DKI | DEEP KNOWLEDGE INVESTING

25 THINGS
TO KNOW ABOUT INVESTING FROM A FORMER WALL STREET HEDGE FUND MANAGER

Written By **Gary Brode**

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The world of finance is complex and can be overwhelming for a lot of people. Even more challenging is the fact that you can't opt out of having some level of financial knowledge. We all have to exercise some oversight of our own budgets, savings, and investments. Some financial products and services are fantastic and are managed by people with the proper incentive to look out for your interests. Others are managed by people more focused on extracting fees while providing you with little real help.

I've spent decades in the hedge fund business and now run Deep Knowledge Investing, a firm dedicated to helping you earn better returns in the stock market. I'm going to share with you some things to know about investing, and help you think about how to manage your portfolio more effectively. At a minimum, this eBook will help you identify the good service providers and products from the bad.

Sincerely,

Gary Brode

CHAPTER I:

HOW GREAT INVESTORS APPROACH THE BUSINESS:

▸ The Hedge Fund Business is Like the NFL:

It's both super-competitive and super-collaborative. During the season, NFL teams will do anything for an edge. During the off-season, coaches will share information about up-and-coming assistants and will even conduct seminars to explain their view of how to design and defend certain kinds of plays.

It's the same in the hedge fund business except without the off-season. Portfolio managers will work insanely hard for a performance edge. However, we also share information including our best ideas. It's common for us to send models and research notes to each other. When I was a junior analyst, I called hedge fund legend, Carl Icahn to share information about a stock. He called me back within 10 minutes happy to talk, and he couldn't have been more gracious.

▸ Risk Control Matters (in Football and Investing):

In a 2022 monthly letter to Deep Knowledge Investing subscribers, I wrote about the Michigan – Ohio State football game. Michigan had a dominant running game, so in response, Ohio State brought their entire defense up to the line of scrimmage on most plays. This was a daring strategy because it means that Ohio State had a numbers advantage on every play; however, it also meant that any mistake meant there was no help behind the front-line defense.

Here was the result: On 80% of plays, Ohio State held Michigan to just over 3 yards. That's great for Ohio State. On the other side of that, Michigan had touchdown plays of 69 yards, 75 yards, 75 yards, 45 yards, and 85 yards. The final score was Michigan 45 – Ohio State 23: A blowout win for Michigan.

For those of you who are wondering what this has to do with investing: **This example illustrates the importance of risk control. An investing strategy that works 80% of the time and gets you annihilated the other 20% is a bad strategy.** It's important not only to be right most of the time; but also, to ensure that your losses don't wipe out your entire portfolio.

▸ We Think This Type of Investment Gives You the Best Opportunity to Succeed:

I'd rather pay a high price for a high-growth great business than buy a weak business cheaply. The reason is because if the company grows quickly for a long period of time, it gives you the best margin for error on your initial purchase price. One example of this is Amazon (ticker: AMZN). People who bought that stock many years ago paid a high multiple of revenue to own it meaning the stock was expensive. Amazon's amazing long-term growth made the initial valuation unimportant.

The other side to this is what's called "cigar butt" investing. The expression comes from the idea that if you're walking down the street, and someone has thrown away a cigar butt, you might be able to pick it up and get a good puff or two at no cost. These investors focus on trying to find businesses that are so cheap that the poor fundamentals of the underlying business don't matter. I've known some smart investors who operated this way, and while it can be an effective way to invest, it's not my preference.

▸ Excel Models Matter Less Than You Think:

There's value to building an Excel model to see where there's leverage in a business and to understand what's happening to margins over time. That model will also allow you to understand quickly what happens if expenses come in a little better/worse than expected. However, huge overly complicated models tend to be a waste of time because they assume a level of detail you don't and can't have. It creates artificial precision and a false confidence in your conclusions.

▶ Meme Alert – Always Check the Borrow and the Short Interest:

With the rise of index investing where stocks are bought regardless of business quality or valuation, and the advent of meme "investing" where groups of amateur Reddit traders collude to raise a stock's valuation, the business of shorting stocks is much more difficult and dangerous than it used to be.

While some regard shorting stocks as immoral, we simply regard it as the same as long investing only in reverse. In a typical long trade, you buy a stock, hope it will rise, and sell it later. When shorting, you sell the stock, hope it will fall, and buy it back later. Both trades involve a buy and a sell – just in a different order.

For those of you who still see the value of shorting individual stocks, we strongly suggest checking the borrow (ensuring your broker has shares to lend and at what rebate/price) and checking the short interest (the percentage of shares traded that are already shorted). Difficulty getting or keeping a borrow, a very high price to borrow the stock, or a high short interest are all signs that the trade is "crowded". That means that many others have had the same idea and the stock is subject to the kind of meme-related short-squeeze that caused stocks like Game Stop (ticker: GME) and AMC Entertainment (ticker: AMC) to rise thousands of percentage points despite no change in the underlying business.

▶ Process Matters – Even When Others Focus on the Wrong Thing:

All investing is a probability bet. There is no guarantee that a particular investment will make money, and frequently, individual stocks are subject to forces outside your control or analysis. I've seen the stocks of great businesses decline because another stock in a barely-related business had a bad quarter. You'd be amazed at how often people (including market professionals) don't understand the companies or assets they own. We once saw a prominent hedge fund manager assert that a company owned computer servers which need to be depreciated on a 3-5 year lifespan. The company actually owned the steel shelving the computers were resting on which have closer to a 300-500 year lifespan. This is not a trivial misunderstanding! If you want to know how this happened, see Point 15 below. If you want to read the details on how we caught the mistake and made money owning the stock, click here.

The best you can do is develop a process that will ensure you're right most of the time and that you don't get wiped out by the losers. Follow that process and focus on that over the results of any one investment.

Strangely, many of the asset allocators and hedge fund managers who pay lip service to the importance of a good process will invest based on the performance of your last stock pick. That's the equivalent of watching a baseball player with a .350 average and 60 home runs in a season strike out once and concluding they're a bad player. Our advice to you is to keep making great high-probability investments. Always ignore the "you're only as good as your last call" crowd.

▸ Embrace the Contradiction Between Being Disciplined and Flexible:

I just told you to follow a consistent investment process. You should have a firm idea of what a good long investment and a good short investment look like for your portfolio and investment style. Now, I'm going to tell you to also embrace the ability to be flexible.

For years, I loved finding good stocks to short, but the shift to index investing and crowded short ideas made that business much less profitable and much more dangerous than it used to be. I responded by shorting the indexes and learning how to value and trade index options.

For years, I focused on finding great companies trading at a good valuation, or investments where there was a misperception about the company outlook. In 2022, we've had high inflation, massive governmental overspending and currency printing, and the most macro market I've ever seen in my life. As a result, I've become open to investing in precious metals, Bitcoin, and to taking huge positions in energy stocks. These are different assets for me, but in 2022, being short the market and being long energy have been the trades that have worked.

CHAPTER II:

WORK ETHIC AND INTELLECTUAL HONESTY:

▸ Insane Work Ethic:

The best hedge fund managers work very long hours at high intensity. Days off are rare, and weekends tend to be the time to catch up on long-form reading you put aside during the week. Here's what all of these people have in common: they're very curious, love to learn, have a long attention span, and a deep desire to understand the details.

▸ Some of You Aren't Going to Like This One:

There's no substitute for doing a lot of work to understand an investment. People often ask me for stock tips, and message boards are full of people with a fantasy that someone is going to give them an idea that will allow them to get rich in 2 days on an options trade.

Here's the truth: high-conviction, short timeframe, high-return ideas are incredibly rare. There's nothing wrong with not wanting to spend all day doing stock research, but if you're hoping to get rich in a week from tips on a Reddit message board, it might be better to just play the lottery.

Think about it this way: When you buy or sell a stock, who's on the other side of your trade? Chances are it's someone like me who spends more than 12 hours a day researching stocks and has done so for decades. We're not always right, but if you're going to enter the arena unarmed, take a minute to think about who your opponent is. In other words, don't bring a plastic knife to a gunfight.

▶ The Best Cultivate Outside Relationships:

While many hedge fund managers do talk to each other, the best information and perspective comes from people outside the finance industry. Ideally, you're doing primary research (talking to people who are actively engaged in the business you're analyzing) instead of secondary research (talking to other finance people who claim to have done the analysis). The ability to find someone with valuable information who's not an insider (which would be an SEC violation) and persuade them to talk to you is crucial.

This is why Deep Knowledge Investing has a large, diverse, and successful Board of Advisors. When I want to know how something really works, I have a deep network of people aligned with me who have valuable experience in a specific field.

CHAPTER III:

POOR WORK ETHIC LEADS TO POOR ETHICS:

▸ Not Everyone is Trying to Make You Money Part I:

Big Wall Street sell-side research departments aren't trying to make you money. They're trying to sell investment banking services to the companies they cover. That's the reason that most stock "recommendations" are buy or strong buy, and they rarely issue sell recommendations. These banks and research teams tout their strong relationships with management as an asset. However, because maintaining those relationships requires never upsetting management, it really means they'll never be honest with you. The entire system is rife with conflict. If you want to understand this in greater detail, click here.

▸ Not Everyone is Trying to Make You Money Part II:

Most wealth advisors try to sell you products that give them the best commission, or just as likely, tie your entire stock portfolio to a couple of the big indexes. One registered investment advisor (RIA) at a big firm told me he spends 99% of his time trying to land new business, and that he views the people who manage client money as "overhead". That means he spends all day trying to convince people they'll get great financial advice, and no time trying to provide great or customized financial advice for them.

Many advisors I know told me they spent much of 2022 on the phone reassuring clients and telling them not to pull their money out of the market. I pointed out that most stock and bond portfolios are down over 20% year-to-date and asked them if they've made any changes or adjustments to client exposure. The answer was always "no". Their goal is to make you feel good about their services while not providing the service you need.

There are some fantastic smart wealth advisors and RIAs out there. We work with some of the best. Ask questions, evaluate carefully, and let us know if we can help you find someone who will actually look out for you.

▸ Not Everyone is Trying to Make You Money Part III:

Many mutual fund managers are “closet indexers”. Because the S&P 500 is weighted by market capitalization, they can own a relatively small number of those stocks and end up with performance that closely mirrors the index. Then, they charge you a management fee for “active management”. We think that managing money is challenging, and that people who excel at it should be well-paid. That shouldn’t apply to managers who pretend to run an “active” portfolio, but who really are set up to track an index which you can do very cheaply and directly through a few exchange traded funds (ETFs).

▸ Not Everyone is Trying to Make You Money Part IV:

All asset allocators (the people who collect money from individual investors and invest it for them in hedge funds, private equity, or other pooled investment vehicles) will tell you they do a lot of work to understand the managers who run the funds. That’s actually true. They take thousands of meetings a year, read countless investment letters, and follow industry trends.

Then, many of them throw that work away, and invest where other allocators are investing. Their goal isn’t to get you the best returns. **It’s to avoid being wrong alone.** They think it’s ok for them to lose your money as long as they do so in a brand-name fund where others are invested. This is the financial equivalent of the old expression “no one ever got fired for buying IBM”. Our view is they’re investing billions of dollars using the same process a high school student uses when deciding which party to attend: Where are the other popular people going to be?

There’s no need to be upset by this. Again, just ask a lot of questions and understand the incentives of the managers. At Deep Knowledge Investing, I assure our clients and subscribers that I own every position I recommend. If I’m wrong, I’m going to lose money. If I’m right, we’re all going to make money. DKI is conflict-free, and our incentives are aligned with yours.

Dirty Secret – Marketing Wins Over Performance Even in the Hedge Fund Business:

Many successful hedge fund managers are able to run large funds because they're great at marketing and spend a lot of time on marketing. I've seen huge funds with mediocre performance and tiny funds with fantastic performance. This is common, and it's much more profitable to run a large fund than a small one even if the small one has better performance.

As a result, at some funds, much of the work is done by junior analysts. They tend to be smart and hardworking but lack experience. We've seen some of the biggest funds take bad positions because a young analyst told the portfolio manager something that was factually true, but completely misunderstood the underlying business model. This happens more often than you'd imagine.

CHAPTER IV:

CREATIVE WORK AND ORIGINAL ANALYSIS:

▸ It Is Possible to Have a View That No One Else Has:

People often ask me what the core advantage Deep Knowledge Investing has that others don't. I respond that I often have a view of the world that's different from others. I see things differently from the crowd.

Years ago, at Silver Arrow, we were looking at Royal Caribbean (ticker: RCL). The stock traded cheaply because market analysts were concerned about new capacity additions in the huge Caribbean market. I spoke with the head of the Caribbean tourist bureau who assured me that the capacity additions were within the normal range. The company reported that bookings and pricing were all strong. Still, the market was convinced that once the new ships entered the water that fall, pricing would plummet.

How do you solve this research problem? We went online to iCruise.com and tried to book a cabin on every single new large ship that was going to enter the market in the next 18 months. It turns out that we could do so. That meant that the future event that had everyone concerned had already happened. The boats might not have been in the water yet, but they were in the sales and reservation systems already. This is related to Point 17 below. We made money because we understood both company fundamentals and what was being misunderstood in the stock market.

Here's the crazy part: I explained this to someone at RCL and told him to mention it on the next conference call. He immediately said he had to go talk to the company's Chief Financial Officer because no one at the company had looked at the problem in this way. We made a huge return on the stock and maintain to this day that an independent point of view that's not shared by others is both possible and incredibly valuable.

▸ Here's the Thing That Even Smart People Get Wrong:

It's difficult to figure out what news or insight is already incorporated into a stock price. Junior finance professionals and amateur investors often understand a business and an idea, but don't think about whether their point of view is widely understood by the market.

On more than one occasion, I've had smart junior analysts present an idea to me. They outline that the company has a positive outlook for future performance. They've been correct, but their view was already priced into the stock. **It's important to both understand the company you're analyzing as well as what the market expects.**

CHAPTER V:

THOUGHTLESS WORK AND POOR ANALYSIS:

People Tend to Focus on What They Can Measure Even if it's Not Predictive:

There is an advantage in investing to having a repeatable process. Unfortunately, in an effort to achieve that, people often focus on what they can track regardless of whether there's valuable information in the metric.

The best example of this I've ever seen relates to the work done by the founders of Long-Term Capital Management. They won a Nobel prize for their work on risk management, and then started a huge hedge fund. Within a few years, the fund suffered losses so great the firm had to be bailed out by the big Wall Street investment banks over fears the losses would cause a market crash and the implosion of the financial system. The performance was so bad that the founders admitted it should have taken multiple lifetimes of the universe to produce a result so awful.

Almost a quarter-century later, billions of dollars are STILL being allocated using the Long-Term Capital Management methods that have been completely discredited by results. (For the curious, this matter relates to considering short-term volatility as the proper measure of investment risk. We disagree.)

Often Wrong – Never in Doubt:

This is an old Wall Street expression referring to people who have great confidence in their conclusions despite not doing much work and having little understanding of the company they're discussing. I've had people insist to me that the stock of a particular company had great value when I know they had never looked at the accounting standards or liabilities of the company. A little humility goes a long way.

▸ Most Long-Term Projections Are Complete Nonsense:

Sell-side research is full of analysts who regularly can't predict the price of a commodity or input for a company over the next year, but still issue detailed ten-year earnings estimates. If you want a sure tell for estimates featuring a high degree of "nonsense", look for what is known as hockey stick projections. These feature years of unimpressive slow growth, but somehow, several years later, the analysts expect the rate of growth to magically double or triple. Sure, there are some situations where this makes sense such as when a long-term capital project reaches completion. But when you see this pattern, it's a good idea to look more closely at the details which would explain the future departure from historical trends.

We often do think about investments in a two to five year time-frame, or even a five to ten year one. In those situations, when a detailed model is likely to be inaccurate, it's best to look for the long-term drivers of revenue and margins. Understanding whether demand for this company's products or services will grow over that time frame along with a clear view of the competitive environment is likely to be more helpful than another Excel model.

CHAPTER VI:

INTELLECTUAL HONESTY:

Never Marry Your Positions:

This is another old Wall Street expression that's stuck around for a reason. Many amateur investors and some professional ones get emotionally attached to a stock. They've spent so much time researching it and have so much capital invested in it (both emotional and financial) that they can't imagine a situation where they're wrong. This is one reason some funds employ performance psychologists.

On occasion, legendary hedge fund manager, Michael Steinhart, would sell his entire portfolio so he could start fresh from a blank position sheet. The act would cost him a little bit in trading costs and profit, but the intellectual exercise of letting go of everything had enormous value.

For me, one of the best parts of investing in liquid equities is I can not only sell a position quickly; but also, take the other side. On more than one occasion, I've sold a stock I owned, and then turned around and shorted the same stock. Sometimes, I've been wrong and changed my opinion. Other times, I've made money, but the stock has reached a valuation that I think is unsustainable. Have close loyal relationships with the people in your life, and be willing to change your mind on any stock you own.

Always Embrace Understanding the Other Side:

Many people avoid the uncomfortable exercise of listening to those who disagree with them. Good hedge fund managers always want to understand the other side. While running Silver Arrow Investment Management, whenever my co-portfolio manager, Raji Khabbaz, and I heard about another fund manager or research firm with a position the opposite of ours, we immediately tried to get a call with them, and would read anything they had published. We once made great returns owning Wayfair (ticker: W) while a famous and well-regarded short research firm thought it was overvalued by more than 80%. In the end, we won that particular round, but only after thoroughly examining and understanding the short thesis against us.

There's an old saying "If you don't know who the sucker is at the poker table, it's you". That often applies in the stock market as well.

CHAPTER VII:

WE ALL SPEND TIME UNDERSTANDING THE MACRO ENVIRONMENT:

▸ We'd All Be Better Off and Richer if a Group of Squirrels Ran the Federal Reserve:

Admittedly, this is from a 2022 Deep Knowledge Investing monthly letter titled "The Squirrel Who Lives in My Backyard is Smarter Than All the Central Bankers in the World Put Together". The reason for this is my backyard squirrel, who is a rodent of unusual character (but normal size), will spend hours a day during the fall running along my fence, and up a tree. He'll then return with one nut to bury for the winter. He runs back and forth climbing constantly and building his stash for the lean winter months one nut at a time. The squirrel saves during the good times to get through the bad times.

Our central bankers "aided" by Congressional overspending made the decision to keep interest rates at or around zero for over a decade and to print massive amounts of currency resulting in huge inflation spikes in 2021 and 2022. This activity resulted in mal-investment and giant unsustainable asset bubbles. When interest rates are artificially low and currency is flooding the market, there is no price discovery, and bad investments get made at ever-higher prices. We would literally have better fiscal policy if we could put a squirrel in charge.

▸ Government Statistics Are Lies:

Many people (including prominent economists and market forecasters) believe government statistics represent reality. This is untrue. These statistics are compiled by government employees to advance a preferred narrative.

The best recent example of this was a change to the way the Consumer Price Index (CPI) calculates the "shelter" component. That's their fancy word for housing. Between 1983 and 1998, the US Bureau of Labor Statistics stopped using actual housing cost, and changed to something called Owners' Equivalent Rent which routinely understates housing cost by a massive amount. Given that shelter makes up about one-third of the CPI, this miscalculation can often mean that the index is understated by as much as 100%.

These changes, which make the CPI less accurate, have taken place under both Republican and Democratic administrations. It's no surprise that no one wants to show high inflation statistics on their watch. As a result, the calculations can get less accurate over time, but rarely more accurate.

At DKI, we regularly check alternative sources of information to determine what's really happening in the housing market, and make our own more-accurate calculation of CPI available to subscribers.

THIS IS WHAT WE DO AT DEEP KNOWLEDGE INVESTING TO CREATE VALUE:

▸ The Biggest Value of Independent Research:

Large firms have lots of resources and big teams. They're also subject to groupthink where there's pressure for everyone to come to the same conclusion, or experience the discomfort of arguing with the people who determine your bonus. Those same firms are rife with conflict and use their "research" departments as advertising to sell investment banking services to the companies they cover. That means job security and big bonuses disappear if the "analyst" writes something a company doesn't like – even if it's true and will help you make money.

Independent research at Deep Knowledge Investing is conflict-free. Our only goal is to help our clients earn high risk-adjusted returns. If that means we say or write things that upset some companies or prominent people, we're fine with that if it helps you understand how the stock market works and can help you make money.

I'm often asked if I own the stocks I have on the DKI Recommended List (available to subscribers). You better believe I do. If it's good enough for you, it means I have my own capital on the line. I'll share your results. Every call. Every time. No conflicts.

Conclusion:

Thanks for reading this. We appreciate your time and attention, and hope that this shines a light into the complexity of the world of finance. Thanks also for your interest in Deep Knowledge Investing. Since our founding in January of 2020, we've helped hedge funds, family offices, registered investment advisors, and individuals earn better returns. If you feel like you've received value from this eBook, or if you're interested in learning more, please subscribe here.