Big ideas to guide an investment process

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Here we will define investing as the art and the practice of deploying capital, only after careful thought and analysis, in such a way as to maximize our odds of getting our principal back and – only then – earning a satisfactory return on our capital. There is no single religion in investing. Several methods and philosophies have merit. Condescension and narrow-mindedness are not helpful.

- Think for yourself. Figure it out. Don't stop asking "Why?" until you have the real answer.
- Know what you don't know.
  - Avoiding stupidity – or being less stupid than everyone else – almost always beats brilliance over time.
  - Overconfidence is deadly.
  - Have the courage to declare something too hard or unknowable. Have the courage to act when something is well understood and attractive.
- Learn something every day. Go to bed a little wiser each night.
- Read as much as possible.
  - Track and measure what you read. Set a daily/weekly quota.
- Never assume anything. Turn every page. Trust, but verify.
- The best way to solve a problem is often by looking at it backward or upside-down.
- Think in probabilities.
  - There are no certainties.
  - Always seek redundancy and/or a margin of safety.
- Pricing ≠ valuation. Pricing and valuation are distinct exercises; confusing or conflating them will create pain.
- The most important subject in investing is psychology.
- Be fearful when others are greedy, and be greedy when others are fearful.
- Overconfidence is the 8th deadly sin.
- Incentives matter almost to the exclusion of everything else.
- Being rational is far more important than being intelligent.
  - Two important questions to ask in investing: "And then what happens next?" *and* "Who doesn't know that?"
- Many, if not all, aspects of investing have ideas that seem to contradict each other.
  - Many great failures – in investing or otherwise – come from the inability to hold two ideas at once.
- Big events or outsized results are almost always caused by a confluence of factors.
- Many great mistakes begin by forgetting what one is trying to accomplish.
  - Investing is the art of laying out money today to get that money back in the future, plus a satisfactory return. Everything else is secondary to this aim.
  - The value of any financial asset is the discounted present value of future cash flows. Everything else is a derivative of this concept.
    - Some cash flows are more reliable than others.
    - Detailed, complex, mechanical DCF calculations often do more harm than good.
- Investors value companies. The future value of a company is the sole focus.
  - Securities are simply a means for making an investment in a company.
- There is nothing wrong with speculation, but never confuse it with investment.
  - Speculators rely on price fluctuations and often need ready buyers to achieve a good outcome. Investors focus on changes in cash/economic value and would own an asset regardless of available buyers.
- The valuation process results in a range, not a number. Remember the concept of confidence intervals.
- The best valuation processes leave plenty of room for error and randomness.
- Multiples are a blunt, crude proxy for a real valuation process. Multiples are a way to quickly *price* an asset, not an (effective) way to truly *value* it.
  - Some multiples are effective shorthand, some are unhelpful, and some are misleading.
- The best valuation processes follow a particular order.
  - Start with the materials a company is *required* to disclose: regulatory filings, audited financials, etc.
  - Then review what a company *chooses* to disclose: press releases, presentations, conference calls, etc.
  - Only consider opinions at the end, and then seek out opinions on both sides with an emphasis on disconfirming evidence.
    - Bias is inherent and unavoidable; don't succumb to an anchor before the real work has even begun. (Remember the utility of a blind valuation.)
    - Valid judgments can only be made after gaining enough perspective to argue the other side at least as well as its proponents.
    - Get good at listening.

- Valuation is not possible without a thorough understanding of a business's competitive environment.
- Data reflect the past. Market prices reflect expectations about the future.
- Markets are capable of crazy, improbable things.
- The labels of "value investing" and "growth investing" are a prime example of the false dichotomy fallacy. Growth is a crucial part of the value of any asset, and all investing is value investing (if you're not trying to buy something for less than it's worth, then what exactly are you trying to do?).
- Capital allocation really, really matters. Every company is unique, but there must be a clear framework and order of priorities. Fix/improve the balance sheet. Invest in the business and growth opportunities. Buy another company. Repurchase shares. Pay a dividend. Those are the choices, and getting them right can turn a good company into a great one; getting them wrong can turn a great company into a bankruptcy filing.
- Temperament and behavior are <u>far</u> more important than IQ and analysis.
- Investing and markets are not a zero-sum game.
  - Very high-IQ investors have little if any advantage over above-average IQ investors.
- Allocating capital requires the discipline to prepare, the arrogance to act, the patience to wait, and the humility to admit mistakes.
- There <u>is</u> such a thing as a dumb question. Questions that could be easily looked up or answered elsewhere show a lack of effort and awareness.
- Genuine curiosity is the most powerful tool an investor can have.
  - Most great investors act like bright, relentless, highly-caffeinated investigative journalists.
    - "Research is formalized curiosity. It is poking and prying with a purpose." – Zora Neale Hurston
  - There are diminishing returns to research, but most people err on the other side by cutting corners.
- Investing is not supposed to be easy. Anyone who says it is easy is lying, selling something, or badly mistaken.
- Earnings are a matter of opinion. Cash drives economic value (and is much harder to fudge).
  - Financial statements used to focus on liquidity and solvency; many financial statements today focus on earnings or, worse yet, "adjusted" earnings or, worst of all, adjusted proxies for earnings like "adj. EBITDA."
  - Balance sheets are more important than cash flow statements. Cash flow statements are more important than income statements.
- www.sec.gov is the best resource available. SEC filings are the mainstay of any research process.
  - The footnotes matter. A lot.
- The "cost of capital" is determined by opportunity cost. Precise calculations of the cost of capital are useless.
- Incentives matter, *almost* to the exclusion of everything else.
- Businesses are dynamic, ever-changing, and run by real human beings.
- Regardless of the problem, turning it upside down and/or working backward is often helpful. Inversion is often the most powerful problem-solving tool available. See below.
- The best investors understand psychology *and* history.
- Most businesses fail, and most stocks lose money.
- The spread of excellence – also known as the paradox of skill – is real.
- Reflexivity is real.
- Conditions change, but principles remain.
- Scramble out of mistakes as quickly as possible.
- Remove ignorance step-by-step, every day. Always look for blind spots.
- Knowing too little is obviously dangerous. Knowing too much can also be dangerous if it forces attention away from what matters.
- Longevity is underrated in companies and investors.
- Human + machine is more powerful than human or machine in isolation.

<u>The Seven Sins of Investment Process</u>

1. Separating securities (stocks, bonds, etc.) from their underlying businesses.
2. Ignoring probabilities, or assuming only one possible state of the world.
   a. Related: Ignoring base rates
   b. Related: Using point estimates instead of ranges.
3. Accepting "facts" without thought or curiosity. Remember to trust but verify.
   a. Related: Failing to ask "Why?"
4. Reversing the proper order of investment research by starting from the outside and working inward.
5. Forest-trees problem: Losing sight of the two or three big ideas that matter to any investment.
6. Confusing valuation with pricing.
   a. Related: Relying on multiples in the valuation process.
7. Ignoring psychological factors (i.e., forgetting the lessons of *The Psychology of Human Misjudgment* and *Thinking, Fast and Slow*, among others).