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# Biggest Mistake Investors Make

George J Schultze, February 11, 2020

An investment figure and author works through a series of errors that he sees people make in trying to build wealth. Not all of the mistakes are particularly large, so he also mentions a few of the less damaging errors that arise.

*What sort of classic errors should wealth managers and investors avoid, and what are the red flags they should be alert to? In this article, author and investment industry luminary George J Schultze walks through some of the terrain. (More details about him below.)*

*The editors of this news service are pleased to share these views and invite readers to respond. Email tom.burroughes@wealthbriefing.com and jackie.bennion@clearviewpublishing.com*

There's an old adage that says there are three rules for investing. The first is, "Never lose money." Rule number two is, "Never forget Rule #1," and the third rule is the same as the second. It's a corny line, but it resonates. It's also a series of rules that are difficult for investors to follow because human beings, being human, have a hard time admitting when they've made a mistake.

But an advisor who is unable to acknowledge when they have misjudged a situation and made a bad call can cost their clients a lot of money. Too many investors are unwilling to cut their losses because they have what behavioral finance calls "anchoring bias," which causes them to wait for the price to return to their purchase price before they can bring themselves to sell. By the time they are emotionally prepared to pull the trigger on a losing position, their losses can be much

greater than necessary.

This tendency to anchor on a losing position isn't limited to individual advisors or their clients. It also happens on a much grander scale. Just a few years back, Pershing Square Capital lost almost $4 billion by holding on to its shares in Valeant Pharmaceuticals, long past the point where the holding made any sense.

Pershing had purchased over 27 million shares of Valeant at an average cost of $196/share, and held onto them before finally selling at around $11 each. I'm sure the initial investment fit the asset manager's thesis at the time, but there was absolutely no rational reason for continuing to hold onto those shares as the price continued to drop ever lower. Fortunately, Pershing's returns rebounded the following year.

Speaking as an asset manager with over 25 years of experience managing other people's money, I can honestly say that our best return years have not been those when we had one or two positions that dramatically outperformed the market. Instead, our best years were those in which we got out of losing positions more quickly than other investors, cutting our losses very quickly; this strategy gave our more profitable holdings the opportunity to flourish. Whatever an advisor's investment philosophy, the biggest mistake they can make is not having a system in place to cull losses and the discipline to abide by it. The next two mistakes I will discuss relate more to my own specialty, distressed investing.

One of the biggest errors an investor can make while investing in distressed securities is buying an overly leveraged company. This can lead to tremendous losses as the economy progresses through a complete business cycle. A company saddled with too much debt might look attractive when times are good, and the leverage may amplify those returns. However, the outlook may worsen considerably as the cycle inevitably turns and the enterprise struggles to meet its fixed commitments.

Right now, with interest rates so low, just about any company can borrow money cheaply. If they're using that borrowing to keep the lights on and the doors open, but not doing anything to strengthen the underlying business, that's almost certainly a recipe for eventual disaster. Money may be cheap right now, but it's not free. Companies need to keep making monthly or quarterly interest payments, and eventually the principal on the loan will also be due. When that happens, the eventual turn of the business cycle may make repayment even harder, since customers, suppliers, and other counter-parties will likely be tightening their purse strings at the same time.

The unnaturally low interest rate environment that we're currently experiencing is unique in the history of corporate finance. It has distorted the financing picture for most firms and, as a result, some buyers are increasingly willing to take on extraordinary balance sheet risk through borrowing. As someone who has spent their career looking for investment opportunities in companies going through distress, I know first-hand that many of these borrowers will eventually be rendered insolvent at which point their owners will face the risk of complete loss of capital.

Another common mistake in distressed investing is buying companies with hidden leverage. By that, I mean financial obligations that go by any other name (like tort liabilities, underfunded pension liabilities, leases, or other fixed contractual obligations) but which aren't easily identified as leverage without further analysis. It's very important to carefully study any company before investing significant capital, since there are a number of accounting tricks that may be used to mask hidden leverage.

Fortunately, recent changes to accounting rules have made masking lease liabilities more difficult. Previously, it was common for firms with huge lease liabilities to maintain them as off-balance sheet liabilities. Starting this year, that's no longer allowed. However, some unscrupulous firms with substantial lease obligations are now employing aggressive asset accounting to mask their newly-disclosed lease debt; they do this by marking up corresponding lease right-of-use assets on the other side of the balance sheet.

A recent example demonstrating how lease liabilities can bring down a firm is WeWork. That company entered into $34 billion in lease commitments – even though it generates under $3 billion in yearly revenue. The new accounting rules made it impossible for WeWork to hide this unsustainable leverage from potential IPO investors – thus, the IPO failed and WeWork's executives are still mopping up the mess.

In fact, there are many examples of companies with other forms of hidden leverage. For instance, Pacific Gas & Electric filed its record-setting bankruptcy as a result of its hidden leverage in the form of wildfire tort liabilities. Utilities were once thought of as safe and conservative investments, but PG&E's example shows how tort liabilities can topple even the biggest firms. Boeing is another example of a big company with hidden leverage. It has underfunded pension liabilities as well as tort liabilities for plane crashes.

Moreover, it now faces legal claims from airlines who can't use the grounded 737 Max planes they've already purchased from Boeing. The airline manufacturer's stock was trading at about $400/share in February 2019, having increased in price five months after the crash of Lion Air Flight 610. After the Ethiopian Airlines catastrophe and the FAA's decision to ground all 737 Max aircraft, its share price has dropped to the low $300's and its outlook remains uncertain.

The main takeaway here is that before you put your money into any company, make sure you've done your homework and know what risks you are actually taking on with your purchase. Large passive ETF strategies ignore this rule by definition, which may give us fundamental investors an advantage over time.

When it comes to distressed investing, the primary lesson is that investors should be extremely cautious with over leveraged firms – including those with disguised debt. Whether it's lease liabilities, underfunded pension liabilities, underfunded employee healthcare liabilities, tort liabilities, or any other thing that can be reasonably considered analogous to debt, you should be alert when you see it. In fact, you should avoid investing in any company with those kinds of liabilities, unless the price is commensurately attractive compared with the risk of future distress and insolvency.

The corollary lesson is that, no matter how diligent your research, you might still be wrong. Don't be afraid to admit it and cut your losses quickly. Learning from other investors' mistakes could make it a lot easier to follow the main investing rule to "never lose money."

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