Having an investment thesis

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Anthony Bolton writes a regular column in the Financial Times sharing his approach to investing. This is the second of these articles, which was published on 3 May 2008. It looks at the importance of having an investment thesis before buying a share.

Behind every share you buy, there should be an investment thesis. As my colleague Peter Lynch has said, you should be able to summarise why you own a particular share in a few simple sentences in a way that your teenage son or daughter would understand. You also need to retest this thesis on a regular basis, especially when there is major news on the company in question: the announcement of its financial results is an obvious point for reflection. If something changes that invalidates the original thesis it's best to sell and move on even if this means exiting at a loss.

Selling at a loss is uncomfortable for many investors. But trying to make money back in a share on which you've lost money just to prove that you were right in the first place is very dangerous. In any case my strong recommendation is to try and forget the price you paid for a share as otherwise it can become a big psychological impediment to taking the right investment decision. Anyway, that share price only means something to you and not to anyone else. As Warren Buffett says, "a stock doesn't know that you own it."

Always bear in mind, too, that investment is an odds game. If you get it right consistently three times out of five you will be doing well. On average you will be wrong at least two times out of five – half the time because an investment thesis proves to be incorrect and half the time because something changes after you purchased the share that invalidates the original thesis. This could be a change at the macro level – such as a movement in interest rates or currencies – or a change at the industry level – such as increased competition or new legislation. Alternatively, it might be a change at the company level: a new product fails to work as well as expected or a price war breaks out in the company's key product market.

When you form your initial investment thesis, it's useful to think about the 'counter' thesis – namely, if your thesis turns out to be wrong, what might be the reasons it doesn't work. By mulling over the factors that might negate the thesis, you should be better placed to spot their emergence earlier. When I purchase shares I particularly like to read broker research that disagrees with my position. I can then think about why I considered the alternative view to be wrong, or be ready to change my view if the broker view started to prove correct.

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At all costs avoid buying shares on impulses or tips – unless you want to gamble as opposed to invest. If you have a specialist area of knowledge, perhaps because of your line of work, you may be able to use this to your advantage by choosing investments in a related field. Sadly, investors with

expertise in one area often go and gamble on stocks in a completely different market based only on tips. It's always puzzled me that doctors buy oil shares instead of healthcare stocks.

Generally, I don't set price targets for shares that I own. In my experience no share develops exactly as one might hope for – some go faster than one's expectations and many go slower. It's more important to keep on checking the investment thesis and this process helps one develop one's conviction. I find it easier to think in terms of levels of conviction than in terms of individual price targets, which anyway can only be very approximate.

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There are three main reasons for selling shares: First, the investment thesis changes. Second, the anomaly in an undervalued share price is corrected; at this point I am happy to reduce or sell the holding. The third reason is if I find something better – a stock where I have more conviction. When I am considering new candidates for the portfolio, a good way to help make a final decision is to compare each candidate with the most similar stock that I already own. If I find I have greater conviction on the new name I will sell the existing holding to make room for it. Besides selling a whole position I will often make adjustments to the size of my holdings as my conviction fluctuates over time.

In investment it is of paramount importance to keep an open mind. The most dangerous thing is to be completely pig-headed about one's investment views, never being prepared to change them. The investment landscape is constantly changing. We are all wrong part of the time. If the evidence changes you must be prepared to change your view.

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