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WHAT MAKES A SUCCESFUL VALUE INVESTOR?

PART III – TEMPERAMENT

In this, Part III of our Multi-Part Series (published monthly), we are going to examine the required temperament for a long-term, Value Investor. In my experience, having the correct temperament as an investor may be the single most important skill necessary to answer the question:

What makes a successful value investor?

Bill Miller is one of the most successful investors of any generation, when he was the lead Portfolio Manager of the Legg Mason Capital Management Value Trust from 1991-2005, he outperformed the S&P 500 Index for 15 consecutive years (a feat replicated neither before nor since), compounding at 9.4% per annum Vs. 9% for the S&P 500. When asked what separates the exceptional investors from the rest he said:

'Broadly speaking, there are only three competitive advantages to be had in investing: informational (I know a meaningful fact that nobody else does); analytical (I have used the publicly available information to arrive at a superior conclusion) and psychological (behavioural), it is the third that distinguishes the exceptional from the rest.'

Buffett and Munger have also both long argued that what distinguishes the successful from the unsuccessful in investing, is not IQ, is not experience, but temperament. Although the right temperament can to a certain extent be taught through repetition and reward, the greater part of it I believe is innate in the greatest investors. It forms a key part of who they are both as individuals and as investors. Let's look at the key characteristics in turn.

The first is to operate with what Buffett calls an 'inner score card' i.e. not caring what others think, versus living by an 'outer score card' whereby we live our lives based on how we think others perceive our actions. This has been made famous when he posed the question 'would you rather be the best lover in the world, but known as the worst or the worst lover in the world, but known as the best?' (don't worry I'm not sure that I want to answer this one in public either!) Human beings are naturally sociable animals, it is therefore unusual for an individual to be able to go against the herd and not to be influenced by them, but this is a necessary trait to be a contrarian investor and to see value where others do not.

Investors that have this innate ability to be independent are able to look at a prospective industry or business and not care what the person next to them thinks. Nor what the television pundits say about it, or the inches of newspaper column devoted to it. They are able to form their own conclusions using all of the available facts, despite a multitude of sources telling them that 'this is going to happen' or 'that is going to happen.' If there is not sufficient information available to them, or if after thorough analysis it leaves in their minds more questions unanswered than answered, or is found not to be a suitable investment, then it is discarded. The ability to walk away from an investment after reaching your own conclusion, despite everyone around you claiming it to be a 'no-brainer' is a unique ability. Independence is an incredibly important attribute for successful investors as you will face the temptation to act constantly and need to be able to resist and say 'no'.

The ability to remain objective and unemotional when conducting the investment process is also essential. Value investing is the search for truth, the separation from what is right from what is wrong. By objectively and rationally evaluating the facts you can develop an edge over the herd mentality that persists in the market, sometimes to enormous extremes, such as during the Dot.Com bubble. Human beings are emotional and thus to expect no emotions to enter your investment process is unrealistic, but by being aware of them and how they can impact our own investment process is in my view, half of the battle won. In fact, whenever I am completing one of our Investment Checklists for a current or potential future holding, I first write down how I am feeling before I start the work. If I am feeling angry or stressed or tired, then I know now is not the best time to be doing investment research, which needs to be done under feelings of equanimity.

Dr. Kenneth Shubin Stein has shown through studies and scientific literature that: hunger, anger, loneliness, tiredness, pain and stress are common preconditions for poor decision making. Once we recognise the creeping influence of one of these conditions that is altering our emotional state and setting us up for failure, we should take a break. Not until emotional balance has been fully restored should we continue with the investment process. Mindful decision making is a necessity.

Similarly, Dr. Shubin Stein also found that there are four actions that can improve brain health and function: meditation, exercise, sleep and nutrition. By focussing on these aspects of our lives we should be able to sustain superior performance for longer periods of time. For me the key takeaways (pun intended) from these studies are that we as investors need to be self-aware of our emotional state and honest in acknowledging when it may be compromising our best judgement. It is also of great help to our investment process as well as to our general physical and mental wellbeing as individuals, if we can construct a lifestyle that is conducive to a state of calm rationality. For me this is done through daily routine as well as hobbies that foster this mindset.

Investing, ultimately, is about predicting the future, to do so we analyse businesses under various future scenarios that we predict likely to occur. We then assess whether the business performs well enough to warrant a valuation significantly different from the one the stock market is ascribing to it today. This is inherently very hard to do. For example, for a currently successful company we have to evaluate the likely effects of competitors drawn to its super normal profits and the effects this will have on the company's growth, profitability and market share 10 years or more into the future. The management team of the business, who arguably know more about this specific company than anyone else even have difficulty doing this for just the next quarter, let alone 10 years out. Yet an investor who is objective and can calmly analyse the facts of the business, its competitors and the industry stands a far higher chance of getting it right. Extreme objectivity is key along with the ability to continuously evaluate and adapt one's view based on new information.

Successful investors need to possess both extreme patience and extreme decisiveness in equal measure. As a value investor we need to have the patience to not act for significant periods of time and let cash accumulate when there are no attractively priced opportunities. This is particularly hard as usually when opportunities are not attractively priced it is because markets are reaching new all-time highs and everyone around you is making seemingly easy money.

John Maynard Keynes pointed out all the way back in 1936 in his book the General Theory of Employment Interest and Money:

'Human nature desires quick results, there is a peculiar zest in making money quickly, and remoter gains are discounted by the average man at a very high rate. The game of professional investment is intolerably boring and over-exacting to anyone who is entirely exempt from the gambling instinct; whilst he who has it must pay to this propensity the appropriate toll.

If he is successful, that will only confirm the general belief in his rashness, and if in the short run he is unsuccessful, which is very likely, he will not receive much mercy. Worldly wisdom teaches that it is better for a reputation to fail conventionally than to succeed unconventionally.'

When it comes to the topic of decisiveness, Seth Klarman the Founder of the eponymous Baupost Group Hedge Fund, points out that most successful investors tend to allow the fear and greed of others to play into their hands. By having confidence in their own analysis and judgement, they respond to market forces not with blind emotion but with calculated reason. Successful investors, for example, demonstrate caution in frothy markets and steadfast conviction in panicky ones. When opportunity arrives, they are extremely decisive and act without hesitation or as he puts it: 'When it's raining gold, you don't put out a thimble but a bucket.' How an investor responds emotionally to the ups and downs of the market is a key factor in their ultimate success or failure.

The ability to remain calm despite the constant noise both in terms of price fluctuations and information surrounding markets and businesses I believe is an innate skill. Concentrated value investing in particular requires a very specific temperament. Being able to take losses and hold your conviction and thus potentially adding to investments as they fall and are subject to extreme adversity is one of the most important. Concentrated investors in particular are willing to remain invested through periods of temporary but sometimes significant capital loss in an attempt to capitalise on opportunities where the probability of a permanent loss of capital is small, but the upside is significant. This resilience is a prerequisite for success both in life and in markets.

The complimentary ability to remain optimistic despite the relatively persistent (and sometimes extreme) adversity that value investors will face is equally important. Peter Lynch who ran one of the most successful mutual funds of all time for Fidelity with the Magellan Fund, said: 'When you invest in stocks, you have to have a basic faith in human nature, in capitalism, in the country at large, and in future prosperity in general.' If you spend too long thinking of all the potential bad outcomes and coming up with any number of the countless reasons not to invest, then you doom yourself to failure. As Nietzsche (time for a little Germanic philosophy) quipped: 'Stare too long into the abyss and you become the abyss.'

Despite the dispassionate and calm rationality, that we must use to evaluate businesses we must not lose sight that the ultimate objective is to find companies to invest in. Not to find excuses not to invest when the positives far outweigh the negatives, and especially during times of market panic.

It is my belief, that success in investing, ultimately, comes down to temperament. Although all of the investors mentioned thus far are extremely intelligent, none would credit their IQ with their success. They love what they do, and thus spend their lives constantly refining their edge in markets by thinking about business and investing. They embody the old adage ‘that if you love what you do, you will never work a day in your life.’ They are unusually disciplined and patient, waiting for the right investment at the right price to deploy their capital. People in general think short-term and demand action, which is why I agree with fellow Fund Manager Mohnish Pabrai on having an investment staff of one, consisting of only the investment manager, as the moment you have people on your team, they’re going to want to act and do things, and then you get in trouble. In most fields, a hunger for action is a virtue, but in the investment business you get paid for being right not for doing things. Finally, the ability to think rationally and yet optimistically about the future is key to any investors decision making process.

There will be many investors that encompass at least one of these temperamental traits and some that will even possess several of them, but there are very few who possess them all in equally sufficient quantities to persevere as concentrated value investors in the long run. As we have seen, some traits can be cultivated, like a passion for business, but most you either possess or you don’t. The intellectual honesty to be able to objectively evaluate your own strengths and weaknesses as an investor and recognise them, is, I believe a crucial part of the journey to becoming a successful investor.

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

Ardal Loh-Gronager

Managing Partner

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