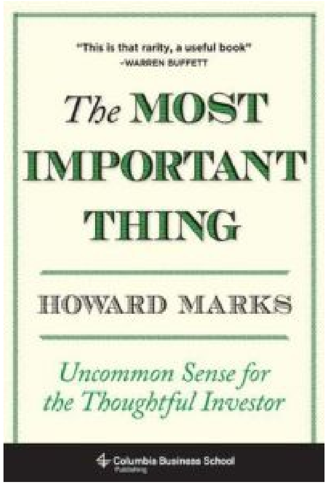

Book The Most Important Thing

Uncommon Sense for the Thoughtful Investor

Howard Marks
Columbia UP, 2011
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Recommendation

Lifetime value investor Howard Marks has distilled his approach and experience into a concise, focused text that offers seasoned investment wisdom to those looking for a way forward in today's financial markets. The book, a compilation of Marks's investor newsletters, contains exceptional chapters on risk management, contrarian thinking and market psychology, as well as a cogent analysis of value investing. While it is somewhat repetitive, *BooksInShort* recommends it to all serious investors who are interested in getting back to the "fundamentals" of investing.

Take-Aways

- If you want your investments to beat the market, develop "second-level thinking."
- Second-level thinkers don't follow the crowd; they use insight and intuition to go beyond the obvious in assessing an investment.
- Good investors analyze a firm's "fundamentals" to get a stock's "intrinsic value."
- Value investors buy the shares only when the price drops below that value.
- Growth investors apply similar analytics to ferret out underpriced shares with the potential for rapid appreciation.
- Buying an overpriced stock rarely pays, regardless of how good the company is.
- Risk is an inevitable ingredient in any investment; understanding it and managing it are crucial, so always consider the "risk-adjusted return" of your portfolio.
- Contrarians make unconventional investments that can defy conventional analysis.
- Patience is a virtue in investing. Don't chase after deals; wait for the right opportunity.
- Professionals who cite skill as the source of their investing success often neglect to acknowledge the importance of luck.

Summary

"More Art than Science"

Investing has much in common with art; both require intuitive and flexible approaches. Unlike in pure science, where practitioners can replicate results consistently, investors can never "routinize" their success. If you want returns that beat market averages, you must cultivate "superior insight," or what legendary investor Benjamin Graham called a "trace of wisdom."

> "The upshot is simple: To achieve superior investment results, you have to hold nonconsensus views regarding value, and they have to be accurate."

Great investors learn to reason differently from the rest of the pack. They develop "second-level thinking," a way of acting and parsing information that deviates from the norm. Second-level thinking requires thoughtful consideration of possible outcomes, probabilities and expectations, as well as understanding how to evaluate a stock's current price relative to future scenarios. However, most investors are "first-level thinkers" who follow the crowd and consider only obvious factors. For example, when markets are in a crisis, first-level thinkers will instinctively sell; second-level investors may very well buy on the market's panic.

Efficient Markets?

The efficient market hypothesis would seem to preclude the ability of any investor to achieve above-average returns. The theory states that all information about any investment is publicly available to all market participants. As a result, the market attributes a fair value to a security, reflected in its price; the higher the risk of that security, the higher the return investors will expect to receive in compensation for their risk taking.

> "A market characterized by mistakes and mispricings can be beaten by people with rare insight."

Yet the market sometimes reacts in ways that bring its efficiency into question. After all, people make up the market – human emotion, fallibility and weakness affect the clinical objectivity the hypothesis demands, leading to market inefficiencies. For example, in January 2000, Yahoo's share price was $237, but it fell to $11 in April 2001. If both prices reflect all available information on Yahoo, that means that the market was wrong at one of those points. Only an unconventional, second-level investor could have profited from that inefficiency.

> "For investing to be reliably successful, an accurate estimate of intrinsic value is the indispensable starting point."

Investors who think differently look for new sources of information and analysis, as well as original ways of assessing the market to find mispricing opportunities. An investor's first question when testing a novel idea or perception should be, "And who doesn't know that?" While the efficient market debate continues, evidence proves that markets do become inefficient, but usually not for long. Widely followed asset classes are highly efficient, even when some mispricing occurs. When it does, that's when second-level investors can beat the market.

Searching for Value

Investors tend to take two basic approaches to investing: They either analyze "fundamentals" – that is, an investment's underlying characteristics – or they conduct "technical analysis," which tracks a security's prior and anticipated price movements. Technical analysis is less in vogue now than in the past; in the 1990s, day traders took advantage of computer technology to act quickly on intraday price changes to capture small upticks in value.

> "Investment success doesn't come from 'buying good things,' but rather from 'buying things well'."

"Intelligent investing" relies on studying fundamentals, which supply the basis for two investment styles: "value investing and growth investing." Value investors seek to buy stocks at a price below those shares' "intrinsic value," based on evaluations of the company. Growth investors use the same analytical approach to look for stocks that will quickly appreciate. Both groups seek growth in a company's cash flow and earnings, but value investors look for current worth and smaller, more consistent gains over time, while growth investors seek future value potential and are more willing to assume macro- and industry-specific risks.

> "As John Maynard Keynes pointed out, 'The market can remain irrational longer than you can remain solvent'."

Timing and confidence in your assessment of a stock's intrinsic value are both crucial to value investing, especially when prices fall below your purchase point. When this happens, dedicated value investors need the courage to buy more shares in the belief that their intrinsic value analysis is correct and that their investment will eventually turn a profit. This type of discipline provides the basis for unemotional and profitable investing.

Price, Value, Risk

Finding the link between the value and price of a security is the linchpin of successful investing. Your analysis of a share's intrinsic value is only half the battle; you must buy that share at a price below that value so that it will eventually earn a profit. If an investor buys a company's shares at too-high a price the purchase will never turn into a good investment, regardless of how great the firm is. Remember that market prices are subject to emotion and crowd psychology, the building blocks of bubbles and fads. It's better to buy a stock at a large markdown, even if it's out of favor; its price will inevitably align with its value. Be patient and wait for the price adjustment.

> "Here's the key to understanding risk: It's largely a matter of opinion."

Risk, an inherent part of dealing with an uncertain future, is another crucial investment variable. Most people are risk averse, but successful investors know that they must identify and manage risk, and that their "risk-adjusted return" determines if their payoff will be commensurate with the amount of risk. Accepting risk without receiving compensation for it violates a basic rule of investing.

> "The risk-is-gone myth is one of the most dangerous sources of risk, and a major contributor to any bubble."

While academics define risk as volatility, most individuals describe it as a potential loss of capital. But each investor's take on risk may differ:

- **Failing to meet an investment objective** – For instance, the pensioner who needs a 4% return to meet his expenses would be delighted with a 6% increase, while the fund manager who must generate 8% for his clients would consider that result a failure.
- **"Underperformance"** – Falling short of some independent benchmark is a common risk, yet many profitable long-term investors underperform during bubbles and speculative markets, to their eventual benefit.
- **"Career risk"** – Fund managers may share partially on upside earnings, but the downside could cost them their clientele.
- **"Unconventionality"** – Some investment managers prefer normal returns to risking their clients' money on unusual strategies.
- **"Illiquidity"** – Being unable to turn your investment into cash when you need it is a risk many investors have to take into consideration.

> "Worry and its relatives, distrust, skepticism and risk aversion, are essential ingredients in a safe financial system."

Risk is difficult to define, measure or predict. Improbable events happen all the time, while probable ones often fail to materialize. People anticipate that the future will look like the past, and they don't account for events unlike any they've already seen. Risk can emerge – and become more dangerous – when crises hit markets. Yet good times can often mask risky portfolios; investors may assume that, because they've sustained no losses, their portfolio managers have good risk controls in place. Be aware that risk, while present, may not necessarily manifest, making it difficult to assess a portfolio's overall risk level.

> "Ignoring cycles and extrapolating trends is one of the most dangerous things an investor can do."

Good fund managers demonstrate their worth when they generate high returns at low risk. Many people don't think about risk management in good times, because high returns subordinate their concerns. But in down markets, solid risk management can dampen losses. Most investors expect volatility and potential losses to follow historical patterns; they don't know how to prepare for exceptionally large, statistically rare losses.

Opportunities in Cycles

The actions of human beings drive markets, so, like human behavior, markets move in cycles. Nothing lasts forever: "Trees don't grow to the sky. Few things go to zero." Yet people tend to extrapolate the past to construct an image of the future, and when events occur that shake that image, emotions overtake investors' objectivity. Big mistakes happen when investors deceive themselves into thinking that cycles – either negative or positive – are a thing of the past, or that "this time it's different."

> "I've recently boiled down the main risks in investing to two: the risk of losing money and the risk of missing opportunity."

Markets operate in cycles of greed and fear, and these cycles carry simultaneously the seeds of opportunity as well as loss. During booms, people downplay risk, but during crashes, investors become overly risk averse and ignore blatant buying opportunities. In both cases, investors alter their risk tolerance levels. Such changes in investor psychology – not market fundamentals – drive short-run price changes. Good investors should remain skeptical about market consensus views; in fact, they should react in ways contrary to prevailing opinion. But being a contrarian can be difficult. It requires adopting and maintaining unconventional investment positions that might not look achievable under conventional analysis.

> "I love the old adage 'What the wise man does in the beginning, the fool does in the end'."

Contrarians sell when others buy and vice versa, hoping to profit by going against the crowd. They seek investments whose prices are low because they are out of favor. To pick up these bargain investments, look for stocks that meet specific criteria, estimate their intrinsic values, compare their current prices to their intrinsic values and evaluate their "risk/return" potential. Then, buy securities with a low price relative to their value, and with potential returns in line with your preferred risk levels.

> "There's only one way to describe most investors: trend followers."

Bubbles happen when an asset class becomes exceptionally attractive. At some point, the buying mania spreads and becomes completely detached from the value of the underlying asset. When people – sometimes irrationally – begin to view an investment as flawed or undesirable and thus avoid it, the asset becomes a bargain.

Being Opportunistic

Value investing is predicated on buying underpriced assets at the best possible risk-adjusted price, but such opportunities are not always available. The smart value investor is patient and waits for opportunities to present themselves. Investing is one of the few professions that rewards patience. If no opportunity exists, don't invest.

> "To boil it all down to just one sentence, I'd say the necessary condition for the existence of bargains is that perception has to be considerably worse than reality."

Know your limitations, and avoid taking on too much risk in pursuit of potential high returns. Many investors assume they know more than they do, which is as bad as not knowing anything. People who try to predict the market often act on flawed knowledge. Instead, ascertain the present: Gauge the temperament of the market and of investors. Notice whether market commentators are optimistic or pessimistic. Look at price/earnings ratios, credit and lending policies, and the popularity of new investment products. This overview is especially important when markets undergo dramatic changes, such as during the period from 2004 to 2007. At that time, cheap leverage, rampant speculation, untested new products – especially in real estate – and the false belief that the markets had conquered risk fueled an investing frenzy. Contrarian investors who recognized those warning signs posted major gains while reducing their risk.

Luck or Skill?

Many investors make risky bets and then take credit for their positive outcomes. Often, however, the result is not due to skill, but luck. People frequently make money on a stock for the wrong reasons, making it even more important that investors find out how a manager achieves stellar performance. Were the results based on luck? Could other random events have produced those same gains, or even losses? Define success by looking for a portfolio that delivers above-average returns with low volatility; see if the same manager consistently produces good results.

> "Operating a high-risk portfolio is like performing on the high wire without a net. The payoff for success may be high and bring oohs and ahhs. But those slipups will kill you."

As an investor, you must determine whether you prefer to make money or avoid losing it. The two options are not the same, and every investor has to find the right balance between going on the offensive and on the defensive. The choice depends on your personality, confidence level and competence. Defensive investors want to avoid bad investments and losses, so they establish what Warren Buffett calls a "margin of safety." This margin occurs when you buy an asset at a great price. If you buy a stock you've valued at \$100 for only \$70, your risk of loss decreases, while your upside expands. Preventing losses is easier than making profits: The latter relies on an unpredictable future, while the former depends on analyzing tangible events and values today.

About the Author

Howard Marks is chairman and co-founder of Oaktree Capital Management, an investment firm with $80 billion under management.