Most Important Thing

1. **Second Level Thinking** : It is not supposed to be easy, anyone who finds it easy is stupid.

- Investing, like economics, is more art than science.
- In basketball, you can't coach height, meaning all the ~~train~~ coaching in the world won't make a player taller. It is almost as hard to teach insight.
- In investing, it calls for 'Perceptive Thinking' - 2nd Level
- The 2nd level thinker takes many things into a/c:
  - What is the range of likely future outcomes?
  - Which outcome do I think will occur?
  - What's the probability that I am right?
  - What does the consensus think?
  - How does my expectation ~~think~~ differ from the consensus?
  - How does the current price for the asset comport with the consensus view of the future, and with 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 am right?

	Conventional Behaviour	Unconventional Behaviour
Favourable outcomes	Avg. good results	Above Avg. good results
Unfavourable "	" Bad results	Below avg. results

Most Important Thing

2. Understanding Market Efficiency (and its limitations)

In theory, there is no difference between theory & practice, but in practice there is - Yogi Berra

- To beat the market, you must hold an idiosyncratic, or non-consensus view.
- Who doesn't know that?
- Poker - "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 true of inefficient market investing.
- Effeciency is what lawyers call a "rebuttable presumption" - something that should be presumed to be true until someone proves otherwise.
- Why should a bargain exist despite the presence of thousands of investors who are reddy 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?
- 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?
- Why should the seller of the asset be willing to part with it at a price from which it will give you an excessive return?
- Efficient market believing professor who doesn't pick up a USD 10 bill since if it were true, someone would have picked up

Most Important Thing

3. Value : For investing to be reliably successful, an accurate estimate of intrinsic value is the indispensable starting point.

- If something can't go on forever, it will stop - Herb Stein
  (Momentum Investing)
- Growth investing lies between Value Investing & Momentum Investing. more emphasis on potential rather than current attributes
  about future / about present
- Investment can be doomed if the company's assets are squandered on money losing operations or unwise acquisitions
- Being too far ahead of time is indistinguishable from being wrong
- An accurate opinion on valuation, loosely held → Limited help
  " incorrect " " " , strongly " → Far worse
- 2 essential ingredients for profit in a declining mkt.:
  - You have to have a strong view on Intrinsic value
  - " " " hold that view strongly enough to be able to hang in & buy even as price declines
  - 3rd : You have to be right.

Most Important Thing

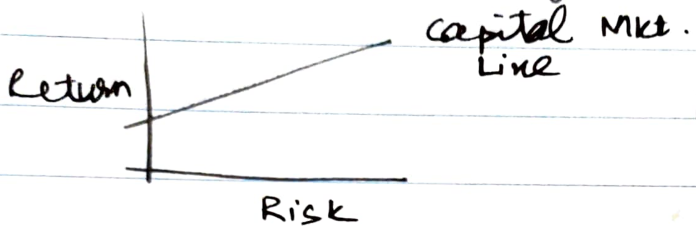
4. Relationship between Price & Value :

- Investment success doesn't come from "buying good things", but rather from "buying things well" — My take = "BUYING GOOD THINGS WELL"
- No asset class or investment has the birthright of a high return. It's only attractive if it's priced right
- Well bought is 1/2 sold
- what is the company's worth?
- You can't make a career out of buying from forced sellers and selling to forced buyers; they're not around all the time, just ~~at~~ on rare occassions at the extremes of crises & bubbles.
- ∴ buying from a forced seller is the best thing in our world, being a forced seller is the worst. This requires both:
    - Long-term capital
    - strong psychological resources
- Investing is a popularity contest and the most dangerous thing is to buy something at the peak of its popularity. At that point, all favourable facts and opinions are already factored into its price, and no new buyers are left to emerge.
- The safest and most potentially profitable thing is to buy something when no one likes it. Given time, its popularity, and thus its price, can only go ~~up~~ one way: up.
- The market can remain irrational longer than you can remain solvent — John Maynard Keynes

Most Important Thing

5. Understanding Risk:

- Risk means more things can happen than will happen
  - 1st step : Understanding Risk
  - 2nd " : Recognizing when risk is high
  - 3rd " : Controlling Risk



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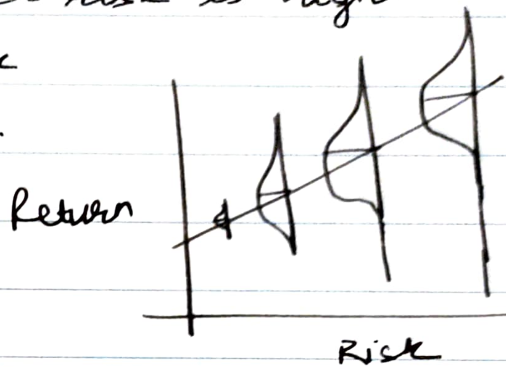


Riskier investment entail wider ranges of outcomes, including the possibility of losses instead of the hoped-for gains

- Riskier investments are those :
  - Outcome is less certain
  - Probability distribution of returns is wider
- Risk: Permanent loss
- Risk of loss can be minimized even if a fundamentally weak asset is bought at a low-enough price.
- Combination of arrogance + failure to understand and allow for risk + small adverse development can be enough to create havoc. It can happen to anyone who doesn't spend the time and effort required to understand the process underlying his portfolio.
- How do you measure risk?
  - 1st, its nothing but a matter of opinion.
  - 2nd, standard for quantification is non-existent

"The relation between different kinds of investments and the risk of loss is entirely too indefinite, and too variable with changing conditions, to the permit of sound mathematical formulation."

- Risk is deceptive, Improbable disaster - It can seem safer than it really is.

The Most Important Thing

5. Understanding Risk:

- Risk is Subjective, Hidden & Unquantifiable
- Alternative Histories: Could have unfolded but didn't
- 'Lucky idiots' - In the short term, its certainly hard to tell them from skilled investors.
- An investment worked - Doesn't mean it wasn't risky & vice versa.
- There's a big difference between probability and outcome. Probable things fail to happen - and improbable things happen - all the time. That's one of the most important things you can know about Investment Risk.
- Probability Distribution: Investors are required to make judgements about future events. To do that, we settle on a central value around which we think events are likely to cluster. This may be the
  - Mean / Expected value than on avg. is expected to happen
  - Median (outcome with ½ the possibilities above and ½ below) or,
  - mode (Single most likely outcome)

To cope with future, it's not sufficient to have a central expectation; we have to have a sense for the other possible outcomes and their likelihood. We need a distribution that describes all the possibilities.

- Rather than enumerating the probability of each observation individually, standard ~~Deviation~~ Distributions provide a convenient way to summarize

5. Understanding Risk:

the probabilities, such that a few statistics can tell you everything you have to know about the shape of things to come.

- The most common bell-shaped distribution is called 'normal' distribution.

Bell shaped Distribution
Normal Distribution

- Key to understanding risk: matter of opinion
- Risk exists only in the future and it's impossible to know for sure what the future holds.
- Projections tend to cluster around historic norms and call for small changes. The point is, people usually expect the future to be like the past and underestimate the potential for change.

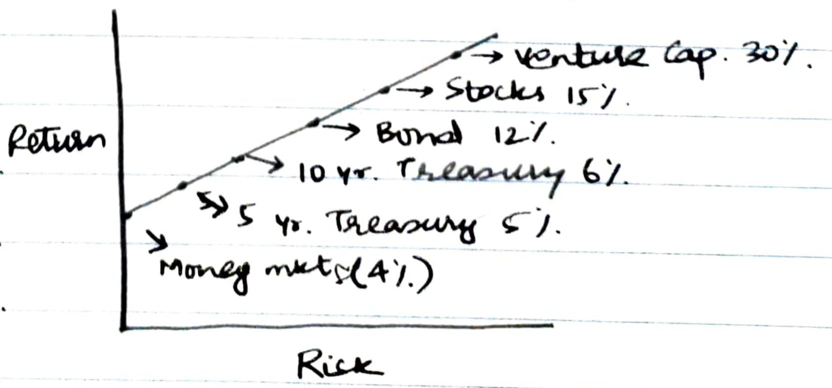
The Most Important Thing

6. Recognizing Risk :

- Risk means uncertainty about which outcome will occur and about the possibility of loss when the unfavourable ones do.
- High risk comes primarily with high prices
- Risk tolerance is antithetical to successful investing.
- Moral hazard risk - Better safety gear can entice climbers to take more risk - making them in fact less safe.
- Risk cannot be eliminated; it just gets transferred and spread.
- Risk-is-gone myth is one of the most dangerous sources of risk and a major contributor to any bubble. At the extreme of pendulum's upswing, the belief that the risk is low and that the investment in question is sure to produce profits intoxicates the herd and causes its members to forget caution, worry and fear of loss, and instead to obsess about the risk of missing opportunity.
- In the months and years leading upto the crisis, few participants worried as much as they're supposed to.

Interest Rate

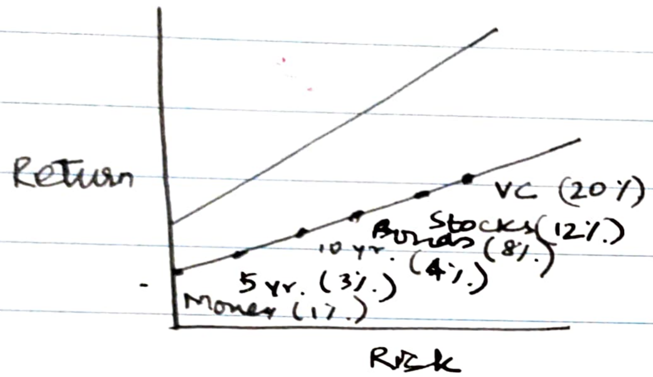
- Money mkt. : 4%.
- 5 Year Treasury : 5%.
- 10 Yr. " : 6%.
- Corporate Bond : 12%.
- Stocks : 15%.
- Venture Cap : 30%.



The Most Important Thing

Recognizing Risk:

Big problem for investment returns today stems from the starting point for the process. Riskless rate isn't 4%, its closer to 1%.



① → Lower interest rate

② Slope ↓ → Expected Return per unit of risk ↓

↓ means

Risk aversion is down

↓

Elevated P/E / Narrow credit spreads

↓

Undisciplined Investor behaviour / Heavy use of leverage / Strong demand for investment vehicles of all types

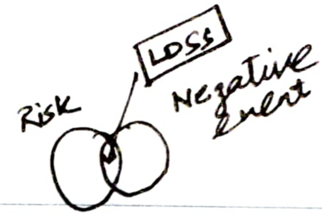
- It's only when the tide goes out that you find out who's been swimming naked
- People vastly over-estimate their ability to recognize risk & under-estimate what it takes to avoid it; thus, they accept risk unknowingly and in so doing contribute to its creation.
- The herd is wrong about risk at least as often as it is about return.
- Investment risk resides most where it is least perceived, and vice versa.

The Most Important Thing

6. Recognizing Risk :

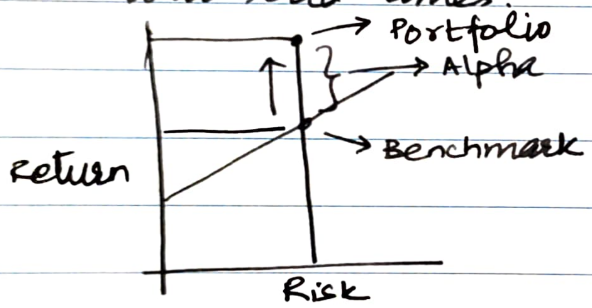
- Broadly negative opinion can make it the least risky thing, since all optimism has been driven out of its price
- Most investors think quality, as opposed to price, is the determinant of whether something's risky. But high quality assets can be risky, and low quality assets can be safe. It's just a matter of the price paid for them.... Elevated popular opinion, then, isn't just the source of low return potential, but also of high risk.

The Most Important Thing



7. Controlling Risk :

- Risk – the possibility of loss – is not observable. What is observable is loss, and loss generally happens when risk collides with negative events.
- Homes in California may or may not have construction flaws that would make them collapse during earthquakes. We find out only when earthquakes occur.
- Risk control is invisible in good times but still essential, since good times can so easily turn into bad times.



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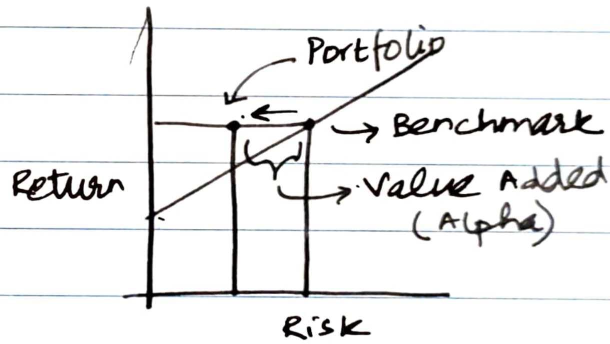

(BETTER)

Not all earnings are created EQUAL

- Prudent home-owners who carry insurance & feel good having protection in place – even when there's no fire.
- Risk control $\xrightarrow[\text{than}]{\text{Better}}$ Risk avoidance

The Most Important Thing

8. Being attentive to cycles:

Rule 1:
- Most things will prove to be cyclical

Rule 2:
- Some of the greatest opportunities for gain/loss come when other people forget Rule no. 1
- Basic reason for cyclicality → Human involvement
- Cycles are self-correcting, and their reversal is not necessarily dependent on exogenous events.
- The worst loans are made at the best of the times.
- If you build it, they will come. If you offer cheap money, they will borrow, buy and build - often without discipline, and with very negative consequences.
- Cycles will never stop occurring
- The belief that cyclicality has been ended exemplifies a way of thinking based on the dangerous premise that "this time, it's different". These 4 words should strike fear - and perhaps suggest an opportunity for profit - for anyone who understands the past and knows it repeats. Thus, it's essential that you be able to recognize this form of error when it arises.
- Ignoring cycles and extrapolating trends is one of the most dangerous things an investor can do.

The Most Important Thing

9. Awareness of the Pendulum:

Investment markets follow a pendulum-like swing:
- between euphoria & depression
- " celebrating +ve developments & obsessing over -ves, and thus,
- between overpriced & underpriced

This oscillation is one of the most dependable features of the investment world, and investor psychology seems to spend much more time at the extremes than it does at a "happy medium".

- The greed/fear cycle is caused by changing attitudes towards risk.
- Finance theory is heavily dependent upon the assumption that investors are risk averse. Reapy dependably high returns from risky investments is an oxymoron. But there are times when this caveat is ignored - when people get too comfortable with risk and hence prices are inadequate to compensate for the risk that's present.
- Main risks in investing is two:
  1. Risk of losing money
  2. " " missing opportunity

It's possible to eliminate either one, but not both. In an ideal world, investors would balance 2 concerns. But from time to time, at the extremes of the pendulum's swing, one or the other predominates.

The Most Important Thing

9. Awareness of the Pendulum :

- 3 stages of a bull market :
  - 1st : When a few forward-looking people begin to believe things will get better
  - 2nd : When most investors realize improvement is actually taking place.
  - 3rd : When everyone concludes things will get better forever.

'What the wise man does in the beginning, the fool does in the end'

- 3 stages of a bear market :
  - 1st : When just a few thoughtful investors recognize that despite the prevailing bullishness, things won't always be rosy.
  - 2nd : When most investors recognize things are deteriorating
  - 3rd : When everyone's convinced things can only get worse.
- Major bottoms occur when everyone forgets that the tide also comes in. Those are the times we live for.
- Swing back from the extreme of the pendulum is usually more rapid — and thus takes much less time — than the swing to the extreme. "The air goes out of the balloon much faster than it went in"

The Most Important Thing

9. Awareness of the Pendulum :

Just like the oscillation of the cycles, we never know

- how far the pendulum will swing in its arc,
- what might cause the swing to stop & turn back,
- when this reversal will occur, or
- how far it will then swing in the opposite direction.

Those who understand the pendulum's behaviour can benefit enormously.

The Most Important Thing

10. Combating Negative Influences:

- Many people will reach similar cognitive conclusions from their analysis, but what they do with those conclusions varies all over the lot because psychology influences them differently.
- 1st emotion that serves to undermine investors' efforts is the desire for money, especially as it morphs into "greed".

Greed is an extremely powerful force. It's strong enough to overcome common sense, risk aversion, prudence, caution, logic, memory of painful past lessons, resolve, trepidation and all the other elements that might otherwise keep investors out of trouble. Instead, from time to time, greed drives investors to throw in their lot with the crowd in pursuit of profit, and eventually they pay the price.

- 2nd psychological factor "Fear". Fear, like greed connotes excess. Fear is overdone concern that prevents investors from taking constructive action when they should.
- 3rd psychological factor: "Willing suspension of disbelief" — People's tendency to dismiss logic, history and time-honoured norms.
  - Nothing is easier than self-deceit. For each man wishes, that he also believes to be true. The belief that some fundamental limiter is no longer valid -

The Most Important Thing

10. Combating Negative Influences :

- and thus historic notions of fair value no longer matter - is invariably at the core of every bubble and consequent crash.
- Inadequate skepticism contributes to Investment losses. Postmortems of financial debacles include 2 classic phrases :
  - It was too good to be true.
  - What were they thinking?
- " Extreme brevity of financial memory "
- 4th psychology factor : Tendency to confirm to the view of the herd rather than resist. Pressure to confirm + Desire to get rich → causes people to drop their independence and skepticism, overcome their innate risk aversion and believe things that don't make sense.
- 5th psychological factor : Envy. Comparing oneself to others — one of the most harmful aspects of human nature.
- 6th psychological factor : Ego - when things go right, it's fun to feel smart and have others agree.
- 7th psychological factor : ~~Capitul~~ Capitulation - a regular feature of investor behaviour late in cycles. Investors hold on to their conviction as long as they can, but when the economic & psychological pressures become irrestible, they surrender & jump on the bandwagon.
  - Testicular Fortitude

The Most Important Thing

10. Combating Negative Influences:

- The entire furor over tech./e.commerce stems from the companies' potential to change the world. These movements are revolutionizing life as we know it. The challenge lies in figuring out who the winners will be, and what a piece of them is really worth today.
- There would be lengthy shake-out period, that profitability wouldn't come easily from providing services gratis, and that shares in money-losing companies valued at high multiples of sales ($\because$ there are no earnings) carried great danger.
- One should have a strong sense of intrinsic value
- Insistence on acting as you should when price diverges from value
- Enough conversance with past cycles - to know that market excesses are ultimately punished, not rewarded.
- Thorough understanding of insidious effect of psychology on the investing process at market extremes.
- A promise to remember that when things seem "too good to be true", they usually are.
- Willingness to look wrong while the market goes from misvalued to more misvalued (as it invariably will), and
- like-minded friends and colleagues from whom to gain support and for you to support.