SIMPLE
BUT
NOT EASY

SIMPLE BUT NOT EASY

An autobiographical and biased book about investing

2nd edition

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PREFACE TO THE SECOND EDITION

FOURTEEN years is a long time in investment. A lot has happened since the first edition of this book was published in 2007. Just to reprint did not seem, now, quite good enough. So this edition contains all of the 2007 book, but with this preface and a new afterword. So, to underline this point, pages 1–237 date from the 2007 edition unchanged (except for being re-typeset). The book has the same title as before; if I had to give it a new one, *Complicated and Extremely Difficult* might be it.

Nassim Nicholas Taleb writes about black swans: beings assumed not to exist, but which do. Thoroughly unpredictable things happen. Hurricanes just occasionally do happen in Hertford, Hereford and Hampshire. The 2008–09 global financial crisis was a black swan, a combination of events which was thought impossible. It was the last stage in a process described by another economist, Hyman Minsky. Because everything is going swimmingly, it is assumed that it will always go swimmingly, so that on the contrary when trouble starts – the Minsky moment – it is quickly calamitous: the result of a long period of low volatility is high volatility.

We have had high volatility in spades. The black swan of the

financial crisis has been followed by the black swan of quantitative easing, with central banks pushing interest rates below zero and buying their own governments' bonds on a colossal scale. A third black swan, associated with near-zero interest rates, has been the appetite for mega-financing, and not just mega-financing but repeat mega-financing, of private companies with enormous losses stretching into the distant future. Now we have seen the blackest swan of them all, the Covid-19 crisis.

While these black swans have been flapping their menacing wings, investment has been at least as difficult as ever, and for many, including me, more difficult. Most books about investment by practitioners are written from hubristic heights. This is not. I began *Simple But Not Easy* with a chapter on howlers. To do justice to all the howlers committed since then would require a very long book.

Underlying individual howlers has been the nagging problem that the whole approach of value investing – that is to say, investing in companies with low valuations in terms of the usual measures such as price-earnings ratios, price-cash flow ratios, and price-book value ratios – has appeared to be a howler. It is certainly requiring immense patience. I am as convinced as ever of the merits of value investing.

The black swans have made much in the world of investment more complicated. The financial crisis revolved around hideously complex financial instruments which hardly anyone understood. They were a little like the Schleswig-Holstein question as described by Lord Palmerston: "only three men in Europe have ever understood it. One was Prince Albert, who is dead. The second was a German professor, who became mad. I am the third, and I have forgotten all about it." What followed the crisis – quantitative easing and negative interest rates – is novel and complicated in the sense that it is outside the experience of us all. But the basic lessons of *Simple But Not Easy* in 2007 are still lessons for 2021.

This edition of *Simple But Not Easy* is dedicated to the memory of two men who died within a few weeks of one another in 2019: Hans Rausing and Peter Stormonth Darling, both inspiring leaders.

Peter Stormonth Darling was chairman of Mercury Asset

Management when I worked there. He and I travelled from time to time to the US and Canada, and once to the Middle East. When he was held up at Immigration for the second night in a row because of a problem with his Canadian passport, his despairing plea reverberated across the terminal of Abu Dhabi airport to the distant corner in which I was chatting with a London banker: "Have I got to go through this all over again?" The banker wryly commented: "I don't think your chairman is constitutionally suited to travel in the Middle East."

But in fact Peter was constitutionally suited to travel anywhere: relaxed, curious, friendly to all, engaging with everyone. He was knowledgeable about all sorts of things and wore his knowledge lightly, never showing off, never grandstanding. He was utterly modest. His geniality and modesty made him the perfect chairman of an organisation which needed to hold together a number of individuals with a lot of ego, ambition and ability. It was impossible to have a bad-tempered meeting if he was chairing it. In investment crises he was a pillar of calm wisdom. His mantra, "do nothing", was much more right generally than the thing which would have been done if anything had been done. His book about S. G. Warburg and Mercury, *City Cinderella* (W&N, 1999), has all the best Warburg anecdotes. He wrote another book, about the Korean war in which he served in the Black Watch; this was privately published and had limited circulation. I suspect he found it too emotional a subject to present to public view. He wrote the foreword to the first edition of this book.

Hans Rausing, who built Tetra Pak, had that very special Rooseveltian gift of always making people feel better. Whatever news you brought him, good or bad, you went away feeling uplifted. That was one of several ways in which he was a great man. He dominated any room because of his enormous character as well as his height. He was an inventor and a pioneering engineer. He was a brilliant businessman. I was once with him at a meeting long after the Tetra Pak days, in Ukraine. Someone put forward a rather ambitious expansion proposition, not thoroughly thought through.

He was supported half-heartedly by his partner. Hans asked opinions, starting with me, and I burbled some management-speak about an interesting idea needing more research but no action for the time being. Everyone else was cautious about it too: too early to do anything, more research needed. "Good," said Hans, banging his fist on the table. "We go ahead." He and I left the meeting room together and he exclaimed happily: "That was an excellent meeting. It reminded me of meetings in the old days at Tetra Pak."

Post-Tetra Pak, he regarded ordinary investment in a portfolio of securities as very dull, just financial jiggery-pokery. Even so, to those like me who were doing it, he never failed to be inspiring, always optimistic and encouraging, never looking back and never blaming. He had some memorable aphorisms: "if it is not necessary to do it, it is necessary not to do it;" "all in the best of disorder;" "if unsure and full of doubt, run around and scream and shout." Another summed up his attitude to fame and fortune: "some people think it is important to be important. I have always thought it important to be unimportant." Many great men do not inspire much affection. He did.

RICHARD OLDFIELD
London
July 2021

INTRODUCTION

"AND what do you do?"

"I'm an investment manager."

"How nice." Pause. Slight embarrassment. "I'm afraid I don't know anything about investment."

The subject is a sure social conversation-stopper. The business of investment, said John Maynard Keynes, is intolerably boring for anyone free from an instinct for gambling. For many it is a no-go area.

A friend who looks after the money of one of Britain's wealthiest families told me that when members of that family come of age, and so into some money of their own, he has a chat with them. He tells them that they can either become actively involved in how their money is managed; or they can leave it to him and his colleagues in the family investment office. If they choose the latter, "Congratulations," he tells them, "you are normal."

Another person in the business has told me, "I have always thought that investing is something to do, rather than to talk about." Investment involves the fluctuating ownership from a sedentary position of what were once pieces of paper and have now been virtualised so that they are no more than entries in some computer records. It is an activity which can seem unreal.

Consequently, it is rather less normal to be interested in investment

than in a dozen other potential enthusiasms. But most investment managers do what they do because they find it strangely captivating.

People outside the profession think it complicated. Generally speaking, it is not. One of the reasons that investment is, for the amateur, a rather obscure activity is that, like anything specialised, it is full of jargon, much of it devised to put off the amateur and to reassure professionals that what they are doing is scientific. But the rudiments of investing in equities and bonds can be expressed in fairly ordinary English, and picked up by anybody.

On the other hand, though not complicated, investment is difficult. People on the outside tend to think that anyone on the inside should be able to do better than the market indices purely by virtue of being a professional. Sadly not. Professional managers find it hard to beat the market over the long term. Fewer than half of professional investment managers outperform the market itself. All of them can be quite sure that they will not outperform the market in every year.

The fact that investment managers in aggregate are not producing anything useful does not mean that all investment managers are useless. How to decide who is likely to do a useful, outperforming, job is a fascinating challenge. To succeed in it the investor must first understand the paradox that investment is simple but not easy.

I should explain what this book is, and what it is not. It is not a stage-one primer. I have not provided a glossary of terms. If the reader wants to find out what an equity is or, more sophisticated, the definition of a Sharpe ratio, there are other places to look. It is not an academic book, and to avoid giving that sort of impression I have eschewed footnotes. Nor is it a detailed exposition of investment analysis. There is no discussion of how to look at a balance sheet or cash flow statement.

What it is meant to be is something in the middle: a commonsensical approach to investing, stripped of mystery and as far as possible of jargon. The aim is to make the subject of investment accessible to the many people who find it potentially interesting but baffling.

Simple But Not Easy has, I hope, plenty of snippets interesting to the experienced professional, but it is aimed also at the interested

amateur investor with some money, possibly a hundred thousand pounds, maybe many millions – a broad spectrum.

The wealth management industry divides the well-off between four groups. Excluding the value of their homes, the 'mass affluent', about 4% of the UK population, each have more than £75,000 in assets to invest. 'High net worth', with up to £5 million, account for 0.7% of the population. 'Ultra high net worth', with more than £5m, are 0.3%. Finally, the 'super rich' are the top 1,000 richest, with more than £50m.

Any of these mass-affluent, high- or ultra-high-net-worth and super-rich individuals may be curious about investing. They might be quite happy to delegate to an investment manager, through one or more funds or portfolios, but want to make their choice without feeling alienated by a sense of ignorance and with a modicum of confidence, using criteria other than the colour of the manager's eyes and how good recent performance seems to have been.

The investor with millions will have the chance to scrutinise investment managers much more closely than the investor with a few hundred thousand; but even the latter, probably choosing a mutual fund or investment trust, has the right to understand what the manager of the chosen fund stands for, and what it is reasonable to expect and not to expect. The investor should have the means to understand as well as the right. This book is an attempt to provide some of the means.

Many investors, though happy to delegate to a manager, are also inclined to do a bit of direct investing themselves. For that, more than this book is needed. But I hope that it will provide some useful background for those who would like, at least to an extent, to DIY.

The advantage of some DIY is not only what it may achieve in itself, but the extra dimension of experience it then brings to judging others. Since investing is simple, those who want to manage their own money and are prepared to spend a bit of time (but not all their time) can do so. Besides having a decent chance of results as good as those of many professionals, they have the satisfaction of doing it themselves.

Having had the rare opportunity to observe other fund managers as well as to be one myself, what I aim to convey here are the fruits of that observation as well as of my own successes and failures. Failures first.

ONE

Howlers Galore

MY family motto used to be *vulnere viresco* – 'through my wound I grow strong'. This was a typical dog-Latin pun on our name: an old field, ploughed up and resown, grows a crop again and flourishes. But in India in the early 1800s an aggrieved employee tried to murder my great great grandfather with a sword. He was wounded in the back and lost two fingers. Thereafter, he could not bear the motto and changed it to something much duller.

Vulnere viresco is a perfect motto for an investment manager. That people learn from their mistakes is a truism. In investment management there are plenty of them to learn from. Mistakes are the things that make one fractionally better at it, at least as much as successes, and any manager who has only successes to talk about is a charlatan or a novice. Howlers, anyway, are much more interesting. That does not mean one should be constantly indulging in lachrymose retrospection. Sir Siegmund Warburg had a maxim, "Always cry over spilt milk." But if investors thought all the time about past mistakes, investment management would be a sorrowful business and so dispiriting that they would be far too depressed ever to invest with confidence; and confidence is vital to good investment. Nonetheless, one should at

least, I feel, examine the spilt milk quite carefully, if not cry over it, because the experience of howlers can be instructive.

Howlers recur. A good investor still makes mistakes nearly, but not quite, half the time. The manager who makes asset allocation decisions correctly all the time, or who chooses shares all of which outperform the market, does not exist. The gap between the successful manager and the unsuccessful is between one who gets it right 55% or 60% of the time and another who gets it right 40–45% of the time.

Here are some of my howlers which I have found particularly illuminating.

1. Ethics matter

In 1982 I had been managing portfolios for about a year. I was interested in the US company Warner Communications. An experienced old hand told me there were ethical problems in the management. I brushed this aside and bought the shares.

One day in early December, the morning after my stag night, I groped my way into the office after little sleep and with a crushing hangover to find that the share price had halved overnight, only a few weeks after my purchase. I had to decide what on earth to do about it, a decision I was in no fit state to make. I staggered round the office, explaining myself to colleagues.

Investment managers have to learn early in their career that share prices can fall precipitously. This was the first time I appreciated what a complete fool one can make of oneself in investment management. Every manager should also learn not simply to abandon ship when such a disaster occurs, but to see whether anything can be salvaged. After such a share price fall, the right answer, emotionally difficult as it is, may be to go back for more.

The author discussing recent events at Warner Communications with colleagues

With one exception, I did not experience quite such a savage collapse in the price of shares I owned for another 22 years. The exception was in the crash of October 1987, when the market indices fell by a third in a couple of days. But that was rather different because it was not specific to an individual company; it was a general market fall, which created a certain feeling of beleaguered companionship, a touch of Dunkirk spirit among investment managers.

The shocker for which I waited 22 years related to the US pharmaceutical company Merck. In October 2004 we held the shares. One day that month the price of Merck fell by 27% after the company announced that it was withdrawing one of its major drugs, Vioxx, because it had been found to increase the risk of heart attacks. I was out of the office at the time, and my colleague who told me the news on the telephone remembers me asking immediately, more hardened by then, "How much cash have we got?" We bought some more shares on the same day, at $31 per share.

There was another sharp fall ten months later, when the first court case resulting from Vioxx went badly against Merck. Immediately after this we made a further purchase at $27. This is generally, though not always, the right reaction to such traumatising falls, and with Merck it was the right reaction. Within six months the shares were

at $35. We had thus rescued respectability from the jaws of disaster. A year or so later – after we had, prematurely, sold, and that is another story – the share price was $50.

The other lesson I learned from that dismal Warner Communications stag night aftermath was to pay some attention when people whose opinion you value say that there is some ethical issue. Ethics is not just a county to the east of London. Ethics matter, for material as well as ethical reasons. Markets are particularly intolerant of seriously unethical behaviour by managements, and the revelation of scandal is something which can be relied upon to cause a collapse in a share price.

2. Travel narrows the mind

In 1997 I was working for a family office and talked regularly with a group of experienced advisers. Early in the year I went to Russia for the first time. The Russian market had been booming and international investors were pouring in. I was one of those who poured. Russia seemed full of potential with its large and well-educated population and an economy which was being liberalised.

The visit confirmed my prejudices. At the next meeting of the family advisers (one of whom had employed several thousand people in Russia, spoke the language, and could quote passages of Pushkin; whereas I had spent two nights in the Baltschung Kempinski Hotel opposite the Kremlin and had jogged down the river as far as Gorky Park) I opined with the confidence of the newly expert: "I think investing in Russia is safer than investing in Coca-Cola."

A few months later the market started to go down. In August 1998 both the stock market and the currency collapsed. The economy crumbled. In US dollar terms, in a few months the Russian market fell in value by 90% – a collapse on the scale of the Great Crash in the US. My comparison of Russia and Coca-Cola haunted me as possibly the silliest thing about investment I had ever said.

It was, and it wasn't.

One lesson of this episode was that travel often narrows the mind.

My visit had confirmed my prejudices because visits nearly always do confirm prejudices. It takes more than a few days divided between aeroplanes, offices and hotel rooms, with the odd visit to a factory and time off to wander round a shop or two, to undermine a good solid prejudice. Visits make visitors think they really know something about the place, and then they are prepared to back the prejudice to an extent to which earlier they would not have dared.

The practicalities of life mean that quite often the visit comes at a fairly late stage in the particular market movement. Making time for the visit and planning it takes a while, and the planning only starts when the market has already been attracting attention for months or more. The investor therefore gets confirmation, and confidence to double the stakes, at what may be close to being the wrong time.

The first lesson, therefore, of "Russia is safer than Coca-Cola" is to keep one's distance.

The next few years provided more interesting lessons. Coca-Cola was a darling among growth stocks in 1997. It was the quintessential all-American company, with the most valuable brand in the world. It had limitless prospects for growth, if only it could persuade the people of China that they should all drink Coke and fulfil the hopes of one of its chairmen, Robert Goizueta, that Coke should be drunk as readily as tap water. In March 1997 its price-earnings ratio was 42. From 1997 to 2006 its earnings per share rose by 60%. But, no longer a darling, the market attributed to it a price-earnings ratio of 21. Consequently its share price at the end of 2006 was 20% lower than in May 1997 – and 48% below its peak in June 1998. Its fall was not spectacular, like that of the Russian market, but gradual and unremarkable.

From its bottom in October 1998 the Russian market doubled and redoubled and redoubled again, and the value of the rouble also doubled. By the end of 2005, the Russian market in US dollar terms was worth 18 times more than at the end of 1998. More to the point, it was worth 3.7 times more than in May 1997.

So, on the one hand, what I said to that group of advisers in May 1997 was memorably foolish. It was clearly safer in a sense to own Coca-Cola, which in any single year went down no more than 21%,

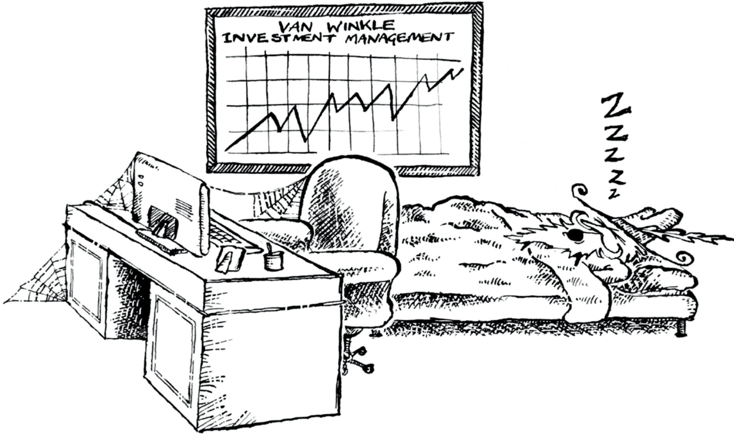
than the Russian market, which in three months fell by 67%. The risk of apoplexy on opening one's newspaper was greater with Russia than with Coca-Cola. On the other hand, the investor who held tight in Russia would in the end, by 2005, have made 270%, about 16% per annum, while the investor in Coca-Cola would have lost 20%. So can it really be said that to own Coca-Cola was safer than to own Russia?

Safety is in the eye of the investor. It depends partly on time horizons. The nature of markets is that people are most enthusiastic about a market, and most sure of a quick buck, when the excesses are greatest. The Russian market had already had three extraordinary years following the collapse of Communism. I fell into the trap of enthusiasm at the peak, joining a crowded party when there was room for little disappointment.

In the event, disappointment is an understatement. Everything which could go wrong did go wrong in the next 18 months. Irrespective of what actually happened, it would have been silly of anyone to invest in a market as volatile as Russia expecting to cash in after a year or two. One should invest in equities, which are volatile, only with a long-term perspective, and in the most volatile of equities with an especially long-term perspective – five years or more – and only with money which one can be sure of not needing in the next few years.

It also matters a great deal how investors react after a 90% fall. Something so devastating can lead to completely the wrong decision. It is easy to say, when your $1,000 has turned into $100, "I can't take any more of this. I would rather be sure of my $100 than risk losing that too." Selling at the bottom is an unsurprisingly common fault, because the bottom in a share price is the moment of maximum fear. If the fall is 90%, the fear is acute.

Perhaps the best thing to be, after a 90% fall, is asleep. If Rip van Winkle were the investor in Russia, he would not have been subjected to the awful emotional pressure which a large share price or market fall exerts: he would have slept through it all.



Later, on waking up to find that his Russian investments had made him 270% and his Coca-Cola had lost him 20%, there would have been no question that Russia had been the safer of the two. This shows the advantage of keeping your distance.

Safety, therefore, is not an absolute term. It is a function both of the investor's time horizon and of the investment's volatility. This Russia/Coca-Cola story is a demonstration, in an extreme way, of the different meanings of safety to different investors. For someone needing a lump of money in a year's time, the only safe investment is a cash deposit or a short-term government bond. For someone with no imminent need of the money and a desire to accumulate capital and increase purchasing power in the long term, it may be safer to invest in equities – volatile but with the historic and likely future characteristic of a high return after inflation – than to put money on deposit with the risk that over the years the real value of the investment will be eroded by inflation.

The other point which comes out of the Russia/Coca-Cola story is that the fall provided a wonderful opportunity to those of a disposition to take it. Anyone who added to Russian holdings after the 1998 debacle did much better than the 270% return between May 1997 and the end of 2005. We did in fact do this. We were not clever

enough to add right at the bottom, by definition the moment when people are most afraid. But we did add after the market had begun to recover, still some 80% below its level in May 1997.

The fall of Russia and its subsequent recovery is a demonstration of the principle that a share price which has fallen is, *prima facie*, cheaper and more interesting than it was before it fell.

3. The unthinkable happens

Another influential howler, on the other hand, was a Russian example of an exception to this principle. A share price which has fallen is more interesting; except sometimes. (Every rule in investment has to have plenty of exceptions. If there were no exceptions, the circumstances in which the rule applied would cease to apply because everyone would instantly take advantage of them.) A share looks cheap; you buy it; it goes down and looks cheaper; you buy more; it goes down and down, getting cheaper and cheaper, until it reaches what practitioners call euphemistically the ultimate cheapness – zero. This is what is generally called the 'value trap'.

Roughly this happened with Yukos. Yukos, an oil and gas company, was at one time the largest Russian company by market capitalisation, so large that at its peak it accounted for more than a third of the total Russian market capitalisation. The company was one of many which sprang from the dismantling of the Soviet state when shares of state enterprises were sold to private buyers, and were accumulated overwhelmingly, by fair means and foul, by a small number of young businessmen who became known as the oligarchs.

After the market collapse in 1998, the shares were astonishingly cheap. The majority were in the hands of Mikhail Khodorkhovsky. At that time the share price of Exxon was such that the investor paid $8 for every barrel of Exxon's oil reserves. For Yukos, the comparable figure was well under $1.

Unlike Gazprom – the company with the largest energy reserves of any in the world – and Lukoil, both still essentially state-controlled

companies, subject to political whim, Yukos was free of state control, a symbol of modern Western-style capitalism come to Russia. This image had been nurtured by Khodorkhovsky, originally regarded as a bandit. He accepted that if Yukos was to be given a valuation anywhere near that of Western companies, it had to behave like a Western company.

He involved highly regarded Western figures in charities and think tanks which he sponsored. Lord Rothschild was a mentor to Khodorkhovsky. American and British senior executives were hired. The company became, in the vogue term used to describe a high standard of corporate governance, transparent. There was no longer a perception, as there remained with a host of other Russian companies, that profits would be siphoned off to the benefit of controlling shareholders, so that ordinary public shareholders would get less than they should.

In the emerging markets portfolios which the firm I then worked for managed, we bought Yukos shares. We were not alone. Yukos had become, in its rehabilitated state, the darling of the Western financial media. Khodorkhovsky was treated accordingly. I saw him in person twice: once at a dinner given by the private equity firm Carlyle Group, when Khodorkhovsky sat at John Major's table, and once, a year or so later, at a conference in Moscow, in very different circumstances, when Yukos was already under severe pressure. On that occasion, Khodorkhovsky, clearly not at ease, arrived to give a speech, gave it in lacklustre fashion, and left immediately without answering any questions.

There were two clouds in what would otherwise have been the clearest blue sky. Sharp-minded observers saw these clouds early. The first was that President Putin was determined to ruin Khodorkhovsky. He had foolishly made himself extremely unpopular with Putin, who had done a deal with all the oligarchs. If they kept out of politics, he would not go after their ill-gotten gains. Most of them wisely kept their side of the bargain. But Khodorkhovsky had political ambitions. In the elections for the Duma, the Russian parliament, in 2003, he financed candidates who opposed the president. Most cynically, one of his senior colleagues stood as a communist candidate.

After a meeting of advisers I wrote a cheerful minute of the discussion about China, Russia and Khodorkhovsky.

Was China finer?
It appeared,
We feared,
When the dollars were counted,
The odds had mounted
That the markets discounted
The convincing prospect
Of the growth we expect.

Was Russia lusher?
It depended
We tended,
On how much imputing
To President Putin
Of a dubious motive
To increase his vote if,
As part of his prospectus,
He was seen by electors
To come out strong
When things done were wrong.

Too much faith in Khodorkhovsky
Could quite frankly be sort of costly.

It was not hard to grasp that too much faith in Khodorkhovsky was rash. He was playing with fire. The tax authorities started to impose enormous charges, relating to past years, on Yukos. Then, landing in his private plane in Siberia, Khodorkhovsky was arrested at gun point and charged with fraud and tax evasion. He was sentenced to eight years imprisonment.

Attracted by the cheapness of Yukos's shares in relation to the company's assets and profits, I did not think Khodorkhovsky's arrest

was the end of the story. Even if Putin was determined to ruin Khodorkhovsky, rather than simply to get him out of politics, there could be some deal in which Khodorkhovsky sacrificed all his shares in Yukos in return for his liberty.

But, more fundamentally, Putin had decided Russia's energy was too important a strategic asset to leave in the hands of international investors. He wanted Yukos's assets back under state control. I was slow to appreciate this. The attack on Yukos emerged in time as part of a strategy by Putin to regain the control of the major energy companies which had been lost with privatisation.

The tax bills Yukos faced were followed by more of the same, on a gigantic scale, so that they would swallow up all of Yukos's assets. Yukos was forced to sell the major subsidiary, Yugansneftegaz. The auction for Yugansneftegaz was rigged. The successful bidder, paying a fraction of the real value, was a newly created company. Within days, Yugansneftegaz was sold on to another company, Rosneft, owned by the state.

Yukos still had important oil assets, but the rump of the company which survived continued to be pummelled by repeated tax demands. Finally, in 2006, the company declared bankruptcy.

The lesson of all this is that the unthinkable can happen. The unthinkable must be thought about. Investors must have convictions, but they should never be too convinced that their convictions are right, however apparently rational.

One of the things which had made me feel that Yukos would turn out all right was that it did not seem to be in Putin's interests to drive the company into ruin. He would alienate a great many foreign investors, and foreign investment was vital to Russia. But this was naïve. The foreign investors kept on coming. In 2006, only two years after this glaring example of state appropriation of assets, international investors were prepared to subscribe to shares in Rosneft when the Russian government decided to sell a portion of the company to the public in an initial public offering on the London Stock Exchange sponsored by Morgan Stanley – a good example of just how short the memory of the market is. Putin had got this right.

Although international investors now speak in a more jaundiced way about Putin's absolutism, the Russian market has continued to rise – far above the levels at which it stood when Yukos first began to bask in international affections.

Yukos was a typical value trap. Something looks cheap. But it is cheap for a reason which may not be apparent at the time to the optimist. Afterwards it always looks obvious. This is the most difficult thing to deal with, because really it *was* obvious: that is why the share price was as depressed as it was. There are many occasions on which the obvious is wrong, but there are also many on which the obvious is right, and the gloom apparent in the share price will have been well justified. To all those, the majority, who have recognised the obvious, the failure of a minority of clever dicks to see it too will seem especially obtuse.

There is no real defence against the value trap. Every situation can only be viewed on its merits. But the assessment of value is not a scientific one. The lesson of Yukos was not that better analysis would have led to a different conclusion, but simply that things do sometimes go just as wrong as the market seems to imply they are likely to. Investors have to work out what the probability of disaster is.

They will often get the probabilities wrong. A very experienced and successful manager, Dominic Caldecott, now retired from Morgan Stanley Asset Management, told me that he did not mind poor performance; what he could not stand was being wrong. I have always felt quite differently. I am quite happy to be right for the wrong reasons: if a share price goes up for reasons I had not expected, that is fine.

4. When the going gets tough, the less-than-tough get going

My Motorola howler is exactly the opposite sort of howler, and more scarring than any other investment mistake of the last ten years. Motorola in 2002 was a cheap stock. Its share price was little more than the book value of its assets, which usually implies undervaluation since the stated value of net assets in a company's accounts is normally less than their market or fair value. It had depressed earnings but it was not too great a leap of imagination to think that it could improve its operating margins significantly.

We bought the shares at a price of $15 in June 2002. The share price fell. We bought some more. We were patient. We waited. There was no improvement. We waited longer. Finally, when the share price reached $8.5, we gave up. We lost our bottle and sold.

Almost immediately, the share price recovered. In fact, its low during this whole period was $7.71, only just below the price at which we surrendered. There was no coincidence in this. The bottom in a share price cycle is the moment at which there is the greatest unhappiness of the greatest number. What this demonstrated is that we were rushing through the exit at more or less exactly the moment that most other people were.

Within a few months, the reasons for the share price recovery became apparent. The key to Motorola had become its mobile telephone handset business. It ranked third in this, behind Nokia and Samsung Electronics. At the time that we sold the holding, Motorola's share of the world handset market was around 12.5%. It then started to produce models which, in this intensely fashionable business, hit the spot. Even with my untutored eye, I could see that their clam-shell models (and later the extremely slim Razr models) were much cooler than the rather chunky things which Nokia continued to produce. Over the next four years, Motorola's share of the handset market rose

to over 20%. At the end of 2006 the share price was \$20.5, compared with the \$15 at which we had bought and the \$8.5 at which we sold.

This is an extreme and particularly depressing illustration of something which happens quite often. If people invest in shares which look cheap, in companies with essentially sound businesses but scope for improvement (which accounts for the moderate valuation), they have to be patient.

In such shares there is generally no catalyst immediately visible which will give a quick result. If there is such a catalyst – a major outside shareholder agitating for change, for example, or new radical management – the chances are that it is already reflected in the share price to some extent and the valuation will not be so moderate. But patience is tough. (After all, the original meaning of patience is suffering.) When the going gets tough, the less than tough get going. It is frustratingly easy to give up on a share after either dreary performance or downright awful performance, just at the point at which everyone else gives up, and just before finally it turns.

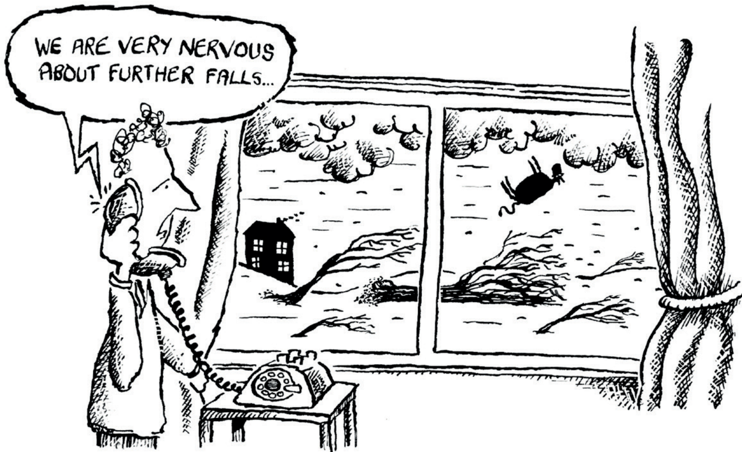
One day in the early 1980s, I had to go to Cambridge by train to talk to undergraduates about investment management as part of my employers' recruitment programme. Equipped with a first-class ticket, I wandered down the platform at Liverpool Street Station looking for a first-class compartment. There was none to be seen. I walked almost the whole length of the train. Just before the furthest carriage, I gave up, convinced that I must have missed it. I turned round and walked all the way back until I found a platform attendant, who told me that the compartment was in fact in the very last carriage – just after the point at which I had reversed.

This struck me instantly, and ever since, as a marvellous allegory of investment. So often investors are tempted to give up, and too often do, just before the thing for which they have been hoping happens.

5. Keep your distance

In October 1987 I was on holiday in Spain when my uncle rang to tell me about the storm which had annihilated woods and left an extraordinary chaos of fallen trees and branches over the roads of southern England. We had many trees, and many of them had fallen. In addition, a chimney had fallen through the roof of our house. We returned home a week early to deal with the carnage.

On Monday 19 October I was fully occupied in thinking how on earth we were to cope with the overwhelming task of clearing up the mess. Halfway through the afternoon, I was rung by someone in my office who told me that the Dow Jones Industrial Average was down 500 points, some 25%. I was then head of the US equity team at Mercury Asset Management, so this should have been important news.



A sense of perspective

Amidst all those fallen trees, which seemed to matter so much more, I thought it a question of supreme indifference. My reaction, far from the madding crowd of the City, was that shares were 25% cheaper than they had been, nothing much else had changed, and we should do some buying.

That was the reaction at a distance. I then made a terrible mistake. Still meant to be on holiday, I went back to work. Immediately, I discovered what I described in my diary as "a wall of gloom, a cloud of anxiety." Twenty years on, with the 1987 Crash no more than a blip in a long bull market, it is difficult to recapture the widespread feeling then that life had changed irreparably. A trader told me that he had seen people staring blankly, paralysed, at their trading screens, with sweat running down their faces.

The head strategist now wanted to sell shares, so as to hold 40% cash in the global portfolios we managed. Within a few hours, I swung from my distanced judgement that shares were cheap, to the consensus, almost uniform, view that the world had changed and that these shares, which had already fallen 25%, should be sold for fear of worse to come.

That is what we did. It was the worst mistake of my career – not one I was wholly or even primarily responsible for, but one in which I went along with the herd.

That episode carried several lessons. The first was the advantage of distance. Away from the City, the instinctive view was the right one. Back amidst the frenzy of a large investment management firm, in the thick of the action and assailed by an onslaught of opinion, I buckled. Distance brings dispassion.

The second lesson was to beware of circular arguments. The argument that the world had changed and that share prices would fall further was based on the fallacy of circular logic.

The thesis of the bears was that the fall in share prices which took place on Black Monday had destroyed the wealth of investors. As a result, it was argued, consumer spending would fall.

This was the so-called 'wealth effect'. If consumer spending fell, the economy as a whole would suffer, and in that case share prices would fall too.

But, simplified, the argument – the markets have fallen, therefore the economy will suffer, therefore the market will fall – had an obvious fallacy. It suggested share prices and the economy would fall in a spiral until shares were worth nothing at all. This could not really happen in a serious economy and stock market. However grave things were, shares would always be worth more than nothing.

In fact, things turned out very differently. There was no wealth effect resulting from the stock market crash. Consumers carried on spending. In time, not long in fact, markets realised this and rose. Those who bought in the face of the huge selling pressure in those days in the second half of October 1987 – and for every seller there has to be a buyer – bought wonderful bargains and made a great deal of money over the next few years.

The other lesson was to avoid single decisions on which investment performance depends too much. In any investment decision the chances of being right are 50–50. An investor who is lucky or good may be right perhaps 55% of the time. That still leaves a large possibility of being wrong. An investor who is wrong in one of these big decisions will be wrong in spades, and performance will be destroyed.

This is what happened to us after October 1987. The decision to hold 40% cash, during a period in which, as it turned out, markets rose reasonably strongly, created severe underperformance. Clients who initially, sharing in the consensus gloom, thought we were being prudent soon got bored of this explanation for underperformance. We lost business. In fact, the international business of Mercury Asset Management took several years to recover from the effects of this one decision.

So the third lesson I learned from this episode was that dogmatic large-scale views of prospects for the world, or for markets in general, are as unwise as betting all one's chips on a single number in roulette. This was the lesson also of howler six.

6. A portfolio needs a lot of little decisions, not one big decision

In my last year at Mercury, after a period of excellent performance in our global portfolios, we blew some of it because of a wrong currency decision.

The yen–dollar exchange rate in mid-1994 was ¥98 to the dollar. There were all sorts of fundamental reasons for the yen to weaken. The economy was weak, and interest rates in Japan were much lower than in the US.

We had plenty of exposure to Japanese shares. That meant, since these shares were denominated in yen, that we also had plenty of unwanted exposure to the Japanese yen in our US dollar-denominated portfolios.

Currency hedging is simple to execute and has an illusory appeal. Prospects for a particular equity market may look good when prospects for the currency of that market look poor. It then seems obvious sense to hold the equities concerned but to hedge the currency. This can most efficiently be done by selling the relevant currency in the forward markets. To hedge the yen currency exposure resulting from holding Japanese shares, the investor can agree – at an exchange rate determined now – to sell yen for US dollars at a point in the future, generally three months or six months.

At any time during the three or six months, the currency transaction, called a forward contract, can be closed by carrying out the opposite transaction: a purchase of yen against dollars. If the yen has fallen in relation to the dollar over that period, there is a realised gain. This gain is matched by the currency loss on the holdings of equities. If the equities have gone up, there is a gain on them. The use of the forward contract, with the gain there matching the currency loss on the equities, allows the benefit of the rise in share price to be preserved intact.

Even if the unexpected happens in the currency markets, and

the yen goes up instead of down, the resulting loss on the forward contract is still offset more or less exactly by the unexpected currency gain on the equity holdings. There is an opportunity cost – it would have been better not to have hedged through the forward contract, so that the currency gain on the equity holdings could have been added to any gain on the equity prices themselves. But an opportunity cost is not the same as a real cost. It does not really hurt.

That is the theory. What happened in 1994–5 was a good example that practice and theory can diverge. Instead of falling as I had expected, the yen appreciated strongly. By June 1995 the exchange rate was ¥86, so that the yen had gained 12%. Since we had hedged almost all of our Japanese equity exposure, around 40% of the portfolios concerned, we missed out on 5% (40% of 12%) of return which we would have had if we had not hedged the currency.

Opportunity cost may be different from real cost; but if it is big enough, and if all around have benefited from the opportunity which you have squandered, it seems to hurt after all.

We then compounded the error. When the exchange rate reached ¥82 to the dollar, we gave up, partially, and moved from hedging 40% of the portfolio to hedging some 15%. For a few days or weeks it looked sensible. The yen continued to strengthen, to ¥80 to the US dollar.

Then it stopped strengthening. Over the next year the yen fell from ¥80 to ¥120 to the US dollar. By reducing the hedging we had missed out on what we had intended in the first place to capture. This was just like giving up in the search for the first-class carriage of the train to Cambridge immediately before getting to it.

It was true that too much had depended on the hedging. The effect of this one decision, good or bad, could overwhelm many other decisions about individual holdings and exposure to the different equity markets. That was the first lesson: a portfolio should depend on a lot of little decisions, not on one big decision. But the time to pay attention to this was before embarking on the whole hedging exercise, rather than after it had all gone wrong. In investment, too late a right is a wrong.

The second lesson is a highly subjective one. Currency decisions and equity decisions do not, in my view, mix well. People who are good at dealing with exchange rates are not usually the same people as those who are good at investing in equities. The dynamics of all markets have much in common, but they also differ.

Dealing in currency markets is, I think, for traders, and not for those who argue the fundamentals. There is one purely technical reason why this is so. An equity can be held for ever. A currency contract has a finite term, usually no more than six months and more generally three months. This means that at the end of the three months investors are obliged to close the existing, maturing, contract, and, if they want, to replace it with a new one.

If the maturing contract has been profitable this is quite an easy path to take. But if the maturing contract realises a loss it gets psychologically more complicated.

After three months, the investor takes the loss on the existing contract, and says, 'Never mind; the loss we have taken on this contract is matched by the unexpected currency gain we have had on the equity holdings. The fundamental reasons for doing this are unchanged. On we go.' The investor takes out a new contract for three months.

At the end of that period, there may again be a loss. Once more the investor justifies renewal: the fundamentals are just the same. Another three months go by. Still the currency marches in the wrong direction.

The time comes to close the latest contract. At this point, the investor says, 'I've had enough. To hell with this,' and closes the contract without taking out a new one. Before very long the currency movement expected all the time starts to happen, but the investor no longer has the forward contract to benefit from it – having turned round before getting to the first-class compartment.

The awkwardness of currency hedging is that the instruments with which it is carried out are short-term. Equities sit in a portfolio, perhaps not behaving well but at least not nagging. Currency forwards nag, because every three months they demand to be looked after. They tug insistently at the investor's skirts.

When currency contracts are going badly, they play the same role as a difficult client homing in on errors, putting investment managers off their stride and on the defensive. That is why, I think, currency hedging is more suited to traders who are better at disposing of the baggage of the past: they start each day as though it were their first. They look at each position entirely afresh, unburdened by the detailed arguments for one course or another.

There is another important point about currencies, and that is that the world currency market is in aggregate a zero-sum game. This is not true of world equity markets. In the long run those holding an international portfolio of equities can hope to make a decent real return, which may be increased or reduced by their investment manager. Those holding an international portfolio of currencies can, over time, expect to make a real return of zero, because all that currencies can do is go up and down in relation to one another.

That is quite enough howlers to leave the general, correct, impression that I have made plenty of them. It is partly because of the lessons I have learned from them that I venture to write this book.