LOH-GRONAGER PARTNERS

WHAT MAKES A SUCCESFUL VALUE INVESTOR?

PART X – HUMILITY

In this, Part X the penultimate publication in our Multi-Part Series (published monthly), we are going to explore the quality trait known as humility and how it can help us to answer the question:

What makes a successful value investor?

Sometimes we can solve a problem or understand something better by looking at it differently. One of the best ways that I have found of doing this is to 'invert' it. The opposite of 'humility' is 'hubris' or 'pride'. On this subject, the ancient Greeks had a powerful proverb from which I feel we can also learn something about humility 'Those whom the gods would destroy, they first make proud.' Humility in life and humility in markets I believe are two sides of the same coin when it comes to success. There is a fine line between confidence in one's convictions and hubris or arrogance. Knowing where you are on the scale at all times, is of vital importance.

In life, the most successful people I know, are those who fail well. Ray Dalio the founder of the world's largest hedge fund, Bridgewater defines this as 'Being able to experience painful failures that provide big learnings without failing badly enough to get knocked out of the game.' They are humble enough to recognise that everyone makes mistakes, but successful people learn from them. In investing, we recognize our humility through the concept of the margin of safety.

Investing with a margin of safety was first described by Benjamin Graham in the core text for any value investor (Securities Analysis available here) which was first published in 1934 and has been in print ever since. To summarise, a margin of safety is achieved when securities are purchased at prices sufficiently below their underlying value to allow for: human error, bad luck, or extreme volatility in a complex, unpredictable and rapidly changing world. This final point is the most important, rapid change in the world around us makes errors in our forecasting inevitable for which the purchase price must compensate us. When we invest with a sufficient margin of safety, we know that if we have made a mistake, we will have at least preserved our capital. If we were conservative enough, we will come out ahead, and if we were even slightly correct, our returns should be large.

As an investor we must all acknowledge that despite our best efforts, we will often be wrong. Dan Loeb who runs the hedge fund Third Point said to a graduating executive MBA class:

'Investing in public equities is a dangerous pursuit that requires risking real money based on limited information. Even when you are diligent about buying at a margin of safety, you will still make money losing mistakes. Aspiring investors who require perfection have gotten into the wrong business.'

Once we are intellectually honest enough to agree that we will make mistakes, we can then begin the process of insuring against them. The purchase price must at a minimum reflect the risk inherent in the business, otherwise it is a firm 'pass'. Patience (our favourite word from Part VIII appearing again!) is key, as the temptation to ride the new market fad will never be far from your mind. Most market participants fixate on their potential short-term return, paying little attention to the risks involved i.e. how much they can lose. Your job as a value investor is to do the opposite, to be long-term orientated and risk averse.

As we have discussed previously, all investing is to a great extent about predicting the future. Ian E. Wilson a former Chairman of General Electirc said when asked about how to make the best management decisions 'No amount of sophistication is going to allay the fact that all your knowledge is about the past and all your decisions are about the future.' As a practical example, anyone at the dawn of the automobile or indeed decades later when they were more popular, would have known that this invention would change the world. Despite this, of the thousands of U.S. car makers that appeared over the last century there are only a few that are still around today, the rest went bankrupt. Predicting the future then is not enough, you have to buy it at the right price. It's not about what you buy, its about what you pay when you buy, investing is about buying with a margin of safety. The simple maths of it is as revolutionary as a new technology is, if you buy shares in a business and it already reflects a spectacular future in the price that you have paid, then anything less than this will result in a loss, even if the future is spectacular, as the price you paid already reflects this.

For human beings remaining grounded when we experience success, especially repeated success often proves to be exceedingly difficult. Success can imbue us with a false sense of security in our abilities and thus alters our perceptions of risk. For example, correctly picking the winner of the first race at a racetrack. If we then correctly picked the winner of the second race, this false belief in our abilities of prediction can be compounded. It is this reinforcement that seduces us of our own talents, further obscuring the facts of the situation (that the horse racing outcome was pure luck) as well as reducing our ability to see that times will change. Hubris.

As investors we must always question our beliefs, we must change our minds when the facts change. Being wrong is an inevitable part of investing. The most spectacular tail of hubris that I have read about in markets is Roger Lowenstein's book When genius Failed (available here) on the rise and fall of the hedge fund Long Term Capital Management (LTCM). The Nobel laureates who founded it, believed that they had cracked the financial markets (they had several years of spectacular returns) and came to believe that they could do no wrong. The result was a 98% loss of their investors' money. It's useful to remember Munger's quip from the 1989 Wesco Annual Report about LTCM when he said:

'It's remarkable how much long-term advantage people like us have gotten by trying to be consistently not stupid, instead of trying to be very intelligent.'

Given that we started this piece discussing ancient Greek proverbs on pride, it seems only fair that we also hear what their cousins the ancient Romans had to say on the topic of dealing with success and the importance of humility. In Roman times. When a victorious general would return home. They were typically granted a 'triumph'– it was technically illegal for an army or general to enter Rome other than at this event – which was effectively a big parade. The general would display all of the plunder and captives from the campaign (e.g. elephants from Africa, treasures from Mesopotamia and slaves from Gaul / Britannia / Hispania / Syria / Dacia / Carthage). At the end of the parade, the general would ride in a chariot to be lauded by the crowds lining the streets and to offer a sacrifice at the Temple of Jupiter on Capitoline Hill in the centre of Rome. The general would be accompanied in the chariot by an 'Auriga' (a slave with gladiator status). The Auriga would continuously whisper to the general 'memento mori' – 'remember you are mortal'. At the peak of his triumph, the general was reminded of his own mortality.

To be successful in markets our investment style has to evolve as we learn from our mistakes of commission (mistakes we actually made, such as not selling a stock when we should have) as well as of omission (mistakes we made from actions we didn't take, such as not buying a stock when we should have). The original value investors of the Graham School were educated during the Great Depression when many companies were trading below their net asset (or liquidation) values. If there was a mathematical probability of making money because the share price was less than the assets of the company, Graham purchased shares in the company. To increase his probability of success, he purchased as many of these as he could find.

From this school and as the markets changed, with companies now infrequently trading below their liquidation value, the investment approach of Phil Fisher evolved. His strategy was that in addition to performing Graham's quantitative analysis of a business, he would also include a rigorous qualitative analysis of the business. He was looking not just for cheap stocks like Graham, but stocks that had the potential to significantly increase their intrinsic value over the long-term. The humility to acknowledge that what works today may not work in the future and to be constantly improving your investment process to incorporate new information is in my view, key to long-term success. In investing, there is nothing that always works, this is because the environment is always changing, and investors' own efforts to respond to the changes in the environment cause it to change further. This is George Soros' theory of 'reflexivity' in action in markets.

So far, we have learnt about the philosophical aspects of humility on human behaviour, but how can we apply this practically to become more successful investors I hear you asking. The first step is to admit that we will be wrong, and we will be wrong often and as such we need to always be protecting our capital first and seeking gains second i.e. only buying with a significant margin of safety. We are not looking to buy a $100m business for $95m, there is nowhere near enough margin for error here. Think about engineering, when engineers build a bridge and say the maximum load is 10 tonnes to cross it, that does not mean it is designed to fail if you drive across with an 11-tonne load. It will likely be designed to support 2 or 3x the maximum stated load as that way it incorporates an enormous margin for error. This same principal can be applied to investing.

To be successful in investing, you need to be an independent thinker who bets against the consensus and is right. That's because the consensus view is baked into the price. You are inevitably going to be painfully wrong a lot, (the 'Wisdom of Crowds' at work again) so knowing how to do that 'well' is critical to your long-term success. The difference between average investors and the most successful investors is that the most successful ones learn and grow from their mistakes, while average investors are set back by them. It is through this recognition of their own fallibility of judgement that successful investors incorporate into their investment process a margin of safety which all but ensures their long-term success. Stay hungry. Stay humble.

I trust you have enjoyed our journey together so far however, if our paths diverge from here, then as the investing legend, Charlie Munger says, 'In the investment business, all knowledge is cumulative' and in this spirit, we wish you continued success on your journey!

Yours sincerely

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