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Is There a Difference Between Being a Good Investor and a Good Stock Picker?

On a recent episode of the rundown – a weekly YouTube show with Andrew Kuhn and Vetle Forsland – Andrew asked the question of whether you could be a good investor without being a good stock picker and vice versa.

To answer this question, I'm going to use an analogy I made on a recent podcast between picking stocks and playing poker. If, in a game of Texas Hold 'em – you are dealt the hole cards Ace / Ace, you have a better chance of winning the hand than if you are dealt 7 / 2.

However, the truth is that a great many hands of Texas Hold 'em will never get to the point where two players turn over their cards and we see who wins. For that reason, it's perfectly possible to do well playing the other players with 7 / 2 (since they can't see your cards, it can't make a ton of difference what those cards actually are). Does that make not folding 7 / 2 a good move as long as you can outplay the other players irrespective of the cards? Likewise, you can be beat with your Ace / Ace if the hand does result in two or more players comparing their hands. We could call this bad luck. We could say it's a pretty obvious observation. But, I think there's something more to this analogy. In a sense, your return on 7 / 2 would have to be of a speculative nature – guessing how other players will react to what you do – rather than an investment nature (what your cards are versus what is on the board). There is an element of the cards and the play that matters with either set of two hole cards (great or terrible). But, the element of the cards could potentially be much more important with Ace / Ace and the element of the players more important with 7 / 2.

Does investing – or stock picking – work the same way?

In a sense, I think it does.

We can break your CAGR as a stock picker into two parts: the return you can get from judging the business right (which I'll compare to judging the cards you are dealt and the cards on the board as they appear) and judging the other market participants right (which I'll compare to judging the players at the poker table).

Multiple expansion is ultimately about judging the other players right. If you know you are very, very right about how other current and potential future holders of a stock will behave – you don't actually need to own the right business. You can win with 7 / 2. You could buy a junk company as long as you correctly predict that the market will award a higher multiple to the stock. Now, some will say you need a positive development in the business that exceeds the current expectations of the market. My experience investing has taught me – that's often not true in any way that can be well-proven. The theory of betting versus future expectations makes sense. But, it's a hard theory to prove empirically in the investment world I've observed. Very big and prolonged multiple expansions and contractions seem to happen for reasons that have everything to do with the players and nothing to do with the cards. Sometimes they have to do with the cards. But, many times they don't. Many times the multiple on a bad business will keep expanding even if the business is not showing actual results that would support such an expansion. And many times the multiple on a good business will stay stagnant or decline even as perfectly decent results are reported.

We could call this sentiment. We could call it momentum. We could say it is all about reading developing bubbles and busts and playing into them – but, then getting out before the other players in the investing game get out.

Now, investors following the Buffett school will often say that as long as you buy right and hold for the long-term, you needn't worry about the "voting machine" aspect of the market and can just worry about the "weighing machine". In other words, it's almost like you could play the hand without regard to the actions of the other players. You know you have the best cards. As the hand develops, you keep seeing you have the best cards. So, you don't need to worry about the players to the extent you would if you owned a bad business that was getting worse.

This is true – to some extent. But, it may be true to less of an extent than investors would like to think.

Here's the discomforting fact. A very long holding period for most investors I know would be 10 years. Most investors who say they're willing to hold for 10 years will never own a stock nearly that long.

So, how much does the play of the other players matter over 10 years? And how much do the actual cards (the business results) matter?

A pretty common multiple expansion or contraction for a stock long-term is 100% or 50%. That is, the stock goes from a P/E of 16 to 8 or a P/E of 16 to 32. As you get to more extremes – away from "normal" P/Es like 16 – the multiple contraction or expansion tends to be more extreme. I've been invested in things that went from a P/E of 5 to 15-20. So, that's a 3-4 times expansion. That's not unusual for stocks with a P/E of 5 if they turn out to be decent businesses, because there's often a point where a decent business will trade at a decent P/E. Likewise, the contraction possibilities become more severe as you pay up for bubble type stocks. Andrew and I talked about **Microsoft (MSFT)** on the podcast. It experienced a multiple contraction of around 70% over a decade where it actually had very good business results. This is because its P/E had gotten to be more than 2 times a "normal" level at the top of the millennium bubble. And then it eventually got priced at maybe 2/3rds of a normal stock's level about 10 years after that bubble (around the time of the financial crisis). If we think of "normal" as "x" then we are basically saying the P/E went from 2x to 0.65x. If that were to reverse – and, over the next 10 years at MSFT, that's exactly what did happen – you go from 0.65x to 2x. This multiple expansion contributed about 12% a year to MSFT's returns.

Now, you could say – that's hindsight bias. But, let's put it in even more troubling terms. Say you only could foresee that the odds of a multiple expansion from 0.65x normal to 2x normal over ten years was about an even money proposition. But, you knew that there was no chance the stock's multiple would be less than 0.65x normal (about a P/E of 10) ten years hence. On a probability weighted basis, a 50/50 chance of an expansion from here still adds more than 6% a year to your returns. There are different ways of calculating exactly what a probability weighted return on a 50/50 chance of having a P/E of 2x normal in 10 years would add to returns. I think the best way of thinking about this would mean your probability weighted CAGR would add about 7.5% to your returns. The reason it adds more than 6% a year is because of the floor I mentioned. If the probability of something going up is 50%, but the probability of it going down is 0% (we assume the other 50% is it staying flat) this floor of absolute certainty means you should calculate the probability adjusted CAGR such that it is even higher than half of the potential upside from the event actually happening. This may sound like a weird way of doing it. But, think logically for a second. Was MSFT's P/E ever going to zero? I mean – I guess earnings could go to zero. But, let's face it – if the stock has an EPS of $4 a share ten years from now – it's not going to have a price of $0. There are not the same odds of a contraction from a 10 P/E to a zero P/E as from a 10 P/E to a 20 P/E (or even a 30 or 40 P/E – in fact, a 40 P/E must be more likely than a zero P/E). This makes the probability weighted potential in low P/E stocks of good businesses higher than you'd initially guess even over periods as long as 10 years (when you've got a P/E of 9 to start with – the odds of the

P/E tripling are just really strong versus the odds of the P/E falling by another two-thirds).

The Microsoft example may be extreme. But, a typical example of multiple expansion isn't much better. If you buy a stock at a P/E of 8 and it goes to 16 – you've added 7% a year to your returns. A stock going from a P/E of 32 to 16 works the same way in reverse. This explains why value investing – in the sense of buying stocks with P/Es of 8 and not buying stocks with P/Es of 32 – works.

The problem is that if we assume 10 years is a truly long investment holding period and we assume multiples will tend to snap back toward a P/E of 16 over any given decade – we get the answer that about half of your return is going to come from other people's changing assessment of the business. Basically, portfolios full of 8 P/E stocks that turn out to be average or 32 P/E stocks that turn out to be average will have returns that differ to the amount of about 7% a year from a basket of equally good 16 P/E stocks. If the business quality, future performance, etc. is equal in the 8, 16, and 32 P/E baskets – your investment results in the cheap basket will be determined 50/50 by business results and multiple expansion, in the 16 P/E basket entirely by business results, and in the 32 P/E basket half by business results and half by multiple contraction (which will offset). You'll have a negative edge in the expensive stocks, a positive edge in the cheap stocks, and no edge in the normally priced stocks.

I'm simplifying by saying these are all equally good businesses with different P/Es. This would also work if you bought stocks with 20 P/Es that turned out to be such amazing businesses you could sell them at

40 P/Es in a decade. I think you understand my point though. It's going to tend to be the case – even over as long as a 10-year holding period – that half your return in going to be dependent on other people coming around to your way of thinking about the business after you do.

The reason for this is that the underlying public companies – if we're looking at an index, for example – will only be delivering about a 7% business result. Their growth rate might be 5% and dividend yield 2%. Some could argue – based on long-term returns – that it's more like 8%. Maybe it is. It's probably not 9% a year. And there's no way it's 10% a year. The only way you make 10% a year in a stock index over the truly long-term is if the index's multiple expands over time.

Now, you could pick such good businesses that free cash flow yield plus growth is greater than the influence of multiple expansion and contraction. But, even then – it's unlikely to be much greater.

Consider a stock with a free cash flow yield of 10% a year and growth of 5% a year. That's likely to be an amazing stock. But – over a 10-year period – it's still likely you'll only be getting about 65% of your return from that free cash flow and that growth. The other 35% of your return is still going to come from multiple expansion. Say the FCF yield will decline from 10% a year to 5% a year while you own it. This will drive 7% a year returns from multiple expansion. You might make 22% a year in the stock (again, an amazing result). But, it's still the case that as much as one-third of your investment is coming from how well you are reading the future actions of the other "players" in the market and not how well you are reading the business.

We could take this to the extreme. Over short periods of time, there is no doubt that you should just play the other players. If you're going to be owning stocks for 10 months at a time instead of 10 years – all you need to do is pick stocks that others will discover after you already have. There's no point in spending much time thinking about the actual businesses you own. Conversely, over very long holding periods – imagine owning a stock for your entire lifetime – the play of other players is irrelevant. You just need to find the right business. This is because multiple expansion from 1x to 2x over 30 years (as long as Buffett has held a few stocks now) would only add 2% a year to your return. A business that doubles its multiple over 30 years is probably giving you an actual return of at least 7% a year (again, it could be closer to 9% a year). Still, this would mean that even over a 30-year holding period – your return from correctly judging the market for the stock instead of correctly judging the underlying business is driving about 20% of your stock return. In fact, I'd say this is a limit that is hard to get much below. It's always going to be the case – even over incredibly long holding periods – that only 80% or less of your return is coming from the actual business while 20% or more is coming from how others view the stock. Over short periods of time – it's more extreme.

For most investors – holding periods are far less than 10 years. This means that the business is driving far less than 50% of the return in a stock. So, your result in a stock will tend to be more than 50% driven by how others view the stock while you own it. In other words, if you could be as correct in your judgments of future market sentiment toward the stock as you are in your judgements of the future of the business – you should actually bet based on your judgment of market participants not of the business.

Does this mean it's hopeless to get better than average investments results by focusing on business judgment alone?

Actually, no.

There are two reasons for this. I'll start with the simpler one.

The simpler reason here is that no matter how big or small the proportion of the return mix that comes from business judgment versus market judgment – it basically never approaches the actual number zero (it does, if you're a day trader – but, not if you hold stocks for years at a time). As a result, all this math we've been talking just means you'll be watering down your edge on whichever side (the business or the market) you have one. You'll never be eliminating your edge.

So, let's say you tend to hold stocks for 10 years at a time and you are so good at business judgment that you can buy things such that they return 10% a year more than other businesses would. For example, you are able to find things you know will grow 10% faster than other stocks with the same free cash flow yield. Multiple expansion or contraction will water down this 10% edge. But, it can never make it go away.

It works the same way in terms of the 50% of your returns that would come from market sentiment. As long as you get an average market sentiment result – your edge on the business judgment side will provide an overall advantage in your annual returns. The only way you could end up with a good business judgment record and yet a bad stock investing record would be if you tended to pick stocks that somehow perform well as businesses but poorly in terms of market sentiment. In other words, their earnings always go up but their P/E always goes down. This is – over a 10-year holding period – not an easy thing to stumble into. It just doesn't happen that often that a stock which wasn't super expensive to begin with keeps seeing its P/E multiple contract while its earnings keep growing. I've owned stocks where EPS rose for 5 years while P/E contracted for 5 years (not a lot, but it has happened). I haven't yet owned one where this divergence between business results and P/E multiple continued for a full 10 years.

Finally, there is one bit of comfort here. I promised a more complicated reason why business judgment alone might work better in terms of driving returns than just being 50% skill and 50% luck. That reason is correlation. Anecdotally: I think multiples and the things they are multiples of tend to move together with correlations greater than nothing. If a company is growing EBITDA by 10% a year while most stocks are growing it by 5% a year, the EV/EBITDA multiple of that stock will – other things (especially starting price) equal – tend to expand. The company with 0% EBITDA growth will tend to see its multiple contract.

So, if you are betting on only one side of a 50/50 return mix, but you know the other side is at least somewhat correlated with the side you are betting on – the truth is that you'll be making a bet that works much like if it accounted for far more than 50% of the stock's return over time. How much more will obviously depend on the degree of correlation between the business as an economic value creating machine and the stock as a speculative vehicle. Over long periods of time, the correlations on these things tend to be high enough that a business judgment focused approached to stock picking (an "investor" approach) works well despite the huge implications of multiple expansion or contraction. In other words, I don't believe business judgment bets only drive 50% of returns. I believe they – over a 10-year period – often drive like 50% directly and then some number between 0% and 50% indirectly via correlation between business results and sentiment. This means – over long periods of time – correct bets on business judgment will drive more than 50% but less than 100% of returns even though they may seem to be only driving 50%. Sentiment toward a stock – over long-enough periods of time – just isn't random and totally unconnected from underlying business results.

So, what's an investor – or non-investor stock picker – to do?

My advice on this has always been the same. If you are going to hold a stock for more than 15 years – almost all of your return is likely to come from business results. If you are going to hold a stock for less than 3 years – almost all of your return is likely to come from market sentiment changes. If you (like most investors I know) target holding periods in the 3-15 year range – you're going to see a very mixed return driven both by a lot of business results and also just by a lot of market sentiment shifts. Without knowing how volatile the business results or sentiment shifts will be – there's no perfect rule for what the business results vs. stock sentiment mix will be. But, 3-15 years is a good guide. Stock picking with a less than 3-year horizon is primarily a sentiment guessing game. Stock picking with a more than 15-year horizon is primarily a business predicting game. And stock picking with a 3-15 year time horizon is a blend of the two.

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