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The 52-Week Low Formula

A CONTRARIAN STRATEGY THAT LOWERS RISK, BEATS THE MARKET, AND OVERCOMES HUMAN EMOTION

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To the five most candid and loving board of advisors who help me become the person they know I am capable of becoming:

my wife, Melissa (Grounded)

daughter, Madyson (Justice)

son, Jake (Humility)

daughter, Leah (Strength)

daughter, Morgan (Joy)

There is one side to the stock market; and it is not the bull side or bear side, but the right side.

—*Reminiscences of a Stock Operator* by Edwin LeFevre, 1923

The conventional view serves to protect us from the painful job of thinking.

—John Kenneth Galbraith

There is nothing like losing all you have in the world for teaching you what not to do. And when you know what not to do in order to lose money, you begin to learn what to do in order to win. Did you get that? You begin to learn!

—*Reminiscences of a Stock Operator* by Edwin LeFevre, 1923

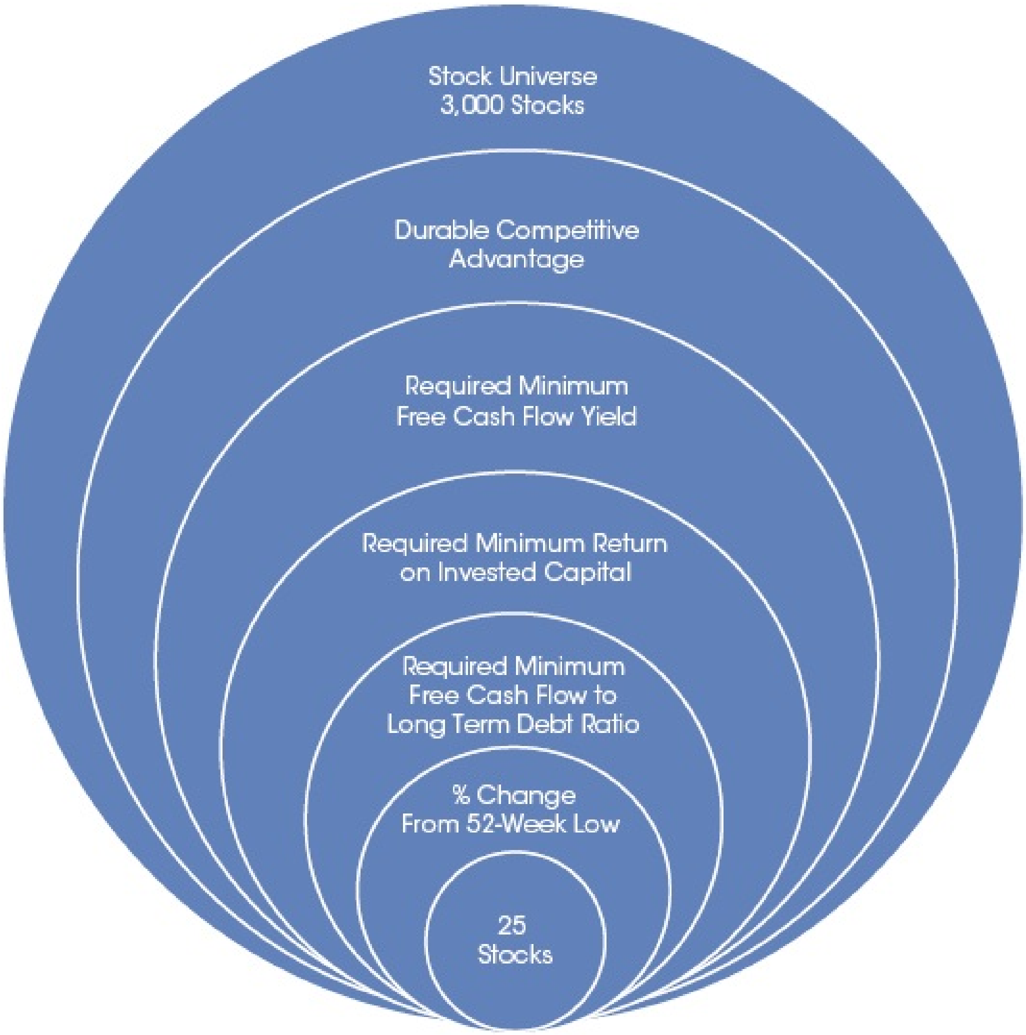
The only function of economic forecasting is to make astrology look respectable.

—John Kenneth Galbraith

The simpleton believes everything, but the shrewd man measures his steps.

—Proverbs 14:15

The 52-Week Low Five Filter Formula



Introduction

Would you like to become a mediocre investor? Do you have an interest in buying high and selling low? Do you seek out information that only confirms your beliefs and emotions? Do you believe the stock market is merely a crapshoot and only the ultra-wealthy make money in it?

If you are answering “no” to all or most of the preceding questions or would like to answer no to them, then I believe my book will help you achieve the opposite of those questions—instead of mediocrity, you can achieve far better. My strategy, if properly followed, can insulate you from mediocre investment results. This book explains how to more effectively buy low and sell high on an ongoing basis. It is also a book about how to be a better thinker in many areas of your life.

I am the last person I ever thought would write a book. In fact, in my senior year of high school I took calculus twice, not because I failed the first semester but because I actually had a knack for math, and it was the highest level of math offered. I actually thought I would be a math teacher. In fact, it is sad to say that I read only one book in high school, and that was reflected in my substandard scores on the high school aptitude tests due to my below-average English skills. I was the guy who scored substandard on my ACTs, the guy sweating up a storm on the soccer field, the kid who shopped at the Salvation Army while my classmates went to the Gap. In my young life, it would have been hard to imagine reading a book, let alone having enough to say to write one.

Then again, maybe it wasn’t so surprising because I’ve never been one to conform to conventional wisdom and, despite my standardized test scores, I have had one big advantage over a lot of other people: a willingness to learn and an internal fire to disprove some of the widely held beliefs of society that kept me working long after most other people would have given up.

I grew up in a military family. My dad was in the Air Force and we moved around quite a lot when I was young, eventually settling in Florida. I was the oldest of the three brothers, the one who went first in everything. In those important developmental years, I was always the new kid in class. To many, this would have been a disadvantage, but without the influence of an older sibling and constantly having to make new friends, I was given a gift—a blank slate on which to form my own opinions and approaches. I think it was a blessing that my parents had me at age 18 and that we shopped at the Salvation Army until I was 12, when my father received his bachelor’s degree in mechanical engineering. My parents showed me through their actions the value of doing things that go against the status quo—young parents, young marriage, college degree midway through career, the value of a dollar, delayed gratification, and many other actions that challenged the norm.

It would be years before I would read a book by Berkshire Hathaway cofounder Charlie Munger and learn about the seventeenth-century German mathematician Carl Gustav Jacob Jacobi and his cardinal rule: “invert, always invert.” That cardinal rule would become my mantra, the way I thought, the way I solved problems in later years, but I think I innately understood what Jacobi was talking about early on in my life, that many of the hardest problems in life are best solved in reverse. It had been the way I lived my life.

Inversion, the way Jacobi described it, is the process of solving problems by first understanding the opposite approach. Understand a desired outcome and, rather than designing a solution for that outcome, design the solution for the opposite. If you are trying to be healthy, figure out all the steps and processes that would make you sick and do the opposite. If you want to build wealth and be financially successful, figure out all the steps that will ensure that you will become destitute and do the opposite. To hit this critical thinking exercise home, I would like to share with you some of the key points within the commencement speech given by Charlie Munger in 1986 to the Harvard School.

Charlie did not tell the graduating class all the ways to be successful but actually laid out the prescriptions for guaranteed misery in life. He expanded on Johnny Carson's three prescriptions to guarantee misery:

1. Be unreliable.
2. Learn only from your own personal experience; minimize what you learn from others.
3. Go down and stay down when you get your first, second, and third severe reverses in the battle of life.

I have actually applied this inversion to my marriage. Instead of asking yourself how you can have a fulfilling marriage, ask yourself: What are the surest ways to have a miserable marriage? Or the extreme—what are the surest ways to destroy my marriage? Or get a lack of respect from my kids? Or live a life of mediocrity? In fact, when I think about it, I pretty much think this way consistently. It is not that I am a pessimist; quite the opposite, actually. I try to think about the negative consequences first, and then strive to make the right choices. Do you remember when you were a kid and you set out to complete the hardest mazes? When you started at the end of the maze, you were more likely to be successful at completing it, and faster than others who took the common path—starting at the beginning.

If you want to build wealth above and beyond the average, figure out how to attain the average and work backwards from there. If you are the new kid in a school and want to make a bunch of new friends, figure out how you would fail and avoid those steps.

It works like this.

Identify the desired outcome:

I want to be a successful investor throughout my lifetime.

Inverse:

I want to find the proven ways to be unsuccessful as an investor.

Solve for the inverse:

What are the behaviors, the messages from the investment world, the mindset, the emotions, and the investment strategy that could help me guarantee substandard and quite disappointing investment results?

Do the opposite:

Seek out research that refutes your deeply held beliefs about investing. Seek out individuals, both living and dead, who you can learn from to help insulate you from poor decision making. Take time to objectively study the lack of accuracy of economic forecasts and analysts' recommendations. Make it a point to understand the various human biases that can negatively impact your desired outcome. Develop a strategy that is built on logic and value and not on emotion and enthusiasm.

This is, in essence, the exact exercise I performed several years ago. I was determined to find a better way forward for our clients, my family, my parents, and future grandchildren.

Had I been like thousands of other high school seniors who achieved less-than-spectacular results on standardized exams, I might have followed a path of less resistance. I would have gone to school and skated by. But a substandard aptitude test in high school was the spark I needed to take a hard look at how to disprove what these tests were forecasting about my future potential. The aptitude tests revealed the potential outcome of my life and helped me realize that what lay ahead was the opposite of the outcome I desired. What followed was a Division I soccer scholarship and a collegiate career built on dean's list performance while carrying three very challenging majors: finance, economics, and real estate. I forced myself to outwork and outthink all my peers because I knew what I didn't want. I knew I didn't want to be just another average student with just another average postcollege career. I wanted more and rose to the challenge.

All this may seem like I am bragging. It may seem like I'm giving you a resume, and I suppose, in a way, I am. But not for the reason you might assume. I mention some of my experiences to help you understand the journey I made on the way to writing this book. I mention overperforming in college to help explain the way I think, because all of these experiences and attributes were at play when I began my career in finance. And they are certainly not unique to me. Think of the most successful people you know. I'd be willing to bet very few of them have settled for their lot in life. Successful people are generally successful thinkers. They begin with the end, and rather than simply laying a sequential plan for getting there, they think of the things that will get in the way and make their plans to compensate for those challenges. They identify the potential problems and avoid them, and they do so with vigor. Some do it consciously, some do it instinctively, but I'd be willing to invest in the notion that they all do it—they solve for the inverse.

Henry David Thoreau once said, "Most men lead lives of quiet desperation and go to the grave with a song still in them." He was talking about living an action-oriented life, but you can take that same idea and realize that what he was also talking about was hope. Hope is a troubling emotion. Economists would probably link hope to the sunk-cost cognitive bias. You've invested in your life, your education, your career, and your portfolio, with the hope that it will result in something fulfilling, something rich, something to quench your quiet desperation. What is actually happening is that you are following a path without a clear destination in mind.

If fitting in in junior high is about conformity, the world of finance is the largest seventh-grade lunchroom in the world. True, there are plenty of examples of the exceptions. You will read many references to Warren Buffett in the pages that follow. But for every Buffett or Munger, there are literally thousands of men and women selling the same mutual funds recommended by the same analysts, and packaged by the same companies.

Why? Well, for one thing, it's easy. A college graduate can make a nice living recommending index funds and mutual funds. There's safety in it. The old adage "no one ever got fired for buying IBM" was meant to describe the complacency of technology purchasing a couple of decades ago, but it is perhaps even truer in the investing world. No one ever got fired for buying the Standard & Poor's (S&P) 500 Index or the most admired mutual fund. So the safety makes it easy. But, more than that, there seems to be a lack of healthy skepticism in many of the financial professionals I have come across over the years.

In addition to the quote from Jacobi, one of my favorite quotes is from President Ronald Reagan, who said when describing U.S./USSR relations, "Trust, but verify." It means that it's okay to trust the way things are done, so long as you have the stamina and dedication to understand why they are done. I'm a trusting person, but I'm also the kind of person who does his homework. College and the sense that I needed to change the path that I had created for myself with substandard test scores proved the value in double-checking conventional wisdom. Take the time and make the effort to understand before blindly following the path in front of you. The result will help you understand the logic behind choices that are commonly made, and also to begin to comprehend their shortcomings.

This is what happened to me as a young financial professional. I toed the party line. I sold the securities recommended by the analysts and even allowed myself to get caught up in the headlines, hype, and talking heads on cable television. I tried to keep up when I should have been digging in and asking questions. Eventually, I began to ask questions. I trusted the analysts and the products, but I began the process of verifying them, and what I found was a better way.

I've spent over 15 years perfecting that better way, molding and shaping it. I've worked with clients and sought experts. I've paid for my own research and invested my own money. I've taken losses and made gains, all in the name of verification. I've inverted nearly every aspect of investing—not just the mechanical and financial side of it, but the emotional and social forces that influence the way we make investing decisions. And the result of this relentless pursuit is the book you are holding now and the principles behind the 52-Week Low formula.

There are literally thousands of investing books. Many of them make big promises about overnight gains. Many of them make claims of extraordinary gains in unprecedented short periods of time. A lot of them want to tell you the "secrets" of investing. I've read a lot of them. I've dissected them. And I have concluded:

- There are no "secrets" to investing well. Good investing comes from strategy and process, not from uncovering some never-before-seen corner of the market. The only rule that really applies is this: buy low, sell high. On the surface, it is simple and it should be.
- Too many of us overcomplicate investing. We don't do it knowingly. It just happens. We get caught up in the hype. We have an instinct to follow the herd. We allow emotions—namely, hope and fear—to cloud our judgments. Investing is not as simple as, say, chewing gum, but it doesn't need to be as complicated as we often make it out to be. We get in our own way when we don't have a process that mandates simplicity.
- There is no magic wand. Just because you heard a tip from a guy who knows a guy who knows Bill Gates does not mean you know anything at all. Trying to bet on the next big thing is not investing; it is gambling. Feel free to do it, but don't play with your mortgage money. I often tell clients that investing in the "next big thing" is as much a retirement strategy as trying to bottle lightning as a strategy for lighting your living room. It doesn't make sense. A good investment strategy is as much about mitigating risk as it is about maximizing returns.
- Investment performance is a long-term construct. If you are reading a book to find one investment that should produce the "big win," you're probably doing the wrong thing. Unprecedented gains are about luck, not skill. I would rather focus on the skill that builds over time than rest my chances on the luck that more often than not leads to heartbreak.
- There's no such thing as a perfect pick. It may seem like Apple is a good idea or that investing all of your money into the stock of the bank you work for makes sense, but it doesn't. My batting average with the 25 companies I buy every six months that make up the 52-Week Low strategy is around .700 to .750. That means three out of every four companies on the list grow during the period I own them. This is a terrific return, well above the average. But it also means that at least one out of every four is wrong. The key is to insulate yourself from being wholly invested in one thing, be it a company or a mutual fund.
- This time is never different. If rule number one of investing is buy low, sell high, then this is rule number two. At the time I am writing this, both the Dow and the S&P are setting new record highs every day. Only a fool thinks this will continue forever. This doesn't mean the 52-Week Low is only about not losing money as opposed to making money. Quite the contrary. You'll see that the strategy consistently outperforms the market, but it doesn't always outperform the market. Sometimes the market soars to new heights, well beyond what the 52-Week Low could achieve. But what goes up must come down, and this strategy is as focused on managing the inevitable downturn and returning to profitability as quickly as possible as it is about taking advantage of large gains. Healthy skepticism protects the realistic. Not having it leaves you exposed to the risk of unintended consequences.

- There is a sharp difference between the mindset of an investor and that of a believer. The 52-Week Low is designed to take emotion as far out of the equation as possible. Emotion blinds us to opportunity and risk. The reason this strategy performs as well as it does is that it helps to take emotion out of the consideration set when making a decision. Mine. Yours. My clients'. As an investor, it's important to disassociate how you feel about a company from the likelihood that company has of making you money. I always laugh when I read a headline about someone's hope for a stock or fear of a trend. Hope and fear are not based on data, they are based on response. It may seem cold. It is not meant to be. I am not a robot. I am an emotional being, just like you and everyone you know. But I recognize the risks that go with feeling and have done my best to remove risk as much as possible.

The 52-Week Low is not a get-rich-quick scheme. I do not and will not promise huge gains. What I will do is show you how having a consistent strategic approach to recognizing opportunity and mitigating risk will benefit you and your investments. I will show you how inversion and a willingness to trust—but verify—should lead to better results. And I will encourage you to do your homework when it comes to the strategy. I have had two independent back tests of the strategy, one of which was performed going all the way back to 1980. The results have been consistent. The 52-Week Low has had a high consistency of outperforming the market in both up markets and down markets. It has mitigated permanent loss during market catastrophes and provided for fast recovery in the aftermath.

Ever since I was a kid, I've understood the value of inversing. And now I encourage you to do the same. I may be the last person I ever expected to write a book, but if I've learned one thing about life and investments, it is this: never trust what you expect. It's always better to trust what you can know.

I hope you will read the pages that follow with an open yet critical mind, because there is no such thing as certainty, particularly when it comes to investing. But after having spent half my life looking for a better way, this is the closest I believe we can come to it.

You will also notice that I don't just cover the mechanics of investing or the filters that drive the 52-Week Low formula in this book. I also cover the biases and cognitive behaviors that drive investors—too often in the wrong direction. Making good investment decisions often requires overcoming these biases and behaviors, going against instinct in pursuit of logic, and sticking with a strategy. I won't dwell too long on these, as there are a lot of great resources out there that help us understand why we make decisions the way we do. But I would be remiss if I ignored the human side of investing completely.

Finally, you will find a series of case studies based on both actual performance and independent back testing that proves the 52-Week Low to not only deliver better performance but mitigate risk and provide faster recovery after periods of great loss in the market. For a full 30-year back-testing report, contact me at **www.52weeklow.com**.

Case Study: Author Profile

Jacobian Inverse: *If I want to remain mediocre and experience a life of misery, I would rather respond to the environment around me than make the effort to change my reality. I will make a habit of finding all the reasons why I am a victim. I will definitely have no interest in challenging collective wisdom, as I am just a small fish in a big pond. If I want to learn as little as possible from this book, I will not seek to understand who the author is, his or her motivation for writing the book, and what circumstances led to its creation. If the author of the book is an expert, I will not learn about how that expertise was gained. I will focus only on the words and do as little as possible to understand the meaning beyond the pages.*

Who do I think I am to write this book, and what do I know about proving collective wisdom or common assumptions wrong?

It's an important question. You're going to read a lot about process and data, numbers, and analysis in the pages that follow. You're going to read my thoughts about removing emotion and emotional investment from the investing process. You're going to read about Warren Buffett and Michael Porter and dozens of other luminaries in the world of finance. You're going to read about companies that have struggled and the opportunities those struggles have created. You're going to read about cognitive biases and the forces that shape the way we make decisions. But you are going to read a little about me and my experiences that have led me to question the common wisdom and have given me the confidence to pursue the right path, not just the one trampled and trodden by those that have come before me.

And the impression that all of these things may leave is an unfounded belief that I am not a people person and that my reliance on logic and data somehow remove the humanity from the relationships I have with my clients, my family, my friends, and loved ones. This is wrong. If I have learned anything at all in more than 15 years of working in the wealth management industry, it is this: it is a relationship business.

The relationships you form with clients are based on your ability to create value—not just monetary value, but real value—in their lives. It's not all that different from the relationship a reader has with an author. The reader has to invest himself in the author—not just his words—in order to derive value from the book. He has to have a feeling that he understands who the author is and what makes him tick before he will lend credence to the author's thoughts, theories, or ideas.

When I'm meeting with a client for the first time, we sit down and talk about each other's lives long before we talk about business. With existing clients, the meetings follow the same pattern. I'm never comfortable ending a meeting without making a human connection. As a financial strategist and adviser, it's important that clients trust me. As a husband, it's important that my wife trusts me. As a father, it's important that my children trust me, and it's important to me that they know who I am. The same goes for my friendships and other relationships. I want them to trust me, to know me.

I want the same of you.

I want readers like you to understand who I am so that you will understand the information I'm conveying a little better. I want you to know that I'm someone who cares very deeply about my clients and considers them to be friends and family, not just a name on an account. I take that responsibility seriously. I welcome it.

This was the central point in my struggle when deciding whether to write about myself. But, with the help of some friends, I've come to realize that readers will not get as much out of this book as I hope they do without understanding a bit about me. So rather than writing a full biography or transcribing my resume, rather than bragging about success or wallowing in defeat, I thought I would start with one crucial and central question and do my best to answer it in the most relevant way possible: Who am I?

I am a man who has been very fortunate in my life to have the opportunity and mindset to challenge common beliefs. I have been able to overcome obstacles and the process of overcoming them has been integral in forming my approach to everything—life, work, relationships, and financial independence by the age of 33.

I am a big believer in challenging the status quo, of going against the grain. But I don't believe in doing so for sport. That is, I don't subscribe to the notion that simply because something is common knowledge or accepted practice, it necessarily is wrong. Rather, I take a scientific approach to life. I experiment and do so with the honest intent of challenging assumed results and creating better outcomes.

You might say that I'm the kind of person who doesn't take "no" for an answer, but I've been told "no" a lot in my life. There are times when "no" is the answer you have to accept because it is the right answer—the only answer. Instead, I'm the kind of person that doesn't accept "no" at face value. I want to understand why it is. I am curious about the ways "no" can be morphed into something different, perhaps even "yes."

I'm also not the kind of person that likes to sit still, to take the path of least resistance simply because it is less resistant. Instead, I keep challenging myself and my thinking. I challenge other people's approaches but am more than happy to accept when their approaches are simply better than mine. The only way to do this, to keep moving forward regardless of how, is to be completely and totally devoted to improvement and results.

I make no claims that my approach—to life and the 52-Week Low—is groundbreaking economic theory. In fact, it's kind of the opposite. Far from revolutionary and complex, the 52-Week Low simplifies the act of investing by removing complicating factors: emotion and biases. It focuses on the core, the purest desired results of any investor—improvement. Improvement in times of gain. Improvement in times of loss. Improved results and improved value.

When I’m sitting down with clients, the thing I want them to understand about me is that I am constantly going to question, to investigate, to find a better way forward. I do this on their behalf and with them in mind. It is not a matter of ego. It is a matter of gratitude. I am grateful that they have invested in me, both emotionally and financially, and I feel the responsibility of duty—the duty to make good decisions, to act with them in mind. I feel the same duty to you.

The fact is that there was no way I could not write this book and share it with the world. Part of me thought about keeping the 52-Week Low mindset and philosophy with only my business partner and brother, Zach, but as I think about my legacy and how I want to leave a lasting positive impact on the world, I had to follow my will and heart to ensure that sharing this became a reality. When I think about the value I bring to others, I believe it is one of hope and one of paradigm shifting. Through extensive reading/research, I have come to realize that the biggest competitor each of us faces is not external factors—it is our minds.

This book represents my life’s work to date. It is a detailed study into the process and strategies that have led to my personal and professional successes. It is not intended to be the be-all, end-all of investing books, but an introduction to a new way of thinking, a different way of thinking.

Now that you know a bit more about who I am, I hope you can answer for yourself who it is I think I am to write this book. And I hope you can read it with that same understanding and appreciate the life experiences and mental makeup that made discovering and refining a strategy like the 52-Week Low not just possible but inevitable.

Foreword

Luke Wiley starts *The 52-Week Low Formula* with a personal confession that he was not the best student when he was young, so it only makes sense that, as a friend, I make a personal confession of my own: I once believed I was going be the next Warren Buffett.

As a child, I raised animals and sold them at the county fair. And with my growing savings came decisions—what to do with the money? To jumpstart my learning, my grandmother gave me a copy of Benjamin Graham's *The Intelligent Investor,* which describes the philosophy of value investing. I was 12 at the time, and instead of being overwhelmingly appreciative, I was secretly depressed I didn't get a Nintendo. Nonetheless, I read the book and loved it. I was hooked on value investing.

Over the next 10 years, I devoured books on value investing and eventually put my hard-earned knowledge to work, investing in value stocks and special situations. Part of my investing education included the finance PhD program at the University of Chicago. The first two years of the program were similar to drinking from a high-powered fire hose that spewed sometimes unintelligible information and math equations from the leading scholars in finance. It was not always the most enjoyable experience. However, I persevered and met Professor Nick Barberis, who was researching the intersection between financial economics and psychology, a growing field that has since come to be known as "Behavioral Finance." I took Professor Barberis's PhD seminar and read hundreds of academic papers on behavioral finance. Although I wasn't sure how I could apply my new knowledge, I recognized that psychology was a powerful force in truly understanding financial economics.

My research on value investing and behavioral finance led to my own co-authored book on value-investing, *Quantitative Value*. My book serves as a reminder that, (1) I will never be Buffett, and (2) combining a systematic decision process with a value investment philosophy has historically been a successful way to compound wealth over time.

In my mind, Luke Wiley's *52-Week Low Formula* has the two ingredients for success: (1) The process is systematic, and (2) the formula adheres to a value investment philosophy. Luke's mantra is to invert your analytical process and forget about home runs. Instead, he shows you an investment process that removes emotion and behavioral bias—and hits for percentages, powerful percentages. In my mind, this process gets us a closer to The Oracle of Omaha and a little further from Ben Graham's manic friend, "Mr. Market."

The quote, "Keep things as simple as possible, but no simpler," is often attributed to the great Albert Einstein. The *52-Week Low Formula* embodies this philosophy because of its elegant simplicity. Luke identifies the five fundamental factors that help investors methodically move down the field and score a touchdown. Luke is masterful in explaining how and why these five fundamental factors work over the long-haul. Just as Ben Hogan once distilled the golf swing into the book *Five Lessons: The*

Modern Fundamentals of Golf, Wiley has reduced the investment process down to five fundamental factors he knows are mission-critical for investment success.

How Luke peels away the investment layers of stock selection and portfolio building is wonderful, and so easily understood. He peppers the book with stories of real companies, real victories, and real losses, to help the reader understand that success with the *52-Week Low Formula*—or any profitable investment program, for that matter—requires an investor with discipline and a focus on long-term performance.

At first, you may be as skeptical as I once was on the merits of the *52-Week Low Formula*. In academic jargon, “52-Week Low” translates as “low momentum.” And as any empirical researcher can tell you, buying a portfolio of low momentum stocks is typically a sucker’s bet. Nonetheless, Luke inverts the evidence on low momentum portfolios and finds great value among baskets of securities often left for dead by the broader investment and academic community. If you are like me, you will be pleasantly surprised by his formula. If you have been beating your head against the wall over-thinking security selection, as many of us often do, Luke’s systematic approach for identifying high performance stocks is worth learning about. And as any great investor will tell you, investment philosophies founded on evidence, margin-of-safety, and a healthy dose of common sense are often associated with higher risk-adjusted returns over the long-haul.

Wesley R. Gray, PhD
Executive Managing Member, Empiritrage
Co-Author of *Quantitative Value*
March 11, 2014

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To the leadership staff and research staff at UBS, thank you for your support and understanding, for your diligence and insight. I could not imagine writing this book while working at any other firm. UBS is indeed a special place. Thank you.

I especially want to thank my team members, Lynn, Karen, and Nick, who continuously make me look good and keep me on track. Your energy, focus, and commitment are major ingredients in the secret recipe.

I am also thankful to Tom Frank, my coworker at UBS, who connected me to Wesley Gray, PhD, author of *Quantitative Value*. Thankfully, Wes believed this strategy had merit and was kind enough to connect me with his editor, Bill Falloon at Wiley. Thank you, Bill, for seeing the value in the 52-Week Low formula. Thanks to all the staff at Wiley for your interest in helping this book be the best it can be for each and every reader.

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