A credo for value investing

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Starting from scratch

- Distinguish between the value of the business and the price of the stock.
- Invest as if you are buying groceries, not perfume.
- “The third-rate mind is only happy when it is thinking with the majority. The second-rate mind is only happy when it is thinking with the minority. The first-rate mind is only happy when it is thinking” – A. A. Milne.
- Investing : “an operation which, upon thorough analysis, promises safety of principal and a satisfactory return” – Benjamin Graham.
- Price determines value.
- “We like pessimism because we like the prices it produces. It’s optimism that is the enemy of the rational buyer” – Warren Buffett.

Clearing the cobwebs in the mind

- Modern portfolio theory: Higher risk → Higher returns
- Value investing: Lower risk (greater margin of safety) → Higher returns.
- EMH: Markets price in all available information all the time.
- Value investing: Human beings “processing information” determine prices. Stock prices are not always rational.
- Work within a fundamental framework that emphasizes the process first and the outcome second.
- Think long term. The power of compounding is unsurpassed in investing.

The “value” mindset

1. Commit to a sound investment philosophy.
2. Find a robust search strategy.
3. Value a business objectively.
4. Have the discipline to say no.
5. Be patient.
6. Be willing to make a significant bet at the point of maximum pessimism.

Where not to go

- Weak accounting
- Excessive financial leverage
- Regulatory uncertainty
- High fixed cost businesses
- Irrational capital allocation and corporate governance
- Asset liability mismatches
- High cost commodity businesses
- Cash flow and earnings disconnect
- Structurally declining businesses
- Obsolescence risk
- Stretched valuation
- Lollapalooza effects

Socrates on investing….

- First, and foremost, focus on avoiding permanent loss of capital.
- The best investors are “pretend” investors – those who can pretend the stock market does not exist.
- The stock market exists to take advantage of attractive opportunities, not to instruct you when to buy and sell.
- The starting point matters. A great initial purchase price is the bedrock of superior “temperament”.
- Avoid using leverage. It’s the only way a smart investor can go broke.

Building the search engine

- “A public opinion is no substitute for thought” – Warren Buffett.
- Disregard the media.
- Stay in touch with the “smart money”.
- Capitaline/Capital Market and the hunt for FCF/OCF, ROE/ROCE, PE, Dividend Yield, Book value and the list of New Lows.
- Common sense is pretty rare.
- The more you read, the better your strike rate is likely to be. (Appendix A beckons the eager beaver).

Valuation matters

- Identify the key variables that make a difference to business performance.
- Figure out an approximation of “intrinsic value” and the “right” cost of capital.
- Built to last. The quest for predictable revenues, low costs, a dominant competitive position, a strong franchise and pricing power.
- All you need is honest management committed to getting the basics right.
- The quality of the business trumps the quality of management.
- Pay attention to book value and capital allocation, not the stock price.
- The three most important words in investing: MARGIN OF SAFETY.

Discipline is everything

- One of the few professions where the person with a 120 IQ is on par with the genius with a 180 IQ.
- Get the footwork right, know what to leave alone, play in the V, keep the head still and run the singles hard.
- The price you pay determines the value you get.
- Be prepared to look stupid…. fairly often!
- Never get married to a stock.
- A circle of competence and a large margin of safety are the best vitamins for amazing discipline.
- Never jump ship at the first sign of trouble. Conversely, stop chasing pretty girls in mini-skirts!
- Only amateurs are excited by tops and bottoms.
- Being disciplined and unemotional is “simple, but not easy”.

The virtue of patience

- "All men's miseries derive from not being able to sit in a quiet room alone" – Blaise Pascal.
- In the long run, stock prices inevitably reflect the fundamentals of the business.
- Beware of the liquidity trap.
- Strive to retain an independent frame of mind.
- Fewer trading errors, lower transaction costs, reduce taxes.
- Cash level in a portfolio → availability of bargains.

The romance with pessimism

- Buy when they cry, sell when they yell.
- The mental hardwiring for buying into pessimism is fostered by the need for capital preservation, discipline and patience.
- Lower prices → reduced risk → higher probability of future gain.
- Euphoria and optimism lead to expensive valuations. The most valuable businesses often have stock prices that offer absolutely no margin of safety.
- Remain mentally flexible in seeking value. The best opportunities arise either from fear of the unknown or an inability to understand true long term growth potential.

Exploring the animal kingdom: How to behave like GOATs

- The curse of excessive intellectual horsepower
  - ❖ Decision paralysis
  - ❖ Effort – Outcome ratios
  - ❖ Overconfidence
- Rules of the road
  - ➢ Be contrarian – a rebel with a cause
  - ➢ Be curious
  - ➢ Study history – macro and corporate with a lattice work of mental models
  - ➢ Thinking broad versus deep
  - ➢ Be patient
  - ➢ Be disciplined
  - ➢ Embrace well-timed greed
  - ➢ Have humility – being liberated by the freedom to say "I don't know"
  - ➢ Understand yourself
- Read "**The Psychology of Human Misjudgment**" (Charlie Munger Speech at Harvard University 1995)

Putting it all together

- Invest only in a business that you understand.
- Declining equity prices are essential to find worthwhile opportunities.
- Always attach the highest priority to capital preservation. Recognize that capital appreciation is a second order derivative.
- Be keen to hunt for bargains in neglected industries/companies.
- PRAY THAT YOU ARE BLESSED WITH GOOD LUCK!

A personal reading list (Appendix A)

1. The Intelligent Investor by Benjamin Graham
2. Common Stocks, Uncommon Profits by Phil Fisher
3. One up on Wall Street by Peter Lynch
4. The Crowd by Gustave Le Bon
5. The Essays of Warren Buffett: Lessons for Corporate America by Larry Cunningham
6. Margin of Safety by Seth Klarman
7. Why Smart People make big money mistakes by Belsky & Gilovich
8. Devil take the Hindmost by Edward Chancellor
9. Contrarian Investment Strategies for the next generation by David Dreman
10. Extraordinary Popular delusions & the madness of crowds by Charles Mackay

A personal reading list (Appendix A)

contd…..

11. Your Money & Your Brain by Jason Zweig
12. You can be a stock market Genius by Joel Greenblatt
13. Fooled by Randomness by Nassim Taleb
14. Winning the Loser's Game by Charles D Ellis
15. A Zebra in Lion Country by Ralph Wanger & Everett Mattlin
16. Speculative Contagion by Frank Martin
17. Reminiscences of a stock operator by Edwin Lefevre
18. Value investing by James Montier
19. The Battle for Investment Survival by Gerald Loeb
20. The Four Pillars of Investing by William J Bernstein