

"This is that rarity, a useful book."

-WARREN BUFFETT

*The* **MOST**  
**IMPORTANT**  
**THING**

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**HOWARD MARKS**

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*Uncommon Sense for  
the Thoughtful Investor*



Columbia Business School  
Publishing



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*For Nancy, Jane and Andrew  
With All My Love*

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# INTRODUCTION

For the last twenty years I've been writing occasional memos to my clients—first at Trust Company of the West and then at Oaktree Capital Management, the company I cofounded in 1995. I use the memos to set forth my investment philosophy, explain the workings of finance and provide my take on recent events. Those memos form the core of this book, and you will find passages from many of them in the pages that follow, for I believe their lessons apply as well today as they did when they were written. For inclusion here I've made some minor changes, primarily to make their messages clearer.

What, exactly, is “the most important thing”? In July 2003, I wrote a memo with that title that pulled together the elements I felt were essential for investment success. Here's how it began: “As I meet with clients and prospects, I repeatedly hear myself say, ‘The most important thing is X.’ And then ten minutes later it's, ‘The most important thing is Y.’ And then Z, and so on.” All told, the memo ended up discussing eighteen “most important things.”

Since that original memo, I've made a few adjustments in the things I consider “the most important,” but the fundamental notion is unchanged: they're *all* important. Successful investing requires thoughtful attention to many separate aspects, all at the same time. Omit any one and the result is likely to be less than satisfactory. That is why I have built this book around the idea of the most important things—each is a brick in what I hope will be a solid wall, and none is dispensable.

I didn't set out to write a manual for investing. Rather, this book is a statement of my investment philosophy. I consider it my creed, and in the course of my investing career it has served like a religion. These are the things I believe in, the guideposts that keep me on track. The messages they deliver are the ones I consider the most lasting. I'm confident their relevance will extend beyond today.

You won't find a how-to book here. There's no surefire recipe for investment success. No step-by-step instructions. No valuation formulas containing mathematical constants or fixed ratios—in fact, very few numbers. Just a way to think that might help you make good decisions and, perhaps more important, avoid the pitfalls that ensnare so many.

It's not my goal to simplify the act of investing. In fact, the thing I most want to make clear is just how complex it is. Those who try to simplify investing do their audience a great disservice. I'm going to stick to general thoughts on return, risk and process; any time I discuss specific asset classes and tactics, I do so only to illustrate my points.

A word about the organization of the book. I mentioned above that successful investing involves thoughtful attention to many areas simultaneously. If it were somehow possible to do so, I would discuss all of them at once. But unfortunately the limitations of language force me to take one topic at a time. Thus I begin with a discussion of the market environment in which investing takes place, establish the playing field. Then I go on to discuss investors themselves, the elements that affect their investment success or lack of it, and the things they should do to improve their chances. The final chapters are an attempt to pull together both groups of ideas into a summation. Because my investment philosophy is “of a piece,” however, some ideas are relevant to more than one chapter; please bear with me if you sense repetition.

I hope you'll find this book's contents novel, thought provoking and perhaps even controversial.

anyone tells me, “I so enjoyed your book; it bore out everything I’ve ever read,” I’ll feel I failed. It’s not my goal to share ideas and ways of thinking about investment matters that you haven’t come across before. Heaven for me would be seven little words: “I never thought of it that way.”

In particular, you’ll find I spend more time discussing risk and how to limit it than how to achieve investment returns. To me, risk is the most interesting, challenging and essential aspect of investing.



When potential clients want to understand what makes Oaktree tick, their number one question is usually some variation on “What have been the keys to your success?” My answer is simple: a consistent and effective investment philosophy, developed and honed over more than four decades and implemented conscientiously by highly skilled individuals who share culture and values.

Where does an investment philosophy come from? The one thing I’m sure of is that no one arrives on the doorstep of an investment career with his or her philosophy fully formed. A philosophy has to be the sum of many ideas accumulated over a long period of time from a variety of sources. One cannot develop an effective philosophy without having been exposed to life’s lessons. In my life I’ve been quite fortunate in terms of both rich experiences and powerful lessons.

The time I spent at two great business schools provided a very effective and provocative combination: nuts-and-bolts and qualitative instruction in the pre-theory days of my undergraduate education at Wharton, and a theoretical, quantitative education at the Graduate School of Business at the University of Chicago. It’s not the specific facts or processes I learned that mattered most, but being exposed to the two main schools of investment thought and having to ponder how to reconcile and synthesize them into my own approach.

Importantly, a philosophy like mine comes from going through life with your eyes open. You must be aware of what’s taking place in the world and of what results those events lead to. Only in this way can you put the lessons to work when similar circumstances materialize again. Failing to do this—more than anything else—is what dooms most investors to being victimized repeatedly by cycles of boom and bust.

I like to say, “Experience is what you got when you didn’t get what you wanted.” Good times teach only bad lessons: that investing is easy, that you know its secrets, and that you needn’t worry about risk. The most valuable lessons are learned in tough times. In that sense, I’ve been “fortunate” to have lived through some doozies: the Arab oil embargo, stagflation, Nifty Fifty stock collapse and “death of equities” of the 1970s; Black Monday in 1987, when the Dow Jones Industrial Index lost 22 percent of its value in one day; the 1994 spike in interest rates that put rate-sensitive debt instruments into freefall; the emerging market crisis, Russian default and meltdown of Long-Term Capital Management in 1998; the bursting of the tech-stock bubble in 2000–2001; the accounting scandals of 2001–2002; and the worldwide financial crisis of 2007–2008.

Living through the 1970s was particularly formative, since so many challenges arose. It was virtually impossible to get an investment job during the seventies, meaning that in order to have experienced that decade, you had to have gotten your job before it started. How many of the people who started by the sixties were still working in the late nineties when the tech bubble rolled around? Not many. Most professional investors had joined the industry in the eighties or nineties and didn’t know a market decline could exceed 5 percent, the greatest drop seen between 1982 and 1999.

If you read widely, you can learn from people whose ideas merit publishing. Some of the most important for me were Charley Ellis's great article "The Loser's Game" (*The Financial Analysts Journal*, July-August 1975), *A Short History of Financial Euphoria*, by John Kenneth Galbraith (New York: Viking, 1990) and Nassim Nicholas Taleb's *Fooled by Randomness* (New York: Texere, 2001). Each did a great deal to shape my thinking.

Finally, I've been extremely fortunate to learn directly from some outstanding thinkers: John Kenneth Galbraith on human foibles; Warren Buffett on patience and contrarianism; Charlie Munger on the importance of reasonable expectations; Bruce Newberg on "probability and outcome"; Michael Milken on conscious risk bearing; and Ric Kayne on setting "traps" (underrated investment opportunities where you can make a lot but can't lose a lot). I've also benefited from my association with Peter Bernstein, Seth Klarman, Jack Bogle, Jacob Rothschild, Jeremy Grantham, Joel Greenblatt, Tony Pace, Orin Kramer, Jim Grant and Doug Kass.

The happy truth is that I was exposed to all of these elements and aware enough to combine them into the investment philosophy that has worked for my organizations—and thus for my clients—for many years. It's not the only right one—there are lots of ways to skin the cat—but it's right for us.

I hasten to point out that my philosophy wouldn't have meant much without skilled implementation on the part of my incredible Oaktree cofounders—Bruce Karsh, Sheldon Stone, Larry Keele, Richard Masson and Steve Kaplan—with whom I was fortunate to team up between 1983 and 1993. I'm convinced that no idea can be any better than the action taken on it, and that's especially true in the world of investing. The philosophy I share here wouldn't have attracted attention were it not for the accomplishments of these partners and the rest of my Oaktree colleagues.

## The Most Important Thing Is . . . Second-Level Thinking

The art of investment has one characteristic that is not generally appreciated. A creditable, if unspectacular, result can be achieved by the lay investor with a minimum of effort and capability; but to improve this easily attainable standard requires much application and more than a trace of wisdom.

*BEN GRAHAM, THE INTELLIGENT INVESTOR*

Everything should be made as simple as possible, but not simpler.

*ALBERT EINSTEIN*

It's not supposed to be easy. Anyone who finds it easy is stupid.

*CHARLIE MUNGER*

Few people have what it takes to be great investors. Some can be taught, but not everyone . . . and those who *can* be taught can't be taught everything. Valid approaches work some of the time but not all. And investing can't be reduced to an algorithm and turned over to a computer. Even the best investors don't get it right every time.

The reasons are simple. No rule always works. The environment isn't controllable, and circumstances rarely repeat exactly. Psychology plays a major role in markets, and because it's highly variable, cause-and-effect relationships aren't reliable. An investment approach may work for a while but eventually the actions it calls for will change the environment, meaning a new approach is needed. And if others emulate an approach, that will blunt its effectiveness.

Investing, like economics, is more art than science. And that means it can get a little messy.

One of the most important things to bear in mind today is that economics isn't an exact science. It may not even be much of a science at all, in the sense that in science, controlled experiments can be conducted, past results can be replicated with confidence, and cause-and-effect relationships can be depended on to hold.

“WILL IT WORK?” MARCH 5, 2000

Because investing is at least as much art as it is science, it's never my goal—in this book or elsewhere—to suggest it can be routinized. In fact, one of the things I most want to emphasize is how essential it is that one's investment approach be intuitive and adaptive rather than be fixed and mechanistic.



At bottom, it's a matter of what you're trying to accomplish. Anyone can achieve average investment performance—just invest in an index fund that buys a little of everything. That will give you what is known as “market returns”—merely matching whatever the market does. But successful investors want more. They want to beat the market.

In my view, that's the definition of successful investing: doing better than the market and other investors. To accomplish that, you need either good luck or superior insight. Counting on luck isn't much of a plan, so you'd better concentrate on insight. In basketball they say, “You can't coach height,” meaning all the coaching in the world won't make a player taller. It's almost as hard to teach insight. As with any other art form, some people just understand investing better than others. They have—or manage to acquire—that necessary “trace of wisdom” that Ben Graham so eloquently called for.

Everyone wants to make money. All of economics is based on belief in the universality of the profit motive. So is capitalism; the profit motive makes people work harder and risk their capital. The pursuit of profit has produced much of the material progress the world has enjoyed.

But that universality also makes beating the market a difficult task. Millions of people are competing for each available dollar of investment gain. Who'll get it? The person who's a step ahead. In some pursuits, getting to the front of the pack means more schooling, more time in the gym or the library, better nutrition, more perspiration, greater stamina or better equipment. But in investing, where these things count for less, it calls for more perceptive thinking . . . at what I call the second level.

Would-be investors can take courses in finance and accounting, read widely and, if they are fortunate, receive mentoring from someone with a deep understanding of the investment process. But only a few of them will achieve the superior insight, intuition, sense of value and awareness and psychology that are required for consistently above-average results. Doing so requires second-level thinking.



Remember, your goal in investing isn't to earn average returns; you want to do better than average. Thus, your thinking has to be better than that of others—both more powerful and at a higher level. Since other investors may be smart, well-informed and highly computerized, you must find an edge they don't have. You must think of something they haven't thought of, see things they miss or bring insight they don't possess. You have to react differently and behave differently. In short, being right may be a necessary condition for investment success, but it won't be sufficient. You must be more right than others . . . which by definition means your thinking has to be different.

## What is second-level thinking?

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- First-level thinking says, “It’s a good company; let’s buy the stock.” Second-level thinking says, “It’s a good company, but everyone thinks it’s a great company, and it’s not. So the stock’s overrated and overpriced; let’s sell.”
- First-level thinking says, “The outlook calls for low growth and rising inflation. Let’s dump our stocks.” Second-level thinking says, “The outlook stinks, but everyone else is selling in panic. Buy!”
- First-level thinking says, “I think the company’s earnings will fall; sell.” Second-level thinking says, “I think the company’s earnings will fall less than people expect, and the pleasant surprise will lift the stock; buy.”

First-level thinking is simplistic and superficial, and just about everyone can do it (a bad sign for anything involving an attempt at superiority). All the first-level thinker needs is an opinion about the future, as in “The outlook for the company is favorable, meaning the stock will go up.”

Second-level thinking is deep, complex and convoluted. The second-level thinker takes a great many things into account:

- What is the range of likely future outcomes?
- Which outcome do I think will occur?
- What’s the probability I’m right?
- What does the consensus think?
- How does my expectation differ from the consensus?
- How does the current price for the asset comport with the consensus view of the future, and will it mine?
- Is the consensus psychology that’s incorporated in the price too bullish or bearish?
- What will happen to the asset’s price if the consensus turns out to be right, and what if I’m right?

The difference in workload between first-level and second-level thinking is clearly massive, and the number of people capable of the latter is tiny compared to the number capable of the former.

First-level thinkers look for simple formulas and easy answers. Second-level thinkers know that success in investing is the antithesis of simple. That’s not to say you won’t run into plenty of people who try their darnedest to make it sound simple. Some of them I might characterize as “mercenaries.” Brokerage firms want you to think everyone’s capable of investing—at \$10 per trade. Mutual fund companies don’t want you to think you can do it; they want you to think *they* can do it. In that case you’ll put your money into actively managed funds and pay the associated high fees.

Others who simplify are what I think of as “proselytizers.” Some are academics who teach investing. Others are well-intentioned practitioners who overestimate the extent to which they’re in control; I think most of them fail to tote up their records, or they overlook their bad years or attribute losses to bad luck. Finally, there are those who simply fail to understand the complexity of the subject. A guest commentator on my drive-time radio station says, “If you have had good experience with the product, buy the stock.” There’s so much more than that to being a successful investor.

First-level thinkers think the same way other first-level thinkers do about the same things, and they generally reach the same conclusions. By definition, this can’t be the route to superior results. As investors can’t beat the market since, collectively, they are the market.

Before trying to compete in the zero-sum world of investing, you must ask yourself whether you

have good reason to expect to be in the top half. To outperform the average investor, you have to be able to outthink the consensus. Are you capable of doing so? What makes you think so?



The problem is that extraordinary performance comes only from correct nonconsensus forecasts, but nonconsensus forecasts are hard to make, hard to make correctly and hard to act on. Over the years many people have told me that the matrix shown below had an impact on them:

You can't do the same things others do and expect to outperform. . . . Unconventional behavior shouldn't be a goal in itself, but rather a way of thinking. In order to distinguish yourself from others, it helps to have ideas that are different and to process those ideas differently. I conceptualize the situation as a simple 2-by-2 matrix:

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	<b>Conventional Behavior</b>	<b>Unconventional Behavior</b>
Favorable Outcomes	Average good results	Above-average results
Unfavorable Outcomes	Average bad results	Below-average results

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Of course it's not that easy and clear-cut, but I think that's the general situation. If your behavior is conventional, you're likely to get conventional results—either good or bad. Only if your behavior is unconventional is your performance likely to be unconventional, and only if your judgments are superior is your performance likely to be above average.

“DARE TO BE GREAT,” SEPTEMBER 7, 2000

The upshot is simple: to achieve superior investment results, you have to hold nonconsensus views regarding value, and they have to be accurate. That's not easy.

The attractiveness of buying something for less than it's worth makes eminent sense. So how do you find bargains in efficient markets? You must bring exceptional analytical ability, insight, or foresight. But because it's exceptional, few people have it.

“RETURNS AND HOW THEY GET THAT WAY,” NOVEMBER 11, 2000

For your performance to diverge from the norm, your expectations—and thus your portfolio—have to diverge from the norm, and you have to be more right than the consensus. Different and better than that's a pretty good description of second-level thinking.

Those who consider the investment process simple generally aren't aware of the need for—or even the existence of—second-level thinking. Thus, many people are misled into believing that everyone can be a successful investor. Not everyone can. But the good news is that the prevalence of first-level thinkers increases the returns available to second-level thinkers. To consistently achieve superior investment returns, you must be one of them.



## The Most Important Thing Is . . . Understanding Market Efficiency (and Its Limitations)

In theory there's no difference between theory and practice, but in practice there is.

YOGI BERRA

The 1960s saw the emergence of a new theory of finance and investing, a body of thought known as the “Chicago School” because of its origins at the University of Chicago’s Graduate School of Business. As a student there in 1967–1969, I found myself at ground zero for this new theory, which greatly informed and influenced my thinking.

The theory included concepts that went on to become important elements in investment dialogue: risk aversion, volatility as the definition of risk, risk-adjusted returns, systematic and nonsystematic risk, alpha, beta, the random walk hypothesis and the efficient market hypothesis. (All of these are addressed in the pages that follow.) In the years since it was first proposed, that last concept has proved to be particularly influential in the field of investing, so significant that it deserves its own chapter.

The efficient market hypothesis states that

- There are many participants in the markets, and they share roughly equal access to all relevant information. They are intelligent, objective, highly motivated and hardworking. Their analytical models are widely known and employed.
- Because of the collective efforts of these participants, information is reflected fully and immediately in the market price of each asset. And because market participants will move instantly to buy any asset that’s too cheap or sell one that’s too dear, assets are priced fairly in the absolute and relative to each other.
- Thus, market prices represent accurate estimates of assets’ intrinsic value, and no participant can consistently identify and profit from instances when they are wrong.
- Assets therefore sell at prices from which they can be expected to deliver risk-adjusted returns that are “fair” relative to other assets. Riskier assets must offer higher returns in order to attract buyers. The market will set prices so that appears to be the case, but won’t provide a “free lunch.” That is, there will be no incremental return that is not related to (and compensatory for) incremental risk.

That's a more or less official summary of the highlights. Now my take. When I speak of the theory, I also use the word *efficient*, but I mean it in the sense of "speedy, quick to incorporate information," not "right."

I agree that because investors work hard to evaluate every new piece of information, asset prices immediately reflect the consensus view of the information's significance. I do not, however, believe the consensus view is necessarily correct. In January 2000, Yahoo sold at \$237. In April 2001 it was at \$11. Anyone who argues that the market was right both times has his or her head in the clouds; it has to have been wrong on at least one of those occasions. But that doesn't mean many investors were able to detect and act on the market's error.

If prices in efficient markets already reflect the consensus, then sharing the consensus view will make you likely to earn just an average return. To beat the market you must hold an idiosyncratic, or nonconsensus, view.

The bottom line for me is that, although the more efficient markets often misvalue assets, it's not easy for any one person—working with the same information as everyone else and subject to the same psychological influences—to consistently hold views that are different from the consensus *and* closer to being correct. That's what makes the mainstream market awfully hard to beat—even if they aren't always right.

“WHAT'S IT ALL ABOUT, ALPHA?” JULY 11, 2000

The most important upshot from the efficient market hypothesis is its conclusion that “you can't beat the market.” Not only was this conclusion founded logically on the Chicago view of the market, but it was buttressed by studies of the performance of mutual funds. Very few of those funds have distinguished themselves through their results.

What about the five-star funds? you might ask. Read the small print: mutual funds are rated relative to each other. The ratings don't say anything about their having beaten an objective standard such as the market index.

Okay then, what about the celebrated investors we hear so much about? First, one or two good years prove nothing; chance alone can produce just about any result. Second, statisticians insist nothing can be proved with statistical significance until you have enough years of data; I remember a figure of sixty-four years, and almost no one manages money that long. Finally, the emergence of one or two great investors doesn't disprove the theory. The fact that the Warren Buffetts of this world attract as much attention as they do is an indication that consistent outperformers are exceptional.

One of the greatest ramifications of the Chicago theory has been the development of passive investment vehicles known as *index funds*. If most active portfolio managers making “active bets” on which securities to overweight and underweight can't beat the market, why pay the price—in the form of transaction costs and management fees—entailed in trying? With that question in mind, investors have put growing amounts in funds that simply invest a market-determined amount in each stock and bond in a market index. In this way, investors enjoy market returns at a fee of just a few hundredths of a percent per year.

Everything moves in cycles, as I'll discuss later, and that includes “accepted wisdom.” So the efficient market hypothesis got off to a fast start in the 1960s and developed a lot of adherents. Objections have been raised since then, and the general view of its applicability rises and falls.

I have my own reservations about the theory, and the biggest one has to do with the way it links return and risk.

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According to investment theory, people are risk-averse by nature, meaning that in general they rather bear less risk than more. For them to make riskier investments, they have to be induced through the promise of higher returns. Thus, markets will adjust the prices of investments so that, based on the known facts and common perceptions, the riskier ones will appear to promise higher returns.

Because theory says in an efficient market there's no such thing as investing skill (commonly referred to today as *alpha*) that would enable someone to beat the market, all the difference in return between one investment and another—or between one person's portfolio and another's—is attributable to differences in risk. In fact, if you show an adherent of the efficient market hypothesis an investment record that appears to be superior, as I have, the answer is likely to be, "The high return is explained by hidden risk." (The fallback position is to say, "You don't have enough years of data.")

Once in a while we experience periods when everything goes well and riskier investments deliver the higher returns they seem to promise. Those halcyon periods lull people into believing that to get higher returns, all they have to do is make riskier investments. But they ignore something that is easily forgotten in good times: this can't be true, because if riskier investments could be counted on to produce higher returns, they wouldn't be riskier.

Every once in a while, then, people learn an essential lesson. They realize that nothing—and certainly not the indiscriminate acceptance of risk—carries the promise of a free lunch, and they're reminded of the limitations of investment theory.



That's the theory and its implications. The key question is whether it's right: Is the market unbeatable? Are the people who try wasting their time? Are the clients who pay fees to investment managers wasting their money? As with most other things in my world, the answers aren't simple . . . and they're certainly not yes or no.

I don't believe the notion of market efficiency deserves to be dismissed out of hand. In principle it's fair to conclude that if thousands of rational and numerate people gather information about an asset and evaluate it diligently and objectively, the asset's price shouldn't stray far from its intrinsic value. Mispricings shouldn't be regularly extant, meaning it should be hard to beat the market.

In fact, some asset classes are quite efficient. In most of these:

- the asset class is widely known and has a broad following;
- the class is socially acceptable, not controversial or taboo;
- the merits of the class are clear and comprehensible, at least on the surface ; and
- information about the class and its components is distributed widely and evenly.

If these conditions are met, there's no reason why the asset class should systematically be overlooked, misunderstood or underrated.

Take foreign exchange, for example. What are the things that determine the movements of one currency versus another? Future growth rates and inflation rates. Is it possible for any one person to systematically know much more about these things than everyone else? Probably not. And if not, the

no one should be able to regularly achieve above-average risk-adjusted returns through currency trading.

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What about the major stock markets, such as the New York Stock Exchange? Here millions of people are prospecting, driven by the desire for profit. They're all similarly informed; in fact, it's one of the goals of our market regulation that everyone should gain access to the same comparable information at the same time. With millions of people doing similar analysis on the basis of similar information, how often will stocks become mispriced, and how regularly can any one person detect those mispricings?

Answer: Not often, and not dependably. But that is the essence of second-level thinking.

Second-level thinkers know that, to achieve superior results, they have to have an edge in either information or analysis, or both. They are on the alert for instances of misperception. My son Andre is a budding investor, and he comes up with lots of appealing investment ideas based on today's facts and the outlook for tomorrow. But he's been well trained. His first test is always the same: "And who doesn't know that?"



In the vocabulary of the theory, second-level thinkers depend on *inefficiency*. The term *inefficiency* came into widespread use over the last forty years as the counterpoint to the belief that investors can beat the market. To me, describing a market as inefficient is a high-flown way of saying the market is prone to mistakes that can be taken advantage of.

Where might errors come from? Let's consider the assumptions that underlie the theory of efficient markets:

- There are many investors hard at work.
- They are intelligent, diligent, objective, motivated and well equipped.
- They all have access to the available information, and their access is roughly equal.
- They're all open to buying, selling or shorting (i.e., betting against) every asset.

For those reasons, theory says that all the available information will be smoothly and efficiently synthesized into prices and acted on whenever price/value discrepancies arise, so as to drive out those discrepancies.

But it's impossible to argue that market prices are always right. In fact, if you look at the four assumptions just listed, one stands out as particularly tenuous: objectivity. Human beings are not clinical computing machines. Rather, most people are driven by greed, fear, envy and other emotions that render objectivity impossible and open the door for significant mistakes.

Likewise, what about the fourth assumption? Whereas investors are supposed to be open to an asset—and to both owning it and being short—the truth is very different. Most professionals are assigned to particular market niches, as in "I work in the equity department" or "I'm a bond manager." And the percentage of investors who ever sell short is truly tiny. Who, then, makes and implements the decisions that would drive out relative mispricings between asset classes?

A market characterized by mistakes and mispricings can be beaten by people with rare insight. Thus, the existence of inefficiencies gives rise to the possibility of outperformance and is a necessary condition for it. It does not, however, guarantee it.

To me, an inefficient market is one that is marked by at least one (and probably, as a result, by all) of the following characteristics:

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- Market prices are often wrong. Because access to information and the analysis thereof are highly imperfect, market prices are often far above or far below intrinsic values.
- The risk-adjusted return on one asset class can be far out of line with those of other asset classes. Because assets are often valued at other-than-fair prices, an asset class can deliver a risk-adjusted return that is significantly too high (a free lunch) or too low relative to other asset classes.
- Some investors can consistently outperform others. Because of the existence of (a) significant misvaluations and (b) differences among participants in terms of skill, insight and information access, it is possible for misvaluations to be identified and profited from with regularity.

This last point is very important in terms of what it does and does not mean. Inefficient markets do not necessarily give their participants generous returns. Rather, it's my view that they provide the raw material—mispricings—that can allow some people to win *and others lose* on the basis of differential skill. If prices can be very wrong, that means it's possible to find bargains *or overpay*. For every person who gets a good buy in an inefficient market, someone else sells too cheap. One of the great sayings about poker is that “in every game there's a fish. If you've played for 45 minutes and haven't figured out who the fish is, then it's you.” The same is certainly true of inefficient market investing.

“WHAT'S IT ALL ABOUT, ALPHA?” JULY 11, 2008



In the great debate over efficiency versus inefficiency, I have concluded that no market is completely one or the other. It's just a matter of degree. I wholeheartedly appreciate the opportunities that inefficiency can provide, but I also respect the concept of market efficiency, and I believe strongly that mainstream securities markets can be so efficient that it's largely a waste of time to work hard finding winners there.

In the end, I've come to an interesting resolution: Efficiency is not so universal that we should give up on superior performance. At the same time, efficiency is what lawyers call a “rebuttable presumption”—something that should be presumed to be true until someone proves otherwise. Therefore, we should assume that efficiency will impede our achievement unless we have good reasons to believe it won't in the present case.

Respect for efficiency says that before we embark on a course of action, we should ask some questions: have mistakes and mispricings been driven out through investors' concerted efforts, or do they still exist, and why?

Think of it this way:

- Why should a bargain exist despite the presence of thousands of investors who stand ready and willing to bid up the price of anything that's too cheap?
- If the return appears so generous in proportion to the risk, might you be overlooking some hidden risk?

- Why would the seller of the asset be willing to part with it at a price from which it will give you an excessive return?
- Do you really know more about the asset than the seller does?
- If it's such a great proposition, why hasn't someone else snapped it up?

Something else to keep in mind: just because efficiencies exist today doesn't mean they'll remain forever.

Bottom line: Inefficiency is a necessary condition for superior investing. Attempting to outperform in a perfectly efficient market is like flipping a fair coin: the best you can hope for is fifty-fifty. For investors to get an edge, there have to be inefficiencies in the underlying process—imperfections, mispricings—to take advantage of.

But let's say there are. That alone is not a sufficient condition for outperformance. All that means is that prices aren't always fair and mistakes are occurring: some assets are priced too low and some too high. You still have to be more insightful than others in order to regularly buy more of the former than the latter. Many of the best bargains at any point in time are found among the things other investors can't or won't do. Let others believe markets can never be beat. Abstention on the part of those who won't venture in creates opportunities for those who will.



Is investment theory, with its notion of market efficiency, the equivalent of a physical law that is universally true? Or is it an irrelevant ivory-tower notion to be disregarded? In the end, it's a question of balance, and balance comes from applying informed common sense. The key turning point in my investment management career came when I concluded that because the notion of market efficiency has relevance, I should limit my efforts to relatively inefficient markets where hard work and skill would pay off best. Theory informed that decision and prevented me from wasting my time in the mainstream markets, but it took an understanding of the limits of the theory to keep me from completely accepting the arguments against active management.

In short, I think theory should inform our decisions but not dominate them. If we entirely ignore theory, we can make big mistakes. We can fool ourselves into thinking it's possible to know more than everyone else and to regularly beat heavily populated markets. We can buy securities for their returns but ignore their risk. We can buy fifty correlated securities and mistakenly think we've diversified....

But swallowing theory whole can make us give up on finding bargains, turn the process over to a computer and miss out on the contribution skillful individuals can make. The image here is of the efficient-market-believing finance professor who takes a walk with a student.

"Isn't that a \$10 bill lying on the ground?" asks the student.

"No, it can't be a \$10 bill," answers the professor. "If it were, someone would have picked it up by now."

The professor walks away, and the student picks it up and has a beer.

"WHAT'S IT ALL ABOUT, ALPHA?" JULY 11, 2000

## The Most Important Thing Is . . . Value

For investing to be reliably successful, an accurate estimate of intrinsic value is the indispensable starting point. Without it, any hope for consistent success as an investor is just that: hope.

The oldest rule in investing is also the simplest: “Buy low; sell high.” Seems blindingly obvious: Who would want to do anything else? But what does that rule actually mean? Again, obvious—on the surface: it means that you should buy something at a low price and sell it at a high price. But what, in turn, does *that* mean? What’s high, and what’s low?

On a superficial level, you can take it to mean that the goal is to buy something for less than you sell it for. But since your sale will take place well down the road, that’s not much help in figuring out the proper price at which to buy today. There has to be some objective standard for “high” and “low,” and most usefully that standard is the asset’s intrinsic value. Now the meaning of the saying becomes clear: buy at a price below intrinsic value, and sell at a higher price. Of course, to do that, you’d better have a good idea what intrinsic value is. For me, an accurate estimate of value is the indispensable starting point.



To simplify (or oversimplify), all approaches to investing in company securities can be divided into two basic types: those based on analysis of the company’s attributes, known as “fundamentals,” and those based on study of the price behavior of the securities themselves. In other words, an investor has two basic choices: gauge the security’s underlying intrinsic value and buy or sell when the price diverges from it, or base decisions purely on expectations regarding future price movements.

I’ll turn to the latter first, since I don’t believe in it and should be able to dispose of it rather promptly. *Technical analysis*, or the study of past stock price behavior, has been practiced ever since I joined the industry (and well before that), but it’s been in decline. Today observations about historical price patterns may be used to supplement fundamental analysis, but we hear far less than we did in the past about people basing decisions primarily on what price movements tell them.

Part of the decline of technical analysis can be attributed to the *random walk hypothesis*, a component of the Chicago theory developed in the early 1960s, primarily by Professor Eugene Fama. The random walk hypothesis says a stock’s past price movements are of absolutely no help in predicting future movements. In other words, it’s a random process, like tossing a coin. We all know that even if a coin has come up heads ten times in a row, the probability of heads on the next throw

still fifty-fifty. Likewise, the hypothesis says, the fact that a stock's price has risen for the last ten days tells you nothing about what it will do tomorrow.

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Another form of relying on past stock price movements to tell you something is so-called momentum investing. It, too, exists in contravention of the random walk hypothesis. I'm unlikely to do it justice. But as I see it, investors who practice this approach operate under the assumption that they can tell when something that has been rising will continue to rise.

Momentum investing might enable you to participate in a bull market that continues upward, but you'll see a lot of drawbacks. One is based on economist Herb Stein's wry observation that "if something cannot go on forever, it will stop." What happens to momentum investors then? How will their approach help them sell in time to avoid a decline? And what will it have them do in falling markets?

It seems clear that momentum investing isn't a cerebral approach to investing. The greatest example came in 1998–1999, with the rise of people called day traders. Most were nonprofessional investors drawn from other walks of life by the hope for easy money in the tech-media-telecom stock boom. They rarely held positions overnight, since doing so would require them to pay for their trades. Several times a day, they would try to guess whether a stock they'd been watching would rise or fall in the next few hours.

I've never understood how people reach conclusions like these. I liken it to trying to guess whether the next person to come around the corner will be male or female. The way I see it, day traders considered themselves successful if they bought a stock at \$10 and sold at \$11, bought it back the next week at \$24 and sold at \$25, and bought it a week later at \$39 and sold at \$40. If you can't see the flaw in this—that the trader made \$3 in a stock that appreciated by \$30—you probably shouldn't read the rest of this book.



Moving away from momentum investors and their Ouija boards, along with all other forms of investing that eschew intelligent analysis, we are left with two approaches, both driven by fundamentals: *value investing* and *growth investing*. In a nutshell, value investors aim to come up with a security's current intrinsic value and buy when the price is lower, and growth investors try to find securities whose value will increase rapidly in the future.

To value investors, an asset isn't an ephemeral concept you invest in because you think it's attractive (or think others will find it attractive). It's a tangible object that should have an intrinsic value capable of being ascertained, and if it can be bought below its intrinsic value, you might consider doing so. Thus, intelligent investing has to be built on estimates of intrinsic value. Those estimates must be derived rigorously, based on all of the available information.

“THE MOST IMPORTANT THING,” JULY 1, 2000

What is it that makes a security—or the underlying company—valuable? There are lots of candidates: financial resources, management, factories, retail outlets, patents, human resources, brand names, growth potential and, most of all, the ability to generate earnings and cash flow. In fact, most analytical approaches would say that all those other characteristics—financial resources, management, factories, retail outlets, patents, human resources, brand names and growth potential—are valuable.



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