THE WINNING INVESTMENT HABITS

OF WARREN BUFFETT AND GEORGE SOROS

MARK TIER

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For Tamsin, Natasha, Shaun, and Bun—
so you don't need to repeat my mistakes

PART ONE

The Winning Investment Habits of Warren Buffett and George Soros

4

George Soros Doesn't Take Risks?

"To survive in the financial markets sometimes means beating a hasty retreat."

—GEORGE SOROS[1]

"It's not risky to buy securities at a fraction of what they are worth."

—WARREN BUFFETT[2]

"WHAT'S YOUR RISK PROFILE?" After discovering that Master Investors such as Warren Buffett and George Soros avoid risk like the plague, I hope this sounds like a pretty dumb question. Because it is.

But let's suspend disbelief for a moment to investigate what it means.

The average investment advisor's recommended portfolio will vary depending on his client's "appetite for risk." If the client wants to avoid risk, he will be offered a well-diversified portfolio of "safe" stocks and bonds that (theoretically) won't lose money—or make much, either.

WINNING HABIT NO. 2:

***PASSIONATELY* AVOID RISK**

The Master Investor	The Losing Investor
As a result [of Habit No. 1], is **risk-averse.**	Thinks that big profits can only be made by taking big risks.

If a client is willing to take risks, he'll probably be advised to invest in a portfolio full of so-called growth stocks, all with great promise but no guarantees.

This counsel makes sense to the advisor and the client who both believe it's impossible to make above-average profits without exposing yourself to the risk of loss … the Fifth Deadly Investment Sin.

When someone asks you, "What is your risk profile?" or "What's your appetite for risk?" what they're *really* asking you is: "How much money are you *willing to lose?"*

Fancy phraseology like "risk profile" merely disguises the belief that you must be willing to take the chance of losing a bundle of money in order to have the *chance* of making any.

Yet the practical application of making preservation of capital your first priority (Habit No. 1) is to be risk averse. If, like Buffett and Soros, you can be risk-averse *and* make far-above-average profits, there must be something severely wrong with the conventional wisdom.

Unsurprisingly, the Master Investor has a very different perspective on risk than the average investment professional. For example, Buffett puts "a heavy weight on certainty. If you do that, the whole idea of a risk factor *doesn't make any sense to me."*[2]

To the Master Investor, risk is contextual, measurable, and manageable or avoidable.

Risk Is Contextual

Is the construction worker who walks along a plank sixty floors up in an unfinished skyscraper without a safety harness taking a risk? What about the expert skier who zooms down the almost vertical double black diamond slope at sixty miles an hour? Or the experienced rock climber, whose fingers are the only things holding him a hundred feet up a vertical cliff?

You would probably say, "Yes!" But what you really mean is: "Yes—if it was me."

Risk is related to knowledge, understanding, experience, and competence. Risk is *contextual.*

While we can't be certain that the construction worker, the skier, and the

rock climber are taking *no* risks, intuitively we know they are taking less risk than we would, if we did what they did. The difference is *unconscious competence.*

Unconscious Competence

If you're an experienced driver, you have the ability to make instantaneous judgments—whether to slow down, speed up, turn right or left—to avoid a potential accident or a pothole in the road.

You can probably recall times when you have hit the brakes or swerved to avoid an accident—yet not been fully aware, *consciously*, of the nature of the danger until *after* you'd taken evasive action. The decision was made entirely at the subconscious level.

Such automatic reactions come as the result of years of experience.

Think about it for a moment and you'll realize that driving a car is quite a complicated activity. Think of all the things you're monitoring at the same time:

- Is that kid going to run onto the road?
- Is that idiot going to swerve in front of me?
- Is that car behind me too close?
- Will that car stop at the corner? [Has he had his brakes checked recently?]
- Is there enough space between me and the car in front in case he brakes hard—unexpectedly?

… and I'm barely scratching the surface of all the things you're monitoring as you drive. (Next time you get behind the wheel of a car, take a moment to become aware of all the things you're doing that you weren't consciously aware of doing.)

Even an apparently simple thing like changing lanes on the freeway is what's called a multibody problem in physics. You have to monitor your speed, the speed of the traffic, the speed of the cars behind you and in front of you on the lane you're in and the lane you want to move into, while maintaining awareness of traffic in the *other* lanes just in case. And you also have to make a judgment as to whether or not the drivers in the other lane are going to let you in.

And you do all this *at the same time,* almost instantaneously.

Multibody problems often stump the physicist. That's even though the physicist has a great advantage over you, the driver: the particles he's studying don't have free will. If they're moving in a certain direction at a certain speed, they don't suddenly swerve right or left or speed up or slow down. Nor do they drink and drive.

In a state of unconscious competence, you solve the multibody problem automatically—and just change lanes.

While your subconscious mind directs your driving, your conscious mind is free to carry on a conversation, be aware of the sights, or listen to the radio.

But for someone who has never driven before and has no experience or competence, just getting behind the wheel of a car is a high-risk, life-threatening activity. Like you … before you'd learned to drive.

The Four Stages of Learning

The Master Investor acts apparently effortlessly and instantaneously in a way that, to the outsider, seems risky—especially when the Master doesn't even seem to pause to think.

Warren Buffett can decide to buy a multimillion dollar company in ten minutes or less, doing all the calculations in his head. He doesn't even need the back of an envelope. What's more, most of the decisions he's made so quickly have proven to be the right ones.

That's only possible for someone who has gone through the four stages of learning:

- *Unconscious incompetence:* doesn't know that he doesn't know.
- *Conscious incompetence:* knows that he doesn't know.
- *Conscious competence:* knows what he knows and knows what he doesn't know.
- *Unconscious competence:* knows that he knows.

Unconscious incompetence is the state where you don't even know that you don't know: the state of mind so many young drivers are in when they begin to learn to drive. That's why young drivers have many more accidents than older, more experienced drivers: They fail (or refuse) to recognize their limited

knowledge, skill, and experience.

People in *this* state are highly likely to take risks—expose themselves to danger or loss—for the simple reason they're totally unaware that that's what they're doing.

Investors who subscribe to any or all of the Seven Deadly Investment Sins are in this state. They *think* they know what they're doing, and they fail to recognize the reality of their ignorance.

Unconscious incompetence is also the reason why the worst thing that can happen to a novice investor is to make a pile of money on his very first investment. His success leads him to believe that he's found the secret of trading or investing and that he really knows what he's doing. So he repeats whatever he did the first time—only, much to his own surprise, to lose money hand over fist.

As futures trader Larry Hite explained to Jack Schwager in his book *Market Wizards:*

> I once worked for a firm where the company president, a very nice guy, hired an option trader who was brilliant, but not very stable. One day the option trader disappeared, leaving the firm stuck with a losing position. The president was not a trader, and he sought my advice.
>
> "Larry, what do you think I should do?"
>
> I told him, "Just get out of the position."
>
> Instead, he decided to hold on to the trade. The loss got a little worse, but then the market came back, and he liquidated the position at a small profit.
>
> After this incident, I told a friend who worked at the same firm, "Bob, we are going to have to find another job."
>
> "Why?" he asked.
>
> I answered, "We work for a man who has just found himself in the middle of a mine field, and what he did was close his eyes and walk through it. He now thinks that whenever you are in the middle of a mine field, the proper technique is to close your eyes and go forward."
>
> Less than one year later … this same man had gone through all of the firm's capital.[3]

Being in a state of unconscious incompetence can be highly hazardous to your wealth.

Conscious incompetence is the first step to mastering any subject. It's the conscious admission to yourself that you really don't know what to do, and the full acceptance of your own ignorance.

This may result in feelings of despair or futility or hopelessness—which stops some people from investing entirely. But it's the only way to realize that to master the subject requires a process of intensive learning.

Conscious competence is when you're beginning to have mastery of a subject, but your actions have yet to become automatic. In this stage of mastery, you have to take every action at the conscious level. While learning to drive, for example, you must be consciously aware about where your hands and feet are, think through each decision about whether to hit the brakes, turn the wheel, change gears … and as you do so, think consciously about *how* to do it.

The Four Levels of Wisdom

The man who knows and knows he knows is wise. Follow him.
The man who knows and knows not he knows is asleep. Wake him.
The man who knows not and knows he knows not is a student. Teach him.
The man who knows not he knows not is a fool. Shun him.

In this stage, your reactions are far slower than the expert's.

This doesn't mean you *can't* do it: far from it. You *could* make the same investment decision as Warren Buffett. But what took Buffett ten minutes to decide might take you ten days … or even ten months: You have to think through every single aspect of the investment and consciously apply the tools of analysis (and acquire most of the knowledge) that Buffett has stored in his subconscious mind.

An amazing number of investors believe they can skip this stage of learning entirely. One way they attempt to do it is by adopting someone *else's* unconscious competence: following a guru or a set of procedures developed by a successful investor.

But people who've read a book on Gann triangles or Dow Theory, or whatever, and follow the steps outlined, or who adopt someone else's commodity trading system, sooner or later find that it doesn't work for them.

There's no shortcut to unconscious competence.

As your knowledge expands, as your skills develop, as you gain experience by applying them over and over again, they become more and more automated and move from your conscious mind into your subconscious.

You eventually reach the stage of …

Unconscious competence. This is the state of a Master, who just does it—and may not even know how, specifically, he does it.

When he acts from unconscious competence, the Master appears to make decisions effortlessly, and acts in ways that might scare you or me to death.

We interpret the Master's actions as being full of risk. But what we really mean is that they'd be full of risk to *us* if *we* took that same action. For example, as one visitor to Soros's office recalled thinking—as Soros interrupted the meeting to place orders worth hundreds of millions of dollars—"I would shake in my boots, I wouldn't sleep. He was playing with such high stakes. You had to have nerves of steel for that."[4]

Nerves of steel? Many people have made comments of that kind about Soros. What they mean is: *I* would have to have nerves of steel to do what Soros is doing.

Soros doesn't need nerves of steel: The Master knows what he is doing. We don't—until we learn what the Master has learned.

He knows what he is doing. Similarly, there's bound to be something you do in your life that, to an outsider, seems full of risk but to you is risk-free. That's because you have built up experience and achieved unconscious competence in that activity over the years. You know what you're doing—and you know what *not* to do.

To someone who doesn't have *your* knowledge and experience, what you do will seem full of risk.

It may be a sport—such as skiing, rock climbing, scuba diving, or car racing. It may be those instant, seemingly intuitive judgments you make in your business or profession.

Let me give you a personal example. Since it's in a field you probably know nothing about, I'll have to give you a little background first.

When I published *World Money Analyst,* profits from mailshots—

solicitations to gain new subscribers—were a regular source of income for me. There were times when I spent hundreds of thousands of dollars I didn't have putting a promotion into the mail. Yet I never felt I was taking a risk.

Can You Walk and Talk?

Two examples of unconscious competence that almost every human being on the planet has mastered are walking and talking.

Do you realize that every time you take a step you're moving dozens of different muscles in your feet and legs? For just one step! You don't even know what muscles you're moving. If you tried to take just *one* step while consciously directing each muscle to contract or relax by the right amount in the right sequence, you'd fall right over.

To walk, you just decide consciously to go *there,* and your subconscious mind does the rest.

It's the same with speaking. You have mastery of your native language—and possibly others. Yet you couldn't explain to me any more than I could explain to you precisely *how* you store words, find them when you need them, and put them into grammatical (or at least understandable) sentences. Often, when you're talking, you don't know what specific word you'll say next. All you're aware of consciously is the meaning you want to communicate.

Unconscious competence is the brain's way of dealing with the limitations of consciousness. We can only hold seven bits of information (plus or minus two) in our conscious minds at the same time. When our subconscious mind takes over, it frees our conscious mind to focus on what's really important.

Practice makes permanent: Repetition and experience are the tools we use to delegate functions to our subconscious mind.

To send out a mailing, you have to pay for printing, lettershopping (putting everything into the envelopes), renting the mailing lists—and postage. Only the postage has to be paid up front; for everything else you can get thirty to ninety days' credit.

From records I'd kept of every mailing I'd ever done I knew that by the seventh day of response I would have received about half the total revenue I could expect. Since that was more than the postage, I could start paying the other bills as they came due.

Ah, you might ask, but how do you *know* that money is going to come in?

The level of response depends on three variables: the headline, the copy (the text of the advertisement), and the mailing list. When you create a new

advertisement, you don’t know for sure that it will work. So you test: You mail out 10,000 or 20,000 pieces to the best mailing lists available. Unless the copy is complete drivel, you’re unlikely to lose very much money. (And if you lose the lot, it’s only a couple of thousand dollars, so why worry?)

If the test mailing works (that is, if it’s profitable), you “roll it out” to other mailing lists. Because I was mailing regularly, I knew which mailing lists worked, which didn’t, and which worked sometimes. So I could select which mailing lists to roll out to, based on the profitability of the test. When the test was highly profitable, I could mail half a million pieces or more … if all I had to pay initially was the postage.

Still think I was taking unnecessary risks? I imagine you do. I’m not trying to convince you otherwise. But because I knew what I was doing, to *me* there was no risk at all.

Think about it for a while and I’m sure you’ll find several similar examples where you feel you are taking little or no risk—but it’s impossible to convince an outsider that there’s no risk involved.

Risk declines with experience: There are many things you do today which you think of as risk-free. But at one time in your life, before you built up the necessary knowledge and experience, they were high-risk activities for you.

When George Soros shorted the pound sterling with $10 billion of leverage (as he did in 1992), was he taking a risk? To us, he was. But we tend to judge the level of risk by our own parameters or to think that risk is somehow absolute. On either of those measures, the risk was huge.

But Soros knew what he was doing. He was confident the level of risk was completely manageable. He’d calculated that the most he could lose was about 4 percent. “So there was really very little risk involved.”[5]

As Warren Buffett says: *“Risk comes from not knowing what you are doing.”*[6]

The highly successful investor simply walks (or more likely *runs*) away from any investment that is risky to *him.* But since risk is relative and contextual, the investment that Warren Buffett may shy away from can be the one that George Soros scoops up with both hands. And vice versa.

Risk Is Measurable

Restricting his investments to those where he has unconscious competence is one way the Master Investor can be risk-averse and, at the same time, make above-average profits. But how did he build that unconscious competence in the first place? By discovering that risk is *measurable*—and by learning *what* to measure.

The Master Investor thinks in terms of *certainty* and *uncertainty,* and his focus is on achieving certainty. He isn't really measuring risk at all. He is measuring the probability of profits in his continual search for, as Warren Buffett puts it, high-probability events. And he finds them by answering the question:

What Are You Measuring?

I once asked an investor what his aim was. He replied: "To make 10 percent a year."

"And what's your measure of whether you're achieving that?"

He answered: "By whether I made 10 percent or not."

This investor is rather like an architect who measures the quality of his building by whether or not it stands up when it's finished. Whatever result you are trying to achieve can only be the measure of whether you *have* achieved it, not the measure of whether you *will.*

A good architect knows that his building will stand up while it's still a blueprint. He knows this by measuring the strength of the materials, the loads they will have to bear, and the quality of the design and construction.

In the same way, the Master Investor knows, *before* he invests, whether he is likely to make a profit.

Profit (or loss) is a *residual:* the difference between income and expenditure. As a result, it's only measurable *with the benefit of hindsight.*

For example, a business does not make profits by aiming to make profits. It must focus on the activities that are measurable *in the present,* and later *result in* profits: in other words, activities that increase sales and income or cut costs. And

by only undertaking activities where the managers are confident that income will exceed costs.

Investment Criteria

Master Investors focus their attention not on profits, but on the measures that will inevitably *lead to* profits: their investment criteria.

Warren Buffett doesn't buy a stock because he expects it to go up. He'll be the first to tell you the price could just as easily drop the moment after he's bought it.

He buys a stock (or the entire company) when it meets his investment criteria, because he knows from experience that he will ultimately be rewarded by either a higher stock price or (when he buys the whole company) rising business profits.

For example, in February 1973 Buffett began buying shares in the Washington Post Co. at $27 a share. As the price fell, Buffett bought more, and by October was the largest outside shareholder. To Buffett, the *Washington Post* was a $400 million business that was on sale for just $80 million. But that's not what Wall Street saw—even though most publishing analysts agreed with Buffett on the company's valuation.

Wall Street saw a collapsing market. The Dow was off 40 percent and the "Nifty Fifty" stocks such as IBM, Polaroid, and Xerox—which only a few years before Wall Street had been happy to buy at 80 times earnings—were off 80 percent or more. The economy was in recession and inflation was *rising.* That wasn't supposed to happen: Recession was supposed to send inflation down. To Wall Street, it looked like the "end of the world" might be coming. This was definitely not a time to buy stocks; and with inflation rising you couldn't even find safety in bonds.

When they looked at the Washington Post Co., investment professionals saw a stock that had fallen from $38 to $20 a share and which, like the market, could only go down. The "risk" of buying was far too high.

The irony is that the *Post* could have sold its newspaper and magazine

businesses to another publisher for around $400 million—but Wall Street wouldn't buy it for $80 million!

To Buffett, when you can buy a sound, attractive business at an 80 percent discount to its value, there's no risk at all.

Buffett wasn't looking at the market—or the economy. He was using his investment criteria to measure the quality of the *Post*'s business. What he saw was a business that he understood: Due to its effective monopoly in the Washington area it had favorable economics that were sustainable (and because of its "monopoly" could raise prices in line with inflation and, so, was an inflation hedge); it wasn't capital-intensive; it was well managed—and, of course, it was available at a very attractive price.

While Wall Street was driven by fear of loss, and called it "risk," Buffett and other investors who knew what to measure were cleaning up. Intriguingly, often when the market is collapsing, investment professionals suddenly discover the importance of preserving capital and adopt a "wait-and-see" attitude—while investors who follow the first rule of investing, "Never lose money," are doing the exact opposite and jumping in with both feet.

After Buffett had made his investment, the price of the Washington Post Co. kept falling. Indeed, it was two years before the market came back to his original average purchase price of $22.75 per share. But Buffett didn't care about the share price; his focus was on his investment criteria, on measuring the quality of the business. And that quality—to judge by earnings alone—was improving.

In the investment marketplace, you are what you measure.

Risk Is Manageable

Soros achieves investment certainty in a very different way. Like Buffett, he measures his investments—all successful investors do—but Soros applies very different investment criteria.

The key to Soros's success is to actively manage risk, one of the four risk-avoidance strategies Master Investors use:

1. Don't invest.

2. Reduce risk.
3. Actively manage risk.

4. Manage risk actuarially

There's a fifth risk-avoidance strategy that's highly recommended by the majority of investment advisors: diversification. But to Master Investors, diversification is for the birds (see chapter 7).

No successful investor restricts himself to just one of these four risk-avoidance strategies. Some—like Soros—use them all.

1. Don't Invest

This strategy is always an option: Put all your money in Treasury bills—the "risk-free" investment—and forget about it.

Surprising as it may seem, it is practiced by every successful investor: When they can't find an investment that meets their criteria, they don't invest at all.

Even this simple rule is violated by far too many professional fund managers. For example, in a bear market they'll shift their portfolio into "safe" stocks such as utilities, or bonds, on the theory they'll go down less than the average stock. After all, you can't appear on *Wall Street Week* and tell the waiting audience that you just don't know what to do at the moment.

2. Reduce Risk

This is the core of Warren Buffett's entire approach to investing.

Buffett, like all Master Investors, invests only in what he understands, where he has conscious and unconscious competence.

But he goes further: His method of avoiding risk is built into his investment criteria. He will only invest when he can buy at a price significantly below his estimate of the business's value. He calls this his "margin of safety."

Following this approach, almost all the work is done *before* an investment is made. (As Buffett puts it: "You make your profit when you *buy."*) This process

of selection results in what Buffett calls “high-probability events”: Investments that approach (if not exceed) Treasury bills in their certainty of return.

3. Actively Manage Risk

This is primarily a trader’s approach—and a key to Soros’s success.

Managing risk is very different from reducing risk. If you have reduced risk sufficiently, you can go home and go to sleep. Or take a long vacation.

Actively managing risk requires full-focused attention to constantly monitor the market (sometimes minute by minute) and the ability to act instantly with total dispassion when it’s time to change course (when a mistake is recognized or when a current strategy is running its course).

Soros’s ability to handle risk was “imprinted” on him during the Nazi occupation of Budapest, when the daily risk he faced was death.

His father, being a Master Survivor, taught him the three rules of risk which still guide him today:

1. It’s okay to take risks.
2. When taking a risk, never bet the ranch.
3. Always be prepared to beat a hasty retreat.

Beating a Hasty Retreat

In 1987, Soros had positioned the Quantum Fund to profit from his hypothesis that a market crash was coming—in Japan—by shorting stocks in Tokyo and buying S&P futures in New York.

But on Black Monday, October 19, 1987, his scenario came apart at the seams. The Dow dropped a record 22.6 percent, which still stands as the largest one-day fall in history. Meanwhile, in Tokyo the government supported the market. Soros was bleeding at both ends of his strategy.

“He was on leverage and the very existence of the fund was threatened,”[7] according to Stanley Druckenmiller, who took over management of the Quantum Fund two years later.

Soros didn't hesitate. Following his third rule of risk management he got the hell out. But because his positions were so large, his selling drove down the price. He offered his 5,000 S&P futures contracts at 230, and there were no takers. Or at 220, 215, 205, or 200. Eventually he liquidated at between 195 and 210. Ironically, once he was out, the selling pressure was gone, and the market bounced back to close the day at 244.50.[8]

Soros had lost his entire profit for the year. But that didn't faze him. He had admitted his mistake; realized he didn't know what was going on; and, as he always did whether the mistake was minor or, as in this case, threatening to his survival, he went into risk-control mode. The only difference this time was the size of his positions and the illiquidity of the market.

Survive first. Nothing else was important. He didn't freeze, doubt, stop to analyze, second-guess, or try to figure out whether he should hold on in case things turned around. He just got out.

Soros's investment method is to form a hypothesis about the market and then "listen" to the market to find out whether his hypothesis is right or wrong. In October 1987, the market was telling him he was wrong, dead wrong. As the market had shattered his hypothesis, he no longer had any reason to maintain his positions. Because he was losing money, his only choice was to beat a hasty retreat.

The crash of 1987 cast a cloud of doom and gloom over Wall Street that lasted for months. "Just about every manager I knew who was caught in that crash became almost comatose afterwards," said Druckenmiller. "They became nonfunctional, and I mean legendary names in our business."[9]

As prominent hedge fund manager Michael Steinhardt candidly admits: "I was so depressed that fall that I did not want to go on. I took the crash personally. The issue of timing haunted me. My prescient forewarnings [recommending caution] earlier in the year made the losses all the more painful. Maybe I was losing my judgment. Maybe I just was not as good as I used to be. My confidence was shaken. I felt alone."[10]

Not Soros. He had taken one of the biggest hits of all, but he was unaffected.

He was back in the market two weeks later heavily shorting the dollar.

Because he knew how to handle risk, because he followed his rules, he immediately put the crash behind him. It was history. And the Quantum Fund ended *up* 14.5 percent for the year.

Emotional Disconnect

A mental strategy that sets Master Investors apart is that they can totally disconnect their emotions from the market. Regardless of what happens in the market, they are unaffected emotionally. Of course, they may feel happy or sad, angry or excited—but they have the ability to immediately put that emotion aside and clear their minds.

Being in a state where you are controlled by your emotions makes you vulnerable to risk. The investor who is overcome by his emotions—even if he knows full well, intellectually, what to do when things go wrong—often freezes up; agonizes endlessly over what to do; and ends up selling, usually at a loss, just to relieve the anxiety.

Buffett achieves the necessary emotional distance through his investment *method.* His focus is on the quality of the business. His only concern is whether his investments continue to meet his criteria. If they do, he's happy—regardless of how the market might be valuing them. If a stock he owns no longer meets his criteria, he'll sell it—regardless of how the market prices it.

Warren Buffett simply doesn't care what the market is doing. No wonder he often says he wouldn't mind if the stock market closed down for ten years.

"I Am Fallible"

Like Buffett, Soros's investment method helps distance him emotionally from the market. But his ultimate protection—aside from the self-confidence that he shares with Buffett—is that he "walks around telling whomever has the patience to listen that he is fallible."[11]

He bases an investment on a hypothesis he has developed about how and why a particular market will move. The use of the word "hypothesis" in itself signifies a very tentative stance, of someone unlikely to become "married to his

position."

Yet, as his public prediction that the "Crash of '87" would start in Japan, not the United States, bears witness, there were times when he was *certain* of what "Mr. Market" would do next. When it didn't happen that way, he would be taken completely by surprise.

Overriding all the other beliefs Soros has is his conviction that he is fallible—the basis, as we will see, of his investment philosophy. So that when the market proves him wrong, he immediately realizes he's made a mistake. Unlike too many investors, he doesn't say "the market is wrong" and hang on to his position. He just gets out.

As a result, he can step back completely from his involvement, so appearing to others to be emotionless, a stoic.

4. Manage Risk Actuarially

The fourth way to manage risk is to act, in effect, like an insurance company.

An insurance company will write a life insurance policy without having any idea *when* it will have to pay out. It might be tomorrow; it might be a hundred years from now.

It doesn't matter (to the insurance company).

An insurance company makes no predictions about when you might die, when your neighbor's house might burn down or be burgled—or about any other specific item it has insured.

The insurance company controls risk by writing a large number of policies so that it can predict, with a high degree of certainty, the *average* amount of money it will have to pay out each year.

Dealing with averages, not individual events, it will set its premium from the *average expectancy* of the event. So the premium on your life insurance policy is based on the average life expectancy of a person of your sex and medical condition at the age you were when you took out the policy. The insurance company is making no judgment about *your* life expectancy.

The person who calculates insurance premiums and risks is called an actuary,

which is why I call this method of risk control "managing risk *actuarially.*"

This approach is based on averages of what's called "risk expectancy."

Even though the Master Investor may use the same, commonly accepted terminology, what he's actually looking at is average *profit* expectancy.

For example, if you bet a dollar on heads coming up when you flip a coin, you have a 50:50 chance of winning or losing. Your average profit expectancy is 0. If you flipped a coin a thousand times and bet a dollar each time, you'd expect to end up with about the same amount of money you started with (provided, of course, that an unusual series of tails didn't wipe you out).

Fifty-fifty odds aren't at all exciting. Especially after you have paid transaction costs.

But if the odds are 55:45 in your favor, it's a different story. Your total winnings over a series of events will exceed your total losses since your average profit expectancy rises to 0.1—for each dollar you invest you can expect *on average* to get back $1.10.

Gambling, Investing, and Risk

gamble *n.* risky undertaking; any matter or thing involving risk
—*v.t.* risk much in the hope of great gain
—*v.i.* to stake or risk money on the outcome of something involving chance

Parallels are often drawn between investing and gambling—with good reason: In essence, the actuarial approach means playing the odds.

Another (but bad) reason is that far too many investors approach the markets with a gambling mentality: "in the *hope* of great gain." This is even more often the case with people entering the commodity markets for the first time.

To make the analogy clear, consider the difference between a gambler and a *professional* gambler.

A gambler plays games of chance for money—in the *hope* of making a great gain. Since he rarely comes out ahead, his primary reward is the excitement of playing the game. Such gamblers keep Las Vegas, Monte Carlo, Macau, and lotteries the world over in business.

The gambler throws himself the mercy of the “gods of chance.” However benign these gods of chance may be, their representatives on earth live by the motto “Never give a sucker an even break.” The result, in Warren Buffett’s words:

> Las Vegas has been built upon the wealth transfers that occur when people engage in seemingly small disadvantageous capital transactions.[12]

A *professional* gambler, by contrast, understands the odds of the game he’s playing and only makes bets when the odds are in his favor. Unlike the weekend gambler, he doesn’t depend on one roll of the dice. He has calculated the odds of the game so that, *over time*, his winnings exceed his losses.

He approaches the game with the mentality of an insurance company when it writes a policy. His focus: average profit expectancy.

He has a system that he follows—just like the Master Investor. And part of the system, naturally enough, is to choose the game where it’s statistically possible to win over time.

You can’t eliminate chance from a game of poker, blackjack, or roulette. But you can learn to calculate the odds and decide whether it’s possible to play that game with the average profit expectancy (the odds) in your favor.

If it’s not, you don’t play.

Sucker!

Professional gamblers do more than just calculate probabilities: They look for situations where the odds are *bound* to be in their favor.

A friend of mine, a member of Alcoholics Anonymous, lived a sixty-minute ferry ride away from town. When he took a late ferry home there were always a bunch of drunks at a table at the back of the ferry, continuing their binge with beers from the bar.

He’d pull up a chair, take a pack of cards from his bag and say, “Anyone feel like a round of poker?”

Professional gamblers never buy lottery tickets.

Professional gamblers don’t actually gamble. They don’t “risk much in the

hope of great gain." They invest little, time after time, with the mathematical certainty that they will achieve a positive return on capital.

Investing isn't gambling. But professional gamblers act at the poker table in the same way Master Investors act in the investment marketplace: They both understand the mathematics of risk and only put serious money on the table when the odds are in their favor.

Actuarial Investing

When Warren Buffett started investing, his approach was very different from the one he follows today. He adopted the method of his mentor, Benjamin Graham, whose system was actuarially based.

Graham's aim was to purchase undervalued common stocks of secondary companies "when they can be bought at two-thirds or less of their indicated value."[13]

He determined value solely by analyzing publicly available information, his primary source of information being company financial statements.

A company's book value was his basic measure of intrinsic value. His ideal investment was a company that could be bought at a price significantly below its liquidation or break-up value.

But a stock may be cheap for a good reason. The industry may be in decline, the management may be incompetent, or a competitor may be selling a superior product that's taking away all the company's customers—to cite just a few possibilities. You're unlikely to find this kind of information in a company's annual report.

By just analyzing the numbers Graham could not know why the stock was cheap. So some of his purchases went bankrupt; some hardly moved from his purchase price; and some recovered to their intrinsic value and beyond. Graham rarely knew in advance which stock would fall into which category.

So how could he make money? He made sure he bought dozens of such stocks, so the profits on the stocks that went up far outweighed the losses on the others.

This is the actuarial approach to risk management. In the same way that an insurance company is willing to write fire insurance for all members of a particular class of risks, so Graham was willing to buy all members of a particular class of stocks.

An insurance company doesn't know, specifically, whose house is going to burn down, but it can be pretty certain how often it's going to have to pay for fire damage. In the same way, Graham didn't know *which* of his stocks would go up. But he knew that, on average, a predictable percentage of the stocks he bought would go up.

An insurance company can only make money by selling insurance at the right price. Similarly, Graham had to buy at the right price; if he paid too much, he would lose, not make, money.

The actuarial approach certainly lacks the romantic flavor of the stereotypical Master Investor who somehow, magically, only buys stocks that are going to go up. Yet it's probably used by more successful investors than any other method. For success, it depends on identifying a narrow class of investments that, taken together, have a positive average profit expectancy.

Buffett started out this way, and still follows this approach when he engages in arbitrage transactions. It also contributes to Soros's success. And it is the basis of most commodity trading systems.

Average profit expectancy is the investor's equivalent of the insurer's actuarial tables. Hundreds of successful investment and trading systems are built on the identification of a class of events which, when repeatedly purchased over time, have a positive average expectancy of profit.

Risk Versus Reward

Most investors believe that the more risk you take on, the greater the profit you can expect.

The Master Investor, on the contrary, does not believe that risk and reward are related. By investing only when his expectancy of profit is positive, he assumes little or no risk at all.

5

“The Market Is Always Wrong”

“Wealth is the product of man’s capacity to think.”

—AYN RAND[1]

“Most men would rather die than think. Many do.”

—BERTRAND RUSSELL[2]

EVERY DECISION AN INVESTOR MAKES—to buy, sell, hold, or do nothing—results from his idea of what makes markets tick; that is, from his investment philosophy.

A philosophy is an explanation of how the world around us works and our means of understanding it. That understanding tells us what’s right and what’s wrong, what works and what doesn’t. It’s our guide to making choices, reaching decisions—and taking action.

Everyone has a philosophy of life—you cannot be human and *not* have one. Most people accept someone else’s philosophy by default. Some consciously choose to adopt or modify someone else’s. And a very few develop their own.

WINNING HABIT NO. 3:

DEVELOP YOUR OWN UNIQUE INVESTMENT PHILOSOPHY

The Master Investor	The Losing Investor
Has developed his own investment philosophy, which is an expression of his personality, abilities, knowledge, tastes, and objectives. As a result, no two highly successful investors have the same investment philosophy.	Has no investment philosophy—or uses someone else’s.

So it is in the investment arena.

An *investment philosophy* is a set of beliefs about:

- the nature of investment reality: how markets work and why prices move;
- a theory of value, including how value can be identified and what causes profits and losses; and
- the nature of a good investment.

Every investor has such a philosophy. As prominent investment psychologist Van Tharp says, you don't trade the market, you trade your beliefs about the market.[3] If you don't know what those beliefs are, how can you know what you are doing?

Most investors cling to a potpourri of beliefs, often self-contradictory, that they have absorbed from their environment. Because they haven't figured things out for themselves, they tend to change their investment beliefs along with the market's prevailing bias.

For example, in the 1990s it was widely believed that stocks will always go up in the long run, that you could get rich by doing nothing more than buying on dips.

In the dot-com boom, the majority of investors, analysts, advisors, and fund managers came to believe that the law of economic gravity ("What goes up must come down") had been repealed, that valuations and even profits didn't matter.

Not Warren Buffett and George Soros. Each devoted much time and thought to developing his own explicit and internally consistent investment philosophy, which doesn't change with the prevailing winds. The Master Investor's philosophy is his mental shield against the market's constant emotional chaos.

Whether the Master Investor has consciously adopted someone else's investment philosophy (as Buffett initially did Graham's) or independently developed his own (applies to both Buffett and Soros), he has consciously thought through each investment belief he holds; he is always fully aware of the why behind every investment action he takes.

The resulting clarity he brings to his investment decisions is a major key to his success.

Just as Buffett's and Soros's abilities, interests, skills, knowledge, and

experiences are very different, so are their investment philosophies.

For example, Buffett was fascinated by money, business, and numbers from an early age. So it's hardly surprising that the focus of his investment philosophy is on his theory of value, which he applies to judge the quality of a business enterprise.

When Buffett comments on the nature of investment reality, he frames his remarks in terms of business value and how managers and investors often act on the basis of some erroneous concept of value.

Soros's main interest in life was and continues to be philosophy. He began his investment career in London arbitraging gold stocks between different international markets and made his name in New York as an expert in European stocks (which he described as "being one-eyed in the kingdom of the blind"). His radically different investment philosophy reflects these antecedents.

"Identifying Market Reality"

Buffett and Soros both view the same investment reality but draw totally different (if not opposite) conclusions about how to deal with it.

Their different rules for action stem from the differences in their psychology, character, history, interests, motives, goals, talents, and skills.

Yet their identification of investment reality is all but identical.

Buffett talks about the manic-depressive Mr. Market who will be wildly overexcited one day and deeply depressed the next.

Soros's initial premise about the nature of investment reality is that "The market is always wrong."

Buffett doesn't delve deeply into the reasons why the market is wrong; he just observes that it is and takes advantage of it. Soros, on the other hand, has developed a detailed theory of why the market is always wrong that is central to his way of profiting from it.

Both, then, vehemently reject investment philosophies like the efficient-market hypothesis (which can be restated as "The market is always right") and the random-walk theory which claim that above-average profits are either

impossible or statistical discrepancies. To those theories, Buffett responds: “I’d be a bum on the street with a tin cup if the markets were always efficient.”[4]

When you put Buffett’s and Soros’s investment philosophies together, you have an almost complete explanation of how investment markets work. Not the only one, to be sure—but wouldn’t it be foolish to ignore the meeting of minds of the world’s two greatest investors?

Appointment with Destiny

What brought everything together for Buffett—what gave him the investment philosophy he was searching for—was Benjamin Graham's book, *The Intelligent Investor*.

> For Buffett, reading the book was an epiphany.
>
> "It was like Paul on the road to Damascus. I read the first edition of the book early in 1950, when I was nineteen. I thought then that it was by far the best book about investing ever written. I still think it is."[5]

Benjamin Graham revolutionized investing with the publication of *Security Analysis* in 1934. Known today as the "Father of Value Investing," Graham gave a mathematically based method of finding certainty in a field dominated then (as now) by approaches such as momentum investing, chart reading, Gann triangles, and Elliot Waves; in an arena where investors behave, more often than not, like lemmings rather than the rational beings humans are supposed to be.

Graham's methodology spoke directly to Buffett's mathematical bent and changed his investment behavior forever.

Meet Mr. Market

The foundation of both Benjamin Graham's and Warren Buffett's investment philosophies is a view of the nature of investment markets that Graham personified in Mr. Market.

In one of his letters to Berkshire Hathaway shareholders, Warren Buffett describes Graham's Mr. Market in this way:

> Ben Graham, my friend and teacher, long ago described the mental attitude toward market fluctuations that I believe to be most conducive to investment success. He said that you should imagine market quotations as coming from a remarkably accommodating fellow named Mr. Market who is your partner in a private business. Without fail, Mr. Market appears daily and names a price at which he will either buy your interest or sell you his.
>
> Even though the business that the two of you own may have economic characteristics that are stable, Mr. Market's quotations will be anything but. For, sad to say, the poor fellow has incurable

> emotional problems. At times he falls euphoric and can see only the favorable factors affecting the business. When in that mood, he names a very high buy-sell price because he fears that you will snap up his interest and rob him of imminent gains. At other times he is depressed and can see nothing but trouble ahead for both the business and the world. On these occasions he will name a very low price, since he is terrified that you will unload your interest to him.
>
> Mr. Market has another endearing characteristic: He doesn't mind being ignored. If his quotation is uninteresting to you today, he will be back with a new one tomorrow. Transactions are strictly at your option. Under these conditions, the more manic-depressive his behavior, the better for you.
>
> But, like Cinderella at the ball, you must heed one warning or everything will turn into pumpkins and mice: Mr. Market is there to serve you, not to guide you. It is his pocketbook, not his wisdom, that you will find useful. If he shows up someday in a particularly foolish mood, you are free to either ignore him or to take advantage of him, but it will be disastrous if you fall under his influence. Indeed, if you aren't certain that you understand and can value your business far better than Mr. Market, you don't belong in the game. As they say in poker, "if you've been in the game 30 minutes and you don't know who the patsy is, *you're* the patsy."[6]

Underlying this Graham-Buffett view of the market are several important beliefs about the nature of investment markets and the attitude to them that investors should adopt if they want to be successful.

First is the belief that *the market is always* (or often) *wrong.*

Second, embedded in this view of the market is Graham's and Buffett's strategy for investment profits. If Mr. Market is subject to psychotic mood swings, then, inevitably, there will be times when he'll offer a price for a stock that is insanely cheap and other times when he'll be willing to buy the same security at a price that's ridiculously high.

But it's impossible to predict *when* Mr. Market's mood swings will occur or to know in advance how depressed or euphoric he will get.

In other words, it's impossible to predict the future course of market prices. So prediction plays no part in a Graham–Buffett-style investment strategy.

Third, as Buffett points out, "Mr. Market is there to serve you, not to guide you.… It will be disastrous if you fall under his influence."

So if it's a mistake to seek guidance from Mr. Market or from people who are under his spell, if it's imperative to avoid getting swept up in Mr. Market's mood swings, what is your basis for making investment decisions?

Graham's and Buffett's answer is to use their own, independently derived

standard of value for determining when a stock is cheap or expensive.

With their determination of value based on their own judgment, their attitude to Mr. Market's manic-depressive behavior is basically one of *indifference*. They *ignore him*. They merely take note of the price Mr. Market offers: If it accords with their own, independently derived judgment of value, they will act; if it doesn't, they will happily wait until Mr. Market changes his mind, confident that sooner or later he will.

Buffett and Graham accept market fluctuations as a given. They don't have a detailed theory of *why* markets fluctuate—and their investment approach doesn't need one. The focus of their investment philosophies is on determining value and the characteristics of a sound investment.

Buffett Changes Course

In 1956, Buffett started managing other people's money, forming a series of partnerships that were eventually amalgamated into one: the Buffett Partnership.

He continued to follow a pure Benjamin Graham approach, as he had since 1950. But Buffett was not Graham.

Though successful as an investor, Graham was primarily a scholar, a theoretician. Buffett—though he did lecture at the University of Omaha, and still loves to teach—is primarily a businessman.

Though Graham had written, in *Security Analysis* in 1934:

> It is an almost unbelievable fact that Wall Street never asks: "How much is the *business* selling for?" Yet this should be the first question in considering a stock purchase.[7]

he didn't *view* a company as a business; and wasn't particularly interested in a company's management or products. He focused only on the numbers.

But the question Graham asked in 1934—"How much is the *business* selling for?"—was to become the foundation of Buffett's own, personal style of investing.

The first indication that he might be departing from Graham was when he invested one-fifth of his partnership assets in a 70 percent controlling interest in Dempster Mill Manufacturing Co., a company that made windmills and farm implements. But its business was static and turning it around just wasn't Buffett's cup of tea. It wasn't long before he put the company up for sale.

> But he did not question the Graham-like premise that had led to its *purchase.* In fact, Graham's influence permeated the partnerships. Aside from Dempster, the money was sprinkled among forty stocks—cigar butts, arbitrages, workouts (such as liquidations)—all from the Graham-Newman playbook.[8]

In 1963 Buffett began accumulating the first stock he bought that Graham definitely would *not* buy: American Express. Again, he bought big, putting twenty-five percent of the partnership's assets into the company.

Buffett adhered then—as he does today—to Graham's fundamental principle that you only buy value you can see at a price which gives you a significant margin of safety. In American Express, Buffett saw both value *and* a margin of safety. But what he was "seeing" and how he calculated value was changing.

An American Express subsidiary operated a warehouse that stored tanks of vegetable oil. In return, it issued receipts to its customers. Unfortunately, one of them—Allied Crude Vegetable Oil and Refining—was run by a crook. Allied's credit rating was zero. But it discovered it could turn vegetable oil into American Express receipts, which were bankable.

When Allied went bankrupt, its creditors came knocking on American Express's door for their receipts—or their money instead. Only then was the scam uncovered: The tanks Allied had in storage were mainly seawater, with just enough vegetable oil floating on top so to make them appear full. American Express was facing a $60 million loss—"more than we had," in the words of CEO Howard Clark.[9]

From $60 a share in November 1963, before the salad oil scandal broke, American Express's stock sank to $35 in early 1964.

Would American Express survive? Wall Street was advising "sell"—in effect, answering no.

Buffett saw the problem as a one-off event *that did not affect American Express's main business:* the American Express card and its traveler's checks.

But how to value the company?

For Graham the company—even at $35 a share—was a no-no. It still cost far more than the value of its tangible assets—its book value.

What American Express had was *in*tangible: its customer base, the world's leading credit card (this was before VISA and MasterCard), and hundreds of millions of dollars in "float" on traveler's checks issued but not yet cashed.

Buffett saw an ongoing business with a valuable, irreplaceable business franchise generating steady earnings—and those earnings could be had at a bargain price.

Buffett's question became: "Has American Express's *business franchise* been affected?" Not the sort of question you can find an answer to in the annual

report.

He became a detective. He spent an evening standing behind the cash register at his favorite steakhouse in Omaha and discovered that people were still charging their American Express cards—it was business as usual. From banks, travel agents, supermarkets, and drugstores he found there had been no decline in sales of American Express traveler's checks and money orders. He called on competitors and found that the American Express card was as strong as ever.

He concluded that American Express would survive. And once he had reached that conclusion, he scooped up American Express shares with both hands.

The "Four Dimensional" Investor

While Benjamin Graham was developing what came to be called value investing in New York, another now-famous investor, Philip Fisher, who wrote *Common Stocks and Uncommon Profits,* was creating what was later called growth investing a continent away in San Francisco.

It was Fisher's influence that led Buffett to his purchase of American Express. Indeed, today Buffett's investment approach seems to have more in common with Fisher's than Graham's.

Where Graham's method of valuation was quantitative, Fisher's was qualitative. Graham relied solely on the numbers from companies' financial statements. To Fisher, by contrast, "reading the printed financial records about a company is never enough to justify an investment."[10] According to Fisher:

> What really counts in determining whether a stock is cheap or overpriced is not its ratio to the current year's earnings, but its ratio to the earnings a few years ahead.… [This is] the key to avoiding losses and making magnificent profits.[11]

Like Graham, Fisher was looking for cheap stocks. He also had "an intense dislike for losing money."[12]

But determining a company's earnings "a few years ahead" is clearly a very different proposition from figuring out its book or liquidation value from an

annual report. As you would expect, Fisher’s investment criteria were very different from Graham’s.

He could estimate, with confidence, a company’s future earnings *only by understanding the company’s business.* So his first rule was to stay within his “circle of competence” at all times. Like Buffett does today, he only invested in industries he understood.

Within that “circle of competence,” he looked for companies that met all of his “Four Dimensions”:

1. They must have a decided edge on their competition by being the lowest-cost producer in the industry, or have superior production, financial, research, and marketing skills.
2. They must have outstanding management, which he saw as the underlying cause of outstanding results.
3. The economic characteristics of the business must all but ensure that the company’s current above-industry-average profits, return on assets, profit margin, and growth of sales will continue for an extended period of time.
4. The price must be attractive.

How did Fisher do it?

By talking to people.

Of course, a lot can be discovered from annual reports and other available company information. Mostly they will tell you which companies to avoid. For example, you can often determine the honesty—or lack thereof—of the management simply by reading a few past years’ annual reports.

But for Fisher, there was no substitute for first-hand information.

When possible, he would talk to the company, of course, and get to know its executives. But no matter how honest and forthcoming company officials are, their perspective is necessarily incomplete.

One of Fisher’s favorite sources of information was scuttlebutt: what people were saying about the company and its products. He would talk to people who dealt with the company—customers, consumers, and suppliers; to former employees; and, especially, to competitors. An executive may be reluctant to give you too much detail about his own company. But he’ll happily tell you everything he knows about his competition.

In his first foray into this kind of analysis—while he was working in the investment department of a bank in San Francisco in 1928—Fisher talked to buyers in the radio department of several San Francisco stores.

> I asked them their opinions of the three major competitors in this industry. I was given surprisingly similar opinions from each of them.… One company, Philco, which from my standpoint unfortunately was privately-owned so that it represented no stock market opportunity, had developed models which had especial market appeal. As a result, they were getting market share at a beautiful profit to themselves because they were highly efficient manufacturers. RCA was just about holding its own market share, whereas another company which was a stock market favorite of the day was slipping dramatically and showing signs of getting into trouble.… Nowhere in material from Wall Street firms who were talking about these "hot" radio issues could I find a single word about the troubles that were obviously developing for this speculative favorite.[13]

Fisher watched the stock he had singled out for trouble sink while the stock market climbed to new highs.

> It was my first lesson in what later was to become part of my basic investment philosophy: reading the printed financial records about a company is never enough to justify an investment. One of the major steps in prudent investment must be to find out about a company's affairs from those who have some direct familiarity with them.[14]

Having discovered an outstanding company that met all his criteria, Fisher would invest a large percentage of his portfolio in it.

Fisher preferred to own just a few outstanding companies, not a large number of average businesses. He rarely owned more than ten stocks, and usually three or four companies accounted for three-quarters of his equity.

Once he had bought a company he would keep it for years—sometimes decades. He described his average holding period as "20 years, and [I] held one stock for 53 years."[15]

When, according to Fisher, was the best time to sell?

> If the job has been correctly done when a common stock is purchased, the time to sell it is—almost never.[16]

He said there were only three times to sell a stock. The first was when you found

you'd made a mistake, and the company didn't meet the criteria after all. The second time was when the company ceased to meet the criteria: For example, a less able management assumed control; or the company had grown so big it could no longer grow faster than the industry as a whole. And the third was when you came across a fantastic opportunity and the only way you could buy it was to sell something first.

Fisher also had his equivalent of Graham's Mr. Market—his philosophy about the nature of the market—which, like Mr. Market, showed him the best time to buy.

He believed (rather like George Soros) that market prices were determined more by perceptions (and *mis*perceptions) than by the facts. In short, he believed that Wall Street focuses on the short term and ignores the long term. And that can present magnificent investment opportunities.

For example, when a company makes a mistake, Wall Street punishes it severely.

> When [a mistake] happens and the current year's earnings drop sharply below previous estimates as the costs of the failure are added up, time and again the investment community's immediate consensus is to downgrade the quality of the management. As a result, the immediate year's lower earnings produce a lower than the historic price earnings ratio to magnify the effect of the reduced earnings. The shares often reach truly bargain prices. Yet if this is the same management that in other years has been so successful, the chances are the same ratio of average success to average failure will continue on in the future. For this reason, the shares of companies run by abnormally capable people can be tremendous bargains at the time one particular bad mistake comes to light.[17]

Fisher could have been describing American Express at the time Buffett invested.

Charlie Munger: Buffett's Alter Ego

At the same time as he was investing in American Express, Buffett continued to buy cheap companies (which he later termed "cigar butts"—they have just a few puffs left but the price is right) like Berkshire Hathaway. And despite the success of his investment in American Express, most of his investments continued to be classic Graham.

That began to change as his friendship with Charlie Munger—whom he met in 1959—deepened.

A lawyer by training, Munger managed an investment partnership from 1962 to 1975, achieving an annual return of 19.8 percent (compared to 5.0 percent for the Dow over the same period). Eventually he and Buffett merged their interests under the single roof of Berkshire Hathaway, with Munger as vice chairman.

> It was Charlie Munger who was most responsible for moving Buffett towards Fisher's thinking. Charlie, in a sense, was the embodiment of Fisher's qualitative theories. Charlie had a deep appreciation of the value of a better business. Both See's Candy Shops and Buffalo News were tangible examples of good businesses available at reasonable prices. Charlie educated Buffett about the wisdom of paying up for a good business.[18]

In 1971, Blue Chip Stamps (a company controlled by Buffett and Munger) was offered See's Candies for $30 million. Unimpressed by the book value of the company (though it included $10 million in cash), they offered $25 million.

Luckily for them, Mr. See phoned back the next day and accepted. Now wholly owned by Berkshire, since 1984 See's has made *over* $25 million in pretax profits *every year*. See's was just the first of the many noninsurance companies Berkshire now owns outright.

These purchases represented a dramatic departure from Graham's style of investing. Like See's (and American Express), their book value was usually far *lower* than the price Buffett paid. And Buffett took management control, buying 80–100% of the shares depending on whether or not the owners wanted to retain a stake.

The method of valuation was primarily Fisher—constrained by Graham; but taking control was pure Buffett. He was returning to his original incarnation as a businessman.

Buffett describes himself today as "85% Graham, 15% Fisher." Whatever the actual mix—and I suspect Fisher's influence is far higher than 15 percent—he has combined the two with his own experience and insights into his own, personal style of investing, which is 100 percent Buffett.

Like American Express and See's Candies, most of the investments he makes

today are in companies that Graham wouldn't buy—but Fisher might.

Reading the Mind of Mr. Market

Unlike Buffett, George Soros never set out to be an investor or businessman. Indeed, as a teenager he had fancied himself as some kind of economic reformer like John Maynard Keynes. Or even a scientist like Einstein.

So in 1949—having escaped from Soviet-occupied Hungary two years before—he enrolled at the London School of Economics to study economics and international politics. The LSE was a hotbed of socialism, no different from most other universities at the time, except that Harold Laski, one of the most influential Keynesians, taught there. (Laski was the model for Ayn Rand's antihero Ellsworth Toohey, in her best-selling novel *The Fountainhead.*)

But the LSE was also home to two very unfashionable thinkers, free market economist Friedrich von Hayek and philosopher Karl Popper. Soros learnt from both, but Popper became his mentor and a major intellectual influence on his life.

> I finished my degree course, which was supposed to take three years, in two. I had to spend an extra year as a registered student to qualify for the degree, and I was allowed to select a tutor. I chose him [Popper] because I was very much taken by his philosophy. I had lived through Nazi persecution and Soviet occupation. Popper's book, *Open Society and Its Enemies*, struck me with the force of revelation—it showed that fascism and communism have a lot in common, and they both stand in opposition to a different principle of social organization, the principle of open society. I was even more influenced by Popper's ideas on scientific method.[19]

Popper provided Soros with the intellectual framework that, later, evolved into both Soros's investment philosophy and his investment *method.*

Soros has acknowledged Popper's influence by naming his charitable organizations Open Society Foundations.

But that was later. In his student days, his aim was still to become an academic, a philosopher of some kind. He began writing a book he called *The Burden of Consciousness.* When he realized he was merely regurgitating Popper's philosophy, he put it aside and turned to a financial career. Ever since,

he has viewed the financial markets as a laboratory where he could test his philosophical ideas.

"Our Views of the World Are Flawed or Distorted"

While struggling with philosophical questions, Soros made what he considered to be a major intellectual discovery:

> I came to the conclusion that basically all our views of the world are somehow flawed or distorted, and then I concentrated on the importance of this distortion in shaping events.[20]

Applying that discovery to himself, Soros concluded: "I am fallible." This was not just an observation; it became his operational principle and overriding belief.

Most people agree that other people make mistakes. Most will admit to having made mistakes—in the past. But who will openly acknowledge that they are fallible *while* making a decision?

Very few, as Soros implies in his comment about his former partner, Jimmy Rogers (fund manager and author of *The Investment Biker*):

> The big difference between Jim Rogers and me was that Jim thought that the prevailing view was always wrong, whereas I thought that we may be wrong also.[21]

When Soros acts in the investment arena, he remains aware that he can be wrong, and is critical of his own thought processes. This gives him unparalleled mental flexibility and agility.

Beliefs and Consequences

If, as Soros believed, *everybody's* view of the world is "somehow flawed or distorted," then our understanding of the world is necessarily imperfect and often wrong.

To take an extreme example: When Christopher Columbus set sail across the Atlantic Ocean for India, everybody "knew" the earth was flat and he would fall off the edge of the world.

This belief made it very difficult for him to find a backer—and even harder to crew his ships. After all, his backers weren't going along for the ride.

While European sailors hugged the shoreline, Polynesians, who had no such belief, sailed their dugout canoes over the trackless Pacific to tiny islands as far apart as Fiji and Hawaii. That's a feat of navigation that will probably never be surpassed.

Soros turned his realization that people's understanding of reality is imperfect into a powerful investment tool. On those occasions when he could see what others could not—because they were blinded, for example, by their beliefs—he came into his element.

When he started the Quantum Fund (originally named the Double Eagle Fund) he tested his theory by searching for developing market trends or sudden changes about to happen that nobody else had noticed.

He found one such trend change in the banking industry.

Heavily regulated since the 1930s, banks were seen as staid, steady, conservative, and, most of all, boring investments. There was no future for a hotshot Wall Street analyst in the banking business.

Soros sensed this was about to change. He had discovered that the old-style managers were retiring and being replaced by new, aggressive youngsters with MBAs. This new management, he felt, would focus on the bottom line and shake up the industry.

In 1972, Soros published a report titled "The Case for Growth Banks," forecasting that bank shares were about to take off. "He recommended some of

the better-managed banks. In time, bank stocks began to rise, and Soros garnered a 50 percent profit.”[22]

Where Buffett seeks to buy $1 for 40 or 50 cents, Soros is happy to pay $1, or even more, for $1 when he can see a change coming that will drive that dollar up to $2 or $3.

How Beliefs Alter Facts

To Soros, our distorted perceptions are a factor in shaping events. As he puts it, "what beliefs do is alter facts"[23] in a process he calls reflexivity, which he outlined in his book *The Alchemy of Finance.*

For some, like the trader Paul Tudor Jones, the book was "revolutionary"; it clarified events "that appeared so complex and so overwhelming,"[24] as he wrote in the foreword of the 1994 paperback edition. Through the book Soros also met Stanley Druckenmiller, who sought him out after reading it and eventually took over from Soros as manager of the Quantum Fund.

To most others, however, the book was impenetrable, even unreadable, and few people grasped the idea of reflexivity Soros was attempting to convey. Indeed, as Soros wrote in the preface to the paperback edition,

> Judging by the public reaction … I have not been successful in demonstrating the significance of reflexivity. Only the first part of my argument—that the prevailing bias affects market prices—seems to have registered. The second part—that the prevailing bias can in certain circumstances also affect the so-called fundamentals and changes in market prices cause changes in market prices—seems to have gone unnoticed.[25]

Changes in market prices cause changes in market prices? Sounds ridiculous.

But it's not. To give just one example, as stock prices go up, investors feel wealthier and spend more money. Company sales and profits rise as a result. Wall Street analysts point to these "improving fundamentals," and urge investors to buy. That sends stocks up further, making investors even wealthier, so they spend even more. And so on it goes. This is what Soros calls a "reflexive process"—a feedback loop: a change in stock prices has caused a change in company fundamentals, which, in turn, justifies a further rise in stock prices. And so on.

You have no doubt heard of this particular reflexive process. Academics have written about it; even the Federal Reserve has issued a paper on it. It's known as "the wealth effect."

Reflexivity is a feedback loop: Perceptions change facts; and facts change

perceptions. As happened when the Thai baht collapsed in 1997.

In July 1997 the Central Bank of Thailand let its currency float. The bank expected a devaluation of around 20 percent, but by December the baht had collapsed from 26 to the US dollar to over 50, a fall of more than 50 percent.

The bank had figured out that the baht was “really worth” around 32 to the dollar. Which it may well have been according to the theoretical models of currency valuation. What the bank failed to take into account was that floating the baht set in motion a self-reinforcing process of reflexivity that sent the currency into free fall.

Thailand was one of the Asian Tigers, a country that was developing rapidly, and was seen to be following in Japan’s footsteps. Fixed by the government to the US dollar, the Thai baht was considered a stable currency. So international bankers were happy to lend Thai companies billions of US dollars. And the Thais were happy to borrow them because US dollar interest rates were lower.

When the currency collapsed, the value of the US dollar debts companies had to repay suddenly exploded … when measured in baht. The fundamentals had changed.

Seeing this, investors dumped their Thai stocks. As they exited, foreigners converted their baht into dollars and took them home. The baht crumbled some more. More and more Thai companies looked like they would never be able to repay their debts. Both Thais and foreigners kept selling.

Thai companies cut back and sacked workers. Unemployment skyrocketed; workers had less to spend—and those who still had money to spend held onto it from fear of uncertainty. The Thai economy tanked—and the outlook for many large Thai companies, *even those with no significant dollar debts,* began to look more and more precarious.

As the baht fell, the Thai economy imploded—and the baht fell some more. A change in market prices had caused a change in market prices.

Applied Reflexivity

For Soros, reflexivity is the key to understanding the cycle of boom followed by bust. Indeed, he writes, "A boom/bust process occurs only when market prices … influence the so-called fundamentals that are supposed to be reflected in market prices."[26]

His method is to look for situations where Mr. Market's perceptions diverge widely from the underlying reality. On those occasions when Soros can see a reflexive process taking hold of the market, he can be confident that the developing trend will continue for longer, and prices will move far higher (or lower) than most people using a standard analytical framework expect.

Soros applies his philosophy to identifying a market trend in its early stages and positioning himself before the crowd catches on.

In 1969 a new financial vehicle, real estate investment trusts (REITs), attracted his attention. He wrote an analysis—widely circulated at the time—in which he predicted a "Four Act" reflexive boom/bust process that would send these new securities sky-high—before they collapsed.

Act I: As bank interest rates were high, REITs offered an attractive alternative to traditional sources of mortgage finance. As they caught on, Soros foresaw a rapid expansion of the number of REITs coming to market.

Act II: Soros expected that the creation of new REITs, and expansion of existing ones, would pour floods of new money into the mortgage market, causing a housing boom. That would, in turn, increase the profitability of REITs and send the price of their trust units skyrocketing.

Act III: To quote from his report, "The self-reinforcing process will continue until mortgage trusts have captured a significant part of the construction loan market."[27] As the housing boom slackened, real estate prices would fall, REITs would hold an increasing number of uncollectible mortgages—"and the banks will panic and demand that their lines of credit be paid off."[28]

Act IV: As REIT earnings fall, there would be a shakeout in the industry—a collapse.

Since "the shakeout is a long time away," Soros advised there was plenty of time to profit from the boom part of the cycle. The only real danger he foresaw "is that the self-reinforcing process [Act II] would not get under way at all."[29]

The cycle unfolded just as Soros had expected, and he made handsome profits as the boom progressed. Over a year later, after REITs had already begun to decline, he came across his original report and "I decided to sell the group short more or less indiscriminately."[30] His fund took another million dollars in profits out of the market.

Soros had applied reflexivity to make money on the way up *and* the way down.

To some, Soros's method may appear similar to trend following. But trend followers (especially chartists) normally wait for a trend to be confirmed before investing. When the trend followers pile in (as in "Act II" of the REIT cycle) *Soros is already there.* Sometimes he would add to his positions as the trend-following behavior of the market increased the certainty of his convictions about the trend.

But how do you know when the trend is coming to an end? The average trend follower can never be sure. Some get nervous as their profits build, often bailing out on a bull market correction. Others wait until a change in trend is confirmed—which only happens when prices have passed their highs and the bear market is under way.

But Soros's investment philosophy provides a framework for analyzing how events will unfold. So he can stay with the trend longer and take far greater profits from it than most other investors. And, as in the REIT example, profit from both the boom and the bust.

Buffett, by contrast, merely notes that Mr. Market is psychotic. Or, to quote Benjamin Graham, "In the short run, the market is a voting machine—reflecting a voter-registration test that requires only money, not intelligence or emotional stability—but in the long run, the market is a weighing machine."[31]

Why Women's Skirts Go Up—and Down

To a mere male such as myself—especially one who wears something comfortable until it literally falls apart—there has never been any logical reason why women's fashions should change so dramatically from one season to the next. Yet a new women's fashion trend can spread like wildfire. Whether inspired by a Paris designer or by something a movie star or teenagers in California, Brooklyn, or Tokyo wore, somehow the new style becomes the in thing to be seen in, and in no time at all you see it everywhere.

Why becomes clear when you view the fashion business through the lens of reflexivity: Behind each new fashion trend is a new *belief* about what looks good. The profitability of billion-dollar companies isn't just shaped by but is *based on* ever-changing beliefs.

If a company is caught with an inventory of clothes that are suddenly out of fashion, it has to write them off. To avoid that, lead times between ordering, production, and sale are continually tightened. Today clothes are made in small batches in China or Mauritius or Bangladesh and air-freighted to retailers around the world. So if a retailer or manufacturer guesses wrong, his loss is small.

Women's fashion buyers are like Wall Street gurus trying to ride the next trend. How well they read the opinion of the market determines their company's profits. And (as on Wall Street) there is never a guarantee that someone who got it right today will repeat their success tomorrow.

The only constant in the women's fashion industry is that what women like to wear this season they probably won't want to be seen dead in a year from now.

Consumers, buyers, retailers, designers, and manufacturers are engaged in a circular and never-ending guessing game of who'll be wearing what when and what will be in and out. The result: a constant state of change, of disequilibrium—the natural state of an industry that is purely reflexive in nature, *ruled entirely by beliefs or opinions.*

Soros's theory of reflexivity is his *explanation* for Mr. Market's manic-depressive mood swings. In Soros's hands it becomes a method for identifying when the mood of the market is about to change, for enabling him to "read the mind of the market."

The Master Investor's Edge

The Master Investor's investment philosophy explains investment reality, how markets work, how to determine value, and why prices change; it is his guide to taking action.

His philosophy makes his investment criteria clear and allows him to identify "high probability events" with reasonable certainty.

To a large degree, investing is a cerebral process, and if there's one single factor that sets the Master Investor apart, it is *the amount of thinking he's done.*

Buffett and Soros have both developed highly detailed and unique investment philosophies.

Every action that they take is an expression of the extent and depth of their *previous* thinking. And they continue to think deeply about every investment they make before they invest a dime.

The Master Investor's investment philosophy also gives him a powerful psychological edge: It's what enables him to keep his head while all those around him are losing theirs.

"I Deserve to Make Money"

Your investment philosophy reflects your beliefs about the external world: the nature of investment reality.

Just as important are the beliefs you have about yourself as an investor. Both Buffett and Soros share certain beliefs about themselves that are an essential component of their success.

- They believe that they deserve to succeed and make money.
- They believe that they are responsible for their own financial destiny; that they, not the markets or some external force, cause their profits or losses; that they are in control.

These beliefs are held *subconsciously*, and are behind the self-confidence the Master Investor exhibits in applying his investment philosophy.

Someone who adopts a proven investment philosophy may still end up being unsuccessful if his subconscious beliefs about himself get in his way.

Psychologists' offices are filled with people who have become successful—yet are now unhappy because, subconsciously, they have a fear of success or feel deep down that they don't deserve to succeed; with people whose subconscious belief that "I'm not lovable" is destroying their relationships; and with investors who inexplicably "give back" some of their profits because deep down they don't feel they deserve to make money.

An integral part of Buffett's and Soros's success is that neither is held back by such self-limiting beliefs.

It’s easy to see why such beliefs are so crucially important.

If you don’t believe that you deserve to make money, then investment success will make you anxious. Inevitably, your emotions will cloud your judgment, and you’ll make some mistake and give the money back.

Similarly, only by taking responsibility for your own results can you be in control of your actions. This doesn’t mean that you can control outside events, but you can define what is within your control and stay there.

Investors who act on some broker’s tip, who do what their friends are doing, or whose main source of investment wisdom is the daily newspaper are like corks bobbing on the ocean waves. They let others control their actions, so it’s never *their* fault when they lose money. As a consequence, they never learn.

BEWARE! Mixing Religion with Markets Can Be Hazardous to Your Wealth

One important factor to keep in mind while you think through your own investment philosophy is what happens to investors who bring a religious-or fundamentalist-style theory to the marketplace. Putting on a set of these blinders will hide investment reality, not reveal it.

When I started my investment newsletter in 1974, I was a gold bug. I *believed* in gold. I believed that inflation would inevitably rise until the dollar disappeared in a South American–style hyperinflation.

Back then, gold bugs made money. Lots of it. Inflation was rising, and commodities was where the action was. For gold bugs, the stock market was dullsville.

When gold bugs congregated at investment seminars like the annual one in New Orleans, attended by over 3,000 investors in its heyday, there was a tone of religious fervor in the air. Among the speakers and attendees alike.

As one prominent investment advisor whispered to me, commenting on the current speaker. “But he doesn’t *believe* in gold!”

If a surfer who is riding a wonderful wave gets to thinking he’s invulnerable, he inevitably gets into trouble when the wave breaks. As it always does.

If he has been making fistfuls of money while riding that wave, the comedown will be traumatic. Following a religious theory about the markets is fine while the theory is working. Once the wave is over, though, it’s a guaranteed road to the poorhouse … as too many gold bugs discovered.

As a gold bug, I was blind to any evidence that the gold wave had broken. Luckily for me, it only took a couple of years for reality to tear the blinders off my eyes.

7

“You Call *That* a *Position*?”

“Too much of a good thing can be wonderful.”

—MAE WEST

“[Soros taught me] it’s not whether you’re right or wrong that’s important, but how much money you make when you’re right and how much you lose when you’re wrong.”

—STANLEY DRUCKENMILLER[1]

“Diversification is a protection against ignorance. [It] makes very little sense for those who know what they’re doing.”

—WARREN BUFFETT[2]

SOON AFTER HE TOOK OVER the Quantum Fund from Soros, Stanley Druckenmiller shorted the dollar against the German mark. The trade was showing a profit when Soros asked him, “How big a position do you have?”

WINNING HABIT NO. 5:

BUY AS MUCH AS YOU CAN

The Master Investor	The Losing Investor
Does not believe in diversification; always buys as much as he can of an investment that meets his criteria.	Lacks the confidence to take a huge position on any one investment.

“One billion dollars,” Druckenmiller answered.

“You call that a position?” Soros said, a question that has become a part of Wall Street folklore.[3]

Soros prompted him to double his position.

“Soros has taught me,” noted Druckenmiller, “that when you have tremendous conviction on a trade, you have to go for the jugular. It takes courage to be a pig. It takes courage to ride a profit with huge leverage. As far as Soros is concerned, when you’re right on something, you can’t own enough.”[4]

"You can't own enough" isn't something you'll hear from your Wall Street investment advisor. He's more likely to follow the conventional wisdom, which states:

1. your money should be divided among stocks, bonds, and cash; and
2. your stock portfolio should have a broad range of stocks, preferably diversified among a variety of industries and even different countries.

Yet the exact opposite of diversification—*concentration* in a small number of investments—is central to both Buffett's and Soros's success.

As *Fortune* once put it: "One of the fictions of investing is that diversification is a key to attaining great wealth. Not true. Diversification can prevent you from losing money, but no one ever joined the billionaire's club through a great diversification strategy."[5] To understand why, let's translate the conventional wisdom into another arena entirely.

The Investment Advisor and Bill Gates

Imagine that this same advice were to be given to businessmen instead of investors. Businessmen like Bill Gates.

The investment advisor turned business consultant would tell the young Gates something along the following lines:

> Mr. Gates, you're making a fundamental mistake focusing all your energies on the software business. Diversify, diversify, diversify … that's the secret of success.
>
> Right now, as you're starting your business, it's the time to set a sound course that will ensure your ultimate success and prosperity.
>
> With DOS, you're a single-product company. All your eggs are in one basket. Very dangerous.
>
> Instead of just making software, why not make computers as well? But give serious consideration to balancing the high-risk business you're in with some other business ventures that will be more stable and countercyclical. Utilities, for example, are very stable businesses.

And what if the same advisor were asked to make career recommendations to the young Pavarotti?

> Opera singing is all very well, but after all the returns to be had aren't all that great.

> Sure, I know you really love opera. And I'm certainly not going to advise you to give it up. Far from it.
>
> But I urge you to consider the virtues of diversifying your repertoire into rock and other more popular types of music. After all, you've got to think about paying the rent.
>
> In any event, the career you've chosen is exceedingly risky. So few people achieve fame and fortune as opera singers—or rock singers, for that matter.
>
> Do you have any other, nonmusical interests?
>
> Good. Cooking is much safer, sounder field. Why not get some training in that part-time so you'll always have something to fall back on?

When put like this, it sounds ridiculous doesn't it? You immediately grasp that this is foolish advice to give to a Gates or a Pavarotti—or anyone else, genius or not.

Yet that's *exactly* what most investment advisors counsel.

Every successful person, regardless of the field, is single-minded in the pursuit of his goal. They do NOT diversify their energies into a variety of fields.

The result of such single-minded devotion to the achievement of one goal is Mastery.

Like the diversified investor, the jack-of-all-trades is master of *none;* so he is rarely as successful as the person who devotes his entire energy to the single-minded pursuit of a single goal.

The reason is simple—and obvious in any field except investing:

- Your time and energy are limited. The more widely you spread your energies, the less you can spend on any one activity.

To quote from the legendary investor Bernard Baruch (who sold all his stocks before the crash of 1929):

> "*It is unwise to spread one's funds over too many different securities.* Time and energy are required to keep abreast of the forces that may change the value of a security. While one can know all there is to know about a few issues, one cannot possibly know all one needs to know about a great many issues."[6] [Emphasis added.]

Diversification—or concentration—of an investment portfolio directly correlates with the amount of time and energy put into making the selections. The more diversification, the less time for each decision.

Diversification and Fear of Risk

The conventional wisdom is like an empty litany that has been repeated so often everyone assumes it to be true. You'll hear it from just about every stockbroker or investment analyst. But ask him to *justify* diversification, and what you'll find at the bottom of this school of money management is the *fear* of risk.

Fear of risk is a legitimate fear—it's the fear of losing money (and so breaking the First Rule of Investing).

But Master Investors don't *fear* risk, because they passionately and actively avoid it. Fear results from uncertainty about the outcome, and the Master Investor only makes an investment when he has strong reasons to believe he'll achieve the result he wants.

Unlike the Master Investor, those who follow the conventional advice to diversify simply don't understand the nature of risk, and they don't believe it is possible to avoid risk *and* make money at the same time.

Worse, while diversification is certainly a method for minimizing risk, it has one unfortunate side effect: It also minimizes profit!

How Diversification Suffocates Your Profits

Compare two portfolios. The first is diversified among one hundred different stocks; the second is concentrated, with just five.

If one of the stocks in the diversified portfolio doubles in price, the value of the *entire* portfolio rises just 1 percent. The same stock in the concentrated portfolio pushes the investor's net worth up 20 percent.

For the diversified investor to achieve the same result, twenty of the stocks in his portfolio must double—or one of them has to go up 2,000%. Now, what do you think is easier to do:

- identify *one* stock that's likely to double in price; or
- identify *twenty* stocks that are likely to double?

No contest, right?

Of course, on the other side of the coin, if one of the diversified investor's stocks drops in half, his net worth only declines 0.5 percent. If the same thing happens in the second portfolio, the concentrated investor sees his wealth drop 10 percent.

But let me ask you the same question again … which is easier to do:

- identify 100 stocks that are *unlikely* to fall in price; or
- identify five stocks that are *unlikely* to fall in price?

Same answer: no contest.

And here we have the key to one difference between the average investor and the Master Investor: Because the Master Investor's portfolio is concentrated, he focuses his energies far more intensely—and far more effectively—on identifying the right investments.

However, concentration is the effect, not the cause. The Master Investor doesn't set out deliberately to hold only a few investments. Concentration stems from the *way* the Master Investor selects his investments.

He spends his time and energy searching for high probability events that meet his criteria. When he finds one, he knows the risk of losing money is low. There's no fear of risk to hold him back.

Second, high probability events are hard to discover. Who knows when he'll find the next one? What's the point in sitting on a pile of cash waiting for an opportunity that may be a long time coming when, right now, he can see piles of money sitting on the table, begging to be scooped up?

When Buffett and Soros buy, they buy big.

There's a Wall Street saying: "Bears make money, bulls make money, but pigs get slaughtered." It should be amended to read "pigs *who don't know what they're doing* get slaughtered."

"Go for the Jugular"

Buffett's and Soros's portfolios clearly don't follow any simple rule of position sizing, such as an equal percentage in each investment.

Neither's portfolio gives any clue as to how it was assembled.

That's because they buy good investments as they discover them. Whatever opportunities they saw, they took—and that's why their portfolios look the way they do today.

The only rule they follow is one you'll never learn from your stockbroker: expectancy of gain. The higher their expectancy of profit, the greater the percentage of their portfolio they'll devote to that investment.

Expectancy of gain is something that can and should be measured or estimated. For example: Buffett is looking at two companies. One is returning 15 percent on capital and the other 25 percent on capital. The shares of both are available at prices he's willing to pay. He would clearly prefer to put more money into the second company.

With the river of cash that Berkshire Hathaway's investments and insurance operations are throwing off every year, Buffett's main problem now is finding enough high probability events to invest in. So he would probably buy both.

But if you or I, with our somewhat more limited resources, were following Buffett's approach, we'd buy stock only in the *second* company. We'd ignore the first one completely. And if we already owned it, we'd probably sell it to put more into the stock that has the far higher expectancy of gain.

So the Master Investor doesn't set out with the *aim* of devising a concentrated portfolio.

Rather, concentration *results from* the way he approaches investing. When Buffett and Soros are certain they're going to make money, their only limit is how much they can buy.

They don't give damn how their portfolio "looks." They just want to make money.

The Investment That Makes a Difference

Over lunch one afternoon my companions—mostly Asian stockbrokers—began reminiscing about the killings they'd made when the Asian markets crashed in 1997. They talked about the blue chip stocks they'd bought at a quarter or a tenth of their current prices.

Whenever investors get together, reminiscing about past successes like this is the kind of talk you'll expect to hear.

But what percentage of their assets had they put into these bargain-basement blue chips in 1997? Since, by and large, they'd focused on the prices they'd paid, not the profits they'd made, I just didn't have the heart to ask. I'm sure their answers would have turned an enjoyable lunch into a wake for all the profits they'd missed.

At such times Buffett, by comparison, loads up to the gills with bargains. He says he feels like an oversexed guy in a whorehouse, and his main complaint is that he doesn't have *enough* money to buy *all* the bargains he can see.

At other times, when he sees a stock he really likes (like Coke), he'll simply buy as much as he can.

Soros has a similar attitude. In 1985, convinced that Jaguar was turning around and the car would become a hot seller in the United States, the Quantum Fund had put $20 million, nearly 5% of its assets, in the stock—a huge position for most funds.

Allan Raphael, who'd initiated the investment, told Soros that it was panning out just as he'd thought and that he was happy with the position. So he was stunned when Soros's reaction was to immediately tell his traders: "Buy another quarter of a million shares of Jaguar.…

"*If the stock goes up, you buy more.* You don't care how big the position gets as part of your portfolio. If you get it right, then build."[7]

To Soros, investment success comes from "preservation of capital *and home*

runs.”[8]

Likewise, Buffett wants investments that are “large enough to have a worthwhile impact on Berkshire’s”[9] net worth.

Neither of them buys piddling amounts. When the opportunity presents itself, *they buy enough to make a real difference to their wealth.*

“[The trustees] wanted me to diversify. Bugger that.”

—Jim Millner[10]

8

A Penny Saved Is a Dollar Earned

"The really good manager does not wake up in the morning and say, 'This is the day I'm going to cut costs,' anymore than he wakes up and decides to practice breathing."

—WARREN BUFFETT[1]

"What is the most powerful force in the universe?… Compound interest."

—ALBERT EINSTEIN

"I don't know what the seven wonders of the world are, but I do know the eighth—compound interest."

—BARON ROTHSCHILD

SINCE WARREN BUFFETT ASSUMED CONTROL of Berkshire Hathaway the company has paid dividends in just one year; and Buffett quips, "I must have been in the bathroom at the time."[2]

WINNING HABIT NO. 6:

FOCUS ON *AFTER*-TAX RETURN

The Master Investor	The Losing Investor
Hates to pay taxes (and other transaction costs) and arranges his affairs to legally minimize his tax bill.	Overlooks or neglects the burden that taxes and transaction costs place on long-term investment performance.

Berkshire doesn't pay dividends, and Buffett doesn't like them. Why?

Taxes.

When dividends are paid, income is taxed twice. First, the company pays income tax; then the shareholder pays tax on his dividends. A dollar of company profits becomes 65 cents after corporate tax. When paid out in dividends, just 55 cents is left after federal income tax; and if you live in New York or California

you end up with just 44 to 45 cents after you have paid state income tax as well.

If a company pays no dividends, the money is taxed only once; and the company can then compound those retained earnings at its return on equity. If it's a Buffett-style company, it can compound that 65 cents of retained earnings at 15 percent or more per year.

For the shareholder to get the same return on the 44 to 55 cents he has left from his dividend check, he must find a company with a 20 percent return on equity.

Buffett doesn't like paying dividends because he doesn't want his shareholders (especially himself) to have their net worth cut by double taxation. He doesn't want to receive dividends either because he knows he'll be better off with them left to compound in the businesses he's already bought.

The Rip Van Winkle Investor

Buffett doesn't like paying capital gains taxes, either. That's one reason his favorite holding period is "forever": capital gains taxes are deferred indefinitely.

In his 1989 Letter to Shareholders, he explained why he likes the "Rip Van Winkle" style of investing:

> Imagine that Berkshire had only $1, which we put in a security that doubled by year end and was then sold. Imagine further that we used the after-tax proceeds to repeat this process in each of the next 19 years, scoring a double each time. At the end of 20 years, the 34% capital gains tax that we would have paid on the profits from each sale would have delivered about $13,000 to the government and we would be left with about $25,250. Not bad. If, however, we made a single fantastic investment that itself doubled 20 times during the 20 years, our dollar would grow to $1,048,576. Were we then to cash out, we would pay a 34% tax of roughly $356,500 and be left with $692,000.
>
> The sole reason for this staggering difference in results would be the timing of tax payments. Interestingly, the government would gain from Scenario 2 in exactly the same 27:1 ratio as we—taking in taxes of $356,5000 vs. $13,000—though admittedly, it would have to wait for its money.[3]

Buffett wants to reduce his tax bill to maximize the annual rate at which his money compounds in value.

The average investor, by contrast, is focused on the profits he hopes to make

from his next investment. Buffett wants to “watch his money grow” over the long term. His time horizon isn’t his next investment, it’s the next decade, even two.

One way to increase the speed at which his money compounds is to cut taxes and other transaction costs. Small amounts saved today can have a large effect on your net worth in the long run, thanks to the magic of compound interest. Buffett magnifies that effect by feeding all these savings into his investment system, to increase the rate of compounding.

George Soros thinks exactly the same way. “I am interested in the overall performance of the [Quantum] Fund *over the long term,*”[4] he writes. “If you keep making 30 to 40 percent per annum for 25 years, you make an awful lot of money even if you start with very little. So the amount of money I have amassed is truly awesome.”[5] But Soros’s method of neutralizing the drag of taxation is much simpler than Buffett’s: He just incorporated the Quantum Fund in a tax haven, the Netherlands Antilles, so it can compound its profits tax-free. If subject to American taxes, the Quantum Fund’s annual compound rate of return would have fallen from 28.2 percent to under 20 percent. Instead of being number 54 on the Forbes 2004 list of the world’s richest people, with $7 billion, Soros wouldn’t have made the list at all. He wouldn’t have been poor, but would have had “only” around $500 million.

No wonder the Master Investor is focused on his total return. No wonder he takes into account *all* factors that will either increase or decrease that return.

Shaving Brokerage Fees

Tax isn’t the only transaction cost that can kill your return.

Consider a commodity trader following an actuarial investment approach. For simplicity’s sake, let’s assume that his system produces one winning trade out of every seven he makes (not an unusual situation).

But to keep the math simple, we’ll also make the highly *un*realistic assumption of mechanical regularity: each winning trade gives him a profit of 65 percent; and on each losing trade he loses 5 percent. Let’s also say that he can

make seven trades every two months—or 42 trades per year—and puts an equal portion of his portfolio into each position (another unrealistic assumption).

If he starts with $7,000 and puts $1,000 into each trade, at the end of two months he has a profit of $650 on one, and losses of $50 on each of the six others. Overall, he has made $350—5 percent.

At the end of the year he has $9,380—an annual of return 34.0 percent.

What's the simplest way he could increase his return?

Most investors look for some way to increase the profit on their winning trades—or to increase the number of winning trades they can make.

But to do that you have to revise your system.

It is much easier, as the seasoned investor does, to *first* focus on cutting costs.

Say this trader can cut the brokerage fee or other transaction costs he pays by a mere 5 percent per trade. That reduces each of his losses from $50 to $47.50.

His annual return jumps to 35.9 percent.

"I *Like* to Pay Lots of Tax"

A successful investor once surprised me by stating: "I *like* to pay lots of tax."

Why? Because he only paid lots of tax when he had made lots of money. To quote Vinod Khosla, cofounder of Sun Microsystems: "One correct move is far better than all the tax savings you can do in a lifetime."[6]

The tax regime you face should definitely be a factor in your investment strategy. But it's a mistake to make "Never Pay Taxes" your primary aim. After all, the simplest way of never paying taxes is to have no income or profit at all. Not recommended.

Return on investment is the ultimate measure. Return on investment means the *after-tax return.* The Master Investor takes into account everything, including taxes and other transaction costs, that will affect his net worth. You should, too.

That's a nice boost. But taken over ten years this tiny savings of just 5 percent per transaction has an enormous effect on his net worth.

Before the change, his initial $7,000 would have grown to $130,700 in ten years. That's an annual compound rate of 34 percent—nothing to sneeze at.

But by shaving his loss on each trade through lower commissions, ten years

later he has $150,800. The savings alone added $20,100 to his net worth—*triple* what he started with.

The Master Investor knows that a penny saved can grow into a dollar through the power of compound interest.

10

If You Don’t Know When to Say Yes, *Always* Say No

“If you don’t understand it, don’t do it.”

—WARREN BUFFETT[1]

“We know that we don’t know.”

—LARRY HITE[2]

I ONCE ASKED A FRIEND of mine, Andrew, one of my favorite questions: “How different would your net worth be today if you’d never made any investments at all, if instead you’d put all your money in the bank and let the interest pile up?”

“Oh, *much* worse off,” he replied. This puzzled me since I knew that in the previous three or four years he had lost money on every one of his forays into the stock market.

Andrew’s wealth came from two sources: the various businesses he had established, and real estate. So I asked him: “How different would your net worth be today if you’d only invested in your businesses or real estate?”

WINNING HABIT NO. 8:

REFUSE TO MAKE INVESTMENTS THAT DO *NOT* MEET YOUR CRITERIA

The Master Investor	The Losing Investor
Refuses to make investments that do *not* meet his criteria. Can effortlessly say no to everything else.	Has no criteria; or adopts someone else’s. Can’t say no to his own greed.

Without hesitation he replied: “*Much* better off.”

In real estate Andrew knew what he was doing. He had a simple rule: a

return of 1% per month or he would walk.

Andrew made a common mistake. He assumed that because he was successful in real estate he could be successful in every investment market.

Although he had clearly defined his criteria for real estate investments, he did not realize that the key to investment success is to *have* criteria.

He deluded himself for four years until his staggering pile of losses forced him to admit that he didn't understand the stock market at all. Only when, so to speak, he went back to investment kindergarten did he start making money in stocks.

When you enter an unfamiliar arena, regardless of your knowledge and skills you are in a state of unconscious *in*competence. Mental habits that underlie success in one area can be so embedded in your subconscious that they lead to failure in another.

If you're a good tennis player you have built up a repertoire of habitual ways of holding the tennis racquet, swinging it, serving, returning the ball, and so on.

The moment you move onto a squash, racquetball, or badminton court, nearly all these habits get in your way. You have to *un*learn your good tennis habits and learn a whole new set of habits to succeed at any of these superficially similar, but in fact very different, games.

Andrew did not have a well-thought-out investment philosophy. He failed to clarify what he did and did not understand. He had not defined his circle of competence. So he didn't know when to say yes and when to say no.

As Warren Buffett puts it, "What counts for most people in investing is not how much they know, but rather how realistically they define *what they don't know*."[3]

The Master Investor is very clear about what he does and doesn't understand. So, when confronted with an investment he doesn't understand, he's simply not interested.

His attitude of indifference contrasts starkly with the behavior of the average investor, who lets his emotions color his judgment.

The Grass Is Always Greener

Investors who don't have the mental anchor of a consistent investment philosophy often end up making investments against their better judgment. This always happens in manias like the dot-com boom.

In the early stages of such a boom, most investors are skeptics. They point out that companies such as Amazon.com, which projected losses as far as the eye can see, had no fundamental value whatsoever. Some of them even shorted such stocks, much to their later regret.

As the so-called New Economy party became more frenzied, the investment mantra became "profits don't matter" and valuations became irrelevant. The prices of the dot-coms kept skyrocketing, while the Old Economy value stocks fell out of favor.

This confused the hell out of the skeptics. Sitting on the sidelines, all the evidence they could see—the rising prices, the profits that people around them were making—contradicted every investment rule they had applied successfully in the past.

Unable to make sense out of what was going on, they began to doubt and question their own investment beliefs, lost confidence in themselves, and, one by one, threw in the towel and joined the party. At the end of the mania, only the true "heretics"—those investors like Buffett with a firm philosophy all their own—stayed out of the fire.

As a result, sad to say, the skeptics are always among the biggest losers from a mania. Having held out till near the very end, they buy just before the bubble bursts … and lose their shirts.

This is an extreme example of the belief that the grass is always greener on the other side. Investors who see other people making money while they are not often succumb to self-doubt and pursue a mirage. Others, like Mary, discount their own knowledge and expertise as being worthless and seek their pot of gold on some other rainbow, totally unaware they're already sitting on the right one.

The common denominator of this behavior is the failure to understand when to say yes and when to say no.

Contrast this with Warren Buffett, who at the height of a bull market in 1969 closed down the Buffett Partnership, writing to his investors:

> I am not attuned to this market environment, and I don't want to spoil a decent record by trying to play a game I don't understand just so I can go out a hero.[4]

False Understanding

Even worse than succumbing to temptation and investing in things you don't understand is to believe, falsely, that you do know what you're doing. This is the state of the teenage driver who, even before he's got his learner's license, is convinced that driving is a piece of cake. Despite what he thinks, he's in a state of unconscious *in*competence.

In 1998 a friend of mine, Stewart, opened a brokerage account with $400,000 and proceeded to buy stocks such as Amazon.com, AOL, Yahoo!, eBay, and Cisco Systems. By the end of 1999, the value of his account had grown to $2 million, of which $800,000 was margin money.

Whenever I spoke to Stewart, as I did frequently, it was impossible to shake his belief in all the New Economy myths. "Warren Buffett has lost his touch," he told me repeatedly. As his profits grew, his conviction that he knew exactly what he was doing became stronger and stronger.

Nevertheless, as the year 2000 dawned, he began to get nervous. He took a few profits, and shorted a few stocks as a "hedge." Unfortunately, the market kept rising and he had to meet his first margin call.

By the end of the year, the value of the stocks in his portfolio had fallen back to his opening balance of $400,000—but he still had $200,000 of margin, and had to meet yet another margin call. Sad to say, the collapse hadn't shaken his belief that the future of his dot-com stocks still glowed. And although everyone advised him not to, he paid his margin down with $200,000 from his savings. Today, with his portfolio down to about $200,000, it's not advisable to ask Stewart about his investments.

His self-delusion that he was an expert on dot-com stocks led him to turn $600,000 of his savings into $200,000, so violating Investment Rule No. 1: "Never lose money." (And its corollary: "Never meet a margin call.")

That's exactly why the Master Investor always says no to any investment he does not understand. By putting his capital at risk outside his circle of

competence, he would be threatening the very foundation of his investment success: preservation of capital.

Defining Your Circle of Competence

The Master Investor is indifferent to investments he doesn't understand because he knows his own limitations. And he knows his limitations because he has defined his circle of competence.

He has also proven to himself that he can make money easily when he stays within that circle. The grass may be greener somewhere outside his circle—but he's not interested. His proven style of investing *fits his personality*. To do something else would be like wearing a suit that doesn't fit. An Armani suit that's too big or too small is worse than a cheap suit that's your exact size.

Buffett and Soros built their circle of competence by answering these three questions:

- What am I interested in?
- What do I know now?
- What would I like to know about, and be willing to learn?

One other important consideration is whether it's possible to make money in an area that intrigues you. For example, I've always been fascinated by airlines. But with one or two possible exceptions, the airline industry is an investment black hole requiring endless amounts of capital which usually ends up going to the pilots' union.

Only by answering these three questions, as the Master Investor has done, can you find *your* investment niche and be crystal-clear about your own limitations. Only then will it be easy for you to walk away from investment "opportunities" that fail to meet your criteria—and stop losing money and start making it.

11

“Start with the A’s”

“If I’m interested in a company, I’ll buy 100 shares of all its competitors to get their annual reports.”

—WARREN BUFFETT[1]

“Discovery consists of seeing what everybody has seen and thinking what nobody has thought.”

—ALBERT SZENT-GYöRGYI VON NAGYRAPOLT[2]

EVERYBODY WANTS TO KNOW HOW Master Investors like Warren Buffett and George Soros find the investments that make them rich.

The simple answer is: on their own.

Buffett’s favorite source of investment ideas is available to anyone, usually free for the asking: company annual reports. In an interview with “Adam Smith” (author of *Supermoney*) Buffett advised novice investors “to do exactly what I did forty-odd years ago, which is to learn about every company in the United States that has publicly traded securities, and that bank of knowledge will do him or her terrific good over time.”

WINNING HABIT NO. 9:

DO YOUR OWN RESEARCH

The Master Investor	The Losing Investor
Is continually searching for new investment opportunities that meet his criteria and actively engages in his own research. Likely to listen only to other investors or analysts whom he has profound reasons to respect.	Is looking for the thousand-to-one shot that will put him on easy street. As a result, often follows the “hot tip of the month.” Always listening to anyone styled as an “expert.” Rarely makes a deep study of any investment before buying. His research consists of getting the latest “hot” tip from a broker, an advisor—or yesterday’s newspaper.

“But there are twenty-seven thousand public companies,” Smith responded.

“Well,” replied Buffett, “start with the A’s.”[3]

Buffett has been reading annual reports since 1950, when he first read Benjamin Graham’s book *The Intelligent Investor*. Today, in Buffett’s office, there are no quote machines, but in the file room are 188 drawers filled with annual reports. Buffett’s only “research assistant” is the person who files them. “I have spent my life,” he says, “looking at companies, starting with Abbott Labs and going through to Zenith.”[4]

As a result, Buffett has an incredible amount of information about all major American companies stored in his long-term memory. Which he continues to update … with the latest corporate reports.

When something he wants to know isn’t in the annual report he’ll go out and dig up the information. As he did in 1965, when …

> Buffett says he spent the better part of a month counting tank cars in a Kansas City railroad yard. He was not, however, considering buying railroad stocks. He was interested in the old Studebaker Corp., because of STP, a highly successful gasoline additive. The company wouldn’t tell him how the product was doing. But he knew that the basic ingredient came from Union Carbide, and he knew how much it took to produce one can of STP. Hence the tank-car counting. When shipments rose, he bought Studebaker stock, which subsequently went from 18 to 30.[6]

It Pays to Advertise

Buffett began buying stocks, but today he prefers to buy entire companies. He quips that his strategy for finding them is “very scientific. We just sit around and wait for the phone to ring. Sometimes it’s a wrong number.”[5]

It’s true that the first contact is usually made by the prospective seller rather than by Buffett. But Buffett actively encourages people to give him that call.

From his comments to shareholders in Berkshire’s annual reports, referrals from his happy sellers, to even the occasional ad in the *Wall Street Journal*,Warren Buffett knows that it pays to advertise.

In this case, thanks to his fieldwork, Buffett could invest with conviction. He had learned something that nobody else outside the company knew. Others who might have had the same idea didn’t “go the distance” to confirm it.

The Master Investor's secret is not so much seeing things that other people don't see, but the way he interprets what he sees. And then being willing to "walk the extra mile" to back up his initial estimate.

Buffett and Soros view the investment world through the filters of their investment criteria. They don't care what other people think. Not only that, what other people think or say is of little or no value to them. Buffett even says, "You have to think for yourself. It always amazes me how high-IQ people mindlessly imitate. *I never get good ideas talking to people.*"[7]

It only makes sense to a Master Investor to depend on other people who share his investment philosophy and use the exact same filters just as successfully as he does—such as Buffett's partner Charlie Munger and Soros's successor at the Quantum Fund, Stanley Druckenmiller.

In the Kingdom of the Blind

Like Buffett, George Soros has always done his own research. He has always looked at the market differently from his investment peers, even before he founded the Quantum Fund.

When he first arrived in New York in 1956 he discovered he had a competitive advantage. In London, experts on European stocks were a dime a dozen, but in New York they were as scarce as hen's teeth. That led to his first big breakthrough on Wall Street in 1959, when European stocks began to boom.

> It started with the formation of the Coal and Steel Community, which eventually became the Common Market. There was a massive interest in European securities among United States banks and institutional investors who thought they were getting in on the ground floor of a United States of Europe.… I became one of the leaders of the European investment boom. It made me a one-eyed king among the blind. I had institutions like Dreyfus Fund and J. P. Morgan practically eating out of my hands because they needed the information. They were investing very large amounts of money; I was at the center of it. It was the first big breakthrough of my career.[8]

Some analysts with the same edge would simply sit in New York and enjoy being the resident "expert." Not Soros. Like his ideas, his research was original and firsthand. Fluent in German and French, as well as English and Hungarian,

he would delve into tax returns to unveil the hidden assets of European companies. And he visited the management—something almost unheard of in those days.

His independent research led to his first big coup in 1960. He discovered that the stock portfolios of the German banks were worth significantly more than their total market value. Turning to the German insurance industry, he found one group of insurance companies, Aachener-Muenchner, whose intricate cross holdings between the various group members meant some of those stocks could be had at an enormous discount to their real value.

> Just before Christmas I went to J. P. Morgan, showed them the chart of these 50 interconnected companies, and told them my conclusion. I said that I was going to write it up during the Christmas holidays. They gave me an order to start buying immediately, before I completed the memo, because they thought that those stocks could double or triple on the basis of my recommendation.[9]

Today, Soros is known for his leveraged investments in futures and forward markets. But in 1969, when he and his then partner, Jimmy Rogers, established the Quantum Fund, futures contracts were only available for agricultural commodities such as wheat and coffee and metals such as silver and copper. The explosion of derivative contracts on currencies, bonds, and market indexes only began in the 1970s. Nevertheless, Soros applied the same principles before the advent of financial futures as he does now, seeking emerging *industry* trends that he could capitalize on by buying—or shorting—individual companies' stocks.

How did Soros and Rogers find such stocks? They read. Intensely. Trade publications like *Fertilizer Solutions* and *Textile Week*. Popular magazines, looking for social or cultural trends that might affect the market. They pored through annual reports. And when they thought they had spotted a trend, they went out and visited company managements.

In 1978 or 1979, Soros recalled, Jimmy Rogers had the idea that the world was going to switch from analog to digital.

> Jim and I went out to the AEA (American Electronics Association) conference in Monterey—it was called WEMA then—and we met with eight or ten managements a day for the entire week. We got our arms around this whole difficult field of technology. We selected the five most promising areas

> of growth and picked one or more stocks in each area. This was our finest hour as a team. We lived off the fruits of our labor for the next year or two. The Fund performed better than ever before.[10]

The growth of futures markets gave Soros a whole new arena to apply his philosophy of reflexivity. These highly liquid markets were ideal for the Quantum Fund. Soros could establish enormous positions far faster than he could in the stock market—and with little danger that his buying or selling would affect the price.

Soros switched his attention to monitoring political, economic, industry, currency, interest rate, and other trends, always on the lookout for linkages between disparate, unfolding events. His method hadn't changed, merely his focus.

He also talked to people. He'd built up an enormous Rolodex of contacts in the markets around the world. He would sometimes call them to help him determine what Mr. Market was thinking.

Always highly self-critical, Soros was constantly refining his ideas. And if one of his staff really liked an idea, Soros would tell them to rethink their idea—and then think again. He'd also urge them to test it by talking to someone with the opposite point of view to see if their thinking measured up.

Both Soros and Buffett follow a rigorous, systematic approach to uncovering investments that meet their criteria. Personally in control of the process, they are willing to take every step necessary to ensure that they have found an investment with a high positive profit expectancy.

Compare this to the search process of the typical individual investor. He bases his investment decisions largely on second-hand information gained haphazardly from his broker, analyst write-ups, investment newsletters, financial TV programs, and newspapers and magazines. Only occasionally will he even bother to read a company's annual report before buying its stock—let alone, as Buffett does, those of all its competitors.

Even fewer individual investors will go out and dig up firsthand information by talking to people involved with the company in one way or another, such as employees, customers, or competitors.

Even when he does follow a rigorous search strategy, he will often overlook one of the most crucial components of the Master Investor's success: carefully monitoring, in a process just as rigorous as his search strategy, all the investments he has already made.

There's No Such Thing As a One-Decision Stock

My own most vivid lesson in the importance of monitoring came from Harold, an investor I met when I was much younger than I am today. He was in his seventies when I first met him (so if he's still alive now he's well past the century mark). Harold began investing as a hobby, using the *Value Line Investment Survey* to find undervalued companies. He was having so much fun (and making so much money) that he quit his job when he was forty to invest fulltime.

He told me about his investment in a company I'll call Paper Forms, Inc., which he had bought, in the late 1970s, at between $2 and $3 a share and finally sold at $21.

Paper Forms was in the business of making all manner of business forms. It had twenty factories and warehouses scattered all over the United States. What caught Harold's eye was that all its premises had been leased for twenty years in the 1950s, with an option to buy at the end of the lease. The exercise prices of the options were set at levels that no doubt seemed high in the preinflation era of the late 1950s, but were ludicrously cheap in the era of double-digit inflation at the end of the 1970s.

Finding Baby Oak Trees

"You shouldn't pay too much attention to what the market thinks. You should do your own research and decide what you think a stock is worth. You can often find some real acorns [i.e., that will grow into oak trees] there that everyone else, for all sorts of reasons, thinks are dangerous.

—Robert Maple-Brown[11]

The company was generating steady if unspectacular profits, so the only

compelling reason to buy the stock was for the hidden value of the real estate options.

And buy it Harold did, accumulating a sizable stake at between $2 and $2.50 a share, becoming the biggest shareholder after the founder’s family.

If anything sounds like a stock you could buy and forget, surely this one does. But if Harold had taken that view, he would never have made a dime in Paper Forms. Because soon after he had started buying, the founder and controlling shareholder of the company died.

His shares ended up in the hands of a bank trust department. Control of the company now rested with the bank’s bean counters.

You’d think that even the dumbest member of the trust department wouldn’t pass over a windfall like the opportunity to buy real estate in the late 1970s at 1950s prices.

But to the bankers, options were dangerous derivatives. Exercising them would put Paper Forms in the risky business of real estate development. Better, in their view, that the company stick to its knitting. After all, what banker was ever criticized for taking the safe, conservative route?

The fact that the founder had died and the bank was now in control of the company was readily available, public information. But Harold knew from experience that with a change in management anything, even the ridiculous, could happen.

As Harold’s sole reason for buying stock in Paper Forms was those options, it was crucial that he know their fate. So by repeatedly phoning the company’s head office—and getting to know some of the middle managers in the process—he made sure he knew what the company was going to do. When he learned that in its wisdom the bank’s trust department had decided NOT to exercise the company’s options, he made an appointment to see the bank’s president.

When they met, he asked the bank’s president if it was true that his trust department had decided not to exercise Paper Form’s options. The bank president said he knew nothing about it, so Harold filled him in. Then he asked:

“How would you like to be the target of a class-action lawsuit on behalf of the minority shareholders for failing to maximize this company’s value?”

“Are you buying shares?” the president asked.

“You bet. And I’m going to keep buying.”

Thanks to Harold’s activism, the bank trust department changed its mind.

Harold continued to buy shares up to $3. Soon after, Paper Forms became the object of a takeover bid. The initial offer price was $18, but again Harold stuck to his guns and he wound up being bought out for $21 per share. If Harold had not actively monitored his investment, his entire profit of $18+ per share would never have come about.

Monitoring is a continual process. It’s a continuation of the search process, not to find an investment but so you know that all is well, or that it’s time to take a profit, liquidate the investment or, like Harold, take some other action to protect your capital.

Only the *frequency* of monitoring differs from one Master Investor to another. Buffett, for example, can safely review his investments on a monthly or even quarterly basis, while keeping his eye out for any news or development that might impact one of his companies in some way.

For Soros, the frequency of monitoring is far more intense, sometimes minute by minute rather than once every month or so.

And while, for Buffett, the distinction between searching and monitoring is clear-cut, in Soros’s investment style the two processes can merge together.

For example, Soros will first test his hypothesis by dipping his toe in the market. Monitoring that position helps him judge the quality of his hypothesis. His tests are also a component of his search strategy—searching for the right *timing;* the right moment to pull the trigger.

Monitoring his test helps him get a “feel for the market”; and the failure of a test may lead him to revise his hypothesis, so refining his search.

Despite the differences in their styles, both Buffett and Soros are personally on the lookout for new investments that meet their criteria at all times. And constantly measuring the investments they already own against their criteria to judge whether and when some further action is needed, whether to take a profit, a loss, or, like Harold, threatening a bank president with a class-action suit.

12

“When There’s Nothing to Do, Do Nothing”

“The trick is, when there’s nothing to do, do nothing.”

—WARREN BUFFETT[1]

“To be successful, you need leisure. You need time hanging heavily on your hands.”

—GEORGE SOROS[2]

“What was Soros’s secret…? Infinite patience, to start with.”

—ROBERT SLATER[3]

BOTH BUFFETT AND SOROS KNOW, and have accepted, that by sticking to their investment criteria there will be times, possibly extended periods, when they cannot find anything to invest in. Both have the patience to wait indefinitely. As Buffett quips, “Lethargy bordering on sloth remains the cornerstone of our investment style.”[4]

WINNING HABIT NO. 10:

HAVE INFINITE PATIENCE

The Master Investor	The Losing Investor
Has the patience when he can’t find an investment that meets his criteria to wait indefinitely until he finds one that does.	Feels that he has to be doing something in the market at all times.

At Berkshire Hathaway’s 1998 annual meeting he told shareholders:

> We haven’t found anything to speak of in equities in a good many months. As for how *long* we’ll wait, we’ll wait *indefinitely*. We’re not going to buy anything just to buy it. We will only buy something if we think we’re getting something attractive … We have no time frame. If the money piles up, then it piles up. And when we see something that makes sense, we’re willing to act very

fast and very *big*. But we’re not going to act on anything if it doesn’t check out.

You don’t get paid for *activity*. You only get paid for being *right*.[5]

For Soros, periods of inactivity are far from frustrating. Indeed, he views them as essential. As he puts it, “To be successful, you need leisure. You need time hanging heavily on your hands.” Why? To have time to think. “I insist on formulating a thesis before I take a position,” he says. “But it *takes time* to discover a rationale for a perceived trend in the market.”[6]

And even when Soros has a solid investment hypothesis, he may have to wait quite a while before the time is right to pull the trigger. For example, when Britain joined the European “snake” in 1987, Soros knew that it would one day fall apart. It wasn’t until the reunification of Germany three years later that he could formulate a specific investment hypothesis, namely that the pound sterling would be thrown out. But two more years had to pass before it was time to go for the jugular. All in all, Soros had to wait five years before he could implement his investment idea. So, his profit of $2 billion was equivalent to $400 million for each year he waited. For the Master Investor, waiting pays off.

Buffett is perfectly happy to wait almost as long. “All I want is one good idea every year,” he says. “If you really push me, I will settle for one good idea every two years.”[7]

Getting Paid for Activity

The Master Investor’s incorporation of waiting into his investment system is a strategy that won’t fly on Wall Street. It’s a myth that the investment professional is paid for making you money. He’s actually paid to turn up every day and “do” something.

Analysts earn their keep by writing reports even when there’s no real reason for one to be written. Market commentators are paid to have an opinion, even on days when they have to invent one. Fund managers are paid to invest, not sit on piles of cash—even at those times when cash is king. Investment newsletter writers have to make a recommendation because a publishing deadline is looming, not necessarily because they’ve got a great stock to recommend.

The Master Investor is different.

As Soros once told his friend Byron Wien, Morgan Stanley's US investment strategist:

> "The trouble with you, Byron, is that you go to work every day [and think] you should do something. I don't.… I only go to work on the days that make sense to go to work.… And I really do something on that day. But you go to work and you do something every day and you don't realize when it's a special day."[8]

Master Investors like Buffett and Soros don't suffer from these same constraints. There is no institutional imperative that forces them to act when their investment system dictates there's nothing sensible to do. Unlike a typical fund manager, they don't buy "defensive" stocks (i.e., stocks that will lose *less* money in a declining market than the market as a whole) when it makes more sense to just sit on a pile of cash.

Nor do they have to go to the office when there's nothing to be done. Buffett learnt from Graham that "there would periodically be times when you couldn't find good values, and it's a good idea to go to the beach."[9]

Or as Soros's former partner Jimmy Rogers put it: "One of the best rules anybody can learn about investing is to do nothing, absolutely nothing, unless there is something to do."[10]

Prospecting for Gold

The investor whose criteria are incomplete (or, more often, nonexistent) feels he must be in the market at all times. Waiting is alien to his mentality because, without criteria, he has no idea what to wait for. When he's not regularly calling his broker saying, "Buy this, sell that," he doesn't feel he's investing.

By contrast, the Master Investor is like a gold prospector. He knows exactly what he's looking for; he has a general idea of where to find it; he's got *all* the right tools; and he keeps searching until he discovers gold. And after he's found one deposit and developed it, he gathers his tools and starts looking all over again.

In this sense, the Master Investor never waits. His time between strikes is

filled with his daily activity of hunting for new opportunities. It’s a continual, never-ending process.

His only distraction from his search is the necessity to park his cash somewhere. Somewhere safe, so it’s immediately available the minute his investment system says it’s time for him to act.

14

Know When to Sell *Before* You Buy

"I know where I'm getting out before I get in."

—BRUCE KOVNER[1]

"Sell when the company no longer meets your buying criteria."

—T. ROWE PRICE[2]

NO MATTER HOW MUCH TIME, effort, energy, and money you put into making an investment, it will all come to naught if you don't have a predetermined exit strategy.

That's why the Master Investor never makes an investment without, first, knowing when he is going to sell.

Exit strategies vary from investor to investor depending on their method and system. But every successful investor has a selling strategy that's compatible with his system.

Both Warren Buffett's and George Soros's exit strategies stem from their buying criteria.

Buffett continually measures the quality of the businesses he's invested in with the same criteria that he used to invest in the first place. Though his favorite holding period is "forever," he will sell a stock market investment when any of those criteria have been broken; for example, the business's economic characteristics have changed, the management loses its focus, or the company has lost its "moat."

WINNING HABIT NO. 12:	
HOLD A WINNING INVESTMENT UNTIL THERE'S A *PREDETERMINED* REASON TO SELL	
The Master Investor	**The Losing Investor**
Holds a winning investment until a predetermined reason to exit arises.	Rarely has a predetermined rule for taking profits. Often scared that a small profit will turn into a loss, so he cashes it in—and regularly misses giant gains.

In 2000, Berkshire's filings with the SEC revealed that it had sold the bulk of its shares in Disney. Buffett was asked why he had sold this stock by a shareholder at the 2002 Berkshire annual meeting.

His policy is to never comment on his investments, so he answered the question obliquely by saying: "We had one view of the competitive characteristics of the company and that changed."[3]

There's no question that Disney had lost its focus. It was no longer the same company that made timeless family classics such as *Snow White and the Seven Dwarfs*. Disney's CEO, Michael Eisner, had awarded himself options with a gusto that must have made Buffett squirm. They'd frittered money away in the dot-com boom, poured capital into Web sites such as search engine Goto.com, and bought other money losers such as InfoSeek. It's easy to see why, in 2000, Disney no longer met Buffett's criteria.

Buffett will also sell an investment when he needs the capital to fund an even better investment opportunity. But this isn't something he has had to do since his early days, when he had more ideas than money. With the cash generated by Berkshire's insurance float, his problem is now the opposite: He has more money than ideas.

His third rule for selling is when he realizes he's made a mistake and should never have made the investment in the first place, the subject of chapter 16.

Like Buffett, George Soros has clear rules on when to liquidate an investment. And like Buffett, they are directly related to his criteria for making the investment.

He will take profits when his hypothesis has run its course, as in his coup

against the pound sterling in 1992. He will take a loss when the market proves that his hypothesis is no longer valid.

And Soros will always beat a hasty retreat whenever his capital is jeopardized. The prime example of that is the way he dumped his long positions in S&P 500 futures during the crash of 1987—an extreme case of the market proving him wrong.

Regardless of his method, like Buffett and Soros every successful investor knows *at the time he invests* what will cause him to take either a profit or a loss. And he knows *when* to do so by continually measuring the progress of his investments against his criteria.

Exit Strategies

When they sell, Buffett, Soros and other successful investors all employ one or more of six possible exit strategies:

1. **When Criteria Are Broken,** as in the example of Buffett selling Disney.
2. **When an Event Anticipated by their System Occurs.** Some investments are made in anticipation of a particular event taking place. Soros's hypothesis that the pound sterling would be devalued is one example; the time to exit was when the pound was kicked out of the European Exchange Rate Mechanism.

   When Buffett engages in takeover arbitrage, the time for him to exit is when the takeover is consummated—or when the deal falls apart.

   In either case, the occurrence of a particular event determines when the investor takes his profit or loss.
3. **When a System-Generated Target Is Met.** Some investment systems generate a target price for an investment, which becomes the exit strategy. This is a characteristic of Benjamin Graham's method, which was to buy stocks well below their intrinsic value and sell them when they rose to that value—or in two to three years if they did not.
4. **When an Investor's System Generates a Sell Signal.** This is a method used primarily by technical traders whose sell signals may be generated by a particular chart pattern, volume or volatility indicator, or some other technical indicator.
5. **When a Mechanical Rule Triggers Action,** such as a stop loss set 10 percent below the entry point, or the use of a trailing stop (a stop that rises as the price goes up, but is not moved if the price goes down) to lock in profits. Mechanical rules are most often used by successful investors or traders who follow an actuarial approach, the rules being generated by the investor's risk control and money management strategy.

One intriguing example of such a mechanical exit strategy was used by the grandfather of a friend of mine. His rule was to sell whenever a stock he owned went up *or* down by 10 percent. By following this rule, he survived the crash of 1929 with his capital intact.

6. **When the Investor Realizes He Has Made a Mistake.** Recognizing and correcting mistakes is essential to investment success, as we'll see in chapter 17.

The investor with incomplete or nonexistent criteria is clearly unable to use the first exit strategy. And neither will he know when he's made a mistake.

An investor without a system cannot have any system-generated targets or sell signals either.

His best bet is to follow a mechanical exit strategy. This will at least limit his losses. But it gives him no guarantee that he'll ever make any profits because he has not done what the Master Investor has done: first identified a class of investments with a positive average profit expectancy and built a successful system around it.

"Cut Your Losses, Let Your Profits Run"

All these exit strategies have one thing in common: For the Master Investor, they take the emotion out of selling.

His focus isn't on the profit or loss he might have made in this investment; it's on following his system, of which his exit strategy is merely one part.

A successful exit strategy cannot be created in isolation. It can only be successful when it's a direct consequence of the investor's investment criteria and investment system.

This is why the typical investor has such difficulty in realizing profits and taking losses. He has heard from every source that investment success depends on "cutting your losses and letting your profits run." The Master Investor will agree with this—which is precisely why he has a system that allows him to successfully implement this rule.

Without such a system, the typical investor has nothing to tell him when a

losing investment should be sold, or how long a winning investment should be held. How can he decide what to do?

Typically, both profits and losses cause him anxiety. When an investment shows a profit, he begins to fear that the profit might evaporate. To relieve that anxiety, he sells. After all, don't the experts say "You can never go broke taking a profit"?

And of course he feels good when he banks a profit, even if it's only 10 percent or 20 percent.

Faced with a loss, he might tell himself that it's only a paper loss—as long as he doesn't realize it. And he is ever hopeful that this is just a "temporary" correction and the price will soon turn around.

Getting Out of a Boom

"The lessons I've learnt are if you are participating in a boom, realize you are speculating not investing, always take your profits, cut your losses and when the boom ends if you have any speculative stocks left, sell them.… When the boom ends the bust is equally incredible in terms of the levels stocks can get to."

—Anton Tagliaferro[4]

If the loss grows, he might tell himself that he'll sell out when the price goes back to what he paid for it.

If the price continues to drop, eventually the hope that it will rise is replaced with fear that it will continue to fall. So he finally sells out, often near the ultimate bottom.

The overall result is that he ends up with a series of small profits which are more than offset by a string of much larger losses, the exact opposite of Soros's recipe for success: capital preservation and home runs.

Without criteria, the question of whether to take a profit or a loss is dominated by anxiety. At each step along the way he finds himself reinventing all the reasons why the stock might be a good investment, convincing himself to hold on and so avoiding the issue.

Most people feel anxious when they are confused but must act regardless. An

investor can procrastinate indefinitely about making an investment. But he cannot escape the decision to take a profit or a loss. He can only rid himself of this anxiety by clarifying his investment philosophy and criteria.

18

Wishing Won't Make It So

"He who would climb the ladder must begin at the bottom."

—ENGLISH PROVERB[1]

"He who wishes to be rich in a day will be hanged in a year."

—LEONARDO DA VINCI[2]

"The only place where success comes before work is in a dictionary."

—VIDAL SASSOON[3]

IN PEOPLE'S MINDS, THE NAMES Warren Buffett and George Soros tend to be linked with their impressive investment track records—24.4 percent and 28.2 percent per year, respectively. It's as though they appeared from nowhere with this genius for investing.

Nothing could be farther from the truth. When Buffett began his Buffett Partnership in 1956, he drew on twenty years of experience of saving, investing, and learning about business and money. Similarly, Soros had already spent seventeen years learning his craft when he established the Double Eagle Fund in 1969.

WINNING HABIT NO. 16:

PAY YOUR DUES

The Master Investor	The Losing Investor
His returns increase with experience; now seems to spend less time to make more money. Has "paid his dues."	Not aware it's necessary to "pay your dues." Rarely learns from experience . . . and tends to repeat the same mistake until he's cleaned out.

For both, it was this long apprenticeship that made it possible for them to post such stellar returns from the very first day they entered the fund management arena.

In this respect, Buffett and Soros are no different from, say, Tiger Woods, who started to learn to play golf as soon as he could stand up. It wasn't as though he just burst onto the scene to win his first professional title at the age of twenty-one. He *already had* nineteen years of experience.

Buffett's Head Start

Compared to Tiger Woods, Buffett was a late starter. He didn't buy his first stock until he was eleven years old. And he waited until he was five before starting his first business, a stand in front of his house selling Chiclets to passersby. This was followed by a lemonade stand positioned not in front of his house but in front of a friend's, as he had noticed there was far more traffic there, and so many more customers. At six, he was buying six-packs of Cokes from the general store for 25 cents, and selling them door to door for 5 cents a bottle.

Many kids have a paper route or some other part-time work in order to supplement their pocket money. Not Buffett.

At the age of fourteen, Buffett had *several* paper routes, set up as a business. He was delivering 500 newspapers a day—but he had organized the route so it only took an hour and a quarter. He used his access to customers to sell them magazine subscriptions to maximize his income. He was making $175 a month from this paper route alone, an incredible sum for a teenager in the mid-1940s, money he planned to keep, not spend.

Other business ventures included collecting lost golf balls and selling them—not just a handful, but hundreds at a time. He and a partner owned pinball machines placed in barbershops. That business brought in $50 a week ($365 in today's dollars), and was sold when he was seventeen for $1,200. He even had half ownership of a Rolls-Royce which was rented out at $35 a day.

This experience in starting and running businesses, tiny as they were

compared to the smallest of Berkshire Hathaway's acquisitions, gave him an understanding of business that's simply not available from reading a book or taking a course.

Indeed, at Wharton (which he attended before going to Columbia) the nineteen-year-old "disgustedly reported that he knew more than the professors."[4] According to a classmate, "Warren came to the conclusion that there wasn't anything Wharton could teach him. And he was right."[5]

Buffett was also fascinated by stocks and spent a lot of time in his father's brokerage, sometimes chalking up prices on the blackboard. He began to chart prices, "bewitched by the idea of deciphering their patterns."[6] His first stock purchase was Cities Service. He bought three shares at $38—and they soon dropped to $27. Buffett hung on, eventually selling out with a $5 profit. After which the stock kept going up all the way to $200.

While other kids read the sports pages or played ball, the young Buffett pored over the stock tables and read the *Wall Street Journal* after school. His high school teachers even asked him for investment advice.

But although he spent a lot of time studying the stock market, he wasn't really doing all that well. He tried everything—"I collected charts and I read all the technical stuff. I listened to tips,"[7] he later recalled—but nothing worked too well. He had neither a framework nor a system—until he found Benjamin Graham.

When he entered Columbia University in 1950 to attend Benjamin Graham's class on security analysis, he was just twenty years old. But he was already a seasoned investor. He had already made many of the mistakes, and had many of the learning experiences, that most of us don't begin to have until our twenties or even thirties …

- he had read every business and investment book he could lay his hands on—over 100 in total;
- he had tried (and discarded) a variety of approaches to investing, including reading charts and listening to hot tips; and
- for a twenty-year-old, he had an unusually wide experience in business, and had already demonstrated his business acumen.

Thanks to the power of compound interest, his unusual head start has added untold billions of dollars to his current net worth.

Buffett's Mentor

For the next six years Buffett absorbed everything he could from Graham, first, as a student where he received the only A+ Graham ever awarded;[8] then, working at Graham-Newman Corp., Graham's fund management company, from 1954 to 1956.

But Buffett was already showing signs that he would excel his teacher.

> Buffett was quicker at everything. Graham would amaze the staff with his ability to scan a page with columns of figures and pick out an error. But Buffett was faster at it. Howard Newman, [Graham-Newman partner] Jerry Newman's son, who also worked there, said, "Warren was brilliant and self-effacing. He was Graham exponential."[9]

And Buffett immediately applied what he had learned.

When he arrived at Columbia in 1950 he had $9,800 accumulated from his teenage business ventures.* When he left New York for Omaha in 1956 to start managing funds on his own, he had turned that sum into $140,000[†]—nearly a million of today's dollars!—an annual compounded return of over 50 percent.

He had acquired his investment philosophy, developed his investment system, and tested it—successfully. He was ready.

The Failed Philosopher

When George Soros graduated from the London School of Economics in the spring of 1953, he was hoping for an academic career. But his grades weren't good enough.

So after graduation he took the first of a series of odd jobs until, as a means of paying the rent, he hit upon the idea that there was money to be made in financial markets.

Soros wrote a personal letter to the managing director of each of the merchant banks in the City of London. One of his few interviews was with the

managing director of Lazard Frères, who gave him an appointment for the sole purpose of telling him he was barking up the wrong tree trying to get a job in the City of London. He told Soros:

> "Here in the City we practice what we call intelligent nepotism. That means that each managing director has a number of nephews, one of whom is intelligent, and he is going to be the next managing director. If you came from the same college as he did, you would have a chance to get a job in the firm. If you came from the same university, you may still be all right. But you're not even from the same country!"[10]

Eventually, Soros did secure a job in the City with Singer & Friedlander, whose managing director was, like Soros, Hungarian. His time there was hardly illustrious, though what he was learning by doing—for example, to arbitrage gold stocks—began to make him more comfortable with a financial career.

But his time there was hardly an abject failure, either. A relative had given him £1,000 (then $4,800) to invest on his behalf. When he left in 1956 to join F. M. Mayer in New York, he took with him $5,000, which was his share of the profits made on that original £1,000. He clearly had a natural talent for operating in the investment marketplace.

In New York, Soros began arbitraging oil stocks—buying and selling the same securities on different international markets to profit from small price discrepancies.

But he first made his mark on Wall Street as a research analyst covering European stocks, where he had enormous success until John F. Kennedy entered the White House. One of Kennedy's first acts as president in 1961 was to introduce the "interest equalization tax" to "protect" the balance of payments. This 15% tax on foreign investments brought Soros's highflying business in European stocks to a crashing halt.

With little to do, he turned back to philosophy. In 1961 and 1962 he worked weekends and evenings on *The Burden of Consciousness,* a book he had begun writing while studying at the London School of Economics. He did indeed complete it, but it failed to satisfy him.

> There came a day when I was rereading what I had written the day before and couldn't make sense

> of it.… I now realize that I was mainly regurgitating Karl Popper's ideas. But I haven't given up the illusion that I have something important and original to say.[11]

It was only then, at the age of thirty-two, that Soros decided to focus his full attention on investing. In 1963 he made his last-but-one move, to Arnhold & S. Bleichroeder, where he began testing his philosophical ideas in the markets. It was here that the Quantum Fund was first conceived and, eventually, born.

In 1967 the First Eagle Fund was launched by Arnhold & S. Bleichroeder with Soros as its manager. A second fund, the Double Eagle Fund, was established in 1969—*seventeen years* after his first job in the City of London. Soros's current net worth in the billions began then with his own investment in the fund of just $250,000. The following year, Jimmy Rogers (author of *The Investment Biker*) became Soros's partner. They set up as independent fund managers—Soros Fund Management—in 1973, taking the Double Eagle Fund with them. It was renamed the Quantum Fund a few years later, and the rest is history.

Easy Money

Everyone would laugh at the idea that you could just pick up a golf club and take on Tiger Woods without any special training. Only a lunatic would bet on a complete novice beating André Agassi at Wimbledon. And who in his right mind would get in the ring with Mike Tyson and expect to last longer than fifteen seconds?

So why do people think they can just open a brokerage account, plonk down $5,000, and hope to make the same kind of returns as Warren Buffett or George Soros?

The myth that investing is an easy way to riches, that no special training or apprenticeship is needed, is implicit in every single one of the Seven Deadly Investment Sins. And it is reinforced by the fortunes that some rank amateurs occasionally make when they're lucky enough to jump on a bandwagon like the Internet boom.

Even Master Investors such as Warren Buffett and Peter Lynch contribute

(unwittingly) to this myth when they say that all you need to do is find a few good companies you can buy at the right price and sit on them.

It's true that there are no barriers to entry. You don't need any special physical skills. You don't need to start while you're in kindergarten, as top athletes and concert pianists must. And every investment book, every talking head on CNBC makes it all *sound* so easy.

And investing *is* easy—when you have reached the state of unconscious competence. But to get there, you must first "pay your dues."

Neither Buffett nor Soros actually set out with the intention of paying their dues. But by going through the process of making mistakes with real money, analyzing them, and learning from them, that is exactly what they were doing. By following this process, the losses they incurred were an investment in their long-term success.

Going through the pain of losing real money is an essential component of accumulating experience. How you react to such losses is the crucial element that determines whether you will ultimately succeed or fail as an investor.

Both Buffett and Soros were dedicated to succeeding. They are always willing to "go the extra mile" to reach their goal. A mistake, a loss, does not impact on their confidence in themselves. They don't take it personally. As Buffett puts it: "A stock doesn't know who owns it. You may have all these feelings and emotions as the stock goes up and down, but the stock doesn't give a damn."[12]

By taking responsibility for their actions they feel in control of their own destiny. They never blame the markets or their broker. *They* lost money because of something *they* did wrong—and so the remedy was within *their* control.

The investor who doesn't react to his mistakes as Buffett and Soros react to theirs won't stick it out long enough to pay their dues.

Paying the Price

Even investors who are spectacularly successful for a while sometimes fail to pay their dues and inevitably pay the price—just like Long-Term Capital

Management.

Long-Term was founded in 1994 by John Meriwether, the former chief of Salomon Brothers' Arbitrage Group, and most of the other traders from the same department. Long-Term started with $1.25 billion, raised mainly with the help of two of its partners, the Nobel Prize–winning economists Robert C. Merton and Myron S. Scholes.

At Salomon, the $500 million a year in profits these traders had averaged trading bond spreads accounted for the bulk of the firm's profits.

For its first few years, Long-Term successfully replicated those profits by following exactly the same strategy. They knew what they were doing, and they did it well.

Too well. By 1997, the partners had a problem: They had too much money, even after they returned a big chunk of it to the investors. And at the same time, the margins on their bread-and-butter business of bond spreads had shrunk as everyone else on Wall Street piled in.

Except for Meriwether, most of the other partners were "quants": people with PhD's in economics or finance who had studied with Merton or Scholes or one of their followers. Underlying their approach was the fundamental belief that "markets are efficient."

At Salomon, they had built computerized models of the bond markets to identify and exploit bond market inefficiencies. Bonds were their circle of competence—and, there, they *had* paid their dues.

But their success had gone to their heads. When faced with the problem of where to put all this new money, they took their bond models and applied them to markets like takeover arbitrage where they had no competitive advantage. Not only were these models unproven and untested outside bonds, the "professors" (as the partners were known) didn't feel that any testing was necessary. They just plunged in with billions of dollars.

Unfortunately for them (as it turned out later), their first forays outside the bond markets were successful. So they expanded to trading currencies, as well as Russian, Brazilian, and other emerging market bonds and spreads on stock options. They even shorted some stocks outright, including Berkshire Hathaway,

a trade that eventually cost them $150 million.

Scholes was one of the few partners who was upset about such trades. "He argued that Long-Term should stick to its models; it did not have any 'informational advantage'"[13] in any of these areas. But he was totally ignored.

The other partners acted as if they could walk on water. To them, their previous success proved they were infallible. They had no Plan B to tell them what to do if things fell apart. On the contrary, with mathematical precision they had calculated that a market implosion that would affect all their positions simultaneously was a ten-sigma event, one that might happen once in the life of the universe.

Their first mistake, of course, was going outside their circle of competence. You will not want to make this mistake. You can *expand* your circle of competence by learning and testing a different way of investing. If you're willing to pay your dues *again.* To just dive in with a billion dollars on the line from day one is akin to getting into the ring with Mike Tyson with your eyes closed. A recipe for disaster.

And sure enough, Long-Term imploded in August 1998 when Russia defaulted on its bonds and the markets went haywire. After having quadrupled their investors' money from $1.25 billion to $5 billion, by October 1998, there was only $400 million left—40 cents on the original dollar.

Of course, their failure to "pay their dues" wasn't the only mistake the "professors" made. Indeed, they violated almost every single one of the 23 Winning Investment Habits. But the way they believed they could jump straight to the end of the learning curve was an integral part of their demise.

If you haven't paid your dues, you'll eventually blow up. It's inevitable.

"It's Frightening Easy"

Like any master of a craft, the Master Investor who has paid his dues develops what some people think of as "a sixth sense where they just know that a stock is going to move.… It's visceral. You just sense it."[14]

It could be a backache, as it is for Soros. A mental picture like the one

Buffett sees of a company ten or twenty years in the future. Or an internal voice saying, “That’s the bottom!” In whatever form it comes, it’s the years of accumulated experience stored in the Master Investor’s subconscious mind communicating in a kind of mental shorthand.

This is why, for the Master, everything he does seems so effortless.

Before he had achieved the state of unconscious competence, it would have been impossible for Buffett to decide to buy a billion-dollar company in just a few minutes. Nor would Soros have been able to take such a giant position in a currency, as he did when he shorted the pound sterling in 1992. Indeed, until the Plaza Accord in 1985 Soros had lost money on his forays into currencies.

But to some degree, Soros’s and Buffett’s increasing expertise is disguised by the mountain of money each has to invest. With billions rather than millions of dollars to invest, only an investment “elephant” will make a significant difference to either Master Investor’s net worth.

While there are very few “elephant-sized” investments with the prospect of large percentage gains, there are endless investments of this kind for the smaller investor. As Buffett demonstrated in the late 1970s when he and his wife separated and he, personally, was strapped for cash.

Although he was then worth $140 million, it was all tied up in Berkshire stock. He refused to sell a single share of his “work of art.” And he would certainly not declare a dividend just to pay his rent.

So he began buying stocks on his personal account.

> “It was almost frightening, how easy it was,” a Berkshire employee said. “He analyzed what he was looking for. All of a sudden he had money.…” According to the broker Art Rowsell, “Warren made $3 million like bingo.”[15]

The investor who believes that all he needs to do is find the holy grail, the right formula, the secret to reading charts, or some guru to tell him what to do and when to do it, can never develop the expertise of a Warren Buffett or a George Soros.

Paying your dues can be a long and arduous process, one that took Buffett and Soros almost twenty years apiece. But they went about the process

unsystematically.

Unlike them, you now know that you must begin at the bottom of the learning curve. This gives you an inestimable advantage over the Master Investor who reached Mastery by a process of trial and error.

20

“Phony! Phony! Phony!”

“In evaluating people, you look for three qualities: integrity, intelligence, and energy. And if you don’t have the first, the other two will kill you.”

—WARREN BUFFETT[1]

“I am willing to use different people employing different approaches as long as I can rely on their integrity.”

—GEORGE SOROS[2]

ONE OF MY INVESTMENT COACHING clients was a woman from Singapore. In our initial conversation she told me that she chose her stocks based on the numbers she found in annual reports and elsewhere. “I do it, I’m good at it,” she said, “but I don’t really enjoy it.”

Later in this conversation she mentioned that she considered herself a good judge of character. So I said to her: “Well, why don’t you go along to the annual meetings of companies you’re looking at so you can meet, or at least observe, the company’s managers and directors. You can see if you’d feel comfortable giving your money to any of these guys to look after.”

WINNING HABIT NO. 18:

KNOW HOW TO DELEGATE

The Master Investor	The Losing Investor
Has successfully delegated most if not all of his responsibilities to others.	Selects investment advisors and managers the same way he makes investment decisions.

This is an aspect of Warren Buffett’s investment strategy that’s usually underemphasized in all examinations of his investment approach: that he loves

dealing with people as well as numbers, and he's an incredibly good judge of character.

Walter Schloss is another Graham student who also worked at Graham-Newman Co. He has since averaged around 20 percent a year buying Graham-style investments. Comparing his style to Buffett's, he says:

> I really don't like talking to management. Stocks really are easier to deal with. They don't argue with you. They don't have emotional problems. You don't have to hold their hand. Now Warren is an unusual guy because he's not only a good analyst, he's a good salesman, and he's a very good judge of people. That's an unusual combination. If I were to [acquire] somebody with a business, I'm sure he would quit the very next day. I would misjudge his character or something—or I wouldn't understand that he really didn't like the business and really wanted to sell it and get out. Warren's people knock themselves out after he buys the business, so that's an unusual trait.[3]

As Ken Chace, whom Buffett promoted to run Berkshire, summed it up: "It's hard to describe how much I enjoyed working for him."[4]

"I Knew He Was a Phony"

How has Warren Buffett been able to acquire businesses whose owners end up "working harder for him than they did for themselves"?[5]

He is a superb judge of character. "I think I can tell pretty well what people's motivation is when they walk in," he says.[6]

In 1978, Warren Buffett was one of the few people in Omaha who closed his door to Larry King, a former Franklin Community Credit Union manager-treasurer who served a fifteen-year sentence [and is no relation to the CNN host of *Larry King Live*].

> "I knew that King was a phony," says Buffett, "and I think that he knew I knew. I'm probably the only person in Omaha he never asked for money." How did Buffett know? "It was like he had a big sign on his head that said 'PHONY, PHONY, PHONY.'"[7]

His unusual ability to gauge a person's character accurately is a crucial aspect of Buffett's investment and business success. It's what allows him to buy companies with management in place, confident that the former owners will stay

on to run the business indefinitely. He can decide whether a manager is “his kind of people” in moments—an ability Schloss admits he doesn’t have.

Whether he’s buying a business in whole or in part, Buffett always acts as if he were the owner hiring the management. So when he’s buying a stock he is effectively asking himself: “If I owned this company would I hire these guys to run it?” And of course, if the answer is no he won’t invest.

For Buffett, every investment is an act of delegation. He is fully aware that he is entrusting the future of his money to other people—and he’s only going to do that with people he respects, trusts, and admires.

He has two roles at Berkshire Hathaway. He says his primary role is the allocation of capital, a role he reserves to himself. But a second role, equally important, is to motivate people to work who simply have no need to.

One of his conditions when he purchases control of a company is that the existing owners stay on to manage it. Now independently wealthy, with lots of Berkshire Hathaway stock or cash in the bank, the previous owners continue to work as hard as ever, sometimes for decades—to make money for Buffett instead of themselves!

Part of his success is in choosing to only do business with people who simply love their work the way he does.

And part of it is the loyalty he inspires. Richard Santulli, who invented fractional ownership of private jets—and who sold the company he created, Executive Jets, Inc., to Berkshire Hathaway—put it succinctly when he said: “If Warren asked me to do anything, I would do it.”[8]

Such loyalty is rare in today’s corporate world. Yet Santulli’s sentiment would be echoed word for word by most chief executives of Berkshire’s many other subsidiaries. “Buffett’s respectful treatment of his managers has instilled in them an ambition to ‘make Warren proud,’ as one puts it.”[9]

Motivating previous owners to work just as hard *after* they’ve sold their company as they did before is a remarkable feat, one simply not achieved by any other company. By any measure, Buffett is an unsung genius at the art of delegation.

He’s so good at delegating that Berkshire has just fifteen people working at

company headquarters—the smallest by far of any Fortune 500 company. This allows Buffett to focus on what he does best, allocating capital, which as we've seen is Buffett's genius.

How Soros Learned to Delegate

In contrast to Buffett, delegation doesn't come naturally to George Soros. "I'm a very bad judge of character," he admits. "I'm a good judge of stocks, and I have a reasonably good perspective on history. But I am, really, quite awful in judging character, and so I've made many mistakes."[10]

Nevertheless, he recognized early on that the fund could only continue to grow by expanding the staff—and it was over this issue that Soros and Jimmy Rogers split. Soros wanted to expand the team; Rogers did not.

So they agreed on a three-step plan, Soros said. "The first step was to try and build a team together. If we didn't succeed, the second step was to build one without him; and if that didn't work, the third step was to do it without me. And that is what happened."[11]

In 1980 the partnership broke up. Soros was now in complete charge. But instead of building a team, as he had proposed, he ended up running the fund himself.

> I was the captain of the ship and I was also the stoker who was putting the coal on the fire. When I was on the bridge, I rang the bell and said "Hard left," and then I would run down into the engine room and actually execute the orders. And in-between I would stop and do some analysis as to what stocks to buy and so on.[12]

Not surprisingly, by 1981 Soros was breaking under the strain, and he had his first losing year. The fund lost 22.9 percent. Worse, a third of his investors pulled their money out, fearful that Soros had lost his grip.

So Soros stepped back, turning his fund into a "fund of funds. My plan was that I would give out portions to other fund managers, and I would become the supervisor rather than the active manager."[13]

This turned out to be a mistake, partly because Soros was delegating the task he did best: investing. Soros describes the three years that followed as lackluster

ones for the Quantum Fund. But by taking a backseat he was able to recover from a problem he (like all traders) faced, that an investor like Buffett doesn't. It's called "burnout."

Trading is highly stressful. It requires total concentration for extended periods of time. Writing about his experience in 1981, Soros said, "I felt the fund was an organism, a parasite, sucking my blood and draining my energy."[14] He was working like a dog "and what was my reward? More money, more responsibility, more work—and more pain—because I relied on pain as a decision-making tool."[15]

In 1984 Soros took back the helm. Though his experiment in delegation hadn't been fully successful, Soros was rejuvenated and in 1985 the fund was up 122.2 percent.

That was also the year that Gary Gladstein came on board. Now, at last, Soros no longer had to worry about the administrative side of his business.

But Soros kept trying to find a successor to take over his role as chief investor. He finally succeeded when Stanley Druckenmiller joined him in 1988. When Druckenmiller was introduced to Soros's son Robert, he was informed that he was "number nine, my father's ninth successor."[16] As Soros wrote:

> It took me five years and a lot of painful experiences to find the right management team. I am pleased that finally I found it, but I cannot claim to be as successful in picking a team as I have been in actually managing money.[17]

Druckenmiller ran the Quantum Fund for thirteen years. But for the first year it was far from clear how long he would stay. He had been hired to be captain of the ship, but Soros had great difficulty in letting go.

Then, in 1989, the Berlin Wall collapsed and Soros spent most of the next five months setting up his Open Society Foundations in Eastern Europe. "When I finally heard from him, he acknowledged I had done extremely well," Druckenmiller recalled. "He completely let go and we never had a contentious argument since then."[18]

Though delegation never came easily to Soros, eventually, after many trials and tribulations, he in fact delegated more of his responsibilities than Buffett

has. When Druckenmiller took full charge, says Soros, “we developed a coach-and-player relationship, which has worked very well ever since.”[19] Their relationship was somewhat akin to Buffett’s relationship with the managers of Berkshire’s operating subsidiaries, though far more intense.

And Soros was happy to let the reins go, to focus on his other activities. While Buffett quips that he plans to hold a seánce after his death for his successors. “I will keep working until five years after I die, and I’ve given the directors a Ouija board so they can keep in touch.”[20]

Teamwork

Knowing how to delegate is absolutely essential to investment success—even if you’re not Warren Buffett and you don’t have to figure out what to do with $31 billion in cash.[21]

We normally think of delegation as something to do when, like Soros, we want to find someone to take over from us. But all successful investing is a result of teamwork. As an investor you must delegate …

- when you open a brokerage account, you’re delegating the care of your money and the execution of your orders;
- when you invest in a mutual fund, commodity pool, limited partnership, or managed account you’re hiring a fund manager, so you’re delegating the investment function of decision making and delegating the care of your money;
- whenever you make an investment of any kind, you’re delegating significant (and at those times when the market moves dramatically, total) control of your money to Mr. Market (think about that: would you knowingly hire a manic-depressive money manager?); and
- whenever you buy shares of a company, you’re delegating the future of your money to the management.

Every act of delegation entails *giving up control.* Merely opening a bank account entails giving up control of your money to a group of people you have never met.

Successful delegation means you know what to expect. You know your brokerage account is segregated from the broker’s assets. You know when you give an order to your broker that it will be executed as you specify. You can

hang up the phone and focus on other things—without having to keep tabs on him to see that it's done the way you want.

The Master Investor delegates authority, but he never delegates responsibility for delegating a task to someone else. "If you picked the right man, fine, but if you picked the wrong man, the responsibility is yours—not his."[22]

And the Master Investor always takes responsibility for all the consequences of his actions. To be sure, he has more things to delegate than the average investor. But the rationale is the same: to free up his mind so that he can focus on the things he does best.

21

“Whatever You Have, Spend Less”

“Annual Income, £20; annual expenditure, £19 19s 6d. Result: Happiness. Annual Income, £20; annual expenditure, £20 0s 6d. Result: Misery.”

—MR. MICAWBER IN CHARLES DICKENS’S *DAVID COPPERFIELD*

“Probably the most tangible benefit [of being a billionaire] is that I get very good tennis games.”

—GEORGE SOROS[1]

“Money, to some extent, sometimes lets you be in more interesting environments. But it can’t change how many people love you or how healthy you are.”

—WARREN BUFFETT[2]

BELIEVE IT OR NOT, you can usually tell whether children are going to be wealthy or not by the time they are three or four years old. If they take their pocket money and immediately blow it on candies—and the next day ask to borrow a dollar you know you’re unlikely to ever get back—let’s hope this behavior doesn’t last them a lifetime. Sadly, too often it does.

WINNING HABIT NO. 19:

LIVE FAR BELOW YOUR MEANS

The Master Investor	The Losing Investor
Lives far below his means.	Probably lives beyond his means (most people do).

But if a child is frugal with his pocket money, always putting aside a chunk of it, you can be confident he has a good chance of achieving financial independence as an adult.

And a frugal kid who invests her pocket money in candies to sell to other kids at a profit might become another Warren Buffett.

Aside from inheriting, marrying, or stealing wealth, there's only one way to accumulate investment capital: Live below your means. This is a behavior that both Warren Buffett and George Soros exhibited from an early age. Their achievement of wealth beyond most people's wildest dreams has not changed those core values. They weren't extravagant as children or teenagers; and they aren't now. The leopard doesn't change his spots.

For most of his life Soros has lived in modest accommodations, often almost indifferent to his surroundings. Once a Swiss art dealer loaned Soros a Paul Klee painting he could easily afford. "He loved it, but sent it back saying he could not separate the painting from the figure on its price tag."[3]

When he married his second wife, Susan Weber, "he sent me out to look for apartments," she said. "Every apartment I show him he turns down. It's too expensive, he says, or it's too big."[4]

Some billionaires insist on traveling around in a chauffeur-driven limousine. Not Soros. He'd grab a taxi, ride a bus, take a tram, or simply walk from one part of town to another. It was never a matter of saving money, just getting there the most efficient way.

Reflecting on his own wealth, Soros once said: "A benefit of being successful was that I could afford the things I wanted, but I did not have extravagant tastes. I always lived on a scale that was more modest than my financial resources."[5]

The Extremist of Omaha

Stories about Buffett's frugality (some call it miserliness) are legion. One day Warren Buffett was riding the elevator up to his office on the fourteenth floor and there was a penny on the floor. None of the executives from construction conglomerate Peter Kiewit Sons, riding in the same elevator, took any notice.

Buffett leaned over, reached down and picked up the penny.

To the Kiewit executives, stunned that he would bother with a penny, the fellow who would one day be the richest person in the world quipped, "The beginning of the next billion."[6]

Buffett is an extremist on the subject of money. And nowhere is his extremism more evident than when it comes to spending it.

Or, to be more accurate, *not* spending it.

The basis of his frugality is his future orientation. When he spends a dollar—or scoops a dime off the street—he's not thinking of *today's* value of that money. He is thinking about the value that money could become.

For Buffett thrift isn't just a personal virtue but an integral aspect of his investment method. He admires managers like Tom Murphy and Dan Burke (of Capital Cities/ABC) who "attack costs as vigorously when profits are at record levels as when they are under pressure."[7] He was a fan of Rose Blumkin, whose motto was "Sell cheap and tell the truth,"[8] long before he bought her business, the Nebraska Furniture Mart. She cut costs so ruthlessly that she drove her competitors out of business. Major national furniture chains simply avoid Omaha because they know they cannot compete.

Buffett loves managers who ensure their companies live below their means. While Buffett and Charlie Munger were accumulating stock in Wells Fargo, they found out that Carl Reichardt, the bank's chairman, had told an executive who wanted to buy a Christmas tree for the office to buy it with his own money, not the bank's.

"When we heard that, we bought more stock,"[9] Munger told shareholders at the 1991 Berkshire annual meeting.

Frugality is a natural aspect of both Buffett's and Soros's characters. As their wealth increased, both indulged in minor extravagances. Minor compared to their wealth. Buffett bought an executive jet he named *The Indefensible.* Aside from his apartment in Manhattan, Soros owns a beach house on Long Island, a country home in upstate New York, and a house in London.

But wealth didn't change their natural frugality. It's easy to see how the consequence of living below your means is important when you're starting out. It's the only way you can accumulate capital to invest. What's less obvious is how this mental habit remains crucial to your investment success even after your net worth has soared into the billions.

Very simply, without this attitude to money you won't keep what you have

earned. Spending money is simple—anyone can do it. Making money is not. That's why living below your means is the attitude that underlies the *foundation* of the Master Investor's success: preservation of capital.

By keeping what he has, and adding to it by living below his means, the Master Investor lets his money compound indefinitely. And compound interest plus time is the foundation of every great fortune.

Most people want to be rich so they can fly first class, live it up in the Ritz, feast on champagne and caviar, and go shopping at Tiffany's without giving a second thought to their credit card bill.

The problem is that people who have this attitude to money don't wait until they're rich before they start indulging their fantasies, even if only on a small scale. As a result they never accumulate any capital, or even worse go into debt so they can live *beyond* their means … and remain poor or middle-class.

Wealth is really a state of mind. In the words of Charlie Munger: "I had a considerable passion to get rich. Not because I wanted Ferraris—I wanted the independence. I desperately wanted it."[10] If you share this attitude, once you have gained that hard-fought independence the last thing you're going to do is jeopardize it by blowing all your money.

The alternative to living below your means is the debt-laden pattern of the middle class: If compound interest isn't working for you, it's working *against* you, bleeding your money away just as a spurting artery drains your life energy.

22

"We Should Pay to Have This Job"

Asked what he would do if he did retire, Mr. Rupert Murdoch, chairman of News Corp., responded: "Die pretty quickly."[1]

—*TIME*

"I'll keep [investing] as long as I live."

—WARREN BUFFETT[2]

BOTH WARREN BUFFETT AND GEORGE SOROS have so much money they don't need to get out of bed in the morning if they don't want to. What motivates them to keep making more money when, given their frugal natures, they couldn't possibly ever spend what they have? What drives them?

There are two kinds of motivation: "away from" and "toward."

Someone may be motivated to become wealthy from a fear of being poor. This is an "away from" type of motivation.

So what happens when he has achieved some level of wealth? Having moved away from poverty, the motivation no longer has the power to direct his actions, so he stops.

WINNING HABIT NO. 20:

IT'S NOT ABOUT THE MONEY

The Master Investor	The Losing Investor
Invests for stimulation and self-fulfillment—*not* for money.	Is motivated by money; thinks investing is the way to easy riches.

"Away from" motivations can be very, very powerful. If you're walking through the jungle and you're suddenly confronted by a tiger, then fear will cause you to run like hell. But once you have achieved safety, there's no reason

to run anymore.

This kind of motivation is like a battery stamped with a "use by" date. After then, it's dead; its power has run out. This kind of motivation won't stir you to pursue a goal over an extended period, like a lifetime.

The exception is when such a motivation is associated with a character-shaping event in one's formative years. This seems to be the case for both Buffett and Soros.

Like most people born in the 1930s, the Great Depression had a lasting impact on the young Warren Buffett, who saw his father lose everything.

The Nazi occupation of Hungary had a far deeper impact on the young George Soros, who even today, with billions of dollars at his disposal, talks about survival as "an ennobled value." In his introduction to *The Alchemy of Finance* he wrote: "If I had to sum up my practical skills, I would use one word: *survival*."[3]

Soros's driving "away from" motivation can explain what he does when he goes to the office, but it isn't enough of a force to keep sending him there every morning when survival is no longer a real issue.

For that, you need a motivation that pulls you *toward* some goal. And if that is a fixed goal, such as becoming a millionaire, or running a four-minute mile, then once achieved it will lose its pulling power.

But if you are inspired by what you do, then any money you make while pursuing your goals is merely a side effect.

Warren Buffett's motivation is easy to understand: He just wants to have fun. "There is no job in the world more fun than running Berkshire and I count myself lucky to be where I am."[4]

Fun to him is "tap dancing" to his office every day, reading piles of annual reports, working with "sensational people," and "making money and watching it grow."[5] As he says:

> "I think if you found an athlete that was doing well—and I'm not comparing myself—but a Ted Williams or an Arnold Palmer or something—after they have enough to eat, they're not doing it for the money. My guess is that if Ted Williams was getting the highest salary in baseball and he was hitting .220, he would be unhappy. And if he was getting the lowest salary in baseball and batting

> .400, he’d be very happy. That’s the way I feel about this job. Money is a byproduct of doing something I like doing extremely well.”[6]

Money is just the way Buffett can measure how well he’s doing what he loves to do.

“We [Charlie and I] should pay to have this job,”[7] he once told shareholders. Given that his salary is a mere $100,000 per year, in a very real sense he does. If Berkshire were a regular mutual fund that charged a one percent management fee, on $77.6 billion[8] in assets Buffett would be getting $776 million a year. That’s quite a haircut.

“There Is More to My Existence Than Money”

Like Buffett, Soros is interested in money “in the same way that a sculptor must be interested in clay or bronze. It was the material in which I worked.”[9] Like the sculptor, his focus isn’t on the material but on the outcome.

He is indifferent to money itself. Talking about his father’s influence he noted that “part of what I learned was the futility of making money for money’s sake. Wealth can be a dead weight.”[10]

But Soros’s primary motivation for investing is very different from Buffett’s. He doesn’t agree with Buffett that investing is fun. “If you’re having fun, you’re probably not making any money,” he says. “Good investing is boring.”[11]

Investing isn’t his calling, as it is Buffett’s. As a student, Soros imagined himself becoming a famous *intellectual* figure like Keynes, Popper, or even Einstein. It’s this ambition that still drives him today.

He describes the first years of his career as a hedge fund manager as “a very stimulating and dynamic period” as he began using his philosophical ideas in the real world. “This is when I started elaborating my concept of boom and bust reflexivity. This is when the philosophy took on a practical application.”[12]

As he wrote in *The Alchemy of Finance:*

> In the first ten years of my business career … selling and trading in securities was a game I played without putting my true self on the line.
>
> All this changed when I became a fund manager. I was putting all my money where my mouth

> was and I could not afford to dissociate myself from my investment decisions. I had to use all my intellectual resources and I discovered, to my great surprise and gratification, that my abstract ideas came in very handy. It would be an exaggeration to say that they accounted for my success; but there can be no doubt that they gave me an edge.[13]

He discovered that the investment marketplace was the perfect arena to test his ideas. He imagined that by proving his ideas in the real world he would be recognized as a philosopher of note.

This was (and remains) a vain hope—if only for the reason that the majority of academic philosophers deny that the real world even exists! And as for testing philosophical ideas in the real world, that's just not the way to impress academics.

Of course, some of Soros's writings (such as *The Alchemy of Finance*) are so opaque that few people can really grasp them. So it's no surprise that academics ignore him completely. Not that many investment professionals can understand what he's trying to get at either.

But Buffett has hardly suffered a better fate in academia, even though his writings are crystal clear, his method of investing is far easier to grasp, and his philosophy is derived from the most famous investment academic of all time: Benjamin Graham.

To be fair, we should add that Graham's ideas don't get much more attention in academia these days than Buffett's, despite Graham's superior academic credentials. One possible reason: Like Soros, Graham drew his investment philosophy from—and tested it in—the real world. Successfully.*

At heart Soros is a thinker, not an investor. His primary satisfaction comes from proving his ideas in the marketplace. "It's the adventure of ideas that attracts me,"[14] he says. "I was also inspired by the fact that I was able to combine the two great abiding interests in my life: philosophical speculation and speculation in financial markets. Both seemed to benefit from the combination: Together, they engaged me more than either one on its own."[15]

Like most people who have accumulated wealth, Soros began giving some of it away. But his method is unique. He didn't write a check to a charity or simply endow a foundation. He established his Open Society Foundations as tools for

applying his philosophical ideas in the political and social arenas. “Being rich,” he once said, “enabled me to do something I really cared about.”[16]

Whether he is making money or giving it away, what drives Soros is ideas. As he says himself:

> The main difference between me and other people who have amassed this kind of money is that I am primarily interested in ideas, and I don’t have much personal use for money. But I hate to think what would have happened if I hadn’t made money: My ideas would not have gotten much play.[17]

He also acknowledges that if he hadn’t become famous as the Man Who Broke the Bank of England, it’s unlikely there’d be much interest in any of the books, such as *The Crisis of Global Capitalism*, he has published.

He’s still motivated by his childhood dream to be remembered as an influential thinker like Keynes or Popper. “I wish I could write a book that will be read for as long as our civilization lasts,” he writes.[18]

> I would value it much more highly than any business success if I could contribute to an understanding of the world in which we live or, better yet, if I could help to preserve the economic and political system that has allowed me to flourish as a participant.[19]

A major reason both Soros and Buffett have accumulated so much money is that it was never their primary aim. If money was the motivating factor they would have stopped long before they were billionaires. Indeed, Buffett himself says he had quite enough money to retire on in 1956 before he even started his investment career.

When Soros burned out in 1981, he was already worth $25 million. Even so, he had not achieved what he wanted to do in life.

Both Master Investors were inspired to keep moving by a combination of powerful “away from” *and* “toward” motivations that still drive and inspire them in their seventies. As a side effect, they accumulated great wealth. For them, making money is a means to an end, not an end in itself.

25

"Eat Your Own Cooking"

"I manage [the Quantum Fund] as if it were my own money—which it is to a large extent."

—GEORGE SOROS[1]

"AROUND HERE, WE EAT OUR own cooking," says Warren Buffett about where he puts *his* money. Ninety-nine percent of his net worth is in Berkshire Hathaway stock.

Buffett has the lowest salary of any CEO of any Fortune 500 company, just $100,000 per year. Not much more than a wet-behind-the-ears graduate with a freshly minted MBA from Harvard gets for his first job. As Berkshire pays no dividends, that's the only money he takes home. Unless he were to sell some Berkshire stock, which is the last thing he wants to do.

So if he needs more spending money, what does he do? Applying the same methodology that made him a billionaire, he buys stocks in his personal account —taking advantage of opportunities too small to make a difference to Berkshire's net worth; selling something when he needs a little extra cash.

WINNING HABIT NO. 23:

PUT YOUR NET WORTH ON THE LINE

The Master Investor	The Losing Investor
Puts his money where his mouth is. For example, Warren Buffett has 99 percent of his net worth in shares of Berkshire Hathaway; George Soros, similarly, keeps most of his money in his Quantum Fund. For both, the destiny of their personal wealth is identical to that of the people who have entrusted money to their management.	Adds little to his net worth through investments—indeed, his investment activities are often hazardous to his wealth. Funds his investments (and makes up his losses) from somewhere else—business profits, salary, pension funds, company bonus plans, etc.

Similarly, Soros has nearly all his net worth in the Quantum Fund. Soros Management receives a 20 percent share of the fund's profits. If this fee is paid in kind—in shares of Quantum rather than cash—no tax is due until those shares are sold. So, before he started using his wealth to fund his Open Society Foundations, Soros personally owned some 40 percent of his Quantum Fund.

With the bulk of their wealth in Berkshire and Quantum, respectively, Buffett and Soros are no different from any entrepreneur: Bill Gates has most of his net worth in Microsoft stock; Rupert Murdoch's money is in News Corp.; Michael Dell's fortune rests in his shares of Dell Computer. Similarly, millions of businessmen around the world you have never heard of, both big and small, have most of their net worth tied up in their own companies.

There's nothing controversial about that. Indeed, you'd expect to find successful businessmen with most of their net worth in their own business. That's where they know how to make money more easily than anywhere else. That's what they love to do.

In Investment Guru Land

But the moment you walk into Investment Guru Land it's a totally different story. You'll find that the investment guru who eats his own cooking is the exception, not the rule.

And this signals the major difference between the Master Investor and the

investment guru. The Master Investor is an investor. The investment guru is a fortune seller. Whether he or she is a fund manager, a newsletter writer, a brokerage house analyst, or a financial advisor—selling *opinions,* not profitable investing, is what it's all about.

And where does the media guru put his or her own money? Good question. One you should ask, especially when you're looking for someone to manage your money.

The investment guru who doesn't eat his own cooking may be entertaining to watch on TV. But if what he's really saying is "Do what I say, not what I do," why on earth would you want to follow his advice or hire him to look after *your* money? (Though it's worth remembering that just because someone *is* following his own advice, it doesn't automatically mean that he's banking any profits.)

Every Master Investor puts his money where his mouth is for the same reason the successful businessman has his net worth tied up in his own business. Investing *his* way is the easiest way he knows to make money. And it's what he loves to do.

How much of your net worth is backing *your* investment strategy? Your answer is the best index of your own confidence in what you are doing.

26

Do You Need to Be a Genius?

"Warren may be as near to a genius at investing as I have observed."

—PAUL A. SAMUELSON[1]*

"It was really to your benefit to talk to him [Soros] about it because he was smart."

—ALLAN RAPHAEL[2]

"He [Buffett] is the smartest man I have ever met, by a long shot."

—RICH SANTULLI[3]

CLEARLY, BOTH SOROS AND BUFFETT exhibit the hallmarks of genius. Both are investment pioneers; both developed their own original investment methods and applied them with outstanding success. Both are inventors and innovators, and could be considered the investment equivalents of Thomas Edison and Alexander Graham Bell.

Does this mean there should be a twenty-fourth Winning Habit: Be a Genius?

Perhaps—if you want to do *everything* that Buffett and Soros did, including inventing or perfecting an entirely new investment method.

But even if you do need to be a Thomas Edison to invent the lightbulb, you don't need to be a Thomas Edison to switch one on. Or to make one—after the genius has blazed the trail for the rest of us to follow. For investors, that trail is laid out in the mental habits and strategies that Buffett, Soros, and other Master Investors all follow religiously.

As Buffett says, "You don't need to be a rocket scientist. Investing is not a game where the guy with the 160 IQ beats the guy with the 130 IQ."[4]

Buffett and Soros share many other characteristics. They both live in the United States, have similar political opinions (for example, both helped fund

Hillary Clinton’s Senate bid), are male, wear glasses, and are married to women named Susan. None of these is relevant to their investment success.

Intriguingly, they have one other thing in common: Neither has passed any of the many securities industry exams that employees of Wall Street firms are routinely required to take.

When Buffett became CEO of Salomon Brothers in 1991, “there was also a rule that because I was an officer of a securities firm I had to take the Series 7 exam [for stockbrokers],” he recalls. “I kept delaying it until I left because I wasn’t sure I could pass it.”[5]

Earlier in his career, Soros actually took such an exam—and failed it miserably.

> “There came a point when they introduced a certificate for security analysts, a sort of professional qualification. After avoiding it for a while I sat for the exam and I failed in every conceivable topic. At that point I told my assistant that he had to take it and pass it. As I understood it, the importance of the certificate would not start to matter for another six or seven years and by that time I would either be so far ahead that I wouldn’t need it, or I would be a failure, in which case, I also wouldn’t need it.”[6]

When the world’s two greatest investors fail or are afraid they’d fail such professional exams, one wonders what the true value of these qualifications is. If neither Buffett nor Soros has them, you certainly don’t need them to achieve investment success. What you do need to do is follow the same mental habits and strategies as Warren Buffett and George Soros.

PART TWO

Making the Habits Your Own

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What Are *You* Going to Measure?

"If you can't measure it, you can't control it."

—MEG WHITMAN, CEO EBAY[1]

THE LINK BETWEEN YOUR INVESTMENT philosophy, your investment method, and your investment system is your investment criteria.

From all possible good investments in your investment niche, how do you know when you have found one to buy? What makes a home run stand out from the others? It will be one that meets all your investment criteria—a detailed checklist of the characteristics of what you have defined as a good investment, against which you can measure the quality of any particular investment.

As you'll recall, Buffett is measuring the characteristics of a good business, including the quality of the management, the nature of its franchise, the strength of its competitive position, its pricing power, its return on equity—and, of course, its price. While Soros is measuring the quality of his investment hypothesis against events as they unfold.

Your investment criteria are the features of an investment in your chosen niche that you can measure *today* which you know will consistently make you profits over time.

Your investment criteria give you six crucial elements of your investment system: what to buy, when to buy it, when to sell it, how much to pay, how to gauge whether everything is on track once you have invested—and what to focus on when you're searching for investments. So you need to specify them in as much detail as you can.

Your Margin of Safety

As we saw in chapter 6, "You Are What You Measure," a complete investment system has twelve elements. They are all bound together by the Master Investor's highest priority: preserving capital. His method of preserving capital is to avoid risk (Habit No. 2). He accomplishes this aim by embedding his preferred method of risk control into all aspects of his system.

Buffett's primary risk-control method is to always have what he calls a "margin of safety." Although this term has become associated with Benjamin Graham and Warren Buffett, in fact *every* successful investor has his own version of the margin of safety: It's the way he minimizes risk.

You may decide to be like Soros and discipline yourself to get the hell out the minute you find yourself in uncharted waters—sell first and ask questions later. Or you may use an actuarial approach to risk control.

Whatever margin of safety you choose, for it to work it must be one of the foundations upon which your system is built—and be woven into your system's rules.

Applying Your Criteria

The Master Investor treats investing like a business. He doesn't focus on any single investment but on the overall outcome of the continual application of the same investment system over and over and over again. He establishes procedures and systems so that he can compound his returns on a long-term basis. And that's where his mental focus is: on his investment process (Habit No. 21).

Once you're clear what kind of investments you'll be buying, what your specific criteria are, and how you'll minimize risk, you need to establish the rules and procedures you'll follow to gain the Master Investor's long-term focus.

The first step is to plan the structure of your portfolio. Will you be buying stocks? Stocks and options? Futures? Writing puts or calls, or using spreads or straddles? Investing in real estate? Is your focus on commodities, currencies, or bonds? Or would you prefer to delegate investment decision making to carefully selected money managers? These are just a few of the many possibilities you can

choose from.

Having made those decisions (which, of course, might be blindingly obvious from identifying your investment niche) you need to define other elements of your system before you leap into the market.

Will you use leverage? If you're going to invest in futures, you may think you'll automatically be using leverage.

Not so. The use of leverage must always be a conscious and preplanned decision. If you keep the full face value of a futures contract in the account, your margin is 100 percent, the same as paying cash for a stock.

Although both Soros and Buffett use leverage, they are both cash-rich. I advise you to follow their example, focusing on the "cash-rich" part, at least until (like them) you have reached the stage of unconscious competence in your investing.

Even then, if you use leverage, follow the Master Investors' example and use it sparingly. (And *never* meet a margin call.)

How are you going to minimize the impact of taxes and transaction costs? Master Investors focus on the long-term rate of compounding. One way they improve that rate is (as we've seen—Habit No. 6) to construct their system in a way that minimizes the taxes which need to be paid and keeps transaction costs as low as possible.

There are many different ways to achieve this. Some depend on the kinds of investments you make or on the period you plan to hold them. Where you live and where your investments are kept is another factor. If, like me, you're an extremist on this subject, you might consider arranging your affairs so you're liable for hardly any taxes at all.

Whatever your situation, you should use all available means to defer or reduce taxes so that your money can compound tax-free for as long as possible. By doing so, you'll harness the power of compound interest to add several percentage points to your annual rate of return—without having to make a single investment decision.

What do you need to delegate? Unless you have a banking license and a seat on the stock (or commodity) exchange, you're going to need to delegate some of

your investment functions.

Few people think of opening a brokerage or bank account as an act of delegation. But it is: You're hiring someone (do you know who they are?) to look after your money. Will it be there when you want it? (Banks and brokerage companies do go bust. Okay, you're insured … but how long will it take you to get your money back?) Will you get the service and execution capabilities you require?

The wealthier you are and the more complex your affairs, the more delegation you'll have to do (Habit No. 18). You may need to choose lawyers, accountants, tax advisors, trust companies, and other advisors.

When you buy, how much are you going to buy? When the Master Investor finds an investment that meets his criteria he buys as much as he can. His only limit is the money he has available. As a result, his portfolio is concentrated, not diversified.

By specializing in your investment niche, all your investments will come from the same category. You have already thrown the mainstream version of diversification out the window (Habit No. 5).

Nevertheless, regardless of your investment approach you will need to establish rules for what's called "position sizing." In other words, how much of your portfolio are you going to put into each individual investment? If the amount varies between different investments, why?

In a sense, position sizing boils down to gaining confidence in what you are doing. Once you reach the point of knowing your kind of bargain the moment you see one, you'll be both happy and comfortable to go for the jugular.

How will you protect your portfolio against systemic shocks such as market panics? When the founders of Long-Term Capital Management developed their system, they dismissed what they called ten-sigma events as so statistically improbable that they weren't worth worrying about.

When the Asian financial crisis of 1997 was quickly followed by the Russian debt default of 1998, LTCM was hit by two ten-sigma events in a row—and blew up.

Ten-sigma events may be improbable, but that doesn't mean they're

impossible. The Master Investor has structured his portfolio and investment strategy so that he will survive even the most extreme market conditions.

If the market collapses overnight, will you live to invest another day? You have to structure your system so that the answer to this question is yes!

The first thing to do is to acknowledge that anything can and will happen in the markets. Generate several worst case scenarios in your mind. Then ask yourself: If any of these things happened, how would you be affected—and what would you *do?*

As we've seen, one of Soros's protections against such systemic risk is his ability to act instantly, as he did in the crash of 1987 when even most investment professionals simply froze up.

The Master Investor's primary protection—and this is true for both Buffett and Soros—is their judicious use of leverage. Every time the market crashes we hear stories of people who lose their shirt because they were overleveraged. The Master Investor simply doesn't get himself into this position. You should follow his example—even if this means flouting yet another standard Wall Street maxim: Be fully invested at all times.

Hire a Master Investor?

"The average trader should find a superior trader to do his trading for him, and then go find something he really loves to do."

—ED SEYKOTA[2]

To judge by the amount of money in mutual funds and with professional investment managers, the majority of people delegate the entire investment process to others.

This is a perfectly legitimate option. Investing takes time and energy, and for many of us that time and energy can be better invested somewhere else.

If this is your choice, you can still achieve superior investment returns by taking Ed Seykota's advice and finding a successful investor to do your investing for you.

But how to judge whether a money manager is likely to be successful or not? Find a person who follows the 23 Winning Investment Habits.

It's also important to find someone whose investment style is compatible with your personality. For example, Warren Buffett is obviously extremely comfortable having Lou Simpson manage GEICO's investments. That's because they share the same investment philosophy and method. By the same token, you could imagine that Buffett wouldn't sleep very well at night if he gave money to

a commodity trader—or even to George Soros himself.

To successfully delegate the task of investing means you must be clear about your own investment philosophy and preferred style. Only then can you find someone who will manage your money in the same way you would like to do it yourself.

At the very least, you need to be able to identify whether the manager has a clear investment philosophy; a complete investment system; whether the system follows logically from the philosophy; whether he's good at "pulling the trigger"—and whether he "eats his own cooking."

Most investors choose their money managers or mutual funds by looking at their track record or by following their broker's or friends' recommendations, or they are seduced by a good marketing story. None of these methods has any relationship to a manager's long-term performance. Evaluating managers by determining how closely they follow Buffett's and Soros's mental habits and strategies is virtually guaranteed to improve your investment returns.

How are you going to handle mistakes? The Master Investor makes a mistake when he doesn't follow his system, or when he has overlooked some factor that, once taken into account, means he shouldn't have made that investment.

Like the Master Investor, you need to recognize when you may have strayed from your system and be awake to factors you might have overlooked. When you realize you have made a mistake, admit it and simply get out of your position (Habit No. 14).

Then review what led you to commit that error—and learn from it (Habit No. 15). Focus on what is under your control—your own actions.

If you're like most people, the hardest aspects of learning from your mistakes are being willing to admit them, and then to be self-critical and to analyze your mistakes objectively.

If you overlooked something, how did that happen? Was some information "too hard" to dig up? Was it a factor you'd not appreciated the importance of before? Did you act too quickly? Were you too trusting of the management? There are a host of such errors that can be made, and the only thing you can be sure about is that you're going to make them. Don't take it personally; like the Master Investor, just be sure you won't make the same mistake again.

If there was some system rule you didn't follow, then you weren't following your system religiously (Habit No. 13). Again, analyze why. Did you follow

your heart, not your head? Did you break this rule knowingly? Did you hesitate too long?

This kind of problem should only crop up when you first set out to apply your system. It may just be that you're at the beginning of the learning curve—or it could be that the system you have devised, or parts of it, aren't truly compatible with your personality.

What's crucial is that you have the mental attitude of accepting your mistakes and treating them as something to learn from.

Keep Your Powder Dry

Cash is a drag on your portfolio, says the conventional wisdom. Its returns are low and often negative after inflation and taxes.

But cash has a hidden embedded option value. When markets crash, cash is king. All of a sudden assets that were being traded at five and ten times the money spent to build them can be had for a fraction of their replacement cost.

Highly leveraged competitors go bankrupt, leaving the field free for the cash-rich company.

Banks won't lend money except to people who don't need it—such as companies with AAA credit ratings and people with piles of money in the bank.

In times like these the marketplace is dominated by forced sellers who must turn assets into cash regardless of price. This is when the investor who has protected his portfolio by being cash-rich is rewarded in spades: people will literally be beating a path to his door to all but give away what they have in return for just a little bit of that scarce commodity called cash.

What are you going to do when your system doesn't seem to be working? There may be times when you lose money—even though you have followed your system religiously and you're as certain as you can be that you have overlooked nothing.

It's important to realize that some investment systems can and do stop working. If this appears to be the case, the first thing to do is to exit the market completely.

Sell everything. Step right back and review every aspect of what you have been doing—including your investment philosophy and investment criteria.

Maybe something has changed. Perhaps it's you. Have you become less

dedicated? Is your motivation still high? Have your interests changed? Are you distracted by some other problem such as divorce or a death in the family? Or are you simply stressed out?

More often, the cause of the change is external. Maybe your tiny niche has been invaded by Wall Street institutions loaded with capital and the margins that were once profitable have become too thin to sustain you.

The Complete System

A complete investment system has detailed rules covering these twelve elements:

1. What to buy
2. When to buy it
3. What price to pay
4. How to buy it
5. How much to buy as a percentage of your portfolio
6. Monitoring the progress of your investments
7. When to sell
8. Portfolio structure and the use of leverage
9. Search strategy
10. Protection against systemic shocks such as market crashes
11. Handling mistakes
12. What to do when the system doesn't work

An exercise that will help you build your system is to photocopy the table here—which shows Buffett's and Soros's rules for each of these twelve elements—and add an extra column: *Me*.

You may be able to fill out some of the fields already. You'll know you system is complete when you can fill out all twelve.

Markets can become more efficient. Is the inefficiency you were exploiting no longer there?

Have you changed your environment? Floor traders who move to screen-based trading are often surprised to discover that the system that made them money on the floor of the exchange depended upon cues such as the noise level on the trading floor or the body language of other traders. Missing those cues, they are forced to develop a different approach to regain their feel for the market.

Have you been so successful you have just got too much money to handle? That is a factor that affected both Buffett and Soros. It's a "problem" we can all hope to have.

By considering all of these issues you'll create an investment system that is unique to you. By taking the time to cover every one of the twelve elements in detail, you will ensure that your system is *complete.*

The Master Investor's Benchmarks

Before beginning to test your system you must establish a measure that will tell you whether or not it is working. The first test, obviously, is whether or not it makes you money. But is that enough?

If your system is profitable, you'll be getting a return on your capital. But will you also be getting an adequate return on all the time and energy you have to devote to implementing your investment strategy?

The only way to tell is to compare your performance to a benchmark.

Buffett and Soros measure their performance against three benchmarks:

1. Have they preserved their capital?
2. Did they make a profit for the year?
3. Did they outperform the stock market as a whole?

The importance of the first two is obvious. The third benchmark tells you if you're being paid for your time; whether your system is paying you more than, say, just investing in an index fund—or leaving your money in the bank.

The benchmarks you choose will depend on your financial goals, and how you value your time. There is no "one-size-fits-all." But only when you have established your benchmark can you measure whether your system is working or not.

Intelligent Diversification

Master Investors spurn diversification (Habit No. 5) for the simple reason that diversification can never result in above-average profits (as we saw in chapter 7).

But if all you want to do is preserve your capital, *intelligent* diversification is a perfectly valid option. “When ‘dumb’ money acknowledges its limitations,” says Buffett, “it ceases to be dumb.”[3]

Diversification may seem like a simple and obvious strategy. But it is no more than a method to achieve certain goals. So those goals must first be defined. Only then can you build a system that will meet them.

The Wall Street wisdom is to put X percent of your portfolio into bonds, Y percent into stocks, and Z percent into cash—with stock market investments further diversified into a variety of categories from so-called conservative “widow and orphan” stocks to high-risk “flavor of the month”–type stocks.

But the aim of this strategy isn’t to preserve capital (which it may) but to reduce the risk of loss. These are two quite different objectives.

I’ve only seen one well-thought-out investment strategy that successfully applies diversification to the aim of not just preserving capital, but increasing that capital’s real purchasing power over time. It was developed by Harry Browne, who named it the Permanent Portfolio. Its purpose, he says, “is to assure that you’re financially safe no matter what the future brings.”[4]

Browne started from the premise that it’s impossible to predict the future price of any investment. But it is possible to foresee the impact of different economic conditions on different classes of assets. For example, when inflation is high the price of gold usually rises, while the higher interest rates that usually accompany rising inflation push down the prices of long-term bonds. During a recession, however, interest rates usually fall, so bonds rise, sometimes skyrocketing, while gold and stocks tend to fall in value.

Browne identified four different classes of investments, each “a cornerstone of a Permanent Portfolio because each has a clear and reliable link to a specific economic environment.”[5]

Stocks, which profit in times of prosperity;
Gold, which profits when inflation is rising;
Bonds, which rise in value when interest rates fall; and,
Cash, which provides stability to the portfolio and gains in purchasing power during deflation.

With 25 percent of the portfolio in each category, at almost any time the value of one of those categories will be rising. There will, of course, be occasional periods when everything is stagnant. But those times are rare.

The key to making the Permanent Portfolio work is volatility. By choosing the most volatile investments in each category, the profit on just one quarter of the portfolio’s assets can more than compensate for any declines in the other categories. So Browne recommends investing in highly volatile stocks, mutual funds that invest in such stocks, or long-term warrants for the stock market portion of the portfolio. By the same reasoning, he advises holding thirty-year bonds or even zero-coupons for the bond portion, as they are far more sensitive to interest rate changes than bonds that mature in just a few years time.

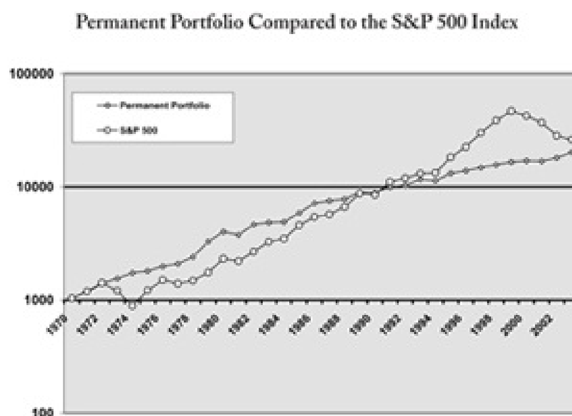
The portfolio can also be diversified geographically to protect against political risk by holding a portion of the gold or cash holdings offshore—in, say, a Swiss bank.

The portfolio only needs to be rebalanced once a year to bring each category back to 25 percent

of the portfolio. For the rest of the year you can literally forget about your money.

The “turnover” of the portfolio is minimal, rarely more than 10 percent a year. So both transaction costs and taxes are kept very low. And in the years that you are earning income, the chances are that you’ll be adding to your portfolio every year. With the Permanent Portfolio approach, that would usually mean buying more of the investments that have fallen in price. So most years you’d only be liable for taxes on interest and dividend income from your bonds, T-bills, and stocks. You would rarely pay any capital gains taxes on your investments until you retire.

The return on this approach is a quite remarkable 9.24 percent per annum (from 1970 to 2002), compared to 10.07 percent per annum for the S&P 500 index. And, as this chart shows, the Permanent Portfolio appears to rise inexorably in value while stocks provide many sleepless nights.



Harry Browne’s Permanent Portfolio is a well-thought-out investment system that applies intelligent diversification to the objective of preserving capital and, indeed, increasing that capital’s purchasing power over time.

Its returns pale by comparison to those achieved by Buffett and Soros. The difference is the amount of time and energy that you must devote to your investments: as little as a few hours per year to successfully manage a Permanent Portfolio, compared to the intensity of time and effort that most other investment systems require.

If you have decided that there are other things you’d rather do in life than worry about your money, intelligent diversification is an option worth considering. You might like to adopt Browne’s Permanent Portfolio approach, or you might prefer to create your own method of intelligent diversification. The important thing is, like Browne’s Permanent Portfolio, the method you use should still meet all the Master Investor’s standards for a complete investment system.

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It’s Easier Than You Think

“What we do is not beyond anybody else’s competence. It is just not necessary to do extraordinary things to get extraordinary results.”

—WARREN BUFFETT[1]

WHEN I MENTIONED TO ONE woman that I was writing this book, she asked me how many Winning Investment Habits there were. When I told her, she exclaimed, “Twenty-three! Why so many? Can’t you make it three?”

I’m afraid not, which may make adopting all the habits seem like a daunting proposition. The good news is that just by adopting a few of them you will immediately see an improvement in your investment results.

That’s what I did. I adopted a kind of cross between Benjamin Graham’s and Warren Buffett’s systems, buying Hong Kong–listed stocks in well-managed companies with low P/Es and high yields. One of these companies turned out to be more poorly managed than I could have ever imagined. It was eventually delisted and I suffered a total loss. But I didn’t take it personally. I learned from the error and moved on.

When everyone else was getting rich in dot-com stocks, I wasn’t tempted. I stuck to my system. Nevertheless, I had one bonus from the Internet boom. I bought shares in a company that rented the exhibition booths at trade shows and the like. One day I noticed that the stock had doubled since I’d last checked the price a week or so before. Unfortunately, I also noticed that a couple of days before it had been even higher.

I did some digging and quickly discovered the stock had soared because the company was having discussions—just talking!—with an American outfit about somehow putting its business onto the Internet. So I immediately called my

broker and told her to dump the stock. It was obvious to me this was like winning the lottery, a windfall gain. Sure enough, a few months later the stock had fallen to less than I'd originally paid for it.

But I can't claim that I have always acted instantly as I did then. Far from it.

I'd owned a stock for a while because it had a 25 percent dividend yield (that is *not* a typographical error). But the company's business fell off as the economy soured and it cut its dividend. This happened while my mental focus was on finishing this book, so I procrastinated for quite some time before selling the stock for far less than I'd have gotten if I'd acted immediately.

Despite my far-from-perfect record in practicing the 23 Winning Investment Habits, I still banked an average 24.4 percent annual return on my Hong Kong stock portfolio for the six years from 1998 to 2003.

But improving your performance isn't the only benefit you can expect from adopting the Winning Investment Habits. You'll also be far more relaxed when making investment decisions. You may even find the process of investing now contributes to your peace of mind rather than being a source of anxiety. You'll no longer view the successes of others with a sense of envy, bewilderment, or self-doubt. Rather, you'll probably react by thinking something like, "Well, that's an interesting way of investing—but it's not for me." You'll no longer be on an emotional roller coaster governed by the manic-depressive changes in Mr. Market's mood.

Indeed, having purged from your mind any belief you may have once had in the Seven Deadly Investment Sins, you'll suddenly realize that 90 percent of what you read in the financial press and hear from talking heads on financial TV programs is totally irrelevant.

The financial media is dominated by the belief that the only way to make money is to predict the market's next move—the First Deadly Investment Sin. Having purged those beliefs from your mind, you may find yourself wondering whether you really need to continue reading the *Wall Street Journal* every day. Or maybe you'll find it a regular source of amusement, as I do—and wonder why you ever wasted your time watching those financial TV channels.

By adopting these habits you'll develop your own way of looking at the

markets, and of doing things, that will separate you once and for all from the investment herd.

AFTERWORD

Where to Get Help

IF YOU WANT TO LEARN more about *Becoming Rich,* I publish an e-mail newsletter that will help you get started and keep going.

Like this book, the newsletter aims to help you practice the Winning Investment Habits yourself. It's available only by e-mail to keep "transactions costs" down—both yours and mine.

To browse some past issues, go to www.marktier.com. You'll find:

- My market commentary—something quite different from what you might expect. For example, don't expect me to make any predictions about the market or give you any advice about what to buy or sell.
- Problems and obstacles other people have had adopting the Winning Investment Habits—and how they solved them. Learning from *other* people's mistakes is a great shortcut to success.
- You'll also have the opportunity to raise your own questions and concerns and get my suggestions on what to do.

Again, to learn more, and browse some past issues, just go to my Web site: www.marktier.com.

I'll also post information there on when and where I'll be giving courses, seminars, and other talks. I'll be offering these all over the world, so there's bound to be something happening somewhere near you soon.

Attention: Money Managers, Financial Advisors, Institutional Investors, and Other Investment Professionals

Readers of this book will turn into very demanding customers. And they'll put you on the spot by asking you all kinds of difficult questions as they decide whether you're really the right people to look after their hard-earned money.

Get a head start—and a jump on your competitors—by getting Mark Tier to help you install a culture of investment excellence in your organization.

And you can also …

Discover *Your* Investment Personality

Compare *your* investment habits to the Master Investors' by taking my unique *Investor Personality Profile* questionnaire. Find out just what you've been doing wrong—and, just as importantly, what you've been doing right.

You'll get a detailed inventory of your investment strengths and weaknesses and personalized advice on what steps you need to take to adopt the Winning Investment Habits—to quickly start to improve your investment performance.

Discover *your* investment personality at www.marktier.com/ipp.htm.

Investment Books Worth Reading

There are thousands of investment books available—with dozens more being issued every month. Some of them are worth reading.

Here are the books that I've found very helpful. They also expand on some aspects of the material in this book.

The Seven Deadly Investment Sins

If you're afflicted by a belief in any of the Seven Deadly Investment Sins, I implore you to read *The Fortune Sellers* by William A. Sherden. Sherden does more than just survey the whole gamut of fortune sellers, from weather forecasters to economists to market gurus. He *measures* their predictions against what he calls the "naïve forecast."

The naïve forecast is simply: Tomorrow's weather will be the same as today's; inflation next year will be the same as it was this year; next year's earnings will be up (or down) *X* percent, just like they were this year. And so on.

Through rigorous analysis, Sherden shows that only one class of forecasters beats the naïve forecast with any regularity: weather forecasters. But only for forecasts for up to four days in the future. And even then, by only a small

margin.

So next time you're tempted to listen to some guru's market prediction, remember that you can beat *any* guru—*on average*—by simply "predicting" that the market will do tomorrow what it did today. Sherden *proves* this in his book.

And in his *Why the Best-Laid Investment Plans Usually Go Wrong,* Harry Browne has a wonderful collection of market and economic forecasts whose authors I'm sure wish they'd never written them.

The Seven Deadly Investment Sins need "powerful magic" to be exorcised—exactly what you'll find in these two books.

Warren Buffett

Books about Warren Buffett are about as scarce as wheat fields in Nebraska. Unless you're a Buffett junkie, the problem is what to read and what *not* to read?

By starting with Roger Lowenstein's biography *Buffett: The Making of an American Capitalist* and then reading *The Warren Buffett Way* by Robert Hagstrom you'll be introduced to both the man and his method.

To hear it straight from the horse's mouth pick up a copy of *The Essays of Warren Buffett,* edited by Lawrence A. Cunningham. These are actually extracts from Buffett's annual letters to his partners and shareholders, organized by topic.

Even better, read Buffett's letters in full. You'll find them, from 1977 to the present, at the Berkshire Hathaway Web site, www.berkshirehathaway.com.

Berkshire Hathaway has also reprinted Buffett's letters to shareholders (1977 to 1995) in two volumes, available for $30 direct from Berkshire Hathaway, Inc., 1440 Kiewit Plaza, Omaha, Nebraska 68131.

If you want to delve deeper into Buffett's method, I can highly recommend *The Real Warren Buffett* by James O'Loughlin.

Andrew Kilpatrick's *Of Permanent Value* is a wonderful compilation of stories and anecdotes about Buffett's experience, his investments, his hobbies, and his outlook on life (plus hundreds of pithy Buffett quips and quotes).

Reading *Buffettology* (by Mary Buffett and David Clark) will help you get a handle on Buffett's investment system. But be warned: The authors oversimplify

and attempt to provide a formula that encapsulates Buffett's stock-picking ability. Oversimplification is a helpful way to *start* learning something. So if you read this book, remember to graduate beyond its formulaic approach before putting your money on the line.

One book you'll do just fine *without* reading is Richard Simmons's *Warren Buffett Step-by-Step: An Investor's Workbook.* Like the authors of *Buffettology*, Simmons attempts to reduce Buffett's system to a formula (and even produces an equation which he doesn't adequately explain). Unlike *Buffettology*, it does not have the redeeming virtue of adding significantly to your understanding of Buffett's methodology.

There are many other books on Warren Buffett—and I think I've read all of them. Here I've recommended the ones I think will allow you to cover the most ground most quickly.

George Soros

Far less, sad to say, has been written about George Soros, no doubt because both the man and his methods are far more complex and less accessible than is the case with Buffett.

The best introduction is Robert Slater's (unauthorized) biography, *Soros: The Life and Times of the World's Greatest Investor.* Slater emphasizes Soros's investment methods and achievements, and it's a great way to gain familiarity with his approach.

A more recent biography, *Soros: The Life and Times of a Messianic Billionaire* by Michael T. Kaufman, was written with full access to Soros and his papers. So it is a far deeper portrait of Soros, the man. And, as you'd expect, there's a lot in Kaufman's book that you won't find in Slater's. Kaufman also had greater access to Soros's Open Society Foundations, so there's more information on his charitable activities.

To really understand Soros's investment methods, it's essential to read his own writings. I suggest you start with *Soros on Soros,* which, given its interview format, is easier to digest than his book *The Alchemy of Finance,* which can be

rough going at times—though definitely worth the effort.

Robert Slater also published a brief volume of what he perceived to be Soros's twenty-four trading secrets, *Invest First, Investigate Later*. Though an excellent summary, much of the material is simply drawn from his biography of Soros.

Other Master Investors

It's worth studying the methods of as many other Master Investors as you can find, especially if you discover that neither Buffett's nor Soros's approach fits you. Here are some suggestions:

Only one book has been written about Carl Icahn: *King Icahn* by Mark Stevens. It's a fascinating journey into his mind and his methods.

Peter Lynch has written about his way of investing in several books, including *One Up on Wall Street* and *Beating the Street.*

Philip Fisher deserves a far higher profile than he has. I urge you to read his book *Common Stocks and Uncommon Profits.*

Benjamin Graham, of course, needs no introduction. His *Intelligent Investor* should be required reading for anyone planning to buy stocks. And if you're really serious, pick up a copy of his classic *Security Analysis* as well.

Bernard Baruch is another legendary investor. James Grant wrote an excellent biography, *Bernard Baruch: The Adventures of a Wall Street Legend.*

A more obscure book that I can highly recommend is *You Can Be a Stock Market Genius* by Joel Greenblatt. The title still turns me off—but the book is well worth reading. It's a wonderful reinforcement of the importance of specializing in your own investment niche.

John Train has several books profiling the methods of successful investors: *The Midas Touch, The Money Masters, The New Money Masters,* and *Money Masters of Our Time.* This is a great way of being introduced to a variety of different approaches, one or more of which you may want to study further.

Sir John Templeton is one of the investors whose methods he analyzed in *The Money Masters* (which is also included in *Money Masters of Our Time*).

Templeton's approach is also examined by Nikki Ross in her book *Lessons from the Legends of Wall Street.*

Investment Gurus by Peter J. Tanous is another useful book surveying a number of different investors.

In *Market Wizards* and *New Market Wizards*, Jack Schwager has done a sterling service by finding and interviewing some of the greatest traders of our generation. Traders talk far more about their systems, methodology, and thought processes than most investors do. As a result, even if the last thing you want to do is buy a futures contract, you'll find these two books of interviews a valuable source of proven ideas for building and testing your own investment system.

Risk and Uncertainty

An understanding of risk and uncertainty is essential for investment success. Simply the best book on this topic I've ever seen is *Fooled by Randomness* by Nassim Nicholas Taleb.

Peter Bernstein has also written a classic on this topic: *Against the Gods: The Remarkable Story of Risk.* Though you'll find this book has more of a historical emphasis, it will also (like *Fooled by Randomness*) open your eyes to the importance of understanding the laws of probability.

Probability

You simply can't be a Master Investor if you don't understand probability. Since a lot of probability theory is counterintuitive, this causes many people problems.

One way to overcome this obstacle is with a book called *Conned Again, Watson* by Colin Bruce. In a series of tales, Sherlock Holmes and his sidekick Dr. Watson solve a variety of crimes and other misdemeanors through Holmes's understanding of the laws of chance. If your reaction to probability is like a kid's reaction to castor oil (you know it's good for you but you can't stand it), here's a sugar-coated solution.

Why Smart People Make Big Money Mistakes (and How to Correct Them) by Gary Belsky and Thomas Gilovich explains how our thought processes are often

flawed when it comes to money and investing. A superficial understanding of probability is often a big part of the problem.

Possibly the best introduction to probability theory—best because it's clearly presented—is *Probability Without Tears* by Derek Rowntree. Unfortunately, it's out of print—but you can probably find a used copy on eBay or Amazon.com.

Trading

If trading, rather than investing, is your calling, Van Tharp's *Trade Your Way to Financial Freedom* is essential reading. Even nontraders can benefit enormously from this book. Tharp is a psychologist who specializes in helping traders overcome their mental blocks. Though designed for commodity traders, most of what Tharp has to say is equally applicable to investors. There's excellent guidance on how to build a system, and an analysis of the importance and significance of position sizing I've not seen anywhere else.

Living Within Your Means

The Richest Man in Babylon by George Clason is the classic on this subject. Give it to your kids (after you have read it yourself).

In *Rich Dad, Poor Dad* Robert Kiyosaki shows how the amount of money you have in the bank is a direct consequence of your beliefs and behaviors. The rich *are* different—because the way they think about money is different.

Kiyosaki does much more than just show you the differences. You'll also learn how you can start thinking about money the same way the rich do—and change your own fortunes as a result.

The Millionaire Next Door by Thomas Stanley and William Danko shows that the one thing millionaires who've *kept* their millions have in common is that they spend less than they earn.

Taxes

I'm no expert on taxes—and I neither need to be nor want to be. All I can say is that you should follow in Buffett's and Soros's footsteps and keep your taxes

(and other transaction costs) as low as possible. So it's essential to gain familiarity with the tax laws that affect you. The approach that I would follow if I were in your shoes is outlined by Terry Coxon in his book *Keep What You Earn.* You can also check www.passporttrust.com and www.yoot.info for details and information.

Transaction Costs

In *Trading Is Hazardous to Your Wealth: The Common Stock Investment Performance of Individual Investors,* a paper published in *The Journal of Finance* (Vol. 4, No. 2, April 2000), the authors Brad M. Barber and Terrance Odean showed that investors who traded stocks actively had, on average, a far lower return than investors who followed a buy-and-hold strategy.

They came to this conclusion by analyzing the performance of 66,465 accounts from a discount brokerage for the period 1991 to 1996. Though somewhat technical, it's well worth reading. It's available in PDF format from http://faculty.haas.berkeley.edu/odean/papers/returns/returns.html

Other Investment Books Worth Reading

For other views on investing from people not directly involved in the industry (including academics) some of the better choices include *A Random Walk Down Wall Street* by Burton Malkiel, *Stocks for the Long Run* by Jeremy Siegel, and *Irrational Exuberance* by Robert Shiller.

Charles Mackay's *Extraordinary Popular Delusions and the Madness of Crowds* is the classic study of how crowd psychology can grab hold of the market.

And I recommend Roger Lowenstein's *Why Genius Failed: The Rise and Fall of Long-Term Capital Management.* Read this so you can avoid making the same mistakes!

The Permanent Portfolio Approach

If you'd like to follow up on Harry Browne's Permanent Portfolio approach to

investing, you'll find it outlined in detail in his *Why the Best-Laid Investment Plans Usually Go Wrong* (mentioned above). Or check out *Fail-Safe Investing*, available from his Web site, www.harrybrowne.org. (You'll also find what I believe is some of the sanest and best-written commentary on current issues you can read anywhere.)

Another option is a mutual fund based on Harry Browne's investment philosophy. It's called the Permanent Portfolio Fund. Call 1-800-531-5142 if you'd like to see a prospectus. (Note: Until 2004 I was an independent director of this fund.)

A Computer Game

Railroad Tycoon is a wonderful computer game that should be issued with a warning: BEWARE: THIS GAME CAN BE ADDICTIVE. I speak with considerable authority on the topic!

You're the CEO of a railroad. Depending on which of the dozens of different scenarios you choose to play, you'll have up to thirty-one computer-generated competitors. You can also play with real competitors over the Internet. It's your job to build your company into the richest, the biggest, or the most profitable of all; carry the most freight; or become the richest player in the game (and, in some scenarios, all of these and more).

Built into the game are economic cycles that go from boom to depression and back (though not always predictably) and the normal constraints that every manager must face between issuing equity, debt, where best to invest (build more track, buy more trains, invest in the industries you serve, take over a competitor), and so on. In your stock market account, you can buy shares in your company—or the competition's. With or without margin.

It's a great teaching tool for teenagers, who can learn about building a business, the economy, and investing without knowing it while they have a lot of fun.

One of the most powerful lessons you can learn from *Railroad Tycoon* is about leverage. It's frightening to see your entire wealth disappear in just

minutes because you were overleveraged and you face a margin call you can't meet—while your company goes bankrupt. But it's a lot cheaper to learn this lesson on a computer than with the help of your friendly stockbroker.

Appendix I

The 23 Winning Investment Habits

The Master Investor	The Losing Investor
1. Preservation of Capital Is *Always* Priority No. 1	
Believes his first priority is *always* **preservation of capital,** which is the cornerstone of his investment strategy.	Has only one investment aim—"to make a lot of money." As a result, often fails to keep it.
2. *Passionately* Avoid Risk	
As a result (of Habit No. 1), is **risk-averse.**	Thinks that big profits can only be made by taking big risks.
3. Develop Your Own Unique Investment Philosophy	
Has developed his own investment philosophy, which is an expression of his personality, abilities, knowledge, tastes, and objectives. As a result, no two highly successful investors have the same investment philosophy.	Has no investment philosophy—or uses someone else's.

The Master Investor	The Losing Investor
4. Develop Your Own, *Personal* System for Selecting, Buying, and *Selling* Investments	
Has developed—and *tested*—his own **personal system** for selecting, buying, *and selling* investments.	Has no system. Or has adopted someone else's without testing and adapting it to his own personality. (When such a system doesn't work for him, he adopts another one—which doesn't work for him either).
5. Buy As Much As You Can	
Does not believe in diversification; always buys as much as he can of an investment that meets his criteria.	Lacks the confidence to take a huge position on any one investment.
6. Focus on *After*-tax Return	
Hates to pay taxes (and other transaction costs) and arranges his affairs to legally minimize his tax bill.	Overlooks or neglects the burden that taxes and transaction costs place on long-term investment performance.
7. Only Invest in What You Understand	
Only invests in what he understands.	Doesn't realize that a deep understanding of what he is doing is an essential prerequisite to success. Rarely realizes that profitable opportunities exist (and quite probably abound) within his own area of expertise.
8. Refuse to Make Investments That *Do Not* Meet Your Criteria	
Refuses to make investments that do *not* meet his criteria. Can effortlessly say "No!" to everything else.	Has no criteria; or adopts someone else's. Can't say "No!" to his own greed.

The Master Investor	The Losing Investor
9. Do Your Own Research	
Is continually searching for new investment opportunities that meet his criteria and actively engages in his own research. Likely to listen only to other investors or analysts whom he has profound reasons to respect.	Is looking for the thousand-to-one shot that will put him on easy street. As a result, often follows the "hot tip of the month." Always listening to anyone styled as an "expert." Rarely makes a deep study of any investment before buying. His research consists of getting the latest "hot" tip from a broker, an advisor—or yesterday's newspaper.
10. Have Infinite Patience	
Has the patience when he can't find an investment that meets his criteria to wait indefinitely until he finds one that does.	Feels that he has to be doing something in the market at all times.
11. Act *Instantly*	
Acts instantly when he has made a decision.	Procrastinates.
12. Hold a Winning Investment Until There's a *Predetermined* Reason to Sell	
Holds a winning investment until a predetermined reason to exit arises.	Rarely has a predetermined rule for taking profits. Often scared a small profit will turn into a loss, so he cashes it in—and regularly misses giant gains.
13. Follow Your System *Religiously*	
Follows his own system *religiously.*	Continually "second-guesses" his system—if he has one. Shifts criteria and "goalposts" to justify his actions.

The Master Investor	The Losing Investor

14. Admit Your Mistakes and Correct Them *Immediately*

Is aware of his own fallibility. Corrects mistakes the moment they become evident. As a result, rarely suffers more than small losses.	Hangs on to losing investments in the hope he'll be able to break even. As a result, often suffers huge losses.

15. Turn Mistakes into Learning Experiences

Always treats mistakes as *learning experiences.*	Never stays with any one approach long enough to learn how to improve it. Always looks for an "instant fix."

16. Pay Your Dues

His returns increase with experience; now seems to spend less time to make more money. Has "paid his dues."	Not aware it's necessary to "pay your dues." Rarely learns from experience . . . and tends to repeat the same mistake until he's cleaned out.

17. Never Talk About What You're Doing

Almost never talks to anyone about what he's doing. Not interested or concerned with what others think about his . investment decisions.	Is always talking about his current investments, "testing" his decisions against others' opinions rather than against reality.

18. Know How to Delegate

Has successfully delegated most if not all of his responsibilities to others.	Selects investment advisors and managers the same way he makes investment decisions.

19. Live Far Below Your Means

Lives far below his means.	Probably lives beyond his means (most people do).

20. It's Not About the Money

Invests for stimulation and self-fulfillment—*not* for money.	Is motivated by money; thinks investing is the way to easy riches.

The Master Investor	The Losing Investor
21. Love What You Do, *Not* What You Own	
Is emotionally involved with (and gets his satisfaction from) the process of investing; can walk away from any individual investment.	Falls in love with his investments.
22. Live and Breathe Investing 24 Hours a Day	
Lives and breathes investing twenty-four hours a day.	Is not fully dedicated to achieving his investment goals (even if he knows what they are).
23. Put Your Net Worth on the Line	
Puts his money where his mouth is. For example, Warren Buffett has 99 percent of his net worth in shares of Berkshire Hathaway; George Soros, similarly, keeps most of his money in his Quantum Fund. For both, the destiny of their personal wealth is identical to that of the people who have entrusted money to their management.	Adds little to his net worth through investments—indeed, his investment activities are often hazardous to his wealth. Funds his investments (and makes up his losses) from somewhere else—business profits, salary, pension funds, company bonus plans, etc.

Appendix II

Records of the Two Master Investors

WARREN BUFFETT'S RECORD: 1956–2002

		Annual Percentage Change[1] in . . .		$1,000 invested in 1956 now worth[1]:	
Year	Net Value of Buffett Partnership/Per Share Book Value of Berkshire[2]	Dow Jones 30 Index/ S&P 500 (dividends included)[3]	Buffett Relative to Index[4]	Dow Jones 30/S&P 500 Index[3]	Buffett Partnership/ Berkshire Hathaway (book value)[2]
1957[5]	9.3%	−8.4%	17.7%	$916.00	$1,093
1958	32.2%	38.5%	−6.3%	$1,268.66	$1,445
1959	20.9%	20.0%	0.9%	$1,522.39	$1,747
1960	18.6%	−6.3%	24.9%	$1,426.48	$2,072
1961	35.9%	22.4%	13.5%	$1,746.01	$2,816
1962	11.9%	−7.6%	19.5%	$1,613.32	$3,151
1963	30.5%	20.6%	9.9%	$1,945.66	$4,112

		Annual Percentage Change[1] in . . .		$1,000 invested in 1956 now worth[1]:	
Year	Net Value of Buffett Partnership/Per Share Book Value of Berkshire[2]	Dow Jones 30 Index/ S&P 500 (dividends included)[3]	Buffett Relative to Index[4]	Dow Jones 30/S&P 500 Index[3]	Buffett Partnership/ Berkshire Hathaway (book value)[2]
1964	22.3%	18.7%	3.6%	$2,309.50	$5,029
1965	36.9%	14.2%	22.7%	$2,637.45	$6,884
1966	16.8%	−15.6%	32.4%	$2,226.00	$8,041
1967	28.4%	19.0%	9.4%	$2,648.95	$10,324
1968	45.6%	7.7%	37.9%	$2,852.91	$15,032
1969[6]	16.2%	−8.4%	24.6%	$2,613.27	$17,467
1970	12.0%	3.9%	8.1%	$2,715.19	$19,563
1971	16.4%	14.6%	1.8%	$3,111.60	$22,772
1972	21.7%	18.9%	2.8%	$3,699.70	$27,713
1973	4.7%	−14.8%	19.5%	$3,152.14	$29,016
1974	5.5%	−26.4%	31.9%	$2,319.98	$30,612
1975	21.9%	37.2%	−15.3%	$3,183.01	$37,316
1976	59.3%	23.6%	35.7%	$3,934.20	$59,444
1977	31.9%	−7.4%	39.3%	$3,643.07	$78,407
1978	24.0%	6.4%	17.6%	$3,876.22	$97,224
1979	35.7%	18.2%	17.5%	$4,581.70	$131,933
1980	19.3%	32.3%	−13.0%	$6,061.58	$157,396
1981	31.4%	−5.0%	36.4%	$5,758.50	$206,819
1982	40.0%	21.4%	18.6%	$6,990.82	$289,546
1983	32.3%	22.4%	9.9%	$8,556.77	$383,070
1984	13.6%	6.1%	7.5%	$9,078.73	$435,168
1985	48.2%	31.6%	16.6%	$11,947.61	$644,918
1986	26.1%	18.6%	7.5%	$14,169.87	$813,242
1987	19.5%	5.1%	14.4%	$14,892.53	$971,824
1988	20.1%	16.6%	3.5%	$17,364.69	$1,167,161
1989	44.4%	31.7%	12.7%	$22,869.30	$1,685,380
1990	7.4%	−3.1%	10.5%	$22,160.35	$1,810,098
1991	39.6%	30.5%	9.1%	$28,919.26	$2,526,897
1992	20.3%	7.6%	12.7%	$31,117.12	$3,039,857
1993	14.3%	10.1%	4.2%	$34,259.95	$3,474,557
1994	13.9%	1.3%	12.6%	$34,705.33	$3,957,520
1995	43.1%	37.6%	5.5%	$47,754.53	$5,663,212
1996	31.8%	23.0%	8.8%	$58,738.08	$7,464,113
1997	34.1%	33.4%	0.7%	$78,356.59	$10,009,376
1998	48.3%	28.6%	19.7%	$100,766.58	$14,843,904
1999	0.5%	21.0%	−20.5%	$121,927.56	$14,918,124
2000	6.5%	−9.1%	15.6%	$110,832.15	$15,887,802
2001	−6.2%	−13.0%	6.8%	$96,379.64	$14,902,758
2002	10%	−22.1%	32.1%	$75,079.74	$16,393,034
2003	21.0%	28.7%	−7.7%	$97,894.36	$19,835,571
47-year compounded annual return		**9.7%**	**23.4%***		

Notes to the Table:

1. Percentage changes for each full calendar year.
2. Percentages for the Buffett Partnership, net of all fees, 1957 to 1968. From 1969, book value of Berkshire Hathaway. Assumes full value at liquidation of Buffett Partnership reinvested in Berkshire Hathaway.
3. When he formed the Buffett Partnership, his target was to exceed the Dow Jones 30 Index by 10% per year. He has used the S&P500 Index as his benchmark for Berkshire Hathaway.
4. Buffett's performance minus the Dow or S&P Index.
5. Buffett Partnership to 1968.
6. Berkshire Hathaway book value, 1969 to present, which is Buffett's own measure of his performance.

Sources: For Buffett Partnership, *Buffett: The Making of an American Capitalist* by Roger Lowenstein, pages 69 & 93; for Berkshire Hathaway Inc.'s book value, Berkshire Hathaway annual reports.

*NOTE: The figure of 23.4% for Buffett's 46-year compounded average annual return is based on Buffett's *own* measure of his performance: the *book value* of Berkshire Hathaway. The average of 24.4% used in the text is calculated on the value of *shares* in Berkshire Hathaway.

George Soros's Record: 1969–2002

	Annual Percentage Change[1] in . . .			$1,000 invested in 1969 now worth[1]:	
Year	in Net Asset Value of Quantum Fund [2]	in S&P 500 with Dividends included[2]	Soros Relative to Index[3]	S&P 500 Index	Quantum Fund (net asset value)[2]
1969	29.38%	−8.4%	37.78%	$916.00	$1,293.82
1970	17.50%	3.9%	13.60%	$951.72	$1,520.24
1971	20.32%	14.6%	5.72%	$1,090.68	$1,829.09
1972	42.16%	18.9%	23.26%	$1,296.81	$2,600.24
1973	8.35%	−14.8%	23.15%	$1,104.89	$2,817.45
1974	17.51%	−26.4%	43.91%	$813.20	$3,310.79
1975	27.58%	37.2%	−9.62%	$1,115.70	$4,223.76
1976	61.90%	23.6%	38.30%	$1,379.01	$6,838.06
1977	31.17%	−7.4%	38.57%	$1,276.96	$8,969.45
1978	55.12%	6.4%	48.72%	$1,358.69	$13,913.70
1979	59.06%	18.2%	40.86%	$1,605.97	$22,130.91
1980	102.56%	32.3%	70.26%	$2,124.70	$44,828.36
1981	−22.88%	−5.0%	−17.88%	$2,018.46	$34,571.15
1982	56.86%	21.4%	35.46%	$2,450.42	$54,229.58
1983	24.95%	22.4%	2.55%	$2,999.31	$67,758.79
1984	9.40%	6.1%	3.30%	$3,182.27	$74,128.24
1985	122.19%	31.6%	90.59%	$4,187.86	$164,708.61
1986	42.12%	18.6%	23.52%	$4,966.80	$234,079.03
1987	14.13%	5.1%	9.03%	$5,220.11	$267,150.79
1988	10.14%	16.6%	−6.46%	$6,086.65	$294,229.58
1989[4]	31.64%	31.7%	−0.06%	$8,016.12	$387,323.81
1990	29.57%	−3.1%	32.67%	$7,767.62	$501,855.47
1991	53.30%	30.5%	22.80%	$10,136.74	$769,344.43
1992	68.11%	7.6%	60.51%	$10,907.14	$1,293,344.92
1993	63.25%	10.1%	53.15%	$12,008.76	$2,111,385.58
1994	3.95%	1.3%	2.65%	$12,164.87	$2,194,785.31
1995	39.04%	37.6%	1.44%	$16,738.86	$3,051,629.49
1996	−1.48%	23.0%	−24.48%	$20,588.80	$3,006,465.38
1997	17.13%	33.4%	−16.27%	$27,465.46	$3,521,472.90

1998	12.17%	28.6%	−16.43%	$35,320.58	$3,950,036.15
1999	34.65%	21.0%	13.65%	$42,737.90	$5,318,723.67
2000	−15.00%	−9.1%	−5.9%	$38,848.75	$4,520,915.12
2001	13.80%	−11.90%	25.70%	$34,225.75	$5,144,801.41
2002	−0.05%	−22.10%	22.05%	$26,661.86	$5,142,229.01
2003	15.00%	28.70%	−13.70%	$34,313.81	$5,913,563.36
1969–2003 compounded annual return		**10.0%**	**28.6%**		
1969–1988 compounded annual return (Soros's management)		**9.5%**	**32.9%**		
1989–31 March 2000[5] compounded annual return (Druckenmiller's management)		**18.6%**	**26.6%**		

Notes to the Table:

1. Percentage changes for each full calendar year (except 1969, from January 31st).
2. Percentages for the net asset value of the Quantum Fund (from May 2000, Quantum Endowment Fund), net of all fees, assuming dividends reinvested.
3. Soros's performance minus the S&P Index.
4. Stanley Druckenmiller took over active management of the Quantum Fund in 1989. George Soros became "coach."
5. Druckenmiller retired in April 2000. Soros changed the name to the Quantum Endowment Fund.

Sources: For Quantum Fund: 1969 to 1984, *The Alchemy of Finance* by George Soros, page 146; 1985 to present, Soros Fund Management.

ACKNOWLEDGMENTS

Both money and psychology have always fascinated me. It was the first interest that led me into the investment industry. In this book I've been able to put both my fascinations together.

As part of my interest in psychology, I studied Neuro Linguistic Programming [NLP], most simply described as applied psychology, eventually becoming a Master Practitioner.

A core concept of NLP is that if someone can do something well, anyone can learn to do it well. An NLP process called "modeling" is the application of that concept—and the origin of the idea of finding out what Warren Buffett, George Soros, and other great investors have in common.

So I must first thank George Zee, who brought many prominent NLP teachers to Hong Kong—and Leo Angart, who continued to organize NLP seminars when George Zee retired.

From Judith DeLozier, Robert Dilts, and David Gordon I learned the process of modeling, which forms the basis of this book.

Robert H. Meier kindly allowed me to access his treasure trove of articles and research material on investments that he'd collected over some twenty-five years of studying the markets. This aided my research immensely.

Writing a book, it turns out, is a team effort. Maurice Cruz's counsel was invaluable in helping me form many of the concepts in this work. And it's safe to say that if Tim Staermose hadn't spent several months working with me, this book would still be unfinished. Many's the time he pointed out where I was getting off-track, and much of the clarity in the writing is due to his invaluable assistance.

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[3]Miles, *Warren Buffett CEO*, page 131.
[4]Kilpatrick, *Of Permanent Value*, page 671.
[5]*Ibid.*, page 30.
[6]Kaufman, *Soros*, page 94.

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[1]Mark Stevens, *King Icahn* (Dutton, New York, 1993), page 6.
[2]Quoted in *ibid.*, page 93.
[3]*Ibid.*, page 55.
[4]*Ibid.*, page 22.
[5]"Icahn, Company Scourge, Joins Hedge Fund Rush," *International Herald Tribune,* 4 August 2004.
[6]Nikki Ross, *Lessons from Legends of Wall Street,* page 178.
[7]*Ibid.*, page 209.
[8]*Ibid.*, page 183.
[9]John Train, *Money Masters of Our Time,* page 61.
[10]Victoria Murphy, "Old Dog, New Tricks," *Forbes,* May 28, 2001.
[11]This, all subsequent quotes, and the information in this section come from my interview with Bernhard in his Hong Kong office on June 28, 2004.

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[1]Kilpatrick, *Of Permanent Value*, page 673.
[2]Buffett, 2000 Letter to Shareholders, page 19.
[3]Lowenstein, *Buffett*, page 202.
[4]Schwager, *New Market Wizards*, page 202.
[5]Lowe, *Warren Buffett Speak*, page 69.
[6]Kaufman, *Soros*, page 80.

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[1]“Meg and the Machine,” *Fortune*, August 11, 2003.
[2]Schwager, *Market Wizards*, page 167.
[3]Buffett, 1993 Letter to Shareholders, page 136.
[4]Harry Browne, *Why the Best-Laid Investment Plans Usually Go Wrong* (Morrow, New York, 1987), page 242.
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[1]John Train, *Money Masters of Our Time*, page 220.
[2]Kent, *Money Talks*, page 152.
[3]Schwager, *New Market Wizards*, page 133.
[4]Buffett, 2001 Letter to Shareholders, page 9.

Chapter 32

[1]Hagstrom, *The Warren Buffett Way*, page 225.

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*“Bernhard Mast” prefers to remain completely anonymous, so this is not his real name.

†See www.marktier.com/ipp.htm.