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Investment Selection: Focus and Reduction

China's mutual fund market reached a new milestone in June, with total number of outstanding mutual funds exceeded 10,000 funds for the new record. With thousands of stocks and mutual funds to choose from, myriad of thematic ETFs, there's never been so many choices available to investors. But too many choices may not be a good thing. In Barry Schwartz's "Paradox of Choice," he noted that people feel life is unbearable when there's no choices. But when choices multiply wildly, too many choices will actually weigh on us. In this case, it's no longer a freedom, but a burden. Therefore, the number of choices and the investor's happiness is not a linear relationship, but rather an upside down "U"-shaped relationship. Sometimes, less choices means more happiness.

When it comes to choosing, Warren Buffett is never troubled. No matter how the capital market evolves, he just does what he likes and is good at by investing in stocks he understands. Defining his own "strike zone" is a choice in of itself: the strategy to hold back from investing unfamiliar companies, and only swing when the company is in his "strike zone" has served Mr. Buffett well over the years. William Green, the author of "Richer, Wiser, Happier" did a series of in-depth interviews with the investment gurus and noticed a thing they share in common: independent thinking, and the discipline to stay within their capabilities throughout the changing market conditions.

Warren Buffett learned from Ben Graham and started his investment career searching for "cigarette butts." Later on in his career, Mr. Buffett teamed up with Charles Munger and created the miracle of Berkshire Hathaway by living the motto: "it's far better to buy a wonderful company at a fair price than a fair company at a wonderful price." In 1972, Buffett paid 12 times earnings for See's Candy, which is twice the book value. And in the shareholder meeting 30 years later, Buffett was still praising See's Candy for its "dream-like business model."

John Templeton, another investment legend, visited 27 countries after graduating from Oxford. His travels laid the foundation for his global investment perspectives for fund management. In 1937, Mr. Templeton dove into US stocks during the Great recession, demonstrating his courageous and independent thinking. After the first oil crisis, Templeton betted on Japan against the prevalent market view. During the 1970-1985 period, Nikkei rose 5 times in the slow bull market which far exceeded SP500's mere doubling.

Peter Lynch, another investment legend, was a golf caddy who met many mature investors. His investment philosophy is to untiringly "turn over rocks", because Mr. Lynch realized the only way he can beat the others is by working harder. He's leave for office at 6:30 am, work after dinner and into weekends, and not taking any holidays. When someone asked Mr. Lynch if he'll slow down with old age, he replied: nope – there's only two speeds in investment, accelerate or park. When Peter Lynch started working at Fidelity Investments, he just missed the oil crisis and there were value stocks everywhere. Mr. Lynch became the unreserved buyer, starting with cyclical stocks like oil or aluminum companies, and adding later the financial and automobile stocks, perfectly illustrating the success in "turning over rocks."

The investment careers of Buffett, Templeton, and Lynch overlapped in the late 70s. They had strong faith in their investment philosophies, which survived the oil crises despite little overlap in their respective holdings. **Different investment philosophies will derive into different investment strategies. But each investor will only sustainably earn what's within their Circle of Capabilities.** Even though Buffett had often expressed his admiration of Peter Lynch, it's hard to imagine Buffet taking the Lynch approach of holding a portfolio of literally hundreds of stocks. Even though the investment philosophy and approaches of these investment gurus have spread wide and far via books and internet, there are still very few money-making practitioners. To be fair, no strategy can work across all markets at all times. The decision-makers will also have different talents and personalities, making it impossible to have one approach that covers all.

Founder of Gotham Capital Joel Greenblatt popularized the principle of "buying great companies at cheap prices." He used the quality and valuation indicators to create the "magic formula." Investors have two choices: either open a managed account to systematically buy the recommended names from his list, or choose at least 20 names from the recommended list and decide on the timing of the trades. Greenblatt looked at the performances of thousands of clients and accounts. He noticed that those investors that made investment decisions themselves, or "DIY Investors," performed much worse. Over two years, the DIY investors achieved cumulative return of +59.4% vs S&P's +62.7%. In comparison, the passive investors that systematically bought the recommended stocks achieved +84.1%, or over 20% above the SP500 performance. Between 1988 to 2009, the annualized return for the passive investors were +19.7%, much higher than the SP500's annualized +9.5%. Yet in these 22 years, there were 6 years where the investor's yearly returns were behind the SP500 index returns. In fact, this portfolio suffered -25.3% and -38.8% loss in 2002 and 2008 respectively. Greenblatt said, his approach will only work in the long term. But most investors can not commit to an investment strategy that underperform for a few years in a row. Greenblatt summarized the three most commonly seen mistakes by investors:

1. When the market rallies, they jump in the market; and when the market tanks, they run away.
2. When the strategy has good performance, they jump right in; and when the strategy under-performs, they abandon it.
3. Investors avoid stocks that have under-performed recently, but these are often the best ones to invest in due to their attractive valuations.

Greenblatt warns the investors: to most people, the best strategy is not the strategy with the highest returns, but the strategy that you can hold onto even during challenging times. Market will often surprise us, which will lead to our doubts about investment strategies when we underperform. Unless you have strong conviction in the investment strategy, you will start having doubts about the strategy as it underperforms the market. It's a slippery slope towards frequent re-positioning and chasing the market, which will likely end up being behind the market performance. When it comes to investment decisions, it's rare to have the cake and eat it too – what is in your control though, is what to keep and what to discard. Only when you look away from short-term fluctuations and thematic topics can you recognize the true long-term values of the target companies. **You can focus by concentrating on your time and energy in your own Circle of Capabilities: invest infrequently but heavily.**