

So You Want To Be The Next Warren Buffett? How's Your Writing?

By Mark Sellers

First of all, I want to thank Daniel Goldberg for asking me to be here today and all of you for actually showing up. I haven't been to Boston in a while but I did live here for a short time in 1991 & 1992 when I attended Berklee School of Music. I was studying to be a jazz piano player but dropped out after a couple semesters to move to Los Angeles and join a band. I was so broke when I lived here that I didn't take advantage of all the things there are to do in Boston, and I didn't have a car to explore New England. I mostly spent 10-12 hours a day holed up in a practice room playing the piano. So whenever I come back to visit Boston, it's like a new city to me.

One thing I will tell you right off the bat: I'm not here to teach you how to be a great investor. On the contrary, I'm here to tell you why very few of you can ever hope to achieve this status.

If you spend enough time studying investors like Charlie Munger, Warren Buffett, Bruce Berkowitz, Bill Miller, Eddie Lampert, Bill Ackman, and people who have been similarly successful in the investment world, you will understand what I mean.

I know that everyone in this room is exceedingly intelligent and you've all worked hard to get where you are. You are the brightest of the bright. And yet, there's one thing you should remember if you remember nothing else from my talk: You have almost no chance of being a great investor. You have a really, really low probability, like 2% or less. And I'm adjusting for the fact that you all have high IQs and are hard workers and will have an MBA from one of the top business schools in the country soon. If this audience was just a random sample of the population at large, the likelihood of anyone here becoming a great investor later on would be even less, like 1/50th of 1% or something. You all have a lot of advantages over Joe Investor, and yet you have almost no chance of standing out from the crowd over a long period of time.

And the reason is that it doesn't much matter what your IQ is, or how many books or magazines or newspapers you have read, or how much experience you have, or will have later in your career. These are things that many people have and yet almost none of them end up compounding at 20% or 25% over their careers.

I know this is a controversial thing to say and I don't want to offend anyone in the audience. I'm not pointing out anyone specifically and saying "You have almost no chance to be great." There are probably one or two people in this room who will end up compounding money at 20% for their career, but it's hard to tell in advance who those will be without knowing each of you personally.

On the bright side, although most of you will not be able to compound money at 20% for your entire career, a lot of you will turn out to be good, above average investors because you are a skewed sample, the Harvard MBAs. A person can learn to be an above-average investor. You can learn to do well enough, if you're smart and hard working and

educated, to keep a good, high-paying job in the investment business for your entire career. You can make millions without being a great investor. You can learn to outperform the averages by a couple points a year through hard work and an above-average IQ and a lot of study. So there is no reason to be discouraged by what I'm saying today. You can have a really successful, lucrative career even if you're not the next Warren Buffett.

But you can't compound money at 20% forever unless you have that hard-wired into your brain from the age of 10 or 11 or 12. I'm not sure if it's nature or nurture, but by the time you're a teenager, if you don't already have it, you can't get it. By the time your brain is developed, you either have the ability to run circles around other investors or you don't. Going to Harvard won't change that and reading every book ever written on investing won't either. Neither will years of experience. All of these things are necessary if you want to become a great investor, but in and of themselves aren't enough because all of them can be duplicated by competitors.

As an analogy, think about competitive strategy in the corporate world. I'm sure all of you have had, or will have, a strategy course while you're here. Maybe you'll study Michael Porter's research and his books, which is what I did on my own before I entered business school. I learned a lot from reading his books and still use it all the time when analyzing companies.

Now, as a CEO of a company, what are the types of advantages that help protect you from the competition? How do you get to the point where you have a wide "economic moat", as Buffett calls it?

Well one thing that isn't a source of a moat is technology because that can be duplicated and always will be, eventually, if that's the only advantage you have. Your best hope in a situation like this is to be acquired or go public and sell all your shares before investors realize you don't have a sustainable advantage. Technology is one type of advantage that's short-lived. There are others, such as a good management team or a catchy advertising campaign or a hot fashion trend. These things produce temporary advantages but they change over time, or can be duplicated by competitors.

An economic moat is a structural thing. It's like Southwest Airlines in the 1990s – it was so deeply ingrained in the company culture, in every employee, that no one could copy it, even though everyone kind of knew how Southwest was doing it. If your competitors know your secret and yet still can't copy it, that's a structural advantage. That's a moat.

The way I see it, there are really only four sources of economic moats that are hard to duplicate, and thus, long-lasting. One source would be economies of scale and scope. Wal-Mart is an example of this, as is Cintas in the uniform rental business or Procter & Gamble or Home Depot and Lowe's. Another source is the network effect, ala eBay or Mastercard or Visa or American Express. A third would be intellectual property rights, such as patents, trademarks, regulatory approvals, or customer goodwill. Disney, Nike, or Genentech would be good examples here. A fourth and final type of moat would be high

customer switching costs. Paychex and Microsoft are great examples of companies that benefit from high customer switching costs.

These are the only four types of competitive advantages that are durable, because they are very difficult for competitors to duplicate. And just like a company needs to develop a moat or suffer from mediocrity, an investor needs some sort of edge over the competition or he'll suffer from mediocrity.

There are 8,000 hedge funds and 10,000 mutual funds and millions of individuals trying to play the stock market every day. How can you get an advantage over all these people? What are the sources of the moat?

Well, one thing that is not a source is reading a lot of books and magazines and newspapers. Anyone can read a book. Reading is incredibly important, but it won't give you a big advantage over others. It will just allow you to keep up. Everyone reads a lot in this business. Some read more than others, but I don't necessarily think there's a correlation between investment performance and number of books read. Once you reach a certain point in your knowledge base, there are diminishing returns to reading more. And in fact, reading too much news can actually be detrimental to performance because you start to believe all the crap the journalists pump out to sell more papers.

Another thing that won't make you a great investor is an MBA from a top school or a CFA or PhD or CPA or MS or any of the other dozens of possible degrees and designations you can obtain. Harvard can't teach you to be a great investor. Neither can my alma mater, Northwestern University, or Chicago, or Wharton, or Stanford. I like to say that an MBA is the best way to learn how to exactly, precisely, equal the market return. You can reduce your tracking error dramatically by getting an MBA. This often results in a big paycheck even though it's the antithesis of what a great investor does. You can't buy or study your way to being a great investor. These things won't give you a moat. They are simply things that make it easier to get invited into the poker game.

Experience is another over-rated thing. I mean, it's incredibly important, but it's not a source of competitive advantage. It's another thing that is just required for admission. At some point the value of experience reaches the point of diminishing returns. If that wasn't true, all the great money managers would have their best years in their 60s and 70s and 80s, and we know that's not true. So some level of experience is necessary to play the game, but at some point, it doesn't help any more and in any event, it's not a source of an economic moat for an investor. Charlie Munger talks about this when he says you can recognize when someone "gets it" right away, and sometimes it's someone who has almost no investing experience.

So what are the sources of competitive advantage for an investor? Just as with a company or an industry, the moats for investors are structural. They have to do with psychology, and psychology is hard wired into your brain. It's a part of you. You can't do much to change it even if you read a lot of books on the subject.

The way I see it, there are at least seven traits great investors share that are true sources of advantage because they can't be learned once a person reaches adulthood. In fact, some of them can't be learned at all; you're either born with them or you aren't.

Trait #1 is the ability to buy stocks while others are panicking and sell stocks while others are euphoric. Everyone thinks they can do this, but then when October 19, 1987 comes around and the market is crashing all around you, almost no one has the stomach to buy. When the year 1999 comes around and the market is going up almost every day, you can't bring yourself to sell because if you do, you may fall behind your peers. The vast majority of the people who manage money have MBAs and high IQs and have read a lot of books. By late 1999, all these people knew with great certainty that stocks were overvalued, and yet they couldn't bring themselves to take money off the table because of the "institutional imperative," as Buffett calls it.

The second character trait of a great investor is that he is obsessive about playing the game and wanting to win. These people don't just enjoy investing; they live it. They wake up in the morning and the first thing they think about, while they're still half asleep, is a stock they have been researching, or one of the stocks they are thinking about selling, or what the greatest risk to their portfolio is and how they're going to neutralize that risk. They often have a hard time with personal relationships because, though they may truly enjoy other people, they don't always give them much time. Their head is always in the clouds, dreaming about stocks. Unfortunately, you can't learn to be obsessive about something. You either are, or you aren't. And if you aren't, you can't be the next Bruce Berkowitz.

A third trait is the willingness to learn from past mistakes. The thing that is so hard for people and what sets some investors apart is an intense desire to learn from their own mistakes so they can avoid repeating them. Most people would much rather just move on and ignore the dumb things they've done in the past. I believe the term for this is "repression." But if you ignore mistakes without fully analyzing them, you will undoubtedly make a similar mistake later in your career. And in fact, even if you do analyze them it's tough to avoid repeating the same mistakes.

A fourth trait is an inherent sense of risk based on common sense. Most people know the story of Long Term Capital Management, where a team of 60 or 70 PhDs with sophisticated risk models failed to realize what, in retrospect, seemed obvious: they were dramatically overleveraged. They never stepped back and said to themselves, "Hey, even though the computer says this is ok, does it really make sense in real life?" The ability to do this is not as prevalent among human beings as you might think. I believe the greatest risk control is common sense, but people fall into the habit of sleeping well at night because the computer says they should. They ignore common sense, a mistake I see repeated over and over in the investment world.

Trait #5: Great investors have confidence in their own convictions and stick with them, even when facing criticism. Buffett never got into the dot-com mania thought he was being criticized publicly for ignoring technology stocks. He stuck to his guns when

everyone else was abandoning the value investing ship and Barron's was publishing a picture of him on the cover with the headline "What's Wrong, Warren?" Of course, it worked out brilliantly for him and made Barron's look like a perfect contrary indicator. Personally, I'm amazed at how little conviction most investors have in the stocks they buy. Instead of putting 20% of their portfolio into a stock, as the Kelly Formula might say to do, they'll put 2% into it. Mathematically, using the Kelly Formula, it can be shown that a 2% position is the equivalent of betting on a stock has only a 51% chance of going up, and a 49% chance of going down. Why would you waste your time even making that bet? These guys are getting paid \$1 million a year to identify stocks with a 51% chance of going up? It's insane.

Sixth, it's important to have both sides of your brain working, not just the left side (the side that's good at math and organization.) In business school, I met a lot of people who were incredibly smart. But those who were majoring in finance couldn't write worth a damn and had a hard time coming up with inventive ways to look at a problem. I was a little shocked at this. I later learned that some really smart people have only one side of their brains working, and that is enough to do very well in the world but not enough to be an entrepreneurial investor who thinks differently from the masses. On the other hand, if the right side of your brain is dominant, you probably loath math and therefore you don't often find these people in the world of finance to begin with. So finance people tend to be very left-brain oriented and I think that's a problem. I believe a great investor needs to have both sides turned on. As an investor, you need to perform calculations and have a logical investment thesis. This is your left brain working. But you also need to be able to do things such as judging a management team from subtle cues they give off. You need to be able to step back and take a big picture view of certain situations rather than analyzing them to death. You need to have a sense of humor and humility and common sense. And most important, I believe you need to be a good writer. Look at Buffett; he's one of the best writers ever in the business world. It's not a coincidence that he's also one of the best investors of all time. If you can't write clearly, it is my opinion that you don't think very clearly. And if you don't think clearly, you're in trouble. There are a lot of people who have genius IQs who can't think clearly, though they can figure out bond or option pricing in their heads.

And finally the most important, and rarest, trait of all: The ability to live through volatility without changing your investment thought process. This is almost impossible for most people to do; when the chips are down they have a terrible time not selling their stocks at a loss. They have a really hard time getting themselves to average down or to put any money into stocks at all when the market is going down. People don't like short-term pain even if it would result in better long-term results. Very few investors can handle the volatility required for high portfolio returns. They equate short-term volatility with risk. This is irrational; risk means that if you are wrong about a bet you make, you lose money. A swing up or down over a relatively short time period is not a loss and therefore not risk, unless you are prone to panicking at the bottom and locking in the loss. But most people just can't see it that way; their brains won't let them. Their panic instinct steps in and shuts down the normal brain function.

I would argue that none of these traits can be learned once a person reaches adulthood. By that time, your potential to be an outstanding investor later in life has already been determined. It can be honed, but not developed from scratch because it mostly has to do with the way your brain is wired and experiences you have as a child. That doesn't mean financial education and reading and investing experience aren't important. Those are critical just to get into the game and keep playing. But those things can be copied by anyone. The seven traits above can't be.

Ok, I know that's a lot of information and I want to leave time for questions so I'll stop there.

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