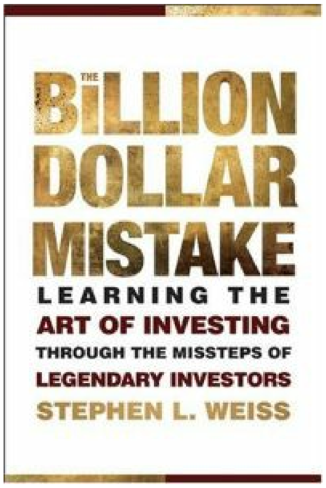

Book The Billion Dollar Mistake

Learning the Art of Investing Through the Missteps of Legendary Investors

Stephen L. Weiss
Wiley, 2010
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Recommendation

You might expect that legendary billionaire investors like Kirk Kerkorian, Aubrey McClendon and Nick Maounis would not make the same mental mistakes as a weekend investor. But they do. These investment geniuses, among the world's smartest – and richest – investors, have lost billions of dollars through boneheaded stock picks. Author Stephen L. Weiss reviews a stack of big investment blunders by these and other renowned financial wizards. Weiss's vast Wall Street experience backs up his analysis, but you'll have to decide if he's correct that people learn more from their mistakes than their achievements. *BooksInShort* thinks you'll enjoy his instructive saga of investment woes.

Take-Aways

- The bedrock investment rule: Don't make mistakes. You can learn what not to do by studying the stock-picking errors of famous investors.
- For instance, brilliant investor Kirk Kerkorian blew millions buying Ford at the wrong time.
- You also can learn how not to repeat your own investment mistakes.
- Never assume that a stock price indicates a company's fundamentals.
- Bernie Madoff's "too-good-to-be-true" investment results should have tipped investors that something was indeed too good to be true.
- When planning an investment, always substitute due diligence for emotion.
- If you don't understand a potential investment, don't invest. For example, unless you know exactly what you are doing, stay away from the commodity markets.
- Be hesitant about short selling. One mistake can cost you everything.
- Gigantic returns often mean gigantic risks.
- Beware of developing favorite investments; check each opportunity anew.

Summary

Don't Do What They Do

Everyone makes mistakes. The fewer you make as an investor, the stronger your portfolio and the richer you become. You can learn what not to do by analyzing blunders made by the world's most famous investors. Superstars make the same idiotic errors average investors make – but on a much grander, more expensive scale. These "legendary investors" are among the "smartest, savviest, sharpest, most successful" people who have ever selected a stock. You can learn valuable lessons from their errors – and from your own.

> "Learn from the mistakes of others. You can't possibly make them all yourself." (Eleanor Roosevelt)

How can you learn to make the same mistake only once? Summarize your investment snafus on sticky notes titled "Don't do this again!" Stick your mea culpas to your computer and listen to yourself.

Bernie Madoff Has a Deal for You

Norma Hill is a typical Bernie Madoff investor. She lost $2.4 million with Bernard L. Madoff Investment Securities. For a widow in her 60s, this is a tragedy. She may have to sell her home to survive. Hill joined Madoff's investment fund group in 1988. She recalls his comforting, soft-sell approach. His first words to her: "If you feel insecure about any of this, by all means, put it in CDs."

> "Something that 'can't miss' can miss."

Hill's friends recommended Madoff highly. She signed with him because she trusted him and because her friends claimed, "He's the gold standard of Wall Street." Madoff was a great psychologist. He charged no fees for his services. Plus, he did business only with select clients, making them feel like privileged members of an elite club. Indeed, being with Madoff was a status symbol. "It was harder to get into Bernie's fund than to get into Harvard," one duped Madoff investor told *The Wall Street Journal*. And Madoff offered an unbeatable deal. He always earned steady, positive returns with no fees and no losses. He offered a "too-good-to-be-true" investment opportunity that most definitely was not true. His investors should have suspected something was fishy about Madoff and his fund.

> "While it may make sense to look at what insiders do, their moves should be regarded less as prescriptions to be followed than as tea leaves to be sifted and read carefully for clues."

As with his other clients, Madoff routinely flooded Hill with paper – "monthly statements and trade confirmations" – concerning transactions he never made. The consummate con man, Madoff successfully ran the world's most gigantic Ponzi scheme. He conned sophisticated investors, including Ezra Merkin (Ascot Funds). He offered a "safe shelter;" his investors received "steady returns wrapped in a risk-averse strategy." He promised, in fact, the impossible dream. Unless you buy "government-insured" CDs, any investment means accepting some element of risk. Lessons to learn from the Madoff debacle include:

- **"Don't put all your eggs in one basket"** – Otherwise, a con artist can get it all.
- **"Referrals aren't gospel"** – Always conduct your own due diligence.
- **"Sophisticated investing is for sophisticated investors"** – Madoff kept his "strategy" complicated so his investors never understood what he did with their money. Unless you are a sophisticated investor, avoid complex investment schemes.
- **"Be skeptical"** – No money manager always "outperforms the market." Steer clear.

The Importance of Due Diligence

Fabled investor Kirk Kerkorian amassed an $18 billion fortune from a steady history of super-smart investment decisions. But even such an astute stock-picker can choose the wrong path, such as Kerkorian's purchase of 100 million shares of Ford Motor Company early in 2008, followed by another 20 million shares, which brought his total stake in Ford to nearly $1 billion. His timing was terrible. Home values were plummeting; credit was super-tight. And American auto companies – like Ford – could not keep up with their competitors.

> "Conventional wisdom suggests that the best portfolio managers are correct only 60% of the time."

As a result of all this, Kerkorian's Ford investment quickly blew up in his face. His $1 billion investment lost two-thirds of its value. How could Kerkorian make such a huge error? He had always been passionate about automobile stocks. In 1990, perhaps inspired by his friend, former Chrysler CEO Lee Iacocca, Kerkorian bought Chrysler stock at $9 per share. By 1994, the stock climbed to $60 a share. Eventually, Kerkorian made $2.7 billion on his investment. In 2005, Kerkorian bought nearly 10% of General Motors. Later, he made an estimated $112 million when he sold his shares. With this history, Kerkorian let his excitement run away with him when he bought his shares in Ford. That's always dangerous to do when investing. Lessons to learn:

- **"Passion is not an investment strategy"**– Don't let emotions overrule your judgment.
- **"There are no return engagements in the investment world"** – Don't assume that any successful investment establishes a future pattern.
- **"Inconsistencies are flags of caution"** – Be careful. Check things out.

Boring Investments Don't Always Remain Boring

Shelby Cullom Davis, a genius stock-picker, expanded a $100,000 nest egg into an $800 million fortune. Davis preferred to buy shares in insurance companies for their "solid, steady, life-time earnings." He did so well with his insurance investments that he became New York State's superintendent of insurance in 1948. His "boring is beautiful" investment concept became a tradition in his family, embodied by his son, Chris Davis, "chairman of Davis Select Advisers, the family-owned investment counseling firm overseeing some $60 billion in client assets."

> "Good investors are made, not born."

However, the younger Davis forgot this philosophy when he bought into American International Group (AIG), "the biggest, most expansive, most unboring, uninsurance insurance enterprise the world has ever seen." AIG branched out into lease financing, airplane leasing, credit derivative swaps and other "esoteric financial instruments." Davis was excited by AIG's financial exuberance, though – like most outside observers – he didn't actually know how it made money. AIG was a "black box," an investment that Davis could not see through and did not understand.

> "Those who cannot remember the past are doomed to repeat it." (George Santayana)

Investors included the US government, which eventually spent $180 billion to bail out AIG after it suffered huge losses in exotic financial instruments, including "subprime mortgage-based securities on credit default swaps." Davis and his firm suffered a loss of "some 6% off the firm's total returns," its "largest mistake" in five years. Davis thought he was buying an insurance company's stock – but he wasn't. He was buying a high-flying financial services firm that dealt in the most complex "dangerous instruments." Lessons to learn:

- **"Review the annual report"** – Look at the "revenue and expense breakdown." This shows how the firm makes its profits or loses money.
- **"Compare performance"** – How does the firm measure up against its competitors? A substantial deviation may indicate that the company is assuming dangerous risk or dabbling in activities that have little to do with its core activities.

Additional Cautionary Investment Tales

These other major investors ended up getting burnt in a big way:

- Bill Ackman of Pershing Square Capital Management is an activist investor. He purchases large stock positions so he can influence or dictate company strategies. His "investment style" is to "unlock the value" of such companies and watch their stock prices increase. Ackman's firm bought a 33.62% stock position in Borders, the bookseller, a firm with a big upside but an even bigger downside. Pershing Square "bought a passive stake" in Borders, a decision that ran counter to Ackman's normal investment style. Eventually, Ackman's firm assumed a "more activist role," but with bad timing. To recover its investment, Pershing Square would have to realize $10 a share for its Borders stock. It didn't. Borders stock fell to "30 cents a share."
- Multibillionaire Adolf Merckle, 74, was one of Germany's wealthiest citizens – until he shorted Volkswagen (VW) stock, lost his fortune and committed suicide. Shorting a stock is tricky ¬– you borrow a stock, sell it and place the proceeds in a margin account. Eventually, you must repurchase the stock and return it to your broker. If the stock price drops, you can make a lot of money. If the stock price increases, you can lose everything. This is what happened to Merckle, whose VW stock skyrocketed in price, jumping from $273 a share to $1,303.60 in a day.
- Leon G. "Lee" Cooperman proved you can get hurt if you buy stocks when you don't know what you are doing – especially if you invest in emerging markets. Cooperman invested in Azerbaijan, where there is no public oversight and corrupt officials bend the law for cash.
- Noted investor Richard Pzena always focused on "normalized earnings power": how a stock would do if a temporarily distressed economy or industry returned to normal. He believed strongly in "historical trends." Pzena watched for investments with low prices that he thought would rise when the economy began to turn around. Thus, Pzena invested heavily in Fannie Mae and Freddie Mac, both of which essentially lost "their equity value" in 2008. His "tried-and-true formula" for deep-value investing did not apply. His investments did not regain their value, and Penza took a bath. He was certain that his investments would prove worthy but this time they didn't. His careful analysis of historical trends did him no good. The future proved to be different than he assumed.
- Geoff Grant made his reputation as a macro trader, specializing in currency options. He knew this complex business inside out and made a lot of money. Grant teamed up with Ron Beller to create a hedge fund firm, Peloton Partners. They did extremely well. Then Grant and his firm got into asset-backed securities (ABS). Grant had no special knowledge of this segment of the capital markets. At first, Peloton Partners was "phenomenally successful" in its ABS investing. But in 2008, things quickly went bad; the firm lost $2 billion. They had to liquidate the ABS fund. What happened? Grant became a victim of "style drift" – moving from macro trading, where he was an expert, to ABS, where he lacked expertise.

  "Don't put all your eggs in one basket."

Other examples of billionaire investors who made "career-defining mistakes" include David Bonderman, who didn't do the proper due diligence on Washington Mutual, which the Federal Deposit Insurance Corporation seized in 2008. Bonderman and his firm, Texas Pacific Group, lost $2 billion. Aubrey McClendon leveraged his wealth to buy "more than $880 million" in shares for Chesapeake Energy, the firm he cofounded in 1989. However, he had to sell "'substantially all' of his holdings in order to meet margin calls." Nick Maounis and his hedge fund, Amaranth Advisors LLC, lost $6.6 billion in 2006 due to a drop in prices for natural gas. Maounis and his partners seriously misjudged the risk management aspect of their investments. Lessons to learn from these examples include:

- **"Know the investment discipline established by your fund manager"** – Watch out if the fund manager suddenly changes his or her investment style.
- **"Leave commodity markets to the pros"** – Futures contracts are "leveraged instruments" which carry high risk.
- **"Develop a checklist"** – Which investment criteria work best for you? Which do not? Make a list of what works and stay with it.
- **"Short selling: Proceed with caution"** – Watch out: The loss potential is unlimited.
- **"Lessen the chance of loss"** – If you decide to short a stock, do so only with "large market capitalization companies" where share trading is extremely liquid.
- **"Emerging markets are extremely risky"** – Investments in developing countries should represent only a fraction of your portfolio.
- **"Know the other players"** – Does someone else play a pivotal role in your investment? If so, do your due diligence about this individual.
- **"Do not assume price declines equal opportunity"** – Stocks normally have the prices they deserve.
- **"Practice patience"** – Smart investors often get into a stock after its recovery begins. Why? They don't want to "catch a falling knife."
- **"Don't be blinded by hyperreturns"** – They equal "higher risk."

About the Author

Stephen L. Weiss has worked on Wall Street for decades and is a senior managing director and head of equities at Leerink Swann, LLC.