Lynch Law

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I was filing some old papers over the weekend and came across a forgotten treasure: a set of bullet-points jotted down by an anonymous attendee of a speech called "Common Sense Investing", given by Fidelity's great Peter Lynch almost exactly 25 years ago, in May 1990 – to the Greater Boston Chamber of Commerce. 1990 was the year Lynch stepped down from running the Fidelity Magellan Fund. As a reminder of his achievement: during his 13 year tenure, 1977-1990, Magellan averaged over a 29% annual return and grew from $18m to $14 billion – the biggest and best performing mutual fund in the industry. We can be sure, therefore, that his topic for the day was the investment approach that had delivered his stunning track record. Now, a quarter of a century seems like long ago and far away, even to a relic like me, whose career was already well underway by 1990. And I wondered - do Lynch's ideas hold up into a new millennium? You must decide. Anyway, in the interest of posterity, I reprint the notes below.

Common Sense Investing

i) Know what you own

ii) It is futile to predict the economy, interest rates, and the stock market

iii) You have plenty of time

iv) The ten most dangerous things people say about stock prices

v) If it has gone down this much already, it can't go much lower

vi) If it has gone this high already, how can it possibly go higher?

vii) Eventually, they always come back

viii) It's $3, what can I lose?

ix) It's always darkest before the dawn

x) When it rebounds to $10 I'll sell

xi) What, me worry? Conservative stocks don't fluctuate much

xii) Look at all the money I've lost, I didn't buy it

xiii) I missed that one. I'll catch the next one

xiv) The stock has gone up, so I must be right. The stock has gone down, so I must be wrong

Other general rules

- Avoid long shots
- Avoid high growth, easy entry industries
- Look at the balance sheet
- Great stocks are always a surprise
- The individual has several advantages versus the professional investor
- There is always something to worry about

The speech reinforces three constant themes in Lynch's practice of and writings about investment.

1. “It is futile to predict the economy, interest rates and the stock market.”

This is for two reasons. First, such predictions are notoriously hard to get right. Nate Silver, the renowned US psephologist, popped up in the UK media recently, trying to make sense of the UK’s muddy general election. His appearance reminded me of some observations in his book “The Signal and the Noise”. There he points out, for instance, that “between 1965-2009 the margin of error on the first reported US quarterly GDP number is plus or minus 4.3%.” In other words, these statistics are subject to revisions so great as to nullify the value of the preliminary data for an investor. Or that “in the1990’s, economists predicted only 2/60 recessions experienced around the world a year ahead of time.” Twenty five years on, Lynch probably wouldn’t be surprised that so many are still prepared to put economic forecasting at the heart of their investment process despite the inaccuracy being so great. But he’d still argue it futile. As Nate Silver concludes – “An economic model conditioned on the notion that nothing major will change is a useless one. But anticipating these turning points is not easy.”

More to the point though, Lynch was always adamant that investors overestimated the importance of economic data anyway. For him good companies created wealth for their owners over time, almost whatever the economic conditions. “You have plenty of time.” A favourite anecdote of mine, reinforcing Lynch’s view, involves another fabled investor, Mercury Asset Management’s stock-picker extraordinaire, Leonard Licht. During the early 1980’s both the government and investors placed great significance on the monthly trends in UK monetary aggregates and before their release City dealing rooms would fall quiet, with tense anticipation. The story goes that on one such occasion at MAM the announcement was made – that M1 had come in below expectations. “Buy me a million M1’s right now!” Licht facetiously called out. He knew M1 – the measure of physical specie circulating in the UK economy - was a superstitious fetish and had zero meaning for the valuation or fate of UK corporations. Who cares about it today? Yet it used to cause equity assets to change hands frenziedly. “There’s always something to worry about” , says Lynch. That’s right, but macro-economic worries are not necessarily relevant for an equity investment. Or stock markets wouldn’t grind inexorably higher over time.

2. You might summarise Lynch’s career and advice in the following proposition – Reversion To Mean Is Less Certain Than You Think. Or, similarly, the simple, but powerful idea of - Run Winners/Avoid Losers.

Famously Lynch built his investment performance around “baggers” - shares that doubled, trebled, sextupled or better over time. Magellan benefited from over a hundred “10-baggers” during his stewardship. Think about that. Few of us are lucky enough to identify and, crucially, have the fortitude to hang onto, 10, let alone 100, stocks that go up 1000%. It might sound obvious, but you don’t get to enjoy those sorts of gains if you sell out early. Yet all the psychological pressure is to take profits on winners and to go fishing where stocks are down and “cheap”.

This is why the speech is so insistent about avoiding two different types of mistake made by investors. First, that of responding to the siren allure of beaten-up companies and share prices – “If it has gone down this much already, it can’t go much lower.”, “Eventually, they always come back.”, “It’s always darkest before the dawn.” He’s saying that broken businesses can go on being broken for a long time – time better spent being invested in good companies.

So, it’s just as important to resist that other mistake – “If it has gone this high already, how can it possibly go higher?” Strategically advantaged companies find new ways to create value. It’s like Charlie Munger argues: positive and negative surprises are not equally distributed across good and bad companies. Good things tend to happen to good companies, while the surprises for insurance companies, say, turn out to be disproportionately bad. Yet investors value all businesses as though the next piece of news is just as likely to be bad as good.

3. “The individual has several advantages versus the professional investor.”

Another investor we admire, Richard Oldfield, wrote a stimulating book with a brilliant title. “Simple but not Easy.” And it is true, because Lynch demonstrated it in his own career, that investment can be simple. It can be simple in that the ideas that make the best returns over time do not have to be intellectually abstruse. For instance, one of Lynch’s key rules was to watch out for where your household shops and what for. It’s important when your wife tells you that M&S has lost the plot in kids’ wear. It’s important that you respond to the realisation that you buy a Cadbury Crunchie every time you fill the car. These are not complex ideas. “Know what you own.” But the practice of investment is not easy. What make it hard are noise and distraction. Lynch wanted the private investor to understand that his or her ideas can be just as valid as those of the professionals and that for some professionals sitting all day in front of scrolling news and price feeds can distract and detract from the delivery of investment returns.

Common Sense never goes out of fashion.

Nick Train, Portfolio Manager

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Source: Lindsell Train & Bloomberg

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