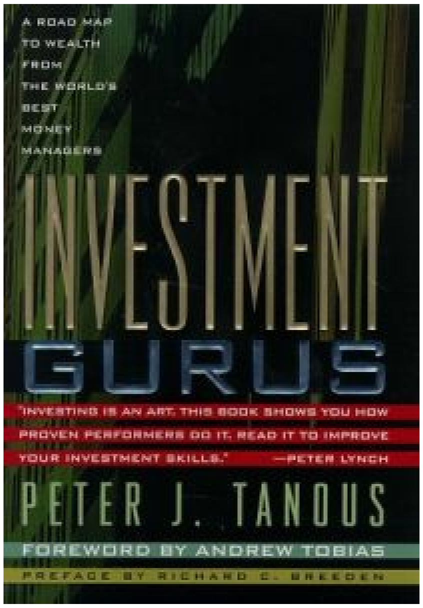

Book Investment Gurus

A Road Map to Wealth from the World's Best Money Managers

Peter Tanous
FT Prentice Hall, 1997

Recommendation

Peter Tanous features interviews with 18 individuals he identifies as top, common stock investment consultants - or "gurus." His choices are based on his work as a consultant identifying investment advisers for corporations. The consultants he selected for this book represent the major stock investing approaches as growth, value or momentum investors. The interview format lets them speak for themselves. He briefly introduces the book with a primer on basic investment terms and principles, and a summary of major themes. *BooksInShort* finds the range of views shown very helpful, but notes that the book suffers from overwriting and a lack of focus and editing. Some tightening would help highlight the main points in the long interviews. The introduction and conclusion are long and general, and a clearer, more detailed summary would be very welcome. Yet, the book offers a lot of information for the average serious investor, much of it straight from the mouths of some very important horses.

Take-Aways

- Common stocks are the best investment over time. Since the 1920s, they have performed better than any other asset.
- Professor William Sharpe's "Sharpe ratio" measures how much extra return you gain based on the risk you are willing to take.
- Active investors pick stocks they think will perform well; passive investors buy through index funds that reflect overall market performance.
- The best measure of risk is volatility; high volatility equals high risk.
- The two major investment styles are growth and value investing.
- Growth managers look for a high growth trend in the sales and earnings of a stock.
- High growth stocks typically have a higher P/E ratio.
- Value managers look for bargains in underpriced stocks that seem likely to turn around.
- Momentum investors follow trends and invest when they think momentum is in their favor.
- Some management gurus can outperform the market over time since the market is not perfectly efficient. They gain an advantage through research and judgment.

Summary

The Major Types of Investment Advisors

Common stocks are the best investment over time. Since the early 1920s, they have performed better than any other type of asset. But with stocks, or any other investment choice, weigh risk relative to return. Nobel prize-winning investment guru, Professor William Sharpe, has developed the "Sharpe ratio," which measures how much extra return you gain based on the risk you are willing to take. The higher the number, the more return you are getting for the risk you are taking - no matter how high or low that risk is.

The Basic Types of Investing

When you select an investment manager, first decide on the best investment approach for you. However, look beyond the manager's investment approach and average annual return, because that could conceal volatility. Look at how returns translate into real dollars and real earnings. Select a manager with a consistent record over time.

> "The efficient market theory is flawed. There are simply too many examples of stocks that were discovered by a great manager before anyone else knew what was going on."

Be aware of the important distinction between active and passive investing. If you are an active investor, you pick stocks because you think they will perform well. Active managers seek to beat the market, either by greater returns or less risk. A passive investor buys the market, a strategy followed by managers of index funds. These funds try to reflect the performance of the overall market. Academic gurus often support passive investing, and don't believe you can consistently beat the market, except due to luck.

> "One thing is certain: if you buy growth stocks and pay a correspondingly high price for the privilege, if something goes wrong, you are going to suffer swiftly and painfully. A high price-earnings ratio has little tolerance for disappointment."

While the industry has no completely foolproof way to measure risk, its best measurement is "volatility," the range of price or value movement in a stock, a portfolio, or the market as a whole. The greater the range of movement in a price, the higher your risk. The "alpha" measure of a stock calculates return against risk, and measures the amount of return that is not due to the market itself. It tells you the amount of value added by the manager of a fund. The "beta" of a stock measures its volatility compared with the overall market. The Standard and Poor's 500 index is considered a benchmark for measuring this factor.

> "In the top down approach the analyst looks first at the company, identifying it usually because it is so attractively priced on its own merits. Value investors almost invariably use this approach."

Standard deviation, another measure of investment risk, measures a portfolio's volatility against itself, on a month-to-month basis. If it's high, the stock is more volatile and, therefore, more risky. Using these measurements will help you assess how well your portfolio is doing, relative to the market, your return and the amount of risk you are taking.

Investment Styles of the Investment Gurus

Different investment managers have different styles. The major styles are:

- Growth managers look for a high growth trend in the sales and earnings of the stocks they buy. They commonly invest in industries with strong growth trends. Typically, these growth stocks have higher price/earnings (P/E) ratios, since investors expect their growth to continue so that the stock eventually catches up with this high valuation, although this outcome is uncertain. You will pay more for such a stock, but if problems develop, the stock price often will fall dramatically. In assessing companies for growth, managers look for good industry fundamentals, a high level of earnings and sales growth and a reasonable P/E.
- Value managers look for bargains, basically under-priced stocks. As an investor, you can do very well when these stocks turn around, although it is hard to know the timing. You need patience. Managers look for a stock with a low price-earnings ratio,

"hidden assets" and a discount price, compared to book value. Generally, over the past 50 years, value stocks have provided higher returns than growth stocks. However, having both is good.
- Momentum investors follow trends. Momentum managers jump on board when they feel the market's momentum is in their favor, and - if they are skillful - they can do very well in good markets. However, they have to be quick in their timing. Typically, they tend to be more interested in stocks hitting new highs than new lows, since they look for stocks with a "strong upward price momentum."
- Top-down investment managers start by looking at the big picture, beginning with the overall economy, to decide whether this is a good time to buy or not. Then, they look for attractive industries and, subsequently, for attractive stocks within these industries.
- Bottom-up investment managers try to identify companies that are attractively priced due to their own merits. Typically, value investors take this approach.

Meeting the Investment Gurus

Investment gurus include growth, value and momentum investors. They include:

- Michael Price, Mutual Shares - Price is one of the most successful value-investing managers. He looks at every merger announcement, since this "tells you what businessmen are willing to pay for a business." This price is the "best indication of value."
- Richard H. Driehaus, Driehaus Capital Management, Inc. - Driehaus, known primarily for momentum investing, is especially interested in small-cap stocks (companies with market capitalization of less than $500 million). He feels that earnings on winners matter most, along with how quickly you cut your losses on the stocks that don't perform. Tactically, he is more of a bottom-up player.
- Mario Gabelli, Gabelli Funds, Inc. - Value investor Gabelli is known for identifying companies selling well below market value. He combines value investing with a "catalyst" approach, wherein he examines a particular time period for some event that will narrow the spread between private market value and stock price.
- William F. Sharpe, Nobel Laureate, Professor of Finance, Standard University Graduate School of Business - Sharpe is an academic most known for creating the Sharpe ratio, a widely known measurement used to assess risk-adjusted investment return.
- Peter Lynch, retired manager, Fidelity Magellan Fund - Lynch is known for his consistently high return of 30% over a period between 1977 and 1990. He has growth bias, but chooses both value and growth stocks. The goal is to have "enough all-stars to counteract the poor performers."
- Laura J. Sloate, Sloate, Weisman, Murray & Co. - Though blind since she was six years old, Sloate led her firm to more than 20% returns over a seven-year period ending in 1995. She seeks a catalyst to bring out a firm's value, such as a management change.
- Scott Sterling Johnson, Sterling Johnston Capital Management - Johnson specializes in small-capitalization emerging growth stocks with a minimum of 35% earnings growth and a maximum of $750 million in market capitalization. He looks for a great product, unique service, dynamic management or other quality that gives a company a competitive advantage. He particularly enjoys the "hunt" for these new companies.
- Eugene Fama, Professor of Finance, University of Chicago Graduate School - Fama is known for his work on efficient capital markets. He believes stocks will become correctly priced, since what is publicly known about them is reflected in their market price. This means that over time, you will never do better than the markets, so active management generally does not pay. For instance, when Fama researched top performing fund groups for ten years after 1976, they only had a 50-50 chance of being in the top half of mutual fund performance for the next ten years.
- Bruce Sherman, Private Capital Management - Sherman earned 25% returns over a five-year period ending in 1995, versus 17% for the S&P 500 index. His approach is to carefully study a company, including spending time with the CEO and CFO asking serious questions and looking at accounting fundamentals. He looks for catalysts that will turn a cheap stock around, such as new technology developments.
- Eric Ryback, Lindner Funds - Ryback purchases high-yield bonds after assessing the "intrinsic value" of a company. After figuring out what the company is worth, he tries to buy that security at a discount. He also uses the technique of "cornering the sinker" to own an entire issue of bonds selling at a low amount relative to what they are worth.
- Merton Miller, Nobel Laureate, Professor Emeritus of Finance, University of Chicago Graduate School of Business - Miller

believes in passive investing for most investors on the grounds that the market is a good source of information on stock prices. In his view, everyone has a little bit of information and the market pulls together that information, evaluates it, and translates into prices. Most people do better by buying a share of the whole market than trying to outguess it.

- Foster Friess, The Brandywine Fund - Friess gathers information on companies through a network of large and small brokers and consultants. When investigating a company, his firm meets with its executives, competitors and customers. The firm uses this information to support a growth-oriented, bottom-up style and seeks growth trends, buying dynamic companies with a 60% to 70% upside.
- Rex Sinquefield, Chairman, Dimensional Fund Advisors, Inc. - Sinquefield's firm employs different vehicles, with one fund that responds like the S&P 500, another that corresponds to S&P's value stocks and other funds that reflect the performance of small-cap stocks. This builds an optimal portfolio based on a passive investment approach.
- John Ballen, Manager, FMF Emerging Growth Fund - Ballen uses a research-intensive approach to buy a stock early in the game. He seeks growth companies, focusing on small firms before others recognize them. He tries to invest in companies with long-range competitive advantages just before the companies grow.
- Roger F. Murray, S. Sloan Colt Professor Emeritus, Columbia University Graduate School of Business - Murray advocates value investing and looks for real earning power by estimating a stock's intrinsic value. He urges ordinary investors to buy the markets rather than stocks or managers, since most people don't have time to make informed choices.
- Robert B. Gillam, McKinley Capital Management, Inc. - Though located in Anchorage, Alaska, Gillam has been successful using modern portfolio theory, including quantitative computer models. He combines quantitative analysis and a momentum approach, seeking industrial groups with excess returns. He uses a database with 13,000 stocks to make specific choices.
- David E. Shaw, D.E. Shaw & Company - Shaw's firm uses higher mathematics to find high-performance trades and arbitrage deals. The "king of the quants" uses a computer program and algorithms to build an optimal risk vs. return portfolio for each investor.

Applying the Advice

Efficient market theorists suggest that beating the market is the effect of normal distribution. Most studies show that the great managers of today will become "the has-beens of tomorrow." Still, in many cases, a great manager can discover a stock before someone else. Some management gurus outperform the market over time because the market is not perfectly efficient. It is "constantly in the process of becoming efficient." Sometimes, a skilled manager can see the changes coming in the market or in a particular stock. This requires the ability to "identify and stay with the winners and quickly shed the losers." Thus, if you put in the time and effort, you can beat the market, although you will have better odds of finding the right investment if you get a guru to do it for you.

About the Author

Peter J. Tanous , a Washington, D.C., registered investment advisor, is President of Lynx Investment Advisory, Inc. He provides consulting services to institutions and individuals on how to select and monitor a money manager. Before founding Lynx, Tanous was Executive Vice President and a director of Bank Audi (USA) in New York City.