



# Counting On Growth

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*Growth Can Be Measured. Count on It.*

TRADITIONAL INVESTMENT and Wall Street analysis consists of talking to company management, customers, and suppliers, and then building complex hypothetical models to try and guess future financial results. Analysts spend their days on the phone and attending meetings to try to uncover winning stock picks. This process is both ponderous and relatively unsuccessful. In its attempt to *sell the story*, all too often the Street gets caught up in the story and starts believing its projections as the gospel truth. Storytelling leads investors down a path of underperformance and losses.

Listening to stories can be great fun. It can be entertaining and interesting. A great way to spend an evening is to sit around with a few adult distilled beverages and share stories with friends. But this is a lousy way to pick stocks and can cost you a lot of money over the long run (and sometimes even the short run). Wall Street loves to find and sell stories. It is the basis of the business. In the late 1960s, the word was *conglomeratization*. Those who listened and believed lost enormous amounts of money. In the early 1980s, the story was all about oil and gas and real estate. Those who listened and believed lost enormous amounts of money. In the late 1990s, the buzz was the *paradigm shift* caused by the technology and Internet revolution. Those who listened and believed lost enormous amounts of money. The more seductive and alluring the investment story, the more likely it is that one is entering the land of financial dragons with Saint George nowhere in sight. The better the story sounds, the more you should beware.

Our ancestors believed in things we now know to be completely wrong. People seem to have a need to invent reasons for their world and what goes on in it. Humans have attributed crop failure to irate gods. Cattle were struck because someone failed to sacrifice the right animal to the troll under the mountain. We now know that crops fail due to overplanting and incompatible soil.

Cattle disappear because of real-life predators such as wolves. The reality is that, short of hard science, we invent reasons for the things that happen in the world, and this tendency to believe in the magical or otherworldly takes place every day on Wall Street. Analysts make claims such as, “The stock was going to be fine but it ran into a double ascending lateral triangle that caused it to break down,” or, “The moving average dipped when it should have swerved.” More fundamentally we hear things like, “Well, the patents should have been granted but the stubborn old FDA just refused to overlook those 2,000 unexplainable deaths of subjects taking the new wonder drug.” Heed this: Stocks don’t dip on lateral triangles or dipping moving averages and companies don’t run into financial problems because of the FDA. In all cases there is a pattern that is discernable with scientific analysis.

I am a numbers guy. Numbers and stocks are two of my greatest passions in life, and fortunately I have been able to combine them into a long and successful career picking growth stocks. I believe that the proof is in the numbers and that a careful study and analysis of the numbers can help us find stocks with growth potential and big gains in the future while avoiding stories and mumbo-jumbo. Getting caught up in the story can cause investors to believe the hype surrounding a stock or a market and stay long after they should have exited. It was pure numbers-based research

that led my firm to sell Cisco and Sun Microsystems in December 2000 and to begin to buy energy stocks and conservative companies, such as Loews and United Healthcare, that didn't participate in the tech bubble. Those who listened to the tech story stayed long after the party ended and had to pay the bill. It was pure *quantitative and statistical analysis* that had us buying homebuilders in 2002 just as they began their multiyear run to a constant string of new highs.

More and more, society understands that it is often the numbers and math of a situation that have the most meaning. Meaningful, real answers, as opposed to mysterious forces, come from scientific analysis of the numbers underlying a situation. Analyzing things from a subjective point of view allows us to color situations with our own opinions, hopes, and dreams and to be influenced by others. And there is just way too much information of a subjective nature floating around us every day. How do we even begin to decipher which is right and which isn't? It's impossible! Malcolm Gladwell pointed out a prime example of this in his book, *Blink*, where he told of a new, simple mathematical algorithm that helped emergency room doctors quickly and simply assess whether a patient was having a heart attack. Researchers discovered that doctors had too much information coming at them too fast, so boiling it down to a simple formula sped up the process, made diagnosis more efficient, and saved lives.

The use of statistical and quantitative analysis has also spread to the sports world. I like to talk about sports with friends and associates, but I approach it differently than most people since I am more clinical and analytical and less emotional about teams and their players. I have always said that if I was ever going to manage a basketball team I would do it by the numbers. I would rank players on all the key statistical categories and select those who ranked the highest overall. We have seen many great shooters in basketball. Allan Iverson and Pistol Pete Maravich are two who come immediately to mind. They could shoot lights out but never came close to a championship. Once Kobe Bryant was separated from Shaq's rebounding and inside scoring ability, the Lakers became average at best. Success comes from putting together a team that excels in all areas—steals, assists, rebounds, blocks, and foul shooting.

I would like to claim that I invented and developed the statistical approach to sports team management, but someone beat me to the punch. In his bestseller, *Moneyball*, Michael Lewis tells the story of Billy Beane, the general manager of the Oakland Athletics. Beane is considered something of a revolutionary among general managers and was the first to rely on the pure numbers. Sure, Bill James kept track of everything trackable about the game in his baseball encyclopedia for years, but that was for

fans, not managers. Beane challenged conventional wisdom and used the numbers, and pretty much *just* the numbers, to assemble his team. This was a major affront to those who believed that you had to have an eye for talent (a story, if you will). Numbers couldn't put together winning teams; only experts could. Beane developed formulas to measure a player's statistics against the cost of the player's contracts. Using the numbers, Beane has turned the Athletics into one of the winningest teams in baseball with a fraction of the payroll cost of the Yankees or Red Sox. The A's are also wildly profitable and they share a market with the San Francisco Giants. In fact, both teams have subsequently hired baseball quantitative analysts to help manage their rosters.

The use of statistical and quantitative analysis continues to grow. One recent, fascinating television show is *Numbers*, a one-hour drama about a math genius who uses mathematical models and statistics to solve crime problems for the FBI. This type of analysis is widely used by law enforcement to crack cases, by insurance companies to assign rates to different drivers in different locations, and even by casinos to separate gamblers from their hard-earned money. In fact, one of the most popular games today is poker, a game where many of the top players are quant folks and rely on numbers to win. So, if statistical and quantitative thinking works in so many areas

of life, why wouldn't it work in the stock market? The fact is that it does.

One of the more important aspects about using the numbers and just the numbers is that it keeps us from falling in love with a story. Because of our reliance on just the numbers, both fundamental and quantitative, we are one of the few firms that can claim to have made a substantial amount of money in Enron. Everyone now knows the Enron story and the accounting and trading frauds that took the company all the way into bankruptcy. What they forget is that Enron was once a powerful growth company with rapidly rising sales and earnings. We were in the stock while it was in a growth mode but exited long before the headlines hit, because the numbers showed weakening fundamentals and increased risk. We didn't know the backstory, but the numbers alerted us to problems before the newspapers reported the bad news.

Numerical reliance saved us in Tenet Healthcare, as well. In the late 1990s into 2001, Tenet was a powerful growth story. They run a chain of hospitals and their business in the United States and Europe was growing at a rapid clip. Then, in late 2002 and the early months of 2003, came allegations of impropriety, overcharging Medicare, and bribing doctors to use their facilities. Some Tenet doctors in Redding, California were doing unnecessary heart surgeries! The SEC began looking into their

billing practices and public disclosures. Long before this happened, we exited the stock when the fundamentals declined and volatility increased in November 2002. From 2001 to today, the stock has fallen from the mid-50s to just \$7.50 a share!

Relying on just the numbers has helped us find growth stocks before Wall Street turned them into stories, and it has helped us exit before the story ended. Wall Street sells stories. I trust numbers. I can't always trust the Wall Street sales machine. But I can trust the numbers from my database. Count on it.