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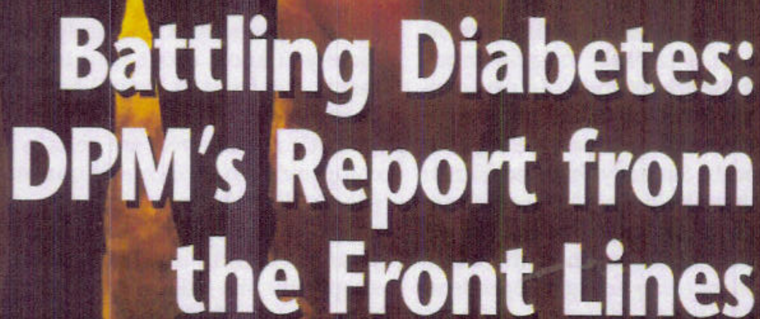

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Can Your Medical Knowledge Enhance Investment Yields?

Podiatrists are in a unique position to invest in medical companies.

By Steven Abernathy

Podiatrists have a unique perspective on the medical products and technology they use in their practice. This knowledge might provide an unexpected benefit: the potential for above-average investment returns.

The strategy—Collaborative Investing®—combines the two most important components of successful investing: product information (from the physician) and financial analysis (from the professional money manager). It's a unique way for podiatrists and other doctors to share their expertise with a professional money manager partner in selecting high quality, long-term investments.

Unless one has personally been treated for bunions, an investment manager is unlikely to know much about the effectiveness of a new digital foot scanning device or whether other devices may provide superior diagnosis. Similarly, busy podiatrists may have little time for in-depth investment analysis. The interaction helps overcome much of the inherent risk of either acting independently while taking advantage of the intrinsic volatility of the medical sector. Who knows more about the medical industry's products and technology than its users?

Nowhere in today's society is specialization better understood than in medicine. Investing can be viewed similarly. How often do you suppose doctors invest in a promising medical development only to see the investment fail because of the company's poor management or over-leveraged financial structure?

Similarly, professional investors regularly make poor investments in medical technologies, not because of poor financial analysis but because they lacked user product knowledge.

Information Versus Diversification

There is a widely held belief in the investment community that the best way to reduce portfolio risk is through diversification; but reducing risk exclusively through diversification can mean reducing potential returns. Diversification is inversely proportional to the information available when making investing decisions. The less you know about your investments, the more you need to diversify. Conversely, the more you know about your investments, the less you should have to diversify.

Let's assume you are certain a company's share price will quadruple during the next quarter. It would be foolhardy to divert any of your investable assets elsewhere simply for the sake of diversification. You would be increasing risk by diversifying into less certain investments and reducing returns by investing in companies not certain to match quadruple performance. Of course, there are no crystal balls that provide such future knowledge, but while diversification is advisable, even necessary, better knowledge can reduce the amount of diversification needed while lowering risk and increasing returns.

As your information improves, you can follow and invest in a smaller number of companies. This allows for construction of a portfolio containing a smaller number of quality companies with risk no greater than those containing two or three times as many holdings. In addition, it's easier to monitor a smaller number of investments.

Uncovering Repeating Variables

The concept of Collaborative Investing® is deceptively simple. Its successful execution over an extended period relies on intensive research and analysis far beyond the medical technology insights of a few hundred doctors. The feedback from physicians is only one aspect, although an important one, of a complex analytical process.

Analysis of historical data accumulated over one hundred years of investing in companies with undervalued assets reveals a repeating pattern: certain variables that consistently reappear in a predictable pattern. Converting that knowledge into a series of financial variables—formulas—distinguishes investments likely to be successful or unsuccessful. These variables include:

- Market capitalization equal to cash, net of debt
- Increased cash flow during the previous quarter
- Stock price up over during the previous quarter

When any of these variables are present, the chances for a successful

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investment are somewhat elevated. When all three are present, a unique leveraging dynamic is created, a sort of recipe for probable success. Companies that display these ratios—plus several other proprietary criteria—are likely to be winners. The formulas lead to selection of companies both more likely and less likely to appreciate than the average company in the S&P. While the formulas do not work every month, over any significant period of time, the methodology produces positive results 76% of the months versus 65% for the S&P.

The methodology is also a more efficient way to find profitable investments than entertaining ideas from analysts, brokerage houses or other traditional methods of finding companies. It is more systematic and reliable, less subject to error, and uncovers both overvalued and undervalued stocks. For example, one recipe may uncover companies with characteristics such as 20 x sales or 100 x earnings, which we know from experience rarely become profitable investments because the investment community's expectations are too high.

Another recipe may uncover companies with traits that are comparably undervalued, which are likely to become profitable investments. It is this amalgamation of two strategies within a portfolio—companies shorted because they are absurdly overpriced, and others held long because they are close to tangible book value accompanied by positive changes. This delivers volatility and risk half that of the S&P 500, and gains well above the S&P. Just as important, the amount of investor capital at risk is dramatically lowered.

Avoiding Losses

All of this contributes to minimizing investment losses, the single greatest threat to the preservation and growth of capital.

Investors tend to pick stocks the way they pick Sunday football games—with their hearts instead of their heads. If they have a couple of winning days, they can brag about their analytical prowess to their family and friends. Forgotten in the excitement is how much of their gains were lost by choosing losers on other weekends.

Next time you talk to a friend or associate, ask about the winning stock in his portfolio. Chances are you won't be able to shut him up. Everybody loves to boast about one's stock victories, and how much profit was made. It's like asking how someone did in Vegas. Everyone wins, of course. Nobody ever takes a beating and admits it, right?

Your investor friends can tell you with great accuracy how much their favorite stock gained in the last week or last year. They also know exactly how much their portfolio is up—or down. While they can probably recall the grisly details of their big losers, they are unlikely to have any inkling of how much they gave up in total portfolio return because of their losers. Nobody wants to dwell on losses. Money managers don't want investors thinking in terms of losses. Even the savviest investors typically are unaware of how much they give back in losses.

The less you know about your investments, the more you need to diversify.

The secret about losses is this: you can give up a significant chunk of your portfolio gains in exchange for avoiding losses and still come out way ahead on overall performance. The key is avoiding big or extended losses.

What to Evaluate

Here are some factors to consider in an investment strategy:

• The physician base should be large and diverse in both discipline and geography in order to produce valid product and technology insights. The popularity of an off-label drug like Tagamet for the treatment of verruca among podiatrists in Chicago may not be shared by their counterparts in Los Angeles or New York. Some products do very well regionally, but never catch on nationally; the same is true for certain technologies. A common error made by inexperienced financial analysts or investment managers is to interview a leading doctor and extrapolate his recommendations all across the nation.

Speaking from personal experience, it is imperative to have vertical as well as geographic diversification of opinion and advice. Within reasonable limits, the greater the size and diversity of the medical base, the better the chances for lowering risk without adversely affecting portfolio returns.

A medical or technology company whose stock is destined to go from 35 to 40 is going to do it whether you as an investor have good information or not. The difference is that good information reduces your risk.

• Both parties must invest together. A significant portion of the financial advisor's assets should be invested in the portfolio. If not, why should you invest yours? Advisor and doctor should eat at the same table.

• The financial advisor's compensation should tie directly to portfolio growth. Performance justifies compensation. There's no reason to pay someone to lose your money.

• Podiatrists should have at least a 3 to 5-year investment horizon to invest. If the funds are likely to be needed in the shorter term, a less volatile alternative, such as bonds, would be appropriate.

• The financial advisor should have a documented history of investment success over more than one economic cycle; a minimum of a ten-year track record. Anything less could be coincidence rather than competence. ■

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