Being an Investor

The 11 attributes of successful investors

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In December 2009 I wrote that "we are in the business of investment and not speculation". To be in the business of "investment" is to have a mindset that when purchasing shares on stock markets, you are buying an entitlement to a share of the cash flows that a business will produce over time. Your job as an investor is to assess (if you can) the likely cash flows a business will generate over its lifetime, discount these cash flows back to the present value (at an appropriate discount rate) and determine whether you are likely to generate an acceptable rate of return via buying a share in the business at the prevailing share price. Conversely, speculation involves trading in anticipation that a share price will move upwards or downwards over a short time horizon, typically less than 12 months.

In 2008, John Bogle, founder of The Vanguard Group, said in a speech to a conference of Financial Planners:

"Investing to me, is all about the long-term ownership of businesses, focussed on the gradual accretion in intrinsic value that is derived from the ability of our corporations to produce the goods and services that our consumers and savers demand, to compete effectively, to thrive on the entrepreneurship, and to capitalise on change, adding value to our society."

"Speculation is just the opposite. It represents the short term, not long term, holding of financial instruments, not businesses, focussed (usually) on the belief that their prices, as distinct from their intrinsic values, will rise."

Warren Buffett neatly summarised the difference between investing and speculation when he said: "Investment is an activity of forecasting the yield on assets over the life of the asset. Speculation is the activity of forecasting the psychology of the market."

Mark Twain waxed on the dangers of speculation when he said: "There are two times in a man's life when he should not speculate; when he can't afford it, and when he can."

In our view, any true investor should aim to generate a satisfactory return on capital over time while minimising the risk of a permanent capital loss.

While investing appears easy, very few people maintain outstanding investment records over the long term. I have spent considerable time thinking about the attributes of successful investors that I admire, and aspire to, and have set out my observations below:

Incorporate a margin of safety

Benjamin Graham who co-authored Security Analysis (1934) and authored The Intelligent Investor (1949) coined the phrase "Margin of Safety". Graham's margin of safety is the difference between a stock's price and its intrinsic value. In theory, the further a stock's price is below its intrinsic value, the greater the margin of safety against future uncertainty. I believe the concept of margin of safety to be one of the most important principles for investors.

Seth Klarman, founder of Baupost said: "A margin of safety is necessary because valuation is an imprecise art, the future is unpredictable, and investors are human and do make mistakes. It is adherence to the concept of a margin of safety that best distinguishes value investors from all others, who are not as concerned about loss."

Invest within your circle of competence

I believe that if an investor can objectively understand the limits of their circle of competence and focus their expertise within that circle they will develop a competitive advantage which should translate into better investment decisions. The most outstanding investment records have been built by people who specialise, develop a deep understanding and stay within their circle of competence. While there are many good investment opportunities outside one's circle of competence, there is a substantial disadvantage in attempting to become an expert in too many things. I have described investors who try to be experts at everything to be like a "fly in a bottle", i.e. moving around continuously but making no progress.

I am reminded of this by the words of John Kenneth Galbraith when he said: "One of the greatest pieces of economic wisdom is to know what you do not know" and those of Confucius: "Real knowledge is to know the extent of one's ignorance".

Charlie Munger, the Vice Chairman of Berkshire Hathaway and Warren Buffett's business partner, said: "The game of investing is one of making better predictions about the future than other people. How are you going to do that? One way is to limit your tries to areas of competence. If you try to predict the future of everything, you attempt too much. You're going to fail through lack of specialisation."

Be prepared to walk away

Unfortunately our inbuilt biases (bias of sunk costs and loss aversion tendency) make it difficult for investors to walk away from investment opportunities or sell investments when something has gone wrong. The inability to ignore sunk costs can lead to irrational decisions, particularly if an investor has spent considerable time (and money) researching a potential opportunity. An investment firm with multiple analysts may make an investment in order to reward the effort put into the research and to avoid the analyst feeling they have wasted their time. If the due diligence does not support an investment case or does not demonstrate a sufficient margin of safety (adjusted for risk),

then the investor must be prepared to walk away and wait patiently.

In addition, people's loss aversion tendency is to strongly prefer avoiding losses rather than obtaining gains. This can lead to poor and irrational investment decisions whereby investors refuse to sell loss making investments in the hope of making their money back. I believe that good investors pay no attention to the purchase price of an investment in deciding the rational course of action regarding whether or not to hold or sell. The rational investor will consider their best estimate of the likely return on the investment on a forward looking basis and compare that return to the next best alternative use of the capital.

Do not overly diversify

In our view, very few investors have achieved outstanding long term investment records by holding a widely diversified investment portfolio. By definition, additional stocks dilute the contribution to future returns of the best investment ideas within the portfolio. While a portfolio not correlated to single factor risk is important, it is not necessary to overly diversify by the number of investments to adequately manage risk.

Warren Buffett said on diversification: "Diversification is a protection against ignorance. It makes very little sense for those who know what they are doing" and Charlie Munger said: "The academics have done a terrible disservice to intelligent investors by glorifying the idea of diversification. Because I just think the whole concept is literally almost insane. It emphasises feeling good about not having your investment results depart very much from average investment results. "

Focus on the batting average

I have observed that long term outstanding investment track records are built upon good "batting averages" rather than a few "out of the ball park" decisions. To develop an outstanding batting average, it is far more important to minimise the inevitable investment mistakes than be obsessed with trying to find the 10x investment winners. Many investors are very happy to talk about their investment winners but very few talk about their error rate. Charlie Munger commented: "It's a good habit to trumpet your failures and be quiet about your successes."

However, maintaining an outstanding batting average is extremely difficult. It requires time, focus, discipline, patience, extensive investment due diligence and the ability to forgo opportunities. At Magellan, we are obsessive with the rigour of our investment research, which I have often described as "inch wide and mile deep". Extensive investment due diligence and staying within your circle of competence is critical to achieving a low error rate and improving the investment batting average. We note that very few tennis players have won the US Open or Wimbledon with a high unforced error rate.

Have a medium term investment horizon

The vast majority of investment managers increase the degree of difficulty of producing superior long term returns by focusing on a short term investment horizon. It is our view that the "institutional imperative" of beating the market benchmark over short periods (quarterly or yearly) is counter-productive. A short term investment focus often rules out many mispriced investments on the fear that they will underperform the market in the short term.

I believe investors with a longer term investment horizon have a significant and easy advantage over investors with short term perspectives. At Magellan, we do not regard the short-term performance of an investment as important. We base our decisions on the rate of return we assess an investment will earn over the next three to five years. In doing so, we do not get caught up with a false precision as to timing. Warren Buffett said: "I have no idea on timing. It's easier to tell what will happen than when it will happen." When we have a high conviction as to "what will happen", we are prepared to invest and wait.

Think in terms of probabilities and not in single point estimates

While the investment process appears straightforward, it is very difficult (if not impossible) to accurately estimate the free cash flow that many businesses will generate over time. In reality, there is a wide range of potential outcomes making it difficult to determine a single point estimate of intrinsic value. It is therefore important for investors to think in terms of probability. However, most investors are attracted by the simplicity of assuming a single point estimate. The reality is that the outcome an investor has in mind is their best or most probable estimate. However, there is a distribution of potential outcomes around this outcome known as the distribution curve. The shape of the distribution curve can vary dramatically depending on the nature and competitive strengths of an individual business. More mature businesses, less subject to economic cycles have particularly strong competitive positions (Nestlé would be an example) and tend to have a tighter distribution of valuation outcomes compared to less mature businesses (like technology and biotechnology companies), or those subject to economic cycles (such as banks), or those subject to significant competitive forces.

Challenge your own ideas (invert the problem)

In our view, confirmation bias is one of the primary causes of investment mistakes. Indeed, investors often seek or rely upon information which confirms the decisions they have made and they become overconfident. Instead, good investors should seek to challenge the status quo and find information that disproves their investment thesis, minimising the risk of confirmation bias. It is much more important to ask yourself why you are wrong than why you are right. Charlie Munger said: "We all are learning, modifying, or destroying ideas all the time. Rapid destruction of your ideas when the time is right is one of the most valuable qualities you can acquire. You must force yourself to consider arguments on the other side." He also said "Invert, always invert: Turn a situation or problem upside down. Look at it backward.

What happens if all our plans go wrong? Where don't we want to go, and how do you get there? Instead of looking for success, make a list of how to fail instead – through sloth, envy, resentment, self-pity, entitlement, all the mental habits of self-defeat. Avoid these qualities and you will succeed. Tell me where I'm going to die, that is, so I don't go there."

Do the analysis and think independently

In 1965 Warren Buffett wrote in his letter to investors in the Buffett Partnership: "We derive no comfort because important people, vocal people or great numbers of people agree with us. Nor do we derive comfort if they don't. A public opinion poll is no substitute for thought."

It is also important to understand that being contrarian does not make you a good investor. Many investors have caught "falling swords" by seeking to be contrarian when other investors are panicking. We undertake extensive analysis before making a contrarian investment call in order to avoid catching the falling sword. Our investment returns over time will depend on whether our analysis of the economics and competitive positioning of a business is correct. Benjamin Graham stated: "You are neither right nor wrong because the crowd disagrees with you. You are right because your data and reasoning are right."

Investment temperament (controlling your biases)

In our view, inherent tendencies gives humans the wrong wiring to be successful investors. A great investor will be obsessed about analysing the facts, will always be rational in deciding a course of action, will understand the limitations of their own knowledge, will continuously challenge their best ideas and will remain completely unemotional in their decision making notwithstanding the environment they are in. Numerous successful investors study behavioural economics to understand (and try to counteract) common human cognitive or psychological biases that can lead to poor decision making. Cognitive biases are "hard wired" as we are all liable to take short cuts, over simplify complex problems and be overconfident in our decision making ability. I have previously written about 10 cognitive biases that I think are important to understand as an investor; confirmation bias, information bias, loss aversion, incentive caused bias, oversimplification tendency, hindsight bias, groupthink, restraint bias, neglect of probability and anchoring bias (see June 2012 investor letter).

Training investors to remain unemotional in their decision-making is almost impossible. Evolution did not have investing in mind when designing the biology of the human body. In times of extreme stress (like during a market crash) our brain causes the adrenal gland to release the adrenaline hormone that leads our heart rate and blood pressure to increase. If we were still cavemen about to be attacked by a wild animal, the release of adrenaline would no doubt have enormous benefits. However, as an investor you need to remain extremely calm and rational during times of immense stress and you do not want your body to release adrenaline. With this in mind, it is unsurprising that few investors are able to take advantage of periods of extreme market pessimism. Conversely, during extended bull market environments, the human brain will likely release endorphins as investors watch ever increasing share prices and perceived prosperity. It is probably unsurprising that numerous well known investors train themselves in stress management techniques such as yoga and meditation.

Warren Buffett famously said: "I will tell you the secret to being rich on Wall Street. You try to be greedy when others are fearful and try to be fearful when others are greedy."

Understand opportunity cost

Economists define opportunity cost as the cost of an alternative foregone to pursue a course of action. In our view, few investors properly consider opportunity cost when deciding to make an investment. An investment opportunity looked at in isolation can often look attractive. A proper assessment of opportunity cost takes into account both the expected return and risk in comparison to the next best alternative. In assessing an investment opportunity we look at what the investment will do to the portfolio's expected return, quality attributes, volatility risk, and currency exposure and if it shares underlying business risks with other portfolio holdings. Only by properly assessing a multitude of factors is one able to assess the opportunity cost of undertaking a course of action. Often, the best course of action is to invest in what you already own.

I have often drawn the analogy that we consider our portfolio to be like a football team. Our portfolio consists of around 25 players and each player has a role to play in winning the game. Some stocks play a defensive role and some play an offensive role. We seek to place the best players in each position and when considering a new investment we ask ourselves which player (or stock) are we prepared to replace it with. By doing so, we are actively assessing the opportunity cost of new investments.

Charlie Munger said: "Everything is based on opportunity costs. Academia has done a terrible disservice: they teach in one sentence in first-year economics about opportunity costs, but that's it. In life, if opportunity A is better than B, and you have only one opportunity, you do A. There's no one-size-fits-all. If you're really wise and fortunate, you get to be like Berkshire. We have high opportunity costs. We always have something we like and can buy more of, so that's what we compare everything to."

I end with another (and final) quote from Charlie Munger that I think well summarises the qualities of a good investor:

"Preparation. Discipline. Patience. Decisiveness".

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