

How to think about investments?

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What should you expect from WIJ

Watheeqa Investment Journal [WIJ] has one mission – “To bring you the best, unconventional insights and the most important ideas in the field of investments”. As we begin our journey – we are clear about how we would want our journal to be known; *A High Quality Thinking and Learning Investment Publication*.

We intend to use WIJ as a conduit to communicate, inspire, inform, illuminate and share our thinking on some of our cherished topics; behavioral finance, perspectives on key developments shaping up the financial world, lessons from renowned global investors, influential investment and non-investment thinkers, writers and practitioners who will help shape our thoughts, unravel popular myths, widely held beliefs and challenge the prevailing conventional investment wisdom. We will review and discuss great books and other thought provoking literature across various fields that will help us build multidisciplinary mental models.

Welcome to our inaugural issue of *Watheeqa Investment Journal*. We trust the journal meets your expectations and stands-up to our own aspirations as well.



We are amidst....

Unprecedented times; a massive bubble burst of historic proportions and this time around it's called the 'Subprime crisis'; thanks to the United States – leading to depression like conditions gripping the markets similar to the late 1920's, deflation in prices across all asset classes – stocks, bonds, real estate, hedge funds, commodities, private equity and you name it. Repercussions of these events are wide, far-reaching and deep – collapse and bankruptcies of countries, global investment banks, financial institutions, acute liquidity crunch and a complete freeze on the credit markets, melt down of stock markets, large scale asset write off's, plant shut downs, huge employee lay-offs, demand contraction and major global economies in throws of a recession. Needless to say, pessimism and fear are at their peaks and investors' confidence; shaken, pummeled and gone. Market participants across the globe are questioning the very existence of capitalism. Undoubtedly, 2008 will go down as a watershed year in financial history. Well, what led us to this disastrous situation in the first place is a subject matter for detailed discussion and analysis some other day – but in brief this is what happened.....

“Please, God, Just One More Bubble”

Warren Buffett in his most recent annual letter to shareholders¹ wrote “You may recall a 2003 Silicon Valley bumper sticker that implored, “Please, God, Just One More Bubble.” Unfortunately, this wish was promptly granted, as just about all Americans came to believe that house prices would forever rise. That conviction made a borrowers income and cash equity seem unimportant to lenders, who shoveled out money, confident that – house price appreciation – would cure all problems. Today, our country is experiencing widespread pain because of that erroneous belief. As house prices fall, a huge amount of financial folly is being exposed.” Keeping the above background in mind we think is a useful way to start.

Party is over; Hangover will be ugly and painful

"You only learn who has been swimming naked when the tide goes out" added Buffett. Now we know for sure Lehman, AIG, Bear Stearns, Morgan Stanley, Merrill Lynch et al., and many; all were swimming naked. The collapse of these giant institutions has wiped out investor wealth beyond anybody's imagination. The contagion which started in late 2007 from the United States has spread like wild fire across the globe. Equity markets world over are down on an average 30-40% and in some cases more than 50% by the end of 2008. The party is over.

We are back to square one – pervasive pessimism very gradually setting the stage for the next cycle to begin; but it's not only going to be painful – mighty ugly as well. The question is when. The answer is when the excesses are completely weeded out. Markets inevitably go through boom and busts. In fact, capitalism is very much intact; it's just that we overly abused gripped by greed. *"History may not repeat itself,"* in Mark Twain's wise formulation, *"but it rhymes"*. Viewed a decade hence, events and bubbles of the last couple of years may just be one more chapter in *Extraordinary Popular Delusions and the Madness of Crowds*.

*'Bull markets are born on pessimism,
grow on skepticism, mature on optimism
and die on euphoria'*

Sir John Templeton



Unknowable, unimportant and uncertain

Meanwhile, everybody is busy trying their best to forecast and predict where the markets will be tomorrow, next week, next month, six months from now and by the end of 2009. At the beginning of each year, driven by institutional imperatives; as a routine and ritual, economists and analysts put together their prognosis on where they see the economy, GDP, market indices, oil prices, inflation, interest rates, sectors that are likely to outperform, stock price targets etc., In fact tomes of pages are devoted to such predictions – what a cruel waste of pulp and trees. We seriously think such an endeavor to predict is not only heroic but also plain foolishness. Let's take oil prices for instance; it is governed by demand and supply – not by intrinsic value.

*'If I knew the price of oil ten minutes from
now, I will resign my job and become a
billionaire'*

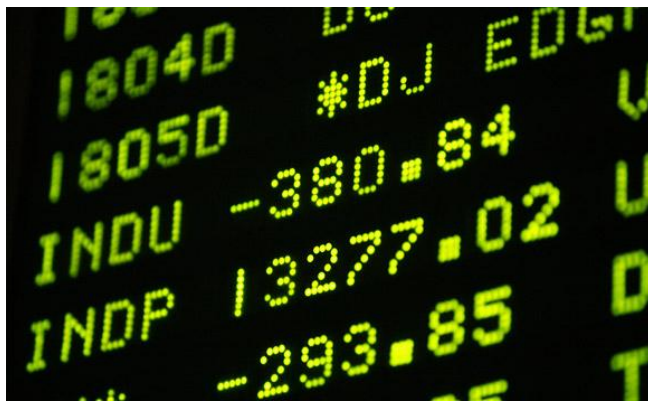
Abdullah Jumah, Saudi Aramco [Outgoing CEO]

I am not too sure of the sequence

Though the demand-supply of oil can be forecast to some precision; not the underlying price of the commodity by any means. There are simply too many moving parts that influence oil. However, (a) basic economics will be largely at play coupled with (b) geopolitical factors (c) natural calamities (d) cartels (e) war (f) labor strikes, of course and most importantly (g) speculative behavior. I am not too sure of the sequence. Unfortunately, most of the companies and investors spend their valuable time and intelligent resources focusing the unknowable, unimportant and uncertain. It's like a person blind-folded searching for a black cat in a pitch dark room. Welcome to the crazy investment world of chaos, deceit, envy, pride, greed and fear.

Sorry, I don't know

For a moment, just assume you are in the beginning of 2008. How many of us predicted that the oil prices will reach their crescendo of USD 140+ a barrel and fall below USD 40 a barrel by the end of 2008, Lehman Brothers – one of the oldest financial behemoth would file for bankruptcy, Nationalization of Freddie Mac and Fannie Mae, the automobile trio-giants GM, Chrysler and Ford at the verge of bankruptcy, US, Japan, Singapore and Europe dip into a recession. We can go on – the list is endless. The bottom-line is; none were predicted – not even a close call let alone wild guess. Honestly, I will be first to admit that I had the faintest idea that any of these events will unfold the way they have. Neither do I have any clue of how the events will unfold in the next twelve months.



How to think about investments

Putting our ideas together on 'How to think about investments', we believe, may be worthwhile especially in times of gloom and doom we are in. Sir John Templeton remarked 'Bull markets are born on pessimism, grow on skepticism, mature on optimism and die on euphoria'. We just saw an end to one of the most euphoric era. Templeton also noted 'The time of maximum pessimism is the best time to buy and the time of maximum optimism is the best time to sell'. Well, this aphorism may sound like music and easy in theory; but we all know how difficult this is in practice. But this is what investing is all about. Yogi Berra said "In theory there is no difference between theory and practice. In practice, there is."

Buffett in his recent open editorial in the *New York Times*² exhorted investors to start investing and wrote "A simple rule dictates my buying: Be fearful when others are greedy and be greedy when others are fearful." Because if you were doing the opposite, chances are that you are a part of the crowd and that's not how intelligent investors conduct their investment operations. This would mean that investors completely ignore the conventional wisdom because by the time it is conventional; it is rarely wisdom.

'Invert, always invert'

Karl Gustav Jacobi, [1804-1851]

'Invert' – I want misery and destroy wealth

It was in the spirit of the great algebraist Karl Jacobi that Charles Munger, Vice chairman of Berkshire Hathaway, delivered a Harvard School commencement speech on 13th June 1986. In Charlie's, infinite wisdom, many difficult problems are best solved in reverse or thinking backwards — that is, by considering those things that will *prevent* your *success* rather than allow it. Inspired by Jacobi's 'Invert, always Invert' model, Charlie's speech centered on how one could go about *embracing misery in life*. I will not go into the details of Charlie's speech here, however, use the 'Invert' model to see how investors and professional money managers can bring *misery* and *destroy wealth*.

Some prescriptions to misery and ways to destroy wealth

- Learn and try very hard to use calculus to arrive at better investment decisions
- Discuss Beta, Capital Asset Pricing Model (CAPM), Efficient Market Hypothesis (EMH), Modern Portfolio Theory (MPT), complex algorithms and volatility at every forum – if possible during the investment committee meetings, at the road signals, near water-coolers, wash-room and office kitchen
- Master the Greek letters – Alpha, Beta, Theta, Gamma and Rho. Memorize beta's for all listed companies

- Forecast and base investment decisions on weather predictions, rainfall, popcorn prices, employment, inflation, population, mortality rates, GDP, current account deficit/surplus and foreign exchange rates
- Insist on analysts having at least 10 excel files, 20 sheets of financial modeling to value a stock and at least a 30 page report. If anything is remotely simple; throw it from the nearest window
- Watch the tickers, stock prices every minute
- Insist a 40 inch Sony TV is installed in your private office to keep-up with the news-flow and business channels etc.,
- Concentrate on asset allocation strategies – constantly balance, rebalance and rebalance the rebalanced portfolio every Monday, Sunday, Tuesday, Wednesday, Friday, Thursday, Saturday
- Diversify asset class by adding the hottest commodities fund that concentrates on popcorns, *Reel*-estate etc., Criteria to use – See if the fund is promoted by the largest investment banker in the country. Criteria to judge the largest investment banker – See if their advertisements are on all the lamp posts and road signals
- Diversify the portfolio with stocks based on the number of steps you climb in your office. If your office is in the first floor – please use your weight in pounds or kg (whichever is high) as the guide
- Insist on group thinking like Zebra’s do in a zoo and an investment committee of at least the size of your office conference room
- Boost portfolio returns and fund Net Asset Values (NAV) by speculating only during these two months – October and January. Other months include – February, April, March, December, September, May, July, June, August, and November.
- Hire investment consultants to figure out what *style* works – Value investing – Growth investing – Momentum investing, what *approach* works – Technical Analysis – Fundamental Analysis, what *strategy* works – Trading – Buy and Hold, what *specialization* works – Mid-caps, Small-caps, Large-caps, Micro-caps
- Invest in stocks of companies whose CEO is on the cover page of some business magazine. Other criteria’s include; CEO must have won awards such as ‘Businessperson of the Year’, ‘Most Powerful Businessperson of the Year’ etc.,
- Predict stock market index levels, oil prices, recession, next quarter earnings and worry about wars and bird flu’s etc.,
- Buy when everybody buys and sell when everybody sells – Buy what is going up and sell what is going down – Buy whatever is popular
- Use time judiciously and read all analyst reports cover to cover and take stock price targets and all recommendations seriously
- Make investment decisions based on tips, rumors, advise from professional ‘experts’ and business channel anchors
- Subscribe to all the Initial Public Offerings
- Think “This time it is different” – Bull markets are permanent
- Think “This time it is different” – Bear markets are permanent
- Use commonsense sparingly like salt and pepper
- ‘Think’ and ‘act’ like a professional money manager
- Benchmark portfolio performance with an index
- Brag fund outperformance by 2% to colleagues, chauffeur, wife, friends, competitors, press journalists and the office tea boy when the markets are down 50% and your fund is down only 48%
- Fire the analyst if he comes to you with a simple idea, logical argument, commonsense analysis, and can present an investment thesis in not more than five sentences. If the analyst knows how to value a business on the back of an envelope, fire him twice.
- Stay active in the markets even during week-ends and public holidays. Try and time the markets even when they are closed

Follow these ‘Inverts’ and I can guarantee results. Pick any five randomly; results still guaranteed.

Pro's are at a huge disadvantage; you are not

Institutional money managers are at a huge disadvantage. They have got to worry about a whole lot of things [*institutional imperatives*] and keep up with their – net asset values (NAV's), benchmarks, regulatory guidelines, all sorts of committees – investment/risk/audit, redemption pressures, peer pressure, constant media scrutiny, market their funds, fund raising programs, compulsions to stay invested all the time, trading portfolio's etc.. In the process, the role becomes severely constrained and marginalized. They end up – true to their titles – fund managers; too busy and hardly have the time to think and act like an 'investor'.

I don't blame them and have nothing against; they are talented, brilliant and hard working. Ask these managers if they are invested in the funds they manage; chances are – they aren't. If they are not – why should you? If their interests are not aligned alongside yours, where is the incentive to perform? Rightly so, a vast majority of these 'professionals' miserably underperform. This is how it has been in the past and I don't think the future is going to be any different. The field of money *management* industry is designed to lose money in the long haul. The field now is one of money *marketing*. I suggest, you select your partners carefully.

Traits of successful investors – How they think & act

John Bogle says that over a five year period 90 percent of the professional fund managers trail behind the broader indices and over a ten year period over 95 percent under-perform and by a wide margin. If that is the case – then what distinguishes the rest? How do accomplished investors approach investments – How do they think about investments and how do they act? This is a subject that has always fascinated us. Over the years, we have gathered some invaluable lessons simply by observing and studying the traits of these outstanding investors. Common attributes – several of them, as they emerge, are pretty easy to list; damn hard to practice. But that's what sets them apart.

'It's only common sense to study success'

Sir John Templeton

Easy to grasp; damn hard to practice

- They are obsessed with 'Margin of Safety' - focused on value; not price. They begin by asking 'how much can we lose in this investment – what's the downside?' They act only when the odds are in their favor. If the downside is protected; the upside potential will take care of itself.
- They focus on intrinsic value of a business and understand that it is not a precise estimate but a range of values. They buy a business only when there is a substantial gap between the value and price – 'Margin of safety' is the key.
- They view stocks as a part ownership in a business not some ticker symbol with quotes that swings up and down
- They take advantage of Mr. Market. They understand that markets are there to 'serve them'; not instruct them.
- They have infinite patience, emotional discipline and razor-sharp like focus
- They read, read and read voraciously. They know knowledge is cumulative and adding to their repertoire – all the time. They are interested in the 'big picture'; not the next quarter or next year earnings. They invest for the long haul; 3-5 years and beyond and understand the principles of 'compounding' thoroughly well
- They don't predict, they analyze
- They understand that valuing a business is more an art and less a science
- They make few, infrequent, and large bets – They repeatedly demonstrate that 'patience is a virtue' – willing to wait in the sidelines for the fat pitch. Eventually, when they find one, they act decisively
- They think independently and rationally. Most of the times they are loners. They tend to buy what's out of favor rather than what's popular

- They fully understand and appreciate that 'Psychology of investing' is equally important as much as 'fundamentals of investing'
- They invest in simple, stable and predictable businesses
- They are willing to wait with buckets of cash in their portfolio's even if they earn sub-par returns – until they find worthwhile opportunities
- They are opportunistic; they cast a wide net, seeking undervalued, mispriced businesses across industries, sectors and company size rather than accepting artificial limitations on market capitalization or other criteria's
- They define risk as permanent loss of capital; not volatility
- They are intensely process driven rather than outcome. They don't confuse means and ends.
- They are humble to admit their mistakes and constantly learn from them.
- They invest within their circle of competence. They understand that it's not only important to 'know things' but also 'know things they don't know'. How big the circle is not important; staying inside that circle is.
- They don't try to do extraordinary things to get extraordinary results. They do simple things consistently right over a fairly long period of time.
- They think in terms of probabilities – seek absolute returns
- They don't try to time the markets
- They are amazing story-tellers, logical thinkers, forthright and crystal clear in their communication be it their investment thesis or shareholder letters.
- They are ardent students of financial history, human psychology and behavior, hard and soft sciences, literature and philosophy.

These, in our view, are some of the fundamental characteristics that great investors tend to practice and share in common. In the following pages, let's see how some of the key ideas hang together, and learn how these successful investors approach and view investments.

Successful investing has little to do with a high IQ

I am sure many would not argue if I said that Sir Isaac Newton was one of the most intelligent, original and influential theorist in the history of science. In addition to his invention of the infinitesimal calculus and a new theory of light and color, Newton transformed the structure of physical science with his three laws of motion and the law of universal gravitation. Back in the spring of 1720, Sir Isaac Newton owned stocks of the South Sea Company, the hottest shares in England. Sensing that the markets were getting out of hand, the great physicist dumped his South Sea shares, pocketing an impressive 100% profit totaling £ 7,000. Swept up in the wild enthusiasm of the market, just a few months later, Newton jumped in again and bought the shares of the South Sea Company – this time at a much higher price. Subsequently, the bubble bust and Newton eventually lost £ 20,000. The period 1719-22, then came be known as the 'South Sea' bubble. Having lost all the money, Newton said *"I could calculate the motions of the heavenly bodies, but not the madness of the people"*.

Let us take the case of Long Term Capital Management [LTCM], a hedge fund run by a battalion of mathematicians, computer scientists, and two Nobel Prize – winning economists, in 1998, lost more than USD 2 billion in a matter of weeks on a huge bet in the bond markets. LTCM had borrowed so much money that its collapse nearly capsized the global financial system.

The Intelligent Investor

Benjamin Graham is considered to be one of the greatest investors of the twentieth century and popularly known as the 'dean of security analysis and value investing'. Ben Graham has been a source of inspiration to many of today's most successful investors and businesspeople alike. Ben Graham in his seminal and timeless classic *"The Intelligent Investor"* [1949 Edition] wrote that *intelligence* – the term as it is understood in common parlance as 'high IQ' had nothing do with intelligent investing per se. Graham explains that *intelligence* simply means being *patient, disciplined and eager to learn*. Graham added *"You must also be able to harness*

your emotions and think for yourself – Intelligent Investing is a trait more of the character than of the brain.”

It's not surprising to see why Newton and LTCM failed as investors. While intelligence was in abundance what they lacked was patience and the emotional discipline.

Chapter 8 and 20 – A must read for serious investors

If you deeply internalize and pay special attention to those two invaluable chapters from *“The Intelligent Investor”*; I believe, as Buffett does – you will not get a poor result from your investments. Buffett's preface³ in the fourth edition of *“The Intelligent Investor”* says it all. He wrote as follows;

“I read the first edition of this book early in 1950, when I was nineteen. I thought then that it was by far the best book about investing ever written. I still think it is. To invest successfully over a lifetime does not require a stratospheric IQ, unusual business insights, or inside information. What's needed is a sound intellectual framework for making decisions and the ability to keep emotions from corroding that framework. This book precisely and clearly prescribes the proper framework. You must supply the emotional discipline.”

On 24th March 2006, while addressing the students of Columbia Business School, Buffett advised *“The only three ideas you will ever really need to be successful as investors are;*

- 1) *Chapter 8 – The investor and market fluctuations – Mr. Market analogy – Make the market serve you; not instruct you.*
- 2) *Chapter 20 – Margin of Safety – The central concept of investment – Make sure you buy a business at a substantial discount to what you think it is conservatively worth*
- 3) *A stock is an ownership interest in an actual business, with an underlying value that does not depend on its share price”*

That's profound common sense and yet we are oblivious as investors. After all, common sense is seldom common

practice. You will not find this wisdom given to you in world-class business schools. No doubt they give you an education, unfortunately, fall short on imparting knowledge. The irony is despite both *“Security Analysis”* and *“The Intelligent Investor”* being the best books ever written on investments – they are yet to find their way to the business school curriculums – not even a 'required reading' and that's very disappointing.

Simplicity and focus on the big picture

Ability to simplify things, I believe is the key. Every time you buy or sell a stock of a business – try writing down your thesis. Doing this kind of an exercise helps bring clarity to one's own thinking process; If I may borrow Munger's language using *Mental Models* or *Checklists*. If you don't use these checklists, as Munger puts *“It's like a one legged guy, trying to take part in an ass kicking contest”*. Writing out one's thesis promotes rationality and gives one a concrete reason for why an investment was made. When you document these kinds of stuff and jot down what's going on your head – it tremendously helps in building your mental models, understand the reasons why you are investing in a business, and in the event the investment turns bad, help you assess which areas of your reasoning, thinking or analysis was fuzzy and flawed. Human mind is fickle and I believe that writing down the investment thesis helps to connect things you have read in the past and stay focused on the important and the knowable. I think evaluating an idea this way is very useful and productive.

*‘Our life is frittered away by
detail.....Simplify, Simplify, Simply’*

Henry Thoreau

Buffett advocates writing down the investment thesis on paper. The thesis should be simple and short, no more than a paragraph. He prescribes an example in a 1991 lecture at Notre Dame, *“I'm paying \$32 billion today for the Coca Cola Company because... if you can't answer that*

question, you shouldn't buy it. If you can answer that question, and you do it a few times, you'll make a lot of money."

Peter Lindmark⁴ wrote *"investors are detailed oriented and most never get to simple. Analysts have multiple spreadsheets and focus intently on miniscule details, which are irrelevant over three to five year periods. Most investors miss the big picture due to their overly analytical minds"*.

Mohnish Pabrai, an accomplished investor in one his interviews said *"Usually two to three variables control most of the outcome. The rest is noise. If you can handicap how those key variables are approximately likely to play out, then you have a basis to do something."* This is such a simple idea but investors do not apply it in their endeavors. Every company has key variables and as Pabrai so eloquently put it *"If I find myself reaching for Excel, it is a very strong sign to take a pass."* If one cannot figure out the key variables, look at a different company, do not stray outside one's circle of competence.

Wallace Weitz says *"There are an infinite number of facts that you can learn about a company, but there are usually two or three very important variables that make the company succeed or fail. A lot of Wall Street gets so bogged down in the minutiae and details that it misses these two or three big things that make or break the investment. Part of what worked for me over the years is being able to distinguish what matters from what doesn't. That's one of Buffett's great gifts. He focuses on the critical issues involved in analyzing. I don't pretend to be able to do it like he does but it's one of the most important things you can do"*

'There are five ascending levels of intellect – Smart, Intelligent, Brilliant, Genius, and Simple'

Albert Einstein

'In the short term, markets are like voting machines; in the long term weighing machines'

Benjamin Graham [1894-1976]

When Buffett looked at Coca-Cola he was probably looking at the total servings sold per annum and the profit per serving of each Coke. Those are Coke's key variables, the number of servings people consume and the profit per serving for Coke products. Buffett was certain that consumption would increase through taking share of other liquids consumed. As well, he figured they could squeeze more than a penny per serving, which they were earning out of the product over time. Order as many analysts reports as you like from a broker and this information will be there but is very difficult to find in the sea of information they inundate investors with.

You react or reflect; it's up to you

How many times have you pressed the accelerator hard when you see the yellow lights at the signals – just to avoid the red lights and gain those extra two minutes? If your answer is 'many times', then the chances are that you are likely to buy a stock when it is going up; in short indulge in 'momentum buying'. I am deliberately avoiding the phrase popularly known as 'momentum investing'. Regardless of what adjective you add to investing; in my view, that's not investing; its speculation driven by impulse. Only in fairy tales will you find someone buying higher and selling even higher. During the very early stages of my investment career I have miserably failed and an innumerable times trying this. The market demands an extraordinarily high tuition fees to impart those lessons. I learnt it quickly and the very hard way. So I know when somebody tells me they are consistently good at this; either they are lying or you are fool or both. Smart and intelligent investors buy low and sell high.

Price versus intrinsic business values

Bill Miller⁵ in one of his reviews to shareholders writes: *"Clients are understandably disappointed when the performance of their portfolio does not keep pace with the broader market. But the price of a publicly traded security is one thing, and its value is something else. Price is what you pay; value is what you get. Price is a function of short-term supply and demand characteristics, which are heavily influenced by the most recent news and results. Value is the present value of the future cash flows of the business, and that is what we focus on"*.

Just read and think and you should do fine

Apart from reading *Outstanding Investor Digest* one of the finest investment publications in my view, I am also an avid reader of Whitney's Value Investor Insight. Whitney and John Heins wrote in one of their editorials⁶ about a candidate who was seeking a job opening as an investment assistant with Buffett. Promptly, Buffett responded to the candidate with a personalized, thoughtful letter *"Our operation has to be seen to be believed. There are no meetings, discussions, investigations, or interactions of any kind. I just read and think. This is more effective for obtaining the kind of ideas I need than anything that interacts with Wall Street, consultants or even assistants."* While turning down the offer, Buffett offered some encouragement and advice: *"As a practical matter, everything I know has been put down in my annual reports or in my few speeches or television appearances. There are no 'secrets' and with a little reading you can know everything I know. Good luck with your career."*

Understanding reasons

In a fascinating book *"Seeking Wisdom - From Darwin To Munger"*, Peter Bevelin⁷ elaborates on the importance of asking 'why' and 'understanding'. Bevelin writes *"Understanding reasons is an important factor in learning. To learn, remember, organize and use ideas, we must understand the "why" and "how". There is no use memorizing what we don't understand. If we don't understand the meaning of an idea, we don't use it. What we don't use, we forget. We also need to be motivated to*

learn. And we can't be motivated if we don't understand why we need to learn something. We need to see its practical use.

Understanding is about the ability to see patterns - how ideas and things relate and hang together; Knowledge that can be used in a variety of situations. Our brains favor the concrete and practical over the abstract and theoretical. We are especially good at remembering images and spatial information. We therefore learn better if the use of ideas and patterns are illustrated through pictures and simple, clear and vivid real-life stories. Stories on what works and what doesn't work increase our ability to retain what we have learned."

Aristotle said: *"For the things we have to learn before we can do them, we learn by doing them."* This means we need to practice what we have learnt in various situations. We also need an organizing framework in order to better retrieve and use knowledge. Charlie Munger adds: *"You can't really know anything if you just remember isolated facts and try and bang 'em back. If the facts don't hang together on a latticework of theory, you don't have them in a usable form."*

Walter Schloss didn't go to college

Buffett wrote in his annual letter to shareholders⁸ *"Let me end this section by telling you about one of the good guys of Wall Street, my long-time friend Walter Schloss, who last year turned 90. From 1956 to 2002, Walter managed a remarkably successful investment partnership, from which he took not a dime unless his investors made money"*.

He added *"Walter did not go to business school, or for that matter, college. His office contained one file cabinet in 1956; the number mushroomed to four by 2002. Walter worked without a secretary, clerk or bookkeeper, his associate being his son, Edwin. Walter and Edwin never came within a mile of inside information. Indeed, they used "outside" information only sparingly, generally selecting securities by certain simple statistical methods Walter learned while working for Ben Graham. When*

Walter and Edwin were asked in 1989 by Outstanding Investor Digest, "How would you summarize your approach?" Edwin replied, "We try to buy stocks cheap."

Following a strategy that involved no real risk - defined as permanent loss of capital - Walter produced results over his 47 partnership years that dramatically surpassed those of the S&P 500. It's safe to say that had millions of investment managers made trades by a) drawing stock names from a hat; b) purchasing these stocks in comparable amounts when Walter made a purchase; and then c) selling when Walter sold his pick, the luckiest of them would not have come close to equaling his record. There is simply no possibility that what Walter achieved over 47 years was due to chance.

Buffett continued "I first discussed Walter's remarkable record in 1984. At that time "efficient market theory" (EMT) was the centerpiece of investment instruction at most major business schools. This theory, as then most commonly taught, held that the price of any stock at any moment is not demonstrably mispriced, which means that no investor can be expected to outperform the stock market averages using only publicly-available information (though some will do so by luck). When I talked about Walter 23 years ago, his record forcefully contradicted this dogma. And what did members of the academic community do when they were exposed to this new and important evidence? Unfortunately, they reacted in all-too-human fashion: Rather than opening the minds, they closed their eyes. To my knowledge no business school teaching EMT made any attempt to study Walter's performance and what it meant for the schools cherished theory. Instead, the faculties of the schools went merrily on their way presenting EMT as having the certainty of scripture."

Buffett concluded "Tens of thousands of students were therefore sent out into life believing that on every day the price of every stock was "right" (or, more accurately, not demonstrably wrong) and that attempts to evaluate businesses - that is, stocks - were useless. Walter meanwhile went on outperforming, his job made easier by

the misguided instructions that had been given to those young minds. After all, if you are in the shipping business, it's helpful to have all of your potential competitors be taught that the earth is flat. May be it was good thing for his investors that Walter didn't go to college".

Outlook

You can safely skip this section, if you wish; since I don't have fresh insights to offer on what the markets are going to do in the near term. Given the nature of my profession - people habitually ask me all the time where I see the markets and more so at the beginning of the year. I pause for a moment and wonder, whether to duck that question or tell the truth. After mustering some courage, I tell the truth - I don't know.

For people who still persist for an answer; I do have one; what matters and that which is most certain to happen is that the markets will move higher, perhaps substantially so, five years hence and that investors will be net savers and buyers of equities. I prefer a certain pay-off to a likely one; which is looking smarter 3/5 years from now than risk standing dumb one year down the line.

Human nature is such that at times of panic, fear, pessimism and stress, it is virtually impossible to think rationally about investments. As markets crash, stocks decline and losses mount, long-term investment plans and disciplines go out the window and fear takes over, leading many to abandon the markets completely, often at just the wrong time. Conclusion - the best time to invest in is - now. We are long-term greedy; you can count us on that.

The American novelist Nathaniel Hawthorne once said, "Easy reading is damn hard writing", but that hasn't deterred us from trying. Certainly, we couldn't think of a better way to begin the New Year. **WJ**

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Reference and end notes

- ¹ Berkshire Hathaway, Letter to shareholders – February 2008, Page 3
- ² Buy American. Iam. – By Warren E. Buffett, Op-Ed Contributor, The New York Times, 17 October 2008
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- ⁵ Bill Miller Commentary, 4Q-2007. Bill Miller is Chairman and Chief Investment Officer, Legg Mason Capital Management
- ⁶ The Value Investor Insight, 31 October 2007 Issue, Editorial comments by Whitney Tilson and John Heins
- ⁷ "Seeking Wisdom – From Darwin To Munger" by Peter Bevelin
- ⁸ Berkshire Hathaway, Annual Letter to shareholders, 2006

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Brief profiles of investors featured in WIJ

Warren E. Buffett, is Chairman and CEO, of Berkshire Hathaway. Buffett, who runs Berkshire, is considered as one of the most successful investors. Over the last 43 years (1965-2007) Buffett has compounded Berkshire's per share book value at an annual rate of 21.1% from USD 19 (1965) to USD 78,008 (2007) while during the same period the S&P 500 (with dividends included) compounded at an annual rate of 10.3%

Charlie T. Munger, is Vice Chairman, of Berkshire Hathaway. Munger is also the Chairman of Wesco Financial Corporation. While Buffett is the public face of Berkshire Hathaway, Munger is another major contributor to Berkshire's tremendous long term success. Munger is well known as an investor for his "multidisciplinary" thinking through his various speeches and writings. One can get to know Munger through "*The Wit and Wisdom of Charlie T. Munger – Poor Charlie's Almanac*" by *Peter D. Kaufman*

Walter Schloss, runs and manages the investment partnership Walter & Edwin Schloss Associates. Walter Schloss is a well known value investor and his partnership was started in the early 1950's. During the period 1956-1988, Walter Schloss's partnership produced annual gross compounded returns of 21.6%, net annual compounded returns of 16.4% compared to 9.8% annual returns of S&P 500 during the same period. *Source; Outstanding Investor Digest, March 6 1989*

Wallace Weitz, is President of Wallace R. Weitz & Company. Wally Weitz, is a well known value investor and ranks as one of the best fund managers. Wallace manages close USD 2 billion in assets and his funds Value, Partners Value and Partners III have earned compounded returns in excess of 11-12% over a 20 year period compared to the S&P 500 returns of 9.9%.

Mohnish Pabrai, is the Managing Partner of Pabrai Investment Funds – A hedge fund that is modeled after the original 1950's Buffett Partnerships. Since its inception in 1999, Pabrai Funds have delivered annualized returns of over 28% (net to investors) as of 2007. Mohnish Pabrai is also the author of the best seller "*The Dhandho Investor*".

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