10 BAGGERS

The story below in italix first appeared in The Washington Post. Barry Ritholtz (author) is chief executive of Ritholtz Wealth Management.

It's a reminder of some of the mental challenges that face investors. Our conclusion is that some diversification is important, realistic expectations over the long term are also critical but perhaps the most important issue to consider for investors in a fund is to invest in the relationship with your fund manager. It is imperative that investors trust their fund manager and the investment process used. Warren Buffet has made this point many times over the years. He makes the point, that one of his most important assets is his patient, understanding shareholder group.

Investing can only be successful over the long term if investors can behave independently from the crowd, to resist primal urges to sell when markets have fallen and buy when markets have already risen. I have been a student of the art of investing for over 20 years. It takes a long time to develop the tolerance for the ups and downs of this business, and it's not for everyone. I think at the heart of this trade (no pun intended) should be a passion for the process and a spirit of an outlier.

Enjoy the read,

Nigel Littlewood

Let's imagine for the moment that you are the World's Greatest Stock Picker.
You have an uncanny talent for ferreting out "the next Microsoft" - companies that are on the sharpest edge of what's next, that are about to undergo tremendous growth.
These firms will rule the world: they will be the most powerful, profitable and influential corporate entities known to man.
Even better, your superpower is that you can find these companies when they are tiny, before they have had their explosive growth, when hardly anyone has heard of them.
You find and buy these stocks while their prices are still in the single digits. Companies such as Apple, Google, Tesla and Netflix that will one day measure their growth in increments of thousands of a per cent.
Can you imagine how much wealth you could create?
I have some bad news for you: even if you had that superpower, it would be worth surprisingly little to you. The odds are that it would not create much wealth, and it might even cost you money.

How could that be possible?

The short answer is your brain. The 1.5 kilogram ball of grey matter sitting atop your spinal cord was never designed to make risk/reward decisions in capital markets.
It took about 100,000 years to optimise for its intended purpose: keeping you alive.
Which is precisely why being the world's greatest stock picker is unlikely to be how any of us is going to get rich. Let's use the shares of four companies as examples: Google, Tesla, Netflix and Apple.
The performance of each since its initial public stock offering has been nothing short of astounding.
Since going public, each stock has generated returns of more than 1000 per cent. A $US10,000 ($11,377) IPO allocation in any one is now worth at least $US100,000.

To give you an idea of just how phenomenal these companies have done, Google is the laggard of the lot. Since its IPO in August 2004, it has gained a mere 1282 per cent.
Tesla edged out the boys from Mountain View, with a gain of 1352 per cent. And they did it in less than four years - Tesla's IPO was June 2010 - versus the decade it took Google to gain 1000 per cent.
Netflix beats that by a country mile, rising 5816 per cent since 2002.
Then there is Apple. It is a beast unto itself, racking up a mind-boggling 22,288 per cent in appreciation since its 1980 debut. It has become world's biggest company by market capitalisation.
Even if you bought large chunks of each of these firms at their IPOs, the odds are that nearly all of these giant gains would have eluded you.

Why? As I shall show you, each of these companies would have sent you running for the exits - repeatedly - over the years, screaming as if your hair's on fire.
Don't believe me? Consider the facts:
• Netflix has lost 25 percent of its value on four separate days. Not over four days; on separate occasions, it lost 25 per cent in a single day. In one four-month stretch in 2011, it lost 80 per cent of its value. On Netflix's worst day, it fell 41 per cent.
• Tesla went up 400 per cent in six months, then lost 40 per cent over the next 10 weeks. In one month, it lost about 25 per cent of its value.
• Google lost nearly 70 per cent in the Great Recession. During its worst quarter, its stock price fell more than 36 per cent.
• Apple has lost 25 per cent or more six times in the past 10 years alone. That was after its meteoric rise. During its worst week, it was cut in half, falling 51 per cent. It sustained similar damage during its worst month and quarter as well - getting cut in half in each time period.

How often have you invested in a stock, only to get scared out of it when things grew shaky? That's fairly typical behaviour for investors.

Now imagine how you would have behaved if you happened to have a significant part of your net worth tied up in that one holding.
Let's say a decade ago, you put $US15,000 into Apple. You bought 1000 shares at $US15 (with $US13 cash) because you thought that newfangled iPod had some potential. Since then, it split two for one and then earlier this year, it split seven for one. You now are holding 14,000 shares of Apple.
At the current price of about $US100, it is worth $US1.4 million dollars. For most people, this is a very high percentage of their net worth. How well do you sleep when 90 per cent of your total net worth goes through giant swings?
Apple was worth about the same amount in September 2012 - just before it gave back almost half its value, falling 44 per cent. Would you have held on? What about all of those prior 50 per cent corrections?
This is not an academic theory. Just consider how you have reacted to much more modest drops in your holdings.

Some years ago, I recommended to the brokers I worked with to do just that regarding Apple. They bought millions of shares at an average price of $US15. At $US20 dollars, they were selling, whooping it up and high-fiving one another.
When I asked why they were selling when my price target was higher ($US30!), I was told: "It's a 33 per cent winner - time to ring the bell, Ritholtz!" That was even before any trouble had hit.
How many of you, dear readers, could hold onto a giant winner like these for the duration? How do you know that any of these are not about to turn into a classic disaster stock? Think about once-giant winners that collapsed: Lehman Brothers, WorldCom, Lucent, JDS Uniphase.
All of these were one-time market heroes; all went bust in spectacular fashion.
Your superpower gives you the ability to find the giant winners, but it does not give you the ability to hold onto them, nor does it give you the ability to distinguish between the superstars and the washouts.
As we have discussed previously, this is a feature, not a bug. The good news is your brain has kept you alive long enough to read this column. The bad news: it also made you sell Apple 10,000 per cent ago.
The reality is, when it comes to risk/reward decisions, you are just not built for it.