Memo to: Oaktree Clients

From: Howard Marks

Re: It's Not Easy

In 2011, as I was putting the finishing touches on my book *The Most Important Thing*, I was fortunate to have one of my occasional lunches with Charlie Munger. As it ended and I got up to go, he said something about investing that I keep going back to: **"It's not supposed to be easy. Anyone who finds it easy is stupid."**

As usual, Charlie packed a great deal of wisdom into just a few words. Let's take the first six: "It's not supposed to be easy." While it's pretty simple to achieve average results, it shouldn't be easy to make superior investments and earn outsized returns. John Kenneth Galbraith said something similar years ago:

> There is nothing reliable to be learned about making money. If there were, study would be intense and everyone with a positive IQ would be rich.

What Charlie and Professor Galbraith meant is this: Everyone wants to make money, and especially to find the sure thing or "silver bullet" that will allow them to do it without commensurate risk. Thus they work hard (actually, study *is* intense), searching for bargain securities and approaches that will give them an edge. They buy up the bargains and apply the approaches. The result is that the efforts of these market participants tend to drive out opportunities for easy money. Securities become more fairly priced, and free lunches become harder to find. **It makes no sense to think it would be otherwise.**

And what about the next seven words: "Anyone who finds it easy is stupid"? It follows from the above that given how hard investors work to find special opportunities, and that their buying eliminates such prospects, **people who think it can be easy overlook substantial nuance and complexity.**

Markets are meeting places where people come together (not necessarily physically) to exchange one thing (usually money) for another. Markets have a number of functions, one of which is to eliminate opportunities for excess returns.

Ed calls me and bids $10,000 for my car. Then he offers to sell it to Bob for $20,000. If Ed's lucky and we both say yes, he doubles his money overnight. To put it simply, anyone who expects to make money easily trading cars this way either thinks (a) Bob and I are idiots or (b) the market won't function in a way that enables us to know about the fair value of my car. If these conditions were met, it would be an "inefficient market."

But if Bob and I have access to market data on used car pricing, Ed's chances of pulling off this deal are greatly reduced. **In most markets, transparency tends to reveal and thus preclude obvious mispricings.** (Thanks to the incredible gains in access to data by way of the Internet, this is certainly more true today than ever before.) **In my view, this is a good part of the basis for Charlie's comment: anyone who thinks it's easy to achieve unusual profits is overlooking the way markets operate. This memo is largely about the challenges they present.**

Second-Level Thinking

I always thought that when I retired, I would write a book pulling together the elements of investment philosophy discussed in my memos. But in 2009, I got an email from Warren Buffett saying that if I'd write a book, he'd give me a blurb for the jacket. It didn't take me long to move up my timing.

Columbia Business School Publishing had been talking to me about a book, and when I told them I was ready, they asked to see a sample chapter. For some reason, I was able to sit down – without previously having given the topic any organized thought – and knock out a chapter about the importance of something I labeled "second-level thinking." This is a crucial subject that has to be understood by everyone who aspires to be a superior investor. And yet I've never covered it explicitly for the readers of my memos. I want to correct that now.

In what ended up being the book's first chapter, I introduced the subject as follows:

> Remember your goal in investing isn't to earn average returns; you want to do better than average. Thus your thinking has to be better than that of others – both more powerful and at a higher level. Since others may be smart, well-informed and highly computerized, you must find an edge they don't have. You must think of something they haven't thought of, see things they miss, or bring insight they don't possess. You have to react differently and behave differently. In short, being right may be a necessary condition for investment success, but it won't be sufficient. You must be more right than others . . . which by definition means your thinking has to be different. . . .
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> For your performance to diverge from the norm, your expectations – and thus your portfolio – have to diverge from the norm, and you have to be more right than the consensus. Different and better: that's a pretty good description of second-level thinking.

Second-level thinking is what immediately pops into my mind when I think about Charlie's observation. And it's a good general heading under which to discuss the great many things that make superior investing a challenge. **In short, to borrow from Charlie, anyone who thinks it's easy must be a first-level thinker**. Let me use some simple examples from the book to illustrate the difference.

- First-level thinking says, "It's a good company; let's buy the stock." Second-level thinking says, "It's a good company, but everyone thinks it's a great company, and it's not. So the stock's overrated and overpriced; let's sell."

- First-level thinking says, "The outlook calls for low growth and rising inflation. Let's dump our stocks." Second-level thinking says, "The outlook stinks, but everyone else is selling in panic. Buy!"

- First-level thinking says, "I think the company's earnings will fall; sell." Second-level thinking says, "I think the company's earnings will fall far less than people expect, and the pleasant surprise will lift the stock; buy."

> First-level thinking is simplistic and superficial, and just about everyone can do it (a bad sign for anything involving an attempt at superiority). All the first-level thinker needs is an opinion about the future, as in, "The outlook for the company is favorable, meaning the stock will go up."

Second-level thinking is deep, complex and convoluted. The second-level thinker takes many things into account:

- What is the range of likely future outcomes?
- Which outcome do I think will occur?
- What's the probability I'm right?
- What does the consensus think?
- How does my expectation differ from the consensus?
- How does the current price for the asset comport with the consensus view of the future, and with mine?
- Is the consensus psychology that's incorporated in the price too bullish or bearish?
- What will happen to the asset's price if the consensus turns out to be right, and what if I'm right?

The bottom line is that first-level thinkers see what's on the surface, react to it simplistically, and buy or sell on the basis of their reactions. **They don't understand their setting as a marketplace where asset prices reflect and depend on the expectations of the participants. They ignore the part that others play in how prices change. And they fail to understand the implications of all this for the route to success.**

For example, when I lived in Los Angeles, a stockbroker often spoke on the radio station I listened to while driving to work. His advice was simple: "If there's a company whose product you like, buy the stock." That's first-level thinking. How seductively easy. But also how error-prone, in that it ignores the possibility that a company with a good product can have a bad business; the good product can become obsolete; or the stock can be priced too high to be a good investment.

On the other hand, second-level thinkers double-think (and triple-think) every angle of every situation. A good example can be seen in the hypothetical newspaper contest John Maynard Keynes wrote about in 1936. Readers would be shown 100 photos and asked to choose the six prettiest girls, with prizes going to the readers who chose the girls readers voted for most often. Naive entrants would try to win by picking the prettiest girls. **But note that the contest would reward the readers who chose not the prettiest girls, but the most popular.** Thus the road to winning would lie not in figuring out which were the prettiest, but in predicting which girls the average entrant would consider prettiest. Clearly, to do so, the winner would have to be a second-level thinker. (The first-level thinker wouldn't even recognize the difference.)

Wikipedia points out that one vying to win the contest might go beyond this distinction:

> This can be carried one step further to take into account the fact that other entrants would each have their own opinion of what public perceptions are. Thus the strategy can be extended to the next order and the next and so on, at each level attempting to predict the eventual outcome of the process based on the reasoning of other agents.
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> "It is not a case of choosing those [faces] that, to the best of one's judgment, are really the prettiest, nor even those that average opinion genuinely thinks the prettiest. We have reached the third degree where we devote our intelligences to anticipating what average opinion expects the average opinion to be. And there are some, I believe, who practice the fourth, fifth and higher degrees." (Keynes, *The General Theory of Employment, Interest and Money,* 1936).

Keynes created his contest to make a point about the stock market. In the short run, beating the market requires the ability to predict which stocks will win the popularity contest among investors. Higher-level thinkers who recognize this dynamic have a head start toward earning the greatest gains. Ben Graham applied the same thinking when he described the market as a "voting machine" in the short run (although he made plain his belief that it's a "weighing machine" in the long run).

The first-level thinker simply looks for the highest-quality company, the best product, the fastest earnings growth or the lowest p/e ratio. He's ignorant of the very existence of a second level at which to think, and of the need to pursue it.

The second-level thinker goes through a much more complex process when thinking about buying an asset. Is it good? Do others think it's as good as I think it is? Is it really as good as I think it is? Is it as good as others think it is? Is it as good as others think others think it is? How will it change? How do others think it will change? How is it priced given: its current condition; how I think its condition will change; how others think it will change; and how others think others think it will change? And that's just the beginning. No, this isn't easy.

(Please note that the above discussion is entirely on the subject of short-term investing, and I go through it only to provide a graphic illustration of the difference between first-level and second-level thinking. Oaktree and I aren't focused on short-term results, and the thinking we apply to long-run considerations is quite different. We think much less about what others will make popular in the short run; instead, we rely on the eventual functioning of the weighing machine. The highest priority – by far – should be an objective evaluation of fundamentals. Market participants can get so caught up in predicting other participants' behavior that they ignore value and fail to buy bargains out of fear that the assets in question will remain unpopular or become more so. This creates great opportunities for those investors whose willingness to think independently and endure the short-term pain that comes with temporary unpopularity enables them to purchase attractive investments from the bargain counter.)

What Keynes's hypothetical contest shows most clearly is that the route to success in the competitive arena may not be what it seems at first glance. When the goal is to lift the greatest weight, achieve the lowest score on the golf course, get the highest grade on a math test or finish a crossword puzzle in the shortest time, the competition is against oneself and the objective challenge at hand. But when the goal, as it is in investing, is to outdo other people in a largely mental pursuit involving a lot of psychology – while they're trying to do the same to you – the challenge is much more complex.

The investor's basic goal of buying desirable assets at fair prices is sensible and straightforward. But the deeper you look, the more you see how many aspects of successful investing are counterintuitive and how much of what seems obvious is wrong. There's a lot more that matters, of course, but these realizations are key.

<u>The Things Everyone Likes</u>

The most outstanding characteristic of first-level thinkers – and of the investing herd – is that they like things with obvious appeal. These are the things that are easy to understand and easy to buy. But that's unlikely to be the path to investment success. Here's how I put it in "Everyone Knows" (April 2007):

What's clear to the broad consensus of investors is almost always wrong.

First, most people don't understand the process through which something comes to have outstanding moneymaking potential. And second, the very coalescing of popular opinion behind an investment tends to eliminate its profit potential.

Take, for example, the investment that "everyone" believes to be a great idea. In my view by definition it simply cannot be so.

- If everyone likes it, it's probably because it has been doing well. Most people seem to think outstanding performance to date presages outstanding future performance. Actually, it's more likely that outstanding performance to date has borrowed from the future and thus presages sub-par performance from here on out.

- If everyone likes it, it's likely the price has risen to reflect a level of adulation from which relatively little further appreciation is likely. (Sure it's possible for something to move from "overvalued" to "more overvalued," but I wouldn't want to count on it happening.)

- If everyone likes it, it's likely the area has been mined too thoroughly – and has seen too much capital flow in – for many bargains to remain.

- If everyone likes it, there's significant risk that prices will fall if the crowd changes its collective mind and moves for the exit.

Superior investors know – and buy – when the price of something is lower than it should be. And the price of an investment can be lower than it should be only when most people don't see its merit. Yogi Berra is famous for having said, "Nobody goes to that restaurant anymore; it's too crowded." It's just as nonsensical to say, "Everyone realizes that investment's a bargain." If everyone realizes it, they'll have bought, in which case the price will no longer be low.

So the things with the most obvious merit become the things that everyone likes. They're also likely to be the things that are most hotly pursued and most highly priced, and thus least promising and most treacherous. What are some examples?

When I first showed up for work in First National City Bank's investment research department in 1968, the bank was investing heavily in the "Nifty Fifty": the stocks of America's best, fastest growing companies. Since these were companies where nothing could go wrong, the official dictum said it didn't matter much what price you paid. It didn't seem unreasonable to pay p/e ratios of 80 or 90 given these companies' growth rates.

But it turned out that the price you pay does matter, and 80-90 times earnings had been too high. Thus, when the market ran into trouble in the early 1970s, many of these stocks lost the vast majority of their value, and investors learned the hard way that it's possible to like a good thing too much. Unsurprisingly, it also turned out that predictions of a flawless future can be wrong, as once-dominant companies such as Kodak, Polaroid and Xerox eventually went bankrupt or required turnarounds.

Roughly ten years ago, everyone was gaga over real estate, especially residential. This was underpinned by some bits of "accepted wisdom" that seemed compelling, such as "you can always live in it," "home prices always go up" and "real estate is a hedge against inflation." Conservative debt investors (rather than buyers of homes themselves) were persuaded to buy levered and tranched mortgage-backed securities by the fact that "there has never been a nationwide wave of mortgage defaults."

But in 2007 it turned out that home prices can go down as well as up, and mortgage loans extended casually based on their flawless record can have flaws. Homes and mortgages, bought when everyone liked them, turned out to be terrible investments.

The fact is, painful bubbles can't come into existence if there isn't an underlying grain of truth. The Nifty Fifty *were* generally terrific companies. Home prices *do* tend to rise over time and offset inflation. Mortgages generally *are* repaid or carry adequate collateral. The Internet *would* change the world. Oil at $147/barrel *was* indispensable and in short supply. But in each case the merits were too obvious; the investment ideas became too popular; and asset prices consequently became dangerously high.

Following the trends that are popular at a point in time certainly isn't a formula for investment success, since popularity is likely to lead investors on a path that is comfortable but pointed in the wrong direction. Here's more from "Everyone Knows":

> The fact is, there is no dependable sign pointing to the next big moneymaker: a good idea at a too-low price. Most people simply don't know how to find it. . . .
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> Large amounts of money (and by that I mean unusual returns, or unusual risk-adjusted returns) aren't made by buying what everybody likes. They're made by buying what everybody underestimates.
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> In short, there are two primary elements in superior investing:
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> - seeing some quality that others don't see or appreciate (and that isn't reflected in the price), and
> - having it turn out to be true (or at least accepted by the market).
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> **It should be clear from the first element that the process has to begin with investors who are unusually perceptive, unconventional, iconoclastic or early. That's why successful investors are said to spend a lot of their time being lonely.**

Risk and Counterintuitiveness

If what's obvious and what everyone knows is usually wrong, then what's right? The answer comes from inverting the concept of obvious appeal. The truth is, the best buys are usually found in the things most people don't understand or believe in. These might be securities, investment approaches or investing concepts, but the fact that something isn't widely accepted usually serves as a green light to those who're perceptive (and contrary) enough to see it. A great example can be found in the area of risk (again from "Everyone Knows"):

> **"I wouldn't buy that at any price – everyone knows it's too risky."** That's something I've heard a lot in my life, and it has given rise to the best investment opportunities I've participated in. In fact, to an extent, it has provided the foundation for my career. In the 1970s and 1980s, insistence on avoiding non-investment grade bonds kept them out of most institutional portfolios and therefore cheap. Ditto for the debt of bankrupt companies: what could be riskier?

The truth is, the herd is wrong about risk at least as often as it is about return. A broad consensus that something's too hot to handle is almost always wrong. Usually it's the opposite that's true.

I'm firmly convinced that investment risk resides most where it is least perceived, and vice versa:

- When everyone believes something is risky, their unwillingness to buy usually reduces its price to the point where it's not risky at all. Broadly negative opinion can make it the least risky thing, since all optimism has been driven out of its price.

- And, of course, as demonstrated by the experience of Nifty Fifty investors, when everyone believes something embodies no risk, they usually bid it up to the point where it's enormously risky. No risk is feared, and thus no reward for risk bearing – no "risk premium" – is demanded or provided. That can make the thing that's most esteemed the riskiest.

This paradox exists because most investors think quality, as opposed to price, is the determinant of whether something's risky. But high-quality assets can be risky, and low-quality assets can be safe. It's just a matter of the price paid for them.

For me, it follows from the above that the bottom line is simple: **the riskiest thing in the world is the widespread belief that there's no risk**. That's what most people believed in 2006-07, and that belief abetted the careless behavior that brought on the Great Financial Crisis. Only an understanding that risk was high could have discouraged that behavior and rendered the world safe.

I call this "the perversity of risk." For most people it's hard to grasp that a perception of safety brings on risk, and a perception of risk can lead to safety. But it's clear for the deeper second-level thinker. This is just another example of the fact that what "everyone knows" is what shapes the environment, bringing high prices when things are perceived to be good, and vice versa.

A perception that fundamental risk is low and the future is positive causes investors to be optimistic. This, in turn, causes asset prices to rise, and thus investment risk to be high. **The problem that befalls most people – the first-level thinkers – is that they fail to distinguish between fundamental risk and investment risk.**

What has to be remembered is the defining role of price. Regardless of whether the fundamental outlook is positive or negative, the level of investment risk is determined largely by the relationship between the price of an asset and its intrinsic value. There is no asset so good that it can't become overpriced and thus risky, and few so bad that there's no price at which they're a buy (and safe). **This is one of the greatest examples of counterintuitiveness. Only those who are able to see its logic can hope to be superior investors.**

What Else?

I've covered a few of the most important topics under the headings of complexity and counter-intuitiveness:

- the importance of second-level thinking,
- the lack of identity between "good company" and "good investment,"
- the unhelpfulness of the things everyone knows, and
- the perversity of risk.

I see, however, that I've already filled seven pages. So rather than continue to provide a full treatment of all the topics I want to cover, let's conduct an exercise. I'll list below a number of elements of time-honored investment wisdom. See if you can tell which are helpful and which aren't:

- The market is "efficient," meaning asset prices reflect all available information and thus provide accurate estimates of intrinsic value.
- Because people are risk-averse, risky deals are discouraged and the market awards appropriate risk premiums as compensation for incremental risk.
- Risky investments produce high returns.
- Adding risky assets to a portfolio makes it riskier.
- It's desirable that everything in a well-diversified portfolio performs well.
- Understanding the science of economics will enable you to safely harness the macro future.
- Sometimes the outlook is clear, and sometimes it's complicated and unpredictable. You have to be careful when it's the latter.
- Correct forecasts lead to investment gains.
- A forecast has to be correct in order to be profitable.
- The earning of a profit proves the investor made a good decision.
- A low price makes for an attractive investment.
- Assets that are appreciating deserve your attention.
- Contrarianism will bring consistent success.
- It's important to do what feels right.
- Assets with greater liquidity are safer.
- The level of risk in a portfolio can be kept low by applying a simple formulaic process.

My answer is that all sixteen reflect potential misconceptions, and they have to be (a) understood at the second level, not the first, and (b) dismissed as always holding the keys to success. Here's why:

- **The market is "efficient," meaning asset prices reflect all available information and thus provide accurate estimates of intrinsic value** – The efficient market hypothesis assumes people are rational and objective. But since emotion so often rules in place of reason, the market doesn't necessarily reflect what's true, but rather what investors think is true. Thus prices can range all over the place. Sometimes they're fair, but sometimes they're way too high or low. It's a big mistake to impute rationality to the market and believe its message.

- **Because people are risk-averse, risky deals are discouraged and the market awards appropriate risk premiums as compensation for incremental risk** – The truth is that investors' risk-averseness fluctuates between too much and too little. When it's the latter, skepticism and conservatism dry up, due diligence is inadequate, risky deals are easy to pull off, and compensation for risk bearing usually turns out to be insufficient. **Investors absolutely cannot depend on the market to discipline itself.**

- **Risky investments produce high returns** – This is one of the greatest of the old saws, and one of the wrongest.

  - A collection of low-risk investments can produce a high return if the low-risk character of the components permits them to perform dependably and keeps there from being any big losers to pull down the overall result. An absence of losses can give you a great start toward a good outcome. **This is the cornerstone of Oaktree's investment philosophy.**

  - On the other hand, high-risk investments can't be counted on for high returns. If they could, they wouldn't be high-risk. High-risk investments can fail to provide the high returns they seemed to promise if the analysis underlying them proves to have been ill-founded or if they run into negative developments.

  The presumed positive relationship between risk and return is predicated on the assumption that there's no such thing as investment skill and value-adding decision making. If markets are efficient and there's no skill, it's reasonable to believe that higher returns can be attained only through the bearing of increased risk. **But if outstanding skill is present, there's no reason to think it can't be used to create portfolios with low risk *and* high return potential.**

- **Adding risky assets to a portfolio makes it riskier** – One of Nobel prize-winner William Sharpe's greatest contributions to investment theory came in the realization that if a portfolio holds only low-risk assets, the addition of a risky asset can make it safer. This happens because doing so increases the portfolio's diversification and reduces the correlation among its components, reducing its vulnerability to a single negative development.

- **It's desirable that everything in a well-diversified portfolio performs well** – The truth is, if all the holdings were to perform well in one scenario, they could all perform poorly in another. That means the benefits of diversification wouldn't be enjoyed. It shouldn't be surprising – or totally disappointing – to have some laggards in a portfolio that's truly well-diversified.

- **Understanding the science of economics will enable you to safely harness the macro future** – There are no immutable rules in play. "In economics and investments, because of the key role played by human nature, you just can't say for sure that 'if A, then B,' as you can in real science. The weakness of the connection between cause and effect makes outcomes uncertain. In other words, it introduces risk." ("Risk Revisited," September 2014).

- **Sometimes the outlook is clear, and sometimes it's complicated and unpredictable. You have to be careful when it's the latter** – The truth is, the future is never worry-free. Sometimes it seems to be, because no risks are apparent. But the skies are never as clear as they seem at their clearest. **Which is more treacherous: when everyone understands that the future presents risks, or when they believe it to be knowable and benign? As I mentioned earlier, I worry about the latter much more than the former.**

- **Correct forecasts lead to investment gains** – The easiest way to have a correct forecast is to extrapolate a trend and see it continue as expected. Most forecasters do a lot of extrapolating, meaning their forecasts are usually broadly shared. Thus when the trend does continue, everyone's right. But since everyone held the same view, the continuing trend was probably discounted in advance in the price of the asset, and the fact that it rolls on as expected doesn't necessarily produce profit. For a forecast to be highly profitable, it has to be idiosyncratic. But, given how often trends continue, idiosyncratic forecasts aren't often right.

- **A forecast has to be correct in order to be profitable** – Just as correct forecasts aren't necessarily profitable, profitable forecasts don't have to be correct. A forecast – even if it's not correct – can be profitable if it's merely less wrong than others. If a trend that everyone else extrapolates turns out not to continue, a prediction of the deviation can be very profitable . . . even if it's not exactly on target.

- **The earning of a profit proves the investor made a good decision** – One of the first things I learned at Wharton was that you can't necessarily tell the quality of a decision from the outcome. Given the unpredictability of future events and, especially, the presence of randomness in the world, a lot of well-reasoned decisions produce losses, and plenty of poor decisions are profitable. Thus one good year or a few big winners may tell us nothing about an investor's skill. We have to see a lot of outcomes and a long history – and especially a history that includes some tough years – before we can say whether an investor has skill or not.

- **A low price makes for an attractive investment** – I talked at the bottom of page seven about the importance of price in determining whether an investment is risky. But if you reread the part in bold, you'll see it doesn't say a low price is the essential element. An asset may have a low absolute dollar price, a low price compared to the past, or a low p/e ratio, but usually the price has to be low relative to the asset's intrinsic value for the investment to be attractive and for the risk to be low. **It's easy for investors to get into trouble if they fail to understand the difference between cheapness and value.**

- **Assets that are appreciating deserve your attention** – Most people impute intelligence to the market, and thus they think rising prices signal fundamental merit. They may be attracted to "momentum investing," which is based on the belief that something that has been appreciating is likely to continue doing so. But the truth is, the higher the price (everything else being equal), the less attractive an asset is. Momentum investing works until it stops, at which time the things that have been doing worst – and may be most undervalued – take over market leadership.

- **Contrarianism will bring consistent success** – It's true that the investing herd is often wrong. In particular, it behaves more aggressively the more prices rise, and more cautiously the more they fall – the opposite of what should happen. But doing the opposite of what the crowd does isn't a sure thing either. Much of the time there isn't anything dramatic to either do or avoid. Contrarianism is most effective at the extremes, and then only for those who understand what the herd is doing and why it's wrong. And they still have to summon the nerve to do the opposite.

- **It's important to do what feels right** – The best investors know intellectually what the right thing to do is. But while this knowledge gives them comfort, they have to tamp down their feelings in order to follow it. The best ideas are ones others haven't tumbled to, and as I wrote in "Dare to Be Great," "Non-consensus ideas have to be lonely. By definition, non-consensus ideas that are popular, widely held or intuitively obvious are an oxymoron. . . . **Most great investments begin in discomfort." Good investors are subjected to the same misleading influences and emotions as everyone else. They're just more capable of keeping them under control.**

- **Assets with greater liquidity are safer** – Greater liquidity generally means you can get out of an asset easier and closer to the price of the last trade. But first, liquidity can dry up when other investors change their mind about the asset. And second, the theoretical ability to get out when you want says nothing about fundamental safety and relatively little about investment safety in the long run. It's much safer to be in well-analyzed assets with good fundamentals and attractive prices, in which case you can hold for a long time without needing to exit. The best defense against a lack of liquidity is arranging your affairs so there's little need for it.

- **The level of risk in a portfolio can be kept low by applying a simple formulaic process** – Rather, risk comes in many forms and they can be overlapping, contrasting and hard to manage. For example, as I said in "Risk Revisited," efforts to reduce the risk of losing money invariably increase the risk of missing out on gains, and efforts to reduce fundamental risk by buying higher-quality assets often increase valuation risk, given that higher-quality assets often sell at elevated valuation metrics.

What does the above consist of? It's a collection of time-honored bromides that range from (a) only effective part of the time to (b) just plain wrong. These investment myths are pervasive but of little help. That fact leaves the investor to struggle in a complex, challenging environment.

<u>Recent Experience</u>

The recent volatility in the world's markets, the S&P 500's 11% drop between August 17 and 25, and the decline of nearly 40% in Chinese equities have given investors an opportunity to experience something else that's not easy: portfolio management under adverse conditions. A few lessons are worth noting, none of which are always easy to employ:

- Emotion is one of the investor's greatest enemies. Fear makes it hard to remain optimistic about holdings whose prices are plummeting, just as envy makes it hard to refrain from buying the appreciating assets that everyone else is enjoying owning. As I mentioned just above, everyone is buffeted by the same influences and emotions. **Superior investors may not be insulated, but they manage to act as if they are.**

- Confidence is one of the key emotions, and I attribute a lot of the market's recent volatility to a swing from too much of it a short while ago to too little more recently. **The swing may have resulted from disillusionment: it's particularly painful when investors recognize that they know far less than they had thought about how the world works.** In this case, when China's growth slowed, its currency depreciated and its market corrected, I think a lot of investors realized they don't know what the implications of these things are for the economies of the U.S. and the world. It's important to remain moderate as to confidence, but instead it's usually the case that confidence – like other emotions – swings radically.

- Especially during downdrafts, many investors impute intelligence to the market and look to it to tell them what's going on and what to do about it. **This is one of the biggest mistakes you can make. As Ben Graham pointed out, the day-to-day market isn't a fundamental analyst; it's a barometer of investor sentiment. You just can't take it too seriously.** Market participants have limited insight into what's really happening in terms of fundamentals, and any intelligence that could be behind their buys and sells is obscured by their emotional swings. It would be wrong to interpret the recent worldwide drop as meaning the market "knows" tough times lay ahead. Rather, China came out with some negative news and people panicked, especially

Chinese investors who had bought stocks on margin and perhaps were experiencing their first serious market correction. Their selling prompted investors in the U.S. and elsewhere to sell also, believing that the market decline in China signaled serious implications for the Chinese economy and others. **The analysis of fundamentals and valuation should dictate an investor's behavior, not the actions of others. If you let the investing herd – which determines market movements – tell you what to do, how can you expect to outperform?**

- While China was the "proximate cause" of the volatility, other things often contribute, and last month was no exception. The word that always comes to mind for me is "confluence." **Investors can usually keep their heads in the face of one negative. But when they face more than one simultaneously, they often lose their cool.** One additional negative last month was the glitch in Bank of New York Mellon's SunGard software, and the bank's consequent inability to price 1,200 mutual funds and ETFs that it administers. It was another dose of disillusionment: no one enjoys learning that the market mechanisms they need to work can't be depended on.

- In good times – perhaps emulating Warren Buffett – investors talk about how much they'd like to see the stocks they own decline in price, since it would allow them to add to positions at lower levels. **But when prices collapse, the chance to average down is usually a lot less welcome . . . and a lot harder to act on.**

- Investors can be tempted to sell during corrections like this one. Oftentimes emotional behavior is cloaked in intelligent-sounding rationalizations like "it's important to sell down to your comfort level." But the valid reasons to sell are principally because you feel fundamentals have deteriorated or because the price has risen enough. **Selling to get more comfortable as prices fall (just like buying for that purpose in a rising market) has nothing to do with the relationship between price and value.**

- Another reason to sell, of course, is fear that the slide will continue. But if you're tempted to do so, ask yourself first whether you think the stock market is going to rise or fall tomorrow, and second how much you'd bet on it. If you can tackle those decisions in your head rather than your gut, you'll probably admit you have no idea what's going to happen in the short term.

- Regardless of the outlook for fundamentals or the relationship between price and value, many people sell in a downdraft because, well, you have to do something, and they feel it's unreasonably passive to just sit there. **But something about which I feel strongly is that it's not the things you buy and sell that make you money; it's the things you hold.** Of course you have to buy things in order to hold them. But my point is that transactions merely adjust what you own, and engaging in them doesn't necessarily increase potential profit. Sticking with what you own may be enough – although it may not be easy in tough times.

- In my memo on liquidity in March, I borrowed an idea from my son Andrew: If you look longingly at the chart for a stock that has risen for twenty years, think about how many days there were when you would've had to talk yourself out of selling. That's not always easy. Two of the main reasons people sell stocks are because they go up and because they go down. When they go up, people who hold them become afraid that if they don't sell, they'll give back their profit, kick themselves, and be second-guessed by their bosses and clients. And when they go down, they worry that they'll fall further.

There may be absolutely no intellectual justification for that feeling. If you liked it a month ago at $80, should you sell it now just because it's at $60? **The best way to get through a downdraft is to verify your thesis, tighten your seatbelt and hang on. If you sell just because there's a downdraft (or an updraft), you'll never get that twenty-year winner.** When you look closely, you'll see that every twenty-year rise included a lot of ups and downs. To enjoy long-term success, you have to hold through them.

- A lot has been written of late about reduced liquidity in the current investment environment, in part a result of restrictions under the Volcker rule. This may have contributed to last month's volatility, but it should be viewed as having exacerbated the short-term pain, not as altering the long-term fundamentals.

Coping with a declining market seems easy ahead of time, since emotions aren't in play and investors know what they should do. It's only when prices start falling in earnest, as they have recently, that it turns out to be harder than expected.

<u>So What Will Work?</u>

Superior investing isn't easy. I've set forth a number of examples of its complexity, and a long list of simplistic rules that can't be depended on. Among the many things that keep investing from being easy is the fact that no tactic works every time. Almost every tool an investor might employ is a two-edged sword. Here's how I put it last year in "Dare to Be Great II":

> - If you invest, you will lose money if the market declines.
> - If you don't invest, you will miss out on gains if the market rises.
>
> - Market timing will add value if it can be done right.
> - Buy-and-hold will produce better results if timing can't be done right.
>
> - Aggressiveness will help when the market rises but hurt when it falls.
> - Defensiveness will help when the market falls but hurt when it rises.
>
> - If you concentrate your portfolio, your mistakes will kill you.
> - If you diversify, the payoff from your successes will be diminished.
>
> - If you employ leverage, your successes will be magnified.
> - If you employ leverage, your mistakes will be magnified.
>
> Each of these pairings indicates symmetry. None of the tactics listed will add value if it's right but not subtract if it's wrong. Thus none of these tactics, in and of itself, can hold the secret to dependably above average investment performance.
>
> **There's only one thing in the investment world that isn't two-edged, and that's "alpha": superior insight or skill.** Skill can help in both up markets and down markets. And by making it more likely that your decisions are right, superior skill can increase the expected benefit from concentration and leverage. But that kind of superior skill by definition is rare and elusive. . . .

> **Why should superior profits be available to the novice, the untutored or the lazy?** Why should people be able to make above average returns without hard work and above average skill, and without knowing something most others don't know? And yet many individuals invest based on the belief that they can. (If they didn't believe that, wouldn't they index or, at a minimum, turn over the task to others?)
>
> No, the solution can't lie in rigid tactics, publicly available formulas or loss-eliminating rules . . . or in complete risk avoidance. **Superior investment results can only stem from a better-than-average ability to figure out when risk taking will lead to gain and when it will end in loss.** There is no alternative.

Superior skill is an essential ingredient if superior investment results are to be achieved reliably. **No tactic or technique will lead to superior results in the absence of superior judgment and implementation.** But by definition, only a small percentage of investors possess superior skill.

It is mathematically irrefutable that (a) the average investor will produce before-fee performance in line with the market average and (b) active management fees will pull the average investor's return below the market average. This has to be considered in light of the fact that average performance can generally be obtained through passive investing, with tiny fees and almost no risk of falling short.

Superior investors and their well-thought-out approaches can produce superior returns on average in the long run. But even they are far from perfect. The best they can hope for is that they'll be right more often than they're wrong, and that their successful decisions will add more than their mistakes subtract.

So, in the end, there's only one absolute truth about investing. Charlie's right: it isn't easy.

September 9, 2015

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