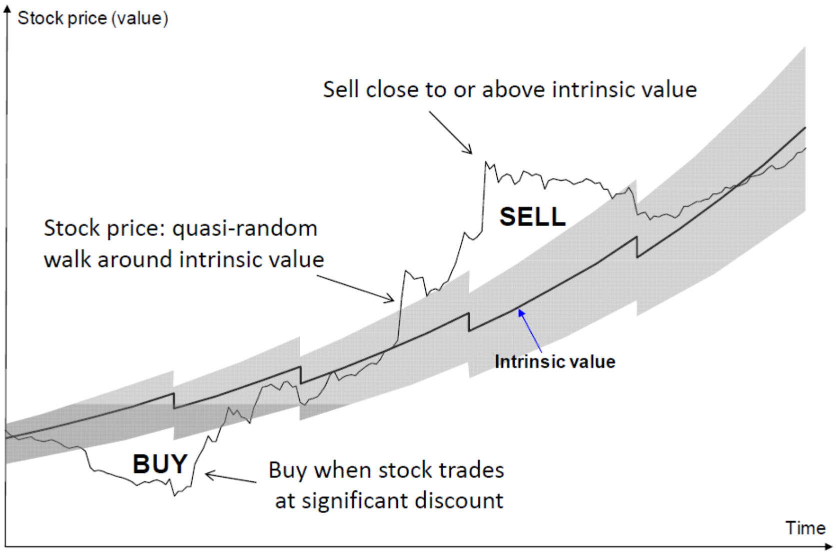
The Investment Philosophy



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So, ditch a top investor who temporarily underperforms at your own peril!!

<u>Common sense on track records</u>

Investing = statistical process:
- (*) Investor performance = quasi-random walk versus market return (with other expected return);
- (*) Every year is like one throw of the dice; investor with edge will not win every year but is very likely to come out ahead over sufficient number of years;
- (*) Track records not easy to interpret, not even over multi-year periods; those looking exclusively at track records don't count the number of green surfaces of the dice.

⇒ Evaluation investment method indispensable in evaluation track record
(Buffet downplays importance of track records in his search for portfolio managers of his investment float; focuses on personality, philosophy and process instead)

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> *Why should the time required for a planet to circle the sun synchronize precisely with the time required for business actions to pay off? While I much prefer a five-year test, I feel three years is an absolute minimum for judging performance. It is a certainty that we will have years when the partnership performance is poorer, perhaps substantially so, than the Dow. If any three-year or longer period produces poor results, we all should start looking around for other places to have our money. An exception to the latter statement would be three years covering a speculative explosion in a bull market.*
>
> --- Warren Buffet

The Investment Process – Common Process mistakes -1

1. **Incoherent investment approach**
   - ***Investing $\neq$ trading***
     (e.g., Buffet: "*stop losses is like buying a house for $1 million and telling your broker to sell when he/she gets a bid for $800,000.*")
   - ***Investing $\neq$ speculation based on hunches/rumours***

2. **Lack of independence**: markets are quite efficient so one must do one's own thorough due diligence (what most others know is already in the stock price)

> *What is already known and published by others has already been acted upon. Assume you are always the last to know.*
>
> --- Charles Kirk

3. **Biased analysis**:
   - ***Mindless extrapolation*** of stock price performance/financial results
   - ***Cherry-picking of information*** about companies
   - ***Sympathy and home bias***: e.g., Kirk Kerkorian invested in GM right before its bankruptcy due to his passion for cars.
   - ***Illusion of familiarity***: e.g., people invest substantial amounts in stock of employer even though they don't know its financials well.

The Investment Process – Common Process mistakes -2

4. **Focus on wrong factors**: economy (too challenging for most investors), short-term "catalysts" (or lack thereof), etc.

> *Charlie and I continue to believe that short-term market forecasts are poison and should be kept locked up in a safe place, away from children and also from grown-ups who behave in the market like children.*
> --- Warren Buffet

5. **Price instead of value**:
   - ***Anchoring to purchase price*** as measure of cheap/expensive
   - ***Price action*** as element in fair value analysis

6. **No attention to quality-price tradeoff**: buying cheap "crap" & overpaying for quality

Common Buying and Selling mistakes- some examples

Common practices among investors	Top Investors
Constantly trying to anticipate the moves of the market	*Far more money has been lost by investors preparing for corrections or trying to anticipate corrections than has been lost in the corrections themselves.* ---Peter Lynch
Constantly trading in an attempt to take advantage of the market's movements	*Inactivity strikes us as intelligent behavior.* ---Warren Buffet
Nobody has gone broke taking a profit.	*Can you imagine a CEO using this phrase to urge his board to sell a star subsidiary?* ---Warren Buffet
Selling winners and hanging on to losing stocks	*Selling winning stocks and hanging on to losing stocks is like cutting the flowers and watering the weeds.* ---Peter Lynch
Buying and selling based on emotion.	*While enthusiasm may be necessary for great accomplishments elsewhere on Wall Street it almost invariably leads to disaster.* -Benjamin Graham
The economy as a first consideration	*The way you lose money in the stock market is to start off with an economic picture. All these great heavy-thinking deals kill you.* ---Peter Lynch

Risk versus return

Top investors deride academic view on risk, have unconventional view on risk:
(*) volatility = opportunity to buy cheap
(*) diversification = protection against ignorance
(*) risk = lack of knowledge

> *To invest successfully, you need not understand beta, efficient markets, modern portfolio theory, option pricing or emerging markets. You may, in fact, be better off knowing nothing of these. Graham & Dodd investors, needless to say, do not discuss beta, the capital asset pricing model, or covariance in returns among securities. These are not subjects of any interest to them. In fact, most of them would have difficulty defining those terms. The investors simply focus on two variables: price and value.*
>
> ---Warren Buffet

> *Do not trust financial market risk models. Reality is always too complex to be accurately modeled. Attention to risk must be a 24/7/365 obsession, with people – not computers – assessing and reassessing the risk environment in real time. Despite the predilection of some analysts to model the financial markets using sophisticated mathematics, the markets are governed by behavioral science, not physical science.*
>
> ---Seth Klarman

Risk versus return – Basic tenets of top investors

The ten commandments of intelligent risk management

1) Do not participate in market folly – not even under the pressure of clients
2) Be patient and tolerant of temporary underperformance
3) Have the courage to accumulate cash when you can't find bargains
4) Have the courage to get cash to work when the market is in a tailspin
5) Always insist on a margin of safety (i.e., buy cheap and sell when something is dear)
6) Know what you hold (very) well
7) First look at a stock's downside (e.g., balance sheet); the upside will take care of itself
8) Always be prepared for the unexpected (e.g., black swans)
9) Use leverage sparingly (if at all)
10) Always remember "If something is too good to be true, it probably isn't."

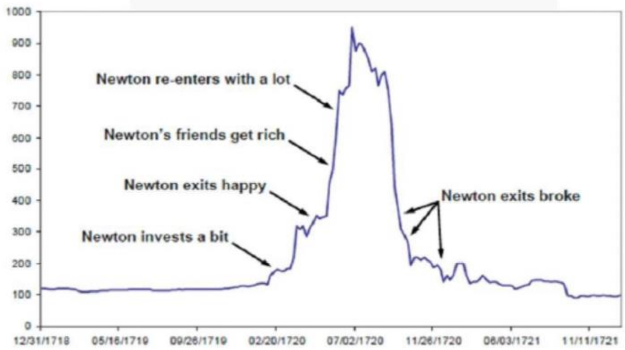
For people who do not adhere to these tenets:
(*) diversification makes sense
(*) volatility = risk
(*) don't ever think that you are investing !!!!

The intelligent investor

Are smart people automatically intelligent investors ?

Newton: probably the greatest genius that ever lived…

FIGURE 1
SOUTH SEA STOCK
DECEMBER 1718 – DECEMBER 1721



Source: Marc Faber, Gloom Boom and Doom, and Riding the South Sea Bubble, Temin and Voth

"I can calculate the movement of the stars, but not the madness of men"

Newton lost a time-adjusted $3 million in the South Sea bubble; After this traumatizing experience, he forbade anyone to speak the words "South Sea" in his presence…

The Intelligent Investor

What does it take to be a successful investor ?

Intellectual Intelligence (IQ)

Without Investor Intelligence

Newton

Let me emphasize that it does not take a genius or even superior talent to be successful as a value analyst. What it needs first is, reasonable intelligence; second, sound principles of operation; third, and most important, firmness of character.
--- Benjamin Graham

Investor Intelligence

Passion
+
Right Attitude
+
Hard work
+
Right mental setup

A winning combination: Warren Buffet

I have heard many men talk intelligently, even brilliantly, about something – only to see them proven powerless when it comes to acting on what they believe. Investors must act in time.
--- Bernard Baruch