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Ask 'why?' before taking a punt on the sharemarket

Margin Call: Stephen Bennie explains the need for questions for poker and understanding IPOs.

By **Stephen Bennie**
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How to survive, thrive and beat the odds

Dr Maria Konnikova was an experimental psychologist who decided to take a year out to learn how to play poker, with the aim of winning professional tournaments. She wrote the book *The Biggest Bluff* about those experiences. She was fortunate to meet and enlist the services of Eric Seidel who became her mentor. Seidel has won the World Series of Poker eight times and is regarded as one of the best ever professional poker players.

Konnikova was making good progress under Eric's tutelage but it was one of his final lessons that was pivotal in her becoming a tournament winner: "Always ask why." For Seidel, understanding what was driving the actions of the other players is crucial. But equally important is to ask yourself why you are acting and behaving the way you are. Once Konnikova applied this lesson she progressed to playing in higher-stake poker tournaments and, ultimately, winning them.

Why the sale?

The lesson is equally applicable to investors. Understanding what is motivating the actions of other market participants can help you make successful investments and avoid disastrous ones. For example, take initial public offerings (IPOs), which can be the entry level into a fantastic investment or a chance to lose the shirt on your back. Understanding the motivations of the IPO vendor is an important part of assessing the opportunity, especially given the vendor knows a great deal more about the business. Often the vendor in an IPO is a private equity company looking to sell a large portion of its holding at the highest price possible. That is its why: to make as much profit as possible from the offer.

Clearly this is a situation rife with potential conflicts and it pays to look at the track record of the private equity business in question. Those that have been around for many years understand the importance of a successful IPO in being able to come back to the sharemarket with another. But even so there is always a tension here that potential investors need to be aware of. A good one to avoid was Intueri Education Group, where the private equity group selling was not well known and was keen to sell as much as possible at the highest price possible. It had wanted to sell 85% at $2.75 but had to settle for 75% at $2.35. Not a great signal even before the company started to trade on the NZX.

A very different IPO situation was the listing of Trade Me in 2011. The owner was media conglomerate, Fairfax, which was suffering from post-global financial crisis wobbles, structural decline in newspapers, and far too much debt. Something had to be done to prop up the balance sheet and done quickly as the bankers had started to lose patience. Selling a chunk of its non-core New Zealand business, Trade Me, was a good way to raise some much-needed cash. In this case, the why was because the bankers forced Fairfax to and to do so at any price. In our opinion, this created the opportunity to own a good business at an attractive price. It always pays to look closely at what a forced seller is offering you.

Management motivations

Why is also a great question to ask about management motivations. A great answer is when key senior executives are also large shareholders. Their why is generally always going to be about making decisions that create the greatest long-term value for shareholders. This is the best motivation possible and is a situation we find attractive. Current examples in our fund would be Redbubble, Corporate Travel Management, AFT Pharmaceutical, Sezzle, Swick Mining Services, and IVE Group.

Another key why is the one you need to ask yourself every day: why do you own the shares you have? There are many different reasons for holding shares, but you should know your reason(s). Our reason tends to be a simple one: the company in question has the ability to grow earnings significantly in the medium to long term, and the sharemarket has either not realised that, in the case of growth, or doesn’t care, in the case of value. This regular reassessment of why also helps to determine when to sell out, as well as what to own.

Examine failures

The other important why to ask yourself is: why did you get that wrong? Konnikova has a relevant quote regarding this why question: “But it ends up that in unpredictable environments like the stock market, successful high self-control people – when in an environment where control is taken away from them – take longer to figure things out. They are too confident and won’t take negative feedback from the environment.”

Having the self-awareness to deeply examine failures is not a natural trait and, for good reason, it is painful. In the investment industry, there is a phenomenon known as ‘portfolio manager memory’. Winners are enhanced, shares were purchased below where they were actually bought, and losers are played down or just plain forgotten. This is understandable but not helpful as it means you are less likely to learn from your mistakes and so prone to repeat those mistakes in the future.

We believe investors should also take Seidel’s advice on board. Be aware of what is motivating buyers and sellers of shares. Understand what is motivating company management. And understand why you made the mistakes you made. Remember, as long as you don’t make the same mistake twice, progress is being made.

Stephen Bennie is a co-founder of Castle Point, a NZ boutique fund manager.

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