

MICHAEL BURRY INVESTMENT STRATEGY

In 2000, Michael Burry wrote an article for MSN Money describing his investment philosophy and how he went about picking stocks. This article is reprinted for you below. Enjoy!

My strategy isn't very complex. I try to buy shares of unpopular companies when they look like road kill, and sell them when they've been polished up a bit. Management of my portfolio as a whole is just as important to me as stock picking, and if I can do both well, I know I'll be successful.

Weapon of choice: research

My weapon of choice as a stock picker is research; it's critical for me to understand a company's value before laying down a dime. I really had no choice in this matter, for when I first happened upon the writings of Benjamin Graham, I felt as if I was born to play the role of value investor. All my stock picking is 100% based on the concept of a margin of safety, as introduced to the world in the book "Security Analysis," which Graham co-authored with David Dodd. By now I have my own version of their techniques, but the net is that I want to protect my downside to prevent permanent loss of capital. Specific, known catalysts are not necessary. Sheer, outrageous value is enough.

I care little about the level of the general market and put few restrictions on potential investments. They can be large-cap stocks, small cap, mid cap, micro cap, tech or non-tech. It doesn't matter. If I can find value in it, it becomes a candidate for the portfolio. It strikes me as ridiculous to put limits on my possibilities. I have found, however, that in general the market delights in throwing babies out with the bathwater. So I find out-of-favor industries a particularly fertile ground for best-of-breed shares at steep discounts. MSN MoneyCentral's Stock Screener is a great tool for uncovering such bargains.

How do I determine the discount? I usually focus on free cash flow and enterprise value (market capitalization less cash plus debt). I will screen through large numbers of companies by looking at the enterprise value/EBITDA ratio, though the ratio I am willing to accept tends to vary with the industry and its position in the economic cycle. If a stock passes this loose screen, I'll then look harder to determine a more specific price and value for the company. When I do this I take into account off-balance sheet items and true free cash flow. I tend to ignore price-earnings ratios. Return on equity is deceptive and dangerous. I prefer minimal debt, and am careful to adjust book value to a realistic number.

I also invest in rare birds -- asset plays and, to a lesser extent, arbitrage opportunities and companies selling at less than two-thirds of net value (net working capital less liabilities). I'll happily mix in the types of companies favored by Warren Buffett -- those with a sustainable competitive advantage, as demonstrated by longstanding and stable high returns on invested capital -- if they become available at good prices. These can include technology companies, if I can understand them. But again, all of these sorts of investments are rare birds. When found, they are deserving of longer holding periods.

Beyond stock picking

Successful portfolio management transcends stock picking and requires the answer to several essential questions: What is the optimum number of stocks to hold? When to buy? When to sell? Should one pay attention to diversification among industries and cyclicals vs. non-cyclicals? How much should one let tax implications affect investment decision-making? Is low turnover a goal? In large part this is a skill and personality issue, so there is no need to make excuses if one's choice differs from the general view of what is proper.

I like to hold 12 to 18 stocks diversified among various depressed industries, and tend to be fully invested. This number seems to provide enough room for my best ideas while smoothing out volatility, not that I feel volatility in any way is related to risk. But you see, I have this heartburn problem and don't need the extra stress.

Tax implications are not a primary concern of mine. I know my portfolio turnover will generally exceed 50% annually, and way back at 20% the long-term tax benefits of low-turnover pretty much disappear. Whether I'm at 50% or 100% or 200% matters little. So I am not afraid to sell when a stock has a quick 40% to 50% a pop.

As for when to buy, I mix some barebones technical analysis into my strategy -- a tool held over from my days as a commodities trader. Nothing fancy. But I prefer to buy within 10% to 15% of a 52-week low that has shown itself to offer some price support. That's the contrarian part of me. And if a stock - - other than the rare birds discussed above -- breaks to a new low, in most cases I cut the loss. That's the practical part. I balance the fact that I am fundamentally turning my back on potentially greater value with the fact that since implementing this rule I haven't had a single misfortune blow up my entire portfolio.

I do not view fundamental analysis as infallible. Rather, I see it as a way of putting the odds on my side. I am a firm believer that it is a dog eat dog world out there. And while I do not acknowledge market efficiency, I do not believe the market is perfectly inefficient either. Insiders leak information. Analysts distribute illegal tidbits to a select few. And the stock price can sometimes reflect the latest information before I, as a fundamental analyst, catch on. I might even make an error. Hey, I admit it. But I don't let it kill my returns. I'm just not that stubborn. In the end, investing is neither science nor art -- it is a scientific art. Over time, the road of empiric discovery toward interesting stock ideas will lead to rewards and profits that go beyond mere money. I hope some of you will find resonance with my work -- and maybe make a few bucks from it.

SUMMARY

In summary, Dr. Michael Burry's investment strategy can be described as follows:

- **Invest with a margin of safety.** Michael Burry's main goal is to protect his downside so that he can prevent a permanent loss of capital. Consequently, known catalysts are not necessary; sheer, outrageous value is enough.
- **Perform bottoms-up, fundamental research.** Michael Burry doesn't care about the level of the stock market, and he has no restriction on potential investments: they can be large cap stocks, small cap, mid cap, micro cap, tech or non-tech. It doesn't matter, as long as Burry can find value in it. That being said, Burry has found that out-of-favor industries provide great opportunities to buy shares of best-of-breed companies at steep discounts.
- **Screen through large numbers of companies by looking at the EV/EBITDA ratio.** Acceptable ratios vary with the industry and its current position in the economic cycle.
- **Intrinsic value is determined by free cash flow.** If a stock passes this loose screen, Burry then looks harder to determine a more specific price and value for the company. This involves looking at true free cash flow and taking into account off-balance sheet items. Burry tends to ignore price-earnings ratios and thinks that return on equity is both deceptive and dangerous. Burry prefers minimal debt.
- **Michael Burry also invests in "rare birds"** - mostly asset plays, but also arbitrage opportunities and companies selling at less than two-thirds of net value (net working capital less liabilities, i.e. Ben Graham's net-net stocks, or companies that are selling for less than their liquidation value).
- **Burry also mixes in the types of companies favored by Warren Buffett** - companies with a sustainable competitive advantage, as demonstrated by longstanding and stable high returns on invested capital - if they become available at good prices. These can include technology companies, if Burry is able to understand them. Burry also classifies these types of Buffett-style investments as rare birds, and - when found - believes they are deserving of longer holding periods.
- **Michael Burry believes that portfolio management is just as important as stock picking:**
 - **Number of stocks to hold:** Burry likes to hold 12-18 stocks diversified among various depress industries. This allows him to focus on his best ideas while smoothing out volatility (not to reduce risk, but to reduce personal stress).
 - **When to buy:** Burry uses some rudimentary technical analysis to determine when to buy a stock – specifically he prefers to buy within 10-15% of a 52-week low that has shown itself to offer some price support.
 - **When to sell:** Burry's turnover generally exceeds 50% annually. He's not afraid to sell if a stock has had a quick 40% or 50% pop. Burry will also sell a stock if it hits a new low. While he acknowledges potentially turning his back on greater value, Burry says this prevents any on stock from blowing up his portfolio.
- **Investing is neither science nor art... it's a scientific art.** Finally, Michael Burry says that fundamental analysis isn't a sure-fire way of succeeding in the stock market – but it *does* at least put the odds on your side.