads. For example, most of Facebook's revenue comes from mobile. Zynga can continue to grow and as the mobile gaming leader, become a force in the market.

3 Conclusion

David and Tom Gardner have performed consistent market beating returns. They are able to do this by making hundreds of predictions of high quality businesses and letting their winner run high and pay dividends for the entire portfolio. There is no secret sauce to picking the perfect stock. Nobody is perfect, but their thorough research does increase likelihood of finding a gem significantly.

I do recommend their Stock Advisor service as it is a great resource to learn solid investing practices with. To have hyperfocus on success, we've shown focusing on David's picks, reinvesting into winners, and identifying common themes of successful stocks such as growth, strong leadership, unconsidered potential factors, and under-rated by Wall Street as surefire methods to refine your strategy.

As always, stay foolish, invest diligently, and with patience, anybody can be successful.