It appears as if the market declines of 2008 and early 2009 are being treated as nothing more than a bad dream, as if the investment industry has gone right back to business as usual. This extreme brevity of financial memory is breathtaking. Surely, we should attempt to look back and learn something from the mistakes that gave rise to the worst period in markets since the Great Depression. In an effort to engage in exactly this kind of learning experience, I have put together my list of the top ten lessons we seem to have failed to learn. So let’s dive in!

Lesson 1: Markets aren’t efficient.

As I have observed previously, the Efficient Market Hypothesis (EMH) is the financial equivalent of Monty Python’s Dead Parrot.\(^1\) No matter how many times you point out that it is dead, believers insist it is just resting.

I must admit I really thought we had this one licked (evidence of hubris on my part, for sure). While many practitioners seem willing to reject the EMH, the academics refuse to jettison their treasured theory. Not only have two economists written a paper arguing that the TMT bubble wasn’t a bubble, but now several have written papers arguing that not only should the EMH be absolved of playing any role in the recent crisis, but that if only we had all understood the EMH better, the crisis wouldn’t have happened in the first place!

Stephen Brown of NYU (author of one of the aforementioned papers) actually argues, “That it was the failure to believe the EMH that was in fact responsible for the crisis.” His view is that “It was believed to be rather easy to make money investing … investors borrowed heavily to invest … The resulting increase in leverage and resulting heavy burden taken on by financial institutions was a leading factor in the recent financial crisis.” Effectively, Brown believes that if no one had ever tried to generate returns, then this crisis would not have occurred. Of course, this seems to ignore the problem that if no one tried to make returns, either markets would not be efficient, or they would not exist!

The good news is that, as Jeremy pointed out at the GMO client conference last fall, it is now “illegal” to believe in efficient markets! The 11th Circuit Court of the United States declared in one of its opinions that “All bubbles eventually burst, as this one did. The bigger the bubble, the bigger the pop. The bigger the pop, the bigger the losses.”\(^2\) So, I guess it’s official now. Personally I’d be delighted to see EMH believers being taken away in handcuffs!

Brown’s viewpoint also ignores the role the EMH plays in a long litany of “derivative” ideas, by which I mean the theories that are based upon the flawed assumptions and recommendations of the EMH. This long and dire list includes the Capital Asset Price Model (CAPM), the Black-Scholes option pricing model, modern risk management techniques (which use market inputs as the best estimators of the future as per the EMH), the whole madness of mark-to-market accounting, market cap indexing, the Modigliani and Miller dividend and capital structure irrelevance propositions, the shareholder value concept, and even the Fed, which stood back and thought that the market knew best.

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\(^1\) See Chapter 1 of *Value Investing* (2009) Montier, J.
Lesson 2: Relative performance is a dangerous game.

While practitioners are generally happy to reject the false deity of the EMH, they are more inclined to continue to worship at the altar of its offspring – the CAPM. This dubious theory is driven by an outstanding number of flawed assumptions (such as investors being able to take any position long or short in any stock without affecting market price, and that all investors view stocks through the prism of mean-variance optimization).

It also leads directly to the separation of alpha and beta, upon which investors seem to spend an inordinate amount of time. Sadly, these concepts are nothing more than a distraction from the true aim of investment, which as the late, great Sir John Templeton observed is, “Maximum total real returns after tax.”

The alpha/beta framework has given rise to the obsession with benchmarking, and indeed a new species, Homo Ovinus, whose only concern is where to stand relative to the rest of the crowd. They are the living embodiment of Keynes’ edict: “That it is better for reputation to fail conventionally, than to succeed unconventionally.”

The supporters of the EMH love to point out that most active managers fail to outperform a passive index. But if such investors are obsessed with career and business risk, then their failure to outperform is sadly not surprising, and certainly not proof that the market is in any way efficient.

Jonathan Lewellen of Dartmouth College³ has recently looked at the aggregate holdings of US institutional investors over the period 1980 to 2007. As he concludes, “Quite simply, institutions overall seem to do little more than hold the market portfolio … Their aggregate portfolio almost perfectly mimics the value-weighted index … Institutions overall take essentially no bet on any of the most important stock characteristics known to predict returns.” Put in our terms, many (if not most) investment managers are more worried about career risk (losing your job) or business risk (losing funds under management) than they are about doing the right thing!

Further evidence of this pervasive problem comes from a recent paper by Randy Cohen, Chris Polk, and Bernhard Silli.⁴ They examined the “best ideas” of US fund managers over the period 1991 to 2005. “Best ideas” were measured as the biggest difference between the managers’ holdings and the weights of the index. The performance of these best ideas is impressive. Focusing on the top 25% of best ideas across the universe of active managers, Cohen, et al, find the average return is over 19% annually against a market return of 12% annually. That is to say, the stocks in which the managers displayed the most confidence outperformed the market by a significant amount.

The depressing corollary is that the other stocks they hold are dragging down their performance. Hence it appears that the focus on relative performance – and hence the fear of underperformance against an arbitrary benchmark – is a key source of underperformance.

As the authors conclude, “The poor overall performance of mutual fund managers in the past is not due to a lack of stock-picking ability, but rather to institutional factors that encourage them to over-diversify.” Thus, as Sir John Templeton said, “It is impossible to produce a superior performance unless you do something different from the majority.”

Of course, this begs the question: why are fund managers so wedded to relative performance? The simple, although unpopular, answer is that clients and consultants force them to be. As Goyal and Wahal⁵ have demonstrated, institutional clients are nearly as bad as retail clients in exhibiting return-chasing behavior. They reviewed nearly 9,000 hiring and firing decisions by institutional pension funds between 1994 and 2003. The firms that tended to get hired had generated good excess returns (2.9% annually) in the three years before being hired. Sadly, they went on to produce post-hire returns of just 0.03% annually. In contrast, the managers that were fired showed three-year pre-firing excess returns of -1% annually, but post-firing returns of 4.2% annually. Effectively, pension plans had a habit of firing their managers at precisely the worst point in time!

Lesson 3: The time is never different.

“Bubbles generally are perceptible only after the fact. To spot a bubble in advance requires a judgment that hundreds of thousands of informed investors have it all wrong. While bubbles that burst are scarcely benign, the consequences need not be catastrophic for the economy.” (Alan Greenspan, June 17, 1999)

“It was far from obvious that bubbles, even if identified early, could be preempted short of the central bank inducing a substantial contraction in economic activity – the very outcome we would be seeking to avoid. Prolonged periods of expansion promote a greater rational willingness to take risks, a pattern very difficult to avert by a modest tightening of monetary policy . . . we recognized that, despite our suspicions, it was very difficult to definitively identify a bubble until after the fact . . . the idea that the collapse of a bubble can be softened by pricking it in advance is almost surely an illusion.” (Alan Greenspan, August 30, 2002)

“There is no housing bubble to go bust.” (Ben Bernanke, October 27, 2005)

The first Greenspan quotation above has eerily strong parallels with the pronouncements of Joseph Stagg Lawrence (a Princeton economist) who, in the autumn of 1929, opined “The consensus of judgment of the millions whose valuations function on that admirable market, the Stock Exchange, is that stocks are not at present overvalued … Where is that group of men with the all-embracing wisdom which will entitle them to veto the judgment of this intelligent multitude?”

It is also worth remembering that Bernanke is the man who gave us some of the very worst economic doctrines of our times. He espoused the “Global Saving Glut,” which effectively argued that it wasn’t the US consumer who was consuming too much, it was the rest of the world who were saving too much. He also gave us “The Great Moderation,” in which he offered various explanations for the “remarkable decline in the variability of both output and inflation.” Although Bernanke allowed for the role of luck, he argued that “improved performance of macroeconomic policies, particularly monetary policy” accounted for the lion’s share of the reduced volatility (nothing like a little modesty and humility from your central bankers!).

This viewpoint, of course, completely misses the credit boom, which created surface stability, but was ultimately an edifice built upon dangerous and unstable debt. Bernanke was also a leading proponent of the limited contagion of the subprime problems. “We believe the effect of the troubles in the subprime sector on the broader housing market will be limited, and we do not expect significant spillovers from the subprime market to the rest of the economy or to the financial system.” Not only is Bernanke the originator of these appallingly poor ideas, but to judge from his recent speech, he believes that he has done nothing wrong and has nothing to learn. I guess there are none so blind as those who will not see!

The aforementioned defender of the EMH orthodoxy, Stephen Brown of NYU, in the same paper states that “The irony is that the strong implication of this hypothesis is that nobody, no practitioner, no academic, and no regulator had the ability to foresee the collapse of this most recent bubble.” This is utter piffle.

Contrary to the protestations of the likes of Greenspan, Bernanke, and Brown, bubbles can be diagnosed before they burst; they are not black swans. The black swan defense is nothing more than an attempt to abdicate responsibility.

A good working knowledge of the history of bubbles can help preserve your capital. Ben Graham argued that an investor should “have an adequate idea of stock market history, in terms, particularly, of the major fluctuations. With this background he may be in a position to form some worthwhile judgment of the attractiveness or dangers … of the market.” Nowhere is an appreciation of history more important than in the understanding of bubbles.

Although the details of bubbles change, the underlying patterns and dynamics are eerily similar. The framework I have long used to think about bubbles has its roots way back in 1867, in a paper written by John Mills. As he put it, “The malady of commercial crisis is not, in essence, a matter of the purse but of the mind.”

His model has been used time and again, and forms the basis of the bubble framework utilized by such luminaries as Hyman Minsky and Charles Kindleberger. Essentially this model breaks a bubble’s rise and fall into five phases as shown below.
**Displacement**:
The Birth of a Boom. Displacement is generally an exogenous shock that triggers the creation of profit opportunities in some sectors, while closing down profit availability in other sectors. As long as the opportunities created are greater than those that get shut down, investment and production will pick up to exploit these new opportunities. Investment in both financial and physical assets is likely to occur. Effectively we are witnessing the birth of a boom. As Mills puts it, “A new confidence begins to germinate early in this period, but its growth is slow.”

**Credit creation**: The nurturing of a bubble. Just as fire can’t grow without oxygen, so a boom needs credit on which to feed. Minsky argued that monetary expansion and credit creation are largely endogenous to the system. That is to say, not only can money be created by existing banks, but also by the formation of new banks, the development of new credit instruments, and the expansion of personal credit outside the banking system. Mills noted that during this phase “The rate of interest [is] almost uniformly low … Credit … continues to grow more robust, enterprise to increase, and profits to enlarge.”

**Euphoria**: Everyone starts to buy into the new era. Prices are seen as only capable of ever going up. Traditional valuation standards are abandoned, and new measures are introduced to justify the current price. A wave of overoptimism and overconfidence is unleashed, leading people to overestimate the gains, underestimate the risks, and generally think they can control the situation. The new era dominates discussions, and Sir John Templeton’s four most dangerous words in investing, “This time is different,” reverberate around the market.

As Mills wrote, “There is a morbid excess of belief … healthy confidence … has degenerated into the disease of a too facile faith … The crowd of … investors … do not, in their excited mood, think of the pertinent questions, whether their capital will become quickly productive, and whether their commitment is out of proportion to their means … Unfortunately, however, in the absence of adequate foresight and self-control, the tendency is for speculation to attain its most rapid growth exactly when its growth is most dangerous.”

**Critical stage/financial distress**: This leads to the critical stage, which is often characterized by insiders cashing out, and is rapidly followed by financial distress, in which the excess leverage that has been built up during the boom becomes a major problem. Fraud also often emerges during this stage of a bubble’s life.

**Revulsion**: The final stage of a bubble’s life cycle is revulsion. Investors are so scarred by the events in which they participated that they can no longer bring themselves to participate in the market at all. This results in bargain-basement asset prices. Mills said, “As a rule, panics do not destroy capital; they merely reveal the extent to which is has been previously destroyed by its betrayal into hopelessly unproductive works … The failure of great banks … and mercantile firms … are the symptoms incident to the disease, not the disease itself.”

He was also aware of the prolonged nature of a recovery in the wake of a bubble. “Economy, enforced on great numbers of people by losses from failures and from depreciated investments restricts their purchasing power … Profits are kept down to the stunted proportions of demand … Time alone can steady the shattered nerves, and form a healthy cicatrice over wounds so deep.”

If bubbles follow the same path over and over, it is a reasonable question to ask why people tend not to see the consequences coming. Unfortunately, we have to overcome at least five behavioural impediments.

The first is overoptimism. Everyone simply believes that they are less likely than average to have a drinking problem, to get divorced, or to be fired. This tendency to look on the bright side helps to blind us to the dangers posed by predictable surprises.

In addition to our overoptimism, we suffer from the illusion of control – the belief that we can influence
the outcome of uncontrollable events. This is where we encounter a lot of the pseudoscience of finance, e.g., measures such as Value-At-Risk (VaR). The idea that if we can quantify risk we can control it is one of the great fallacies of modern finance. VaR tells us how much you can expect to lose with a given probability, i.e., the maximum daily loss with a 95% probability. Such risk management techniques are akin to buying a car with an airbag that is guaranteed to work unless you crash! Talk about the illusion of safety.

The third hurdle to spotting predictable surprises is self-serving bias – the innate desire to interpret information and act in ways that are supportive of our own self-interests. As Warren Buffett puts it, “Never ask a barber if you need a haircut.” If you had been a risk manager in 2006 and suggested that some of the collateralized debt obligations (CDOs) that your bank was working on might have been slightly suspect, you would, of course, have been fired and replaced by a risk manager who was happy to approve the transaction. Whenever lots of people are making lots of money, it is unlikely that they will take a step back and point out the obvious flaws in their actions.

The penultimate hurdle is myopia – an overt focus on the short term. All too often we find that consequences occurring at a later date tend to have much less bearing on our choices the further into the future they fall. This can be summed up as, “Let us eat and drink, for tomorrow we shall die.” Of course, this ignores the fact that on any given day we are roughly 260,000 times more likely to be wrong than right with respect to making it to tomorrow. Saint Augustine’s plea “Lord, make me chaste, but not yet” is pure myopia. One more good year, one more good bonus, and then I promise to go and do something worthwhile with my life, rather than working in finance!

The final barrier to spotting predictable surprises is a form of inattentional blindness. Put bluntly, we simply don’t expect to see what we are not looking for. The classic experiment in this field shows a short video clip of two teams playing basketball. One team is dressed in white, the other in black. Participants are asked to count how many times the team in white passes the ball between themselves. Now, halfway through this clip, a man in a gorilla suit walks onto the court, beats his chest, and then walks off. At the end of the clip, participants are asked how many passes there were. The normal range of answers is somewhere between 14 and 17. They are then asked if they saw anything unusual. Nearly 60% fail to spot the gorilla! When the gorilla is mentioned and the tape re-run, most participants say that the clip was switched, and the gorilla wasn’t in the first version! People simply get too caught up in the detail of counting the passes. I suspect that something similar happens in finance: investors get caught up in all of the details and the noise, and forget to keep an eye on the big picture.

Lesson 4: Valuation matters.

At its simplest, value investing tells us to buy when assets are cheap and to avoid purchasing expensive assets. This simple statement seems so self-evident that it is hardly worth saying. Yet repeatedly I’ve come across investors willing to undergo mental contortions to avoid the valuation reality.

For instance, I often use a Graham and Dodd P/E to assess valuation – a simple measure that takes the current price and divides it by 10-year average earnings. In the past I was informed by investors that this measure was inappropriate as it didn’t include any growth (of course, this was during the time when new valuation measures like eyeballs and clicks were in fashion). Conversely, during the latest crisis, investors were making arguments that the Graham and Dodd P/E was overstating the earnings, and thus making the market look artificially cheap.

In both cases, of course, you were best off just following the advice demonstrated in Exhibit 1. Buying when markets are cheap generates significantly better returns than buying when markets are expensive. Of course, the flip side is that one must be prepared to not be fully invested when the returns implied by equity pricing are exceptionally unattractive.

Regrettably, the current juncture doesn’t offer many exciting value-based opportunities. Most equity markets look roughly fairly valued, while the US is once again looking expensive. This holds true across many valuation approaches (including the GMO 7-year forecasts as well as the Graham and Dodd P/Es), and also across many different asset classes. All of which leads us nicely on to our next lesson.

Lesson 5: Wait for the fat pitch.

According to data from the New York Stock Exchange, the average holding period for a stock listed on its exchange is just 6 months (Exhibit 2). This seems like the investment equivalent of attention deficit hyperactivity disorder. In other words, it appears as if the average investor is simply concerned with the next couple of earnings reports, despite the fact that equities are obviously a long-duration asset. This myopia creates an opportunity for those who are willing or able to hold a longer time horizon.

Warren Buffett often speaks of the importance of waiting for the fat pitch – that perfect moment when patience is rewarded as the ball meets the sweet spot. However, most investors seem unable to wait, forcing themselves into action at every available opportunity, swinging at every pitch, as it were.

As tempting as it may be to be a “man of action,” it often makes more sense to act only at extremes. But the discipline required to “do nothing” for long periods of time is not often seen. As noted above, overt myopia also contributes to our inability to sit back, trying to understand the overall investment backdrop.

Lesson 6: Sentiment matters.

Investor returns are not only affected by valuation. Sentiment also plays a part. It is a cliché that markets are driven by fear and greed, but it is also disturbingly close to the truth. Sentiment swings like a pendulum, from irrational exuberance to the depths of despair. As Keynes wrote in February 1931:

“There is a great deal of fear psychology about just now. Prices bear very little relationship to ultimate values … They are determined by indefinite anxieties … Just as many people were quite willing in the boom … to assume that the increase in earnings would continue geometrically.”

Exhibit 3 uses a measure of sentiment designed by Baker and Wurgler. It is a composite measure that uses six underlying proxies for sentiment: the closed-end fund discount, NYSE share turnover, the number of and average first-day returns of IPOs, the equity share in new issues, and the dividend premium (the relative price of dividend paying and non-dividend paying stocks). The series has undergone one other alteration; the impact of the economic cycle has been removed, so this is a pure sentiment gauge.

Baker and Wurgler found that certain groups of stocks generated better returns when sentiment was high or low. In general, when sentiment was low, buying young, volatile, unprofitable firms (i.e., junk) generated the best returns. Of course, when sentiment was high, buying mature, low volatility, profitable firms (i.e., quality) was the best strategy. This is the mean reversion of sentiment in action, and yet further evidence of why it pays to be a contrarian investor.
High quality stocks appear to be one of the few fat pitches currently available. As mentioned above, in general markets look essentially close to fair value. However, quality stocks continue to register as distinctly cheap on our metrics. This attractiveness is only enhanced when one considers sentiment. At present, measures such as the Advisors Intelligence Index (a measure of the enthusiasm of investors) show a record low level of bears!

Lesson 7: Leverage can’t make a bad investment good, but it can make a good investment bad!

Leverage is a dangerous beast. It can’t ever turn a bad investment good, but it can turn a good investment bad. Simply piling leverage onto an investment with a small return doesn’t transform it into a good idea. Leverage has a darker side from a value perspective as well: it has the potential to turn a good investment into a bad one!

Leverage can limit your staying power, and transform a temporary impairment (i.e., price volatility) into a permanent impairment of capital. Mills was aware of the dangers that the use of leverage posed and how it could easily result in asset fire sales. “The … trader who employs, in addition to his own means, a proportion of borrowed Capital … has found, in the moment of crisis, the conjuring power of his name utterly vanished, and has been compelled to provide for inexorably maturing obligations by the forced sales of goods or produce at such prices as would tempt forth reluctant capital.”

Keynes too opined, “An investor who proposes to ignore near-term market fluctuations needs greater resources for safety and must not operate on so large a scale, if at all, with borrowed money.”

While on the subject of leverage, I should note the way in which so called financial innovation is more often than not just thinly veiled leverage. As J.K. Galbraith put it, “The world of finance hails the invention of the wheel over and over again, often in a slightly more unstable version.” Anyone with familiarity of the junk bond debacle of the late 80s/early 90s couldn’t have helped but see the striking parallels with the mortgage alchemy of recent years!

Lesson 8: Over-quantification hides real risk.

Finance has turned the art of transforming the simple into the perplexing into an industry. Nowhere (at least outside of academia) is overly complex structure and elegant (but not robust) mathematics so beloved. The reason for this obsession with needless complexity is clear: it is far easier to charge higher fees for things that sound complex.

Two of my investing heroes were cognizant of the dangers posed by elegant mathematics. Ben Graham wrote:
Mathematics is ordinarily considered as producing precise and dependable results; but in the stock market the more elaborate and abstruse the mathematics the more uncertain and speculative are the conclusions we draw there from ... Whenever calculus is brought in, or higher algebra, you could take it as a warning that the operator was trying to substitute theory for experience, and usually also to give to speculation the deceptive guise of investment.

I can’t imagine a better description of recent times: the rise of the Gaussian copula, which “enabled” the pricing of such delights as CDOs, correlation trading, etc.

Keynes was also mindful of the potential pitfalls involved in over-quantification. He argued “With a free hand to choose co-efficients and time lag, one can, with enough industry, always cook a formula to fit moderately well a limited range of past facts … I think it all hocus – but everyone else is greatly impressed, it seems, by such a mess of unintelligible figures.”

In general, critical thinking is an underappreciated asset in the world of investment. As George Santayana observed, “Scepticism is the chastity of the intellect, and it is shameful to surrender it too soon or to the first comer: there is nobility in preserving it coolly and proudly.” Scepticism is one of the key traits that many of the best investors seem to share. They ask themselves, “Why should I own this investment?” This is a different default from the average Homo Ovinus, who asks, “Why shouldn’t I own this investment?” In effect, investors should consider themselves to be in the rejection game.

Investment ideas shouldn’t be accepted automatically, but rather we should seek to pull them apart. In effect, investors would be well-served if they lived by the Royal Society’s motto: *Nullius in Verba* (for which a loose modern translation would be, “Take no one’s word for it.”).

One prime area for scepticism (subjected to repeated attack in this note) is risk. Hand in hand with the march toward over-quantification goes the obsession with a very narrow definition of risk. In a depressing parody of the “build it and they will come” mentality, the risk management industry seems to believe “measure it, and it must be useful.” In investing, all too often risk is equated with volatility. This is nonsense. Risk isn’t volatility, it is the permanent loss of capital. Volatility creates opportunity. As Keynes noted, “It is largely fluctuations which throw up the bargains and the uncertainty due to fluctuations which prevents other people from taking advantage of them.”

We would be far better off if we abandoned our obsession with measurement in favor of understanding a trinity of risks. From an investment point of view, there are three main paths to the permanent loss of capital: valuation risk (buying an overvalued asset), business risk (fundamental problems), and financing risk (leverage). By understanding these three elements, we should get a much better understanding of the true nature of risk.

**Lesson 9: Macro matters.**

In his book on value investing, Marty Whitman says, “Graham and Dodd view macrofactors … as crucial to the analysis of a corporate security. Value investors, however, believe that such macrofactors are irrelevant.”

If this is the case, then I am very happy to say that I am a Graham and Dodd investor.

Ignoring the top-down can be extraordinarily expensive. The credit bust has been a perfect example of why understanding the top-down can benefit and inform the bottom-up. The last 12 months have been unusual for value investors as two clear camps emerged from their normally more homogenous whole.

A schism over financials has split value investors into two diametrically opposed groups. The optimistic/bottom-up view was typified by Richard Pzena. In his Q1 2008 quarterly report he wrote:

*A new fear has permeated conventional investment thinking: the massive leveraging-up of the recent past has gone too far and its unwinding will permanently hobble the global financial system. This view sees Bear Stearns as just one casualty in a gathering wave that has already claimed many U.S. subprime mortgage originators along with several non-U.S. financial institutions and will cause countless others to fail. And it sees the earnings power of those that survive as being permanently impaired.*

We believe the latter.
The alternative view (pessimistic, top-down informed) is well summed up by Steven Romick of First Pacific Advisors in a recent interview in Value Investor Insight:

**VII: Has your negative general view on the prospects for financial services stocks changed at all?**

**SR:** We believe in reversion to the mean, so it can make a lot of sense to invest in a distressed sector when you find good businesses whose public shares trade inexpensively relative to their earnings in a more normal environment. But that strategy lately has helped lead many excellent investors to put capital to work too early in financials. Our basic feeling is that margins and returns on capital generated by financial institutions in the decade through 2006 were unrealistically high. “Normal” profitability and valuation multiples are not going to be what they were during that time, given more regulatory oversight, less leverage (and thus capital to lend), higher funding costs, stricter underwriting standards, less demand, and less esoteric and excessively profitable products.

Essentially, the difference between these two camps comes down to an appreciation of the importance of the bursting of the credit bubble. Those who understood the impact of the bursting of such a bubble didn’t go near financials. Those who focused more (and in some cases exclusively) on the bottom-up just saw cheapness, but missed the value trap arising from a bursting credit bubble.

It often pays to remember the wise words of Jean-Marie Eveillard. “Sometimes, what matters is not so much how low the odds are that circumstances would turn quite negative, what matters more is what the consequences would be if that happens.” In terms of finance jargon, expected payoff has two components: expected return and probability. While the probability may be small, a truly appalling expected return can still result in a negative payoff.

The bottom-up can also inform the top-down. As Ben Graham pointed out, “True bargain issues have repeatedly become scarce in bull markets … Perhaps one could even have determined whether the market level was getting too high or too low by counting the number of issues selling below working capital value. When such opportunities have virtually disappeared, past experience indicates that investors should have taken themselves out of the stock market and plunged up to their necks in US Treasury bills.”

Another example of the complementary nature of top-down and bottom-up viewpoints is offered by Seth Klarman. In his insightful book, Margin of Safety, Klarman points out that the inflationary environment can have dramatic consequences for value investors:

**Trends in inflation or deflation also cause business values to fluctuate. That said, value investing can work very well in an inflationary environment. If for 50 cents you buy a dollar of value in the form of an asset, such as natural resource properties or real estate, which increases in value with inflation, a 50-cent investment today can result in the realisation of value appreciably greater than $1. In an inflationary environment, however, investors may become somewhat careless. As long as assets are rising in value, it would appear attractive to relax one’s standards and purchase $1 of assets, not for 50 cents, but for 70 or 80 cents (or perhaps even $1.10). Such laxity could prove costly, however, in the event that inflation comes to be anticipated by most investors, who respond by bidding up security prices. A subsequent slowdown in the rate of inflation could cause a price decline.**

Conversely,

In a deflationary environment assets tend to decline in value. Buying a dollar’s worth of assets for 50 cents may not be a bargain if the asset value is dropping … The possibility of sustained decreases in business value is a dagger at the heart of value investing (and is not a barrel of laughs for other investment approaches either).

Neither top-down nor bottom-up has a monopoly on insight. We should learn to integrate their dual perspectives.

**Lesson 10: Look for sources of cheap insurance.**

The final lesson that we should take from the 2008-09 experience is that insurance is often a neglected asset when it comes to investing. The cash flows associated with insurance often seem unappealing in a world when many seem to prefer “blow up” (small gain, small gain … big loss) to “bleed out” (small loss, small loss … big gain). Insurance by its very nature means that you are paying out a premium, so in the short term you are pretty much guaranteed to suffer small losses. Of course, if the event occurs, then you receive a significant payout. It is the short-term losses that make insurance seem
unattractive to many investors. However, this disliked feature often results in insurance being cheap.

One should always avoid buying expensive insurance. The general masses will tend to want insurance after the event – for instance, when I lived in Japan, the price of earthquake insurance always went up after a tremor! So, as is so often the case, it pays to be a contrarian when it comes to purchasing insurance.

However, insurance serves a very useful function within a portfolio. If we accept that we have only a very limited ability to divine the future, then cheap insurance can help us protect ourselves from the known unknowns. Among the many imponderables facing us at the moment are the possible return of inflation, the moral hazard issues from extended easy monetary policy, and what happens if/when the authorities decide to end the quantitative easing. Hunting for cheap insurance that protects investors against these conundrums would seem to be worthwhile.

**Will we learn?**

Sadly the evidence from both history and psychology is not encouraging when it comes to supporting the idea that we might learn from our mistakes. There is a whole gamut of behavioral biases that prevent us from learning from mistakes. However, just this once I really hope this time is different!