

CHAPTER 1

THE UNREASONABLE MAN

Forty-five years ago, Warren Buffett began a career managing money. At the relatively young age of 25 and with a relatively small amount of capital (his own investment was only \$100), Buffett started an investment partnership. With the support of family members and a few close friends, the Buffett Partnership began operations, on day one, with \$105,000 and seven limited partners.

Buffett set himself a tough goal: to beat the Dow Jones Industrial Average by ten percentage points each year. He achieved that and more. From 1956 until 1969, the year the partnership disbanded, Buffett generated an average annual return that was 22 percentage points higher than the Dow. Along the way, the partnership took a controlling interest in a small textile company called Berkshire Hathaway. Over a 35-year period, Buffett grew its book value from \$19 per share to \$37,987 per share. That works out to a rate of 24 percent compounded annually. It is not surprising that Warren Buffett was recently voted the greatest investor of the twentieth century.

When we look back on the life of Warren Buffett, we can identify several important experiences that helped him become

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successful. He was raised in a loving home under the moral guidance of two parents who exemplified midwestern values. His father, a stockbroker and U.S. Congressman, stressed both honesty and integrity in all his dealings with clients and the public. Young Buffett had an entrepreneurial streak from the beginning; he quickly learned to appreciate the value of a dollar and, just as important, the value of growing a dollar. Taken together, Buffett's early personal experiences helped provide him with a lifelong moral compass.

In addition to this strong moral foundation, Buffett possessed a seemingly inexhaustible appetite for knowledge. While working at his father's brokerage firm, he devoured all the investment books he could find, which led him ultimately to one of the greatest investment books ever written: Ben Graham's *The Intelligent Investor*.

But it is not enough to say that Buffett's investment success is simply a result of good character and a good education. To this we must add the all-important characteristics of courage and self-confidence. Buffett deeply believed in the lessons taught by his father and by Ben Graham, so he was unafraid when he found himself at odds with the more popular Wall Street view. This quality, which we might call "intelligent contrarianism," has most helped Warren Buffett achieve remarkable success.

"The reasonable man adapts himself to the world," wrote George Bernard Shaw. "The unreasonable one persists in trying to adapt the world to himself. Therefore all progress depends on the unreasonable man."¹ Shall we conclude that Warren Buffett is "the unreasonable man"? To do so presumes that his investment approach represents progress in the financial world, an assumption I strongly make. For when we look at the recent achievements of "reasonable" men, we see, at best, mediocrity and at worst, disaster.

After the 1973–1974 bear market, the U.S. economy endured several difficult years. Not until 1981 were we able to

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finally throw off the shackles of high inflation and high interest rates, setting the stage for a new bull market. And did we ever have one! In the past 20 years, we have seen the Dow Jones Industrial Average rise from 1,000 to over 10,000.

Another interesting trend during this extraordinary period of price appreciation is the increased activity and interest level of individual investors. Using Individual Retirement Accounts, self-directed 401(k) plans, discount brokers, and electronic trading, individuals have taken a much more hands-on role in managing their own financial affairs. The net effect has been to shift a large portion of financial assets and decision making away from professional investors.

This in no way implies that professional investors have been left with little to do. On the contrary, they have kept themselves busy inventing program trading, leveraged buyouts, derivative securities, and index futures. And they have launched hundreds of hedge funds at a dizzying pace. These funds have shown the ability to roll financial markets, crush foreign currencies, and put to risk the economies of entire countries. This constant game of “I can design a more complex strategy than you can,” played at a feverish pace in order to generate the highest return in the shortest period of time, has frightened many investors.

Today, the distinction between one money manager and another has faded. Fundamental research has been replaced by the whirl of computers. Black boxes have replaced management interviews and company investigations. Automation has replaced intuition. As a consequence, professional money managers have put more distance between the financial securities we own and the businesses these securities represent. No wonder the average investor is becoming more of a do-it-yourselfer. No wonder passive index investing has increased in popularity. With most money managers unable to add value to their clients’ accounts, active money management is increasingly viewed as a “satellite” strategy, a smaller adjunct to the much larger indexing strategy.

Throughout the past few decades, money managers have flirted with many different investment approaches: small capitalization, large capitalization, growth, value, momentum, thematic, and sector rotation. At some point, each has proved financially rewarding, and each has stranded its followers in periods of mediocrity.

Buffett is the exception. He has rarely suffered periods of underperformance. His investment performance, documented over the past 45 years, has been consistently superior. What makes his record all the more remarkable is that, despite the market's ever-changing landscape, his investment strategy has changed very little. While other investors and speculators, over time, have been distracted by fads and have toyed with many esoteric approaches to investing, Buffett's consistent common-sense approach has helped him amass a multibillion-dollar fortune.

How did he do it?

When we study Buffett's success and compare his approach with the practices of a majority of other investors, we can easily distill critical differences in three areas. The differences have to do with the way Buffett:

1. Analyzes stocks.
2. Manages a portfolio.
3. Thinks about the stock market.

LESSON 1

Analyze Stocks as Businesses

When Buffett invests, he sees a business. When he looks at a stock, he quickly moves past the share price and begins to analyze the attributes of the business. One by one, he weighs them against the business tenets, the management tenets, and

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the financial tenets that represent the core of his investment analysis (see page 79). Next, he calculates what the business is worth. Only then does he take a look at the stock price.

Most other investors look *only* at the stock price. They spend far too much time and effort watching, predicting, and anticipating price changes, and far too little time understanding the business. And even when investors do try to gauge the value of a stock, they use single-factor models like price-to-earnings ratios, book values, and dividend yields. But these simple metrics, as we shall see, tell us nothing about the value of the company.

I am convinced this is a critical variable that helps to explain Buffett's investment success. Most people look only at stock factors; Buffett analyzes only business factors.

Buffett's unique combination of business experiences gives him an advantage that separates him from all other investors. He gained hands-on experience by owning and managing a wide variety of businesses while simultaneously investing in common stocks. He has experienced both success and failure in his business ventures, and he has applied to the stock market the lessons he learned.

Other professional investors have not had the same kind of education. While they were busy studying capital asset pricing models, beta, and modern portfolio theory, Buffett studied the income statements, balance sheets, capital reinvestment requirements, and cash-generating abilities of his companies.

That kind of direct experience offers insights that can be learned only from doing. As Buffett himself puts it, "Can you really explain to a fish what it's like to walk on land? One day on land is worth a thousand years of talking about it, and one day running a business has exactly the same kind of value."²

Owning and operating businesses has given Buffett a distinct advantage. But I do not mean to suggest that to be successful using the Warren Buffett tenets you first have to manage a business. What is most important for all investors, whether

they have ever managed a business or not, is to think about the stock as if they actually had to manage the business.

LOOK AT THE STOCK AS A BUSINESS

Look at the company's economics, and look as intently as if you were taking over as CEO tomorrow. Then check the price.

Buffett believes the investor and the businessperson should look at the company in the same way because they both want essentially the same thing. The businessperson wants to buy the entire company, and the investor wants to buy portions of the company. If you ask businesspeople what they think about when purchasing a company, the most frequent answer is: "How much cash can be generated from the business?" Finance theory dictates that, over time, there is direct correlation between the value of the company and its cash-generating ability. Theoretically, then, the businessperson and the investor should be looking at the same variables.

"In our view," says Buffett, "investment students need only two well-taught courses: How to Value a Business, and How to Think About Market Prices."³

The necessary first step for anyone who wants to emulate Warren Buffett's approach is to think about stocks first and foremost as businesses. "Whenever Charlie [Munger] and I buy common stocks for Berkshire," Buffett has said, "we approach the transaction as if we were buying into a private business. We look at the economic prospects of the business, the people in charge of running it, and the price we must pay."⁴

LESSON 2

Manage a Focused, Low-Turnover Portfolio

In 1996, Stephen Jay Gould, the noted biologist, prolific writer, and lifelong Yankees fan, published *Full House: The Spread of Excellence from Plato to Darwin*. Gould is fascinated by the complex nature of life, and he studies intensely the variations of different systems. In this illuminating book, he talks about, among other things, the death of .400 hitting in major league baseball.

The record books say that between 1901 and 1930, a span of 30 years, there were nine seasons in which at least one player achieved a batting average better than .400. But in the 68 years that followed, only one player reached that milestone: Ted Williams hit .406 in 1941.

From those statistics, we might conclude that batting skills, over time, have deteriorated. But Gould wants us to consider the ease with which statistics can be misread. He believes another force is at work. Hitting is not getting worse, but, overall, defensive play is getting better. The pitching is more sophisticated, the fielding skills are better, and the team's ability to develop a full defense against strong hitting is much advanced. Gould the scientist explains, "As play improves and the bell curve marches toward the right wall, variation must shrink at the right tail. [And] .400 hitting disappears as a consequence of increasing excellence in play."⁵

Peter L. Bernstein, founding editor of the *Journal of Portfolio Management* and author of two outstanding works on finance—*Capital Ideas: The Improbable Origins of Modern Wall Street* and *Against the Gods: The Remarkable Story of Risk*—takes Gould's thesis on .400 hitting and applies it to the business of portfolio management. "The performance data for equity portfolio managers," he says, "reveals patterns that are

astonishingly similar to what has happened in baseball.”⁶ Bernstein reasons that a lack of above-average performance by professional money managers is a result of the ever-increasing level of investment management education and knowledge. As more and more people become more and more skilled at investing, the odds of a breakout performance by a few superstars diminish.

It is an intriguing analogy. Following this argument to the end, one could conclude that heavy hitters like Warren Buffett will gradually be displaced completely by an efficient market of well-informed, intelligent investors. Indeed, Bernstein points out that Berkshire Hathaway’s record, when compared against the S&P 500, was better in the 1960s and 1970s than in the 1980s and 1990s. However, I would argue: considering that the stock market is more competitive today and that Berkshire’s enlarged capital base becomes a relative handicap in this kind of comparison, Warren Buffett still qualifies as a .400 hitter.

In his article (titled “Where, Oh Where Are the .400 Hitters of Yesteryear?”), Bernstein willingly left the back door unlocked in his performance analysis. He wrote that, to become a .400 hitter, the portfolio manager must be “*willing to make the kinds of concentrated bets that are essential if the aim is to provide high excess returns*” (emphasis added).⁷ To my mind, “concentrated bets” equate to a focused portfolio of no more than 20 stocks. Never mind that Bernstein believes the risk of tracking error and high standard deviation would dissuade any portfolio manager from taking on a focus portfolio. The fact still remains: A focus portfolio stands the best chance of beating a market rate of return, and providing the “high excess returns” that only the .400 hitters can deliver.

Not surprisingly, if we open Bernstein’s back door and look out, whom do we see? Brilliant financial thinkers: John Maynard Keynes, Phil Fisher, Warren Buffett, Charlie Munger, Lou Simpson, and Bill Ruane, all of whom we shall meet later. Just as a young rookie might have intently watched Ted Williams, we

can learn a great deal by studying the batting stance and swing of these .400 hitters. As Buffett once said, “The key to life is to figure out who to be the batboy for.”⁸

Best way to hit a home run: Don't swing at everything; wait for a fat pitch.

* * *

Best way to outperform the market: Don't load up on hundreds of stocks; wait for the few outstanding opportunities.

How many stocks should an investor own? Buffett would tell you it depends on your investment approach. If you have the ability to analyze and value businesses, then you are not likely to need many stocks. As a buyer of businesses, there is no law that requires you to own a stock from every major industry. And you are not required to include 40, 50, or 100 stocks in your portfolio to achieve adequate diversification. Even the high priests of modern finance have discovered that, on average, “85 percent of the available diversification is achieved with a fifteen-stock portfolio and increases to 95 percent with a thirty-stock portfolio.”⁹

Buffett believes that the only investors who need wide diversification are those who do not understand what they are doing. If “know-nothing” investors want to own common stocks, they should own a large number of equities and space out their purchases over time. In other words, they should use an index fund and dollar-cost average their purchases. There is nothing shameful about this simple technique. In fact, Buffett points out, the index investor will actually outperform the majority of investment professionals. “Paradoxically,” he notes,

“when ‘dumb’ money acknowledges its limitations, it ceases to be dumb.”¹⁰

A BETTER YARDSTICK

If adapting Buffett’s investment strategy required only a change in perspective, then probably more investors would follow his lead. Unfortunately, applying Buffett’s approach requires changing not only perspective but also how performance is evaluated and communicated.

The traditional yardstick for measuring performance is price change: the difference between the price originally paid for the stock and its market price today. In the long run, the market price should approximate the change in the value of the business. However, in the short run, prices gyrate widely above and below a company’s value; they are dependent on factors other than the progress of the business. The problem remains that most investors use short-term price changes to gauge the success or failure of their investment approach. Unfortunately, these short-term price changes often have little to do with the changing economic value of the business and much to do with anticipating the behavior of other investors.

In addition, professional investors are required by their clients to report performance in quarterly periods. Frequently, clients become impatient while waiting for the price of their portfolio to advance at some predetermined rate. If they aren’t seeing short-term performance gains, clients become dissatisfied and skeptical of the investment professional’s ability. Knowing that they must improve short-term performance or risk losing clients, professional investors become obsessed with chasing stock prices.

Buffett believes it is foolish to use short-term prices to judge a company’s success. Instead, he lets his companies report their value to him via their economic progress. Once a year, he checks several variables, including return on equity, changes in

operating margins, debt levels, capital expenditure needs, and, lastly, the company's growth in cash earnings. If these economic measurements are improving, he knows the share price, over the long term, should reflect this improvement. What happens to the stock price in the short run is inconsequential.

Don't judge a company's success by short-term change in the price of its stock. Instead, consider the business fundamentals.

The difficulty of using economic measurements as yardsticks for success is that communicating performance in this manner is not customary. Clients and investment professionals alike are programmed to follow prices. The stock market reports price changes daily. The client's account statement reflects price changes monthly, and the investment professional is measured on the same basis quarterly. The answer to this dilemma may lie in employing Buffett's concept of "look-through" earnings, described in Chapter 6. The goal of the business owner, Buffett explains, is to create a portfolio of companies that, in 10 years, will produce the highest level of look-through earnings.

When growth of look-through earnings replaces price changes as the highest priority in your portfolio, many things begin to change. First, you are less likely to sell your best businesses just because you have a profit. Ironically, corporate managers understand this when they focus on their own business operation. "A parent company," Buffett explains, "that owns a subsidiary with superb long-term economics is not likely to sell that entity regardless of price."¹¹ A CEO wanting to increase the value of his or her business will not sell the company's crown jewel. Yet this same CEO will impulsively sell stocks in his or her personal portfolio with little more logic than "You

can't go broke taking a profit." "In our view," Buffett explains, "what makes sense in business also makes sense in stocks: An investor should ordinarily hold a small piece of an outstanding business with the same tenacity that an owner would exhibit if he owned all the business."¹²

*See yourself as owning a portfolio of businesses,
not a portfolio of stocks.*

Now that you are managing a portfolio of businesses, not only will you avoid selling your best businesses, you will exercise much greater care when you pick new businesses for purchase. As the manager of a portfolio of businesses, you must resist the temptation to purchase a marginal company just because you have cash reserves. If the company does not pass your tenet screen, do not purchase it. Be patient and wait for the right business. It is wrong to assume that if you are not buying and selling, you are not making progress. In Buffett's mind, it is too difficult to make hundreds of smart decisions in a lifetime. He would rather position his portfolio so he has to make only a few smart decisions.

Ty Cobb once said, "Ted Williams sees more of the ball than any man alive—but he demands a perfect pitch." That intense discipline may explain why Williams is the only .400 hitter in the past seven decades. Warren Buffett is a great admirer of Ted Williams and, on several occasions, has shared Williams's disciplined approach with Berkshire's shareholders. In *The Science of Hitting*, Williams explained his technique. He divided the strike zone into seventy-seven cells, each representing the size of a baseball. Now, said Buffett, "Swinging only at the ball in his 'best' cell, Williams knew, would allow him to hit .400; reaching for the balls in the 'worst' spot, the low outside corner of the strike zone, would reduce him to .230."¹³

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The investment analogy of Williams's hitting advice is obvious. For Buffett, investing is a series of "business" pitches, and, to achieve above-average performance, he must wait until a business comes across the strike zone in the "best" cell. Buffett believes investors too often swing at bad pitches, and their performance suffers. Perhaps it is not that investors are unable to recognize a good pitch—a good business—when they see one; maybe the difficulty lies in the fact that investors can't resist swinging the bat.

Don't be tempted to swing at the pitches that are low and outside. Learn to wait for the fat pitch. Williams, waiting for his best pitch, took risks of striking out. In that regard, investors have it easier, Buffett says. Unlike Williams, "We can't be called out if we resist three pitches that are barely in the strike zone."¹⁴

LESSON 3

Understand the Difference Between Investment and Speculation

What separates an investor from a speculator? This old but persistent debate has passionate proponents on both sides. Several great financial thinkers, including John Maynard Keynes, Ben Graham, and Warren Buffett, have all taken a turn at explaining the difference between investment and speculation.

According to Keynes, "Investment is an activity of forecasting the yield over the life of the asset; speculation is the activity of forecasting the psychology of the market."¹⁵ For Graham, "An investment operation is one which, upon thorough analysis, promises safety of principal and a satisfactory return. Operations not meeting this requirement are speculative."¹⁶ Buffett believes: "If you're an investor, you're looking at what the asset—in our case, businesses—will do. If you're a speculator, you're primarily forecasting on what the price will do independent of the business." (OID)¹⁷

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Generally, they all agree that speculators are obsessed with guessing future prices, while investors focus on the underlying asset, knowing that future prices are tied closely to the economic performance of the asset. If they are correct, it would appear that much of the activity that dominates the financial markets today is speculation, not investing.

Perhaps we have been looking at this question the wrong way. Instead of getting into a shouting contest about what is investment and what is speculation, maybe we should concern ourselves more with the element of knowledge.¹⁸

I have come to believe that as we gain more understanding about how businesses work and how stock prices behave; as we begin to understand that focus portfolios, as opposed to broadly diversified portfolios, give the best chance of outperforming index funds; as we begin to appreciate that high-turnover portfolios increase our investment cost while low-turnover portfolios increase our potential return, then we have begun to lay the bricks of knowledge that drive us toward a focus investment approach.

Just as important, when we begin to understand the mathematical impossibility of predicting the future behavior of the stock market, we begin to look suspiciously at any speculative strategy that seeks to profit from anticipated changes in stock prices.

And when we understand the ill effects of the psychology of misjudgment, so pointedly emphasized by Charlie Munger (and discussed fully in Chapter 7), we also protect ourselves from making foolish mistakes. The psychology involved in investing is all-important, and Munger has done a great service to all investors by insisting that we pay attention to it. We can get the economics right and get the probabilities right, but if we allow our emotions to override our good judgment, there will be no benefit to the focus investment approach—or any other investment approach, for that matter.

It is important to remember that the focus investment approach is not for everyone. It is a unique style that is often at

odds with how the majority of people think about investing. “Each person,” says Charlie, “has to play the game given his marginal utility considerations and in a way that takes into account his own psychology. If losses are going to make you miserable—and some losses are inevitable—you might be wise to utilize a very conservative pattern of investment and savings all your life.” (OID)¹⁹

Buffett would concur. As long as you have a long-term investment horizon, the risk of focus investing, says Buffett, “becomes the risk of yourself—of whether you’re able to retain your belief in the real fundamentals of the business and not get too concerned about the stock market.” (OID)²⁰

THE SEARCH FOR PATTERNS



“Something about the mind, wired to find patterns both real and imaginary, rebels at the notion of fundamental disorder.”²¹ Those words, written by George Johnson in his book *Fire in the Mind*, reveal the dilemma that all investors face. The mind craves patterns, argues Johnson; patterns suggest order, which allows us to plan and make sense of our resources.

What we have come to understand is that Warren Buffett is seeking patterns—the patterns that can be found when analyzing a business. He also knows these business patterns will, at some point, reveal the future pattern of the stock price. Of course, a stock price pattern will not obligingly follow every change in the business pattern, but if your time horizon is long enough, it is remarkable how the price patterns eventually match up with the business patterns.

Too many investors are seeking patterns in the wrong place. They are certain that there is some predictable pattern for gauging short-term price changes. But they are mistaken. There simply are no predictable patterns for guessing the future direction of the stock market. The exact patterns do not repeat. Still, these investors keep trying.

How do investors maneuver in a world that lacks pattern recognition? By looking in the right place at the right level. Although the economy and the market as a whole are too complex and too large to be predictable, there are recognizable patterns at the company level. Inside each company, there are business patterns, management patterns, and financial patterns.

If you study those patterns, in most cases you can make a reasonable prediction about the future of that company. Warren Buffett focuses on those patterns, not on the unpredictable behavioral patterns of millions of investors. “I have always found it easier to evaluate weights dictated by fundamentals than votes dictated by psychology,” he says.²²

Always recognize the difference between investment and speculation, and develop the discipline never to cross the line.

One thing we can say with certainty is that knowledge works to increase our investment return and reduces overall risk. I believe we can also make the case that knowledge is what defines the difference between investment and speculation. In the end, the greater your level of knowledge, the less likely that pure speculation will dominate your thinking and your actions.

Ron Chernow, a talented financial writer, claims that “financial systems reflect the values of societies.”²³ I believe that is largely true. From time to time, we seem to misplace our values, and then our markets succumb to speculative forces. Soon, we right ourselves and continue on with our financial walk, only to trip and fall back into destructive habits. One way to stop this vicious cycle is to educate ourselves about what works and what does not.

Early in his career, Warren Buffett drew an intellectual line between investment and speculation. His success has come from

not only recognizing the difference between investment and speculation but having the discipline never to cross the line.

WHY HAS WALL STREET IGNORED WARREN BUFFETT?

The field of money management has, for several reasons, evolved into an antithesis of Warren Buffett. Amazingly, in an industry noteworthy for copying success, Wall Street has somehow managed to disregard focus investing, even though its practitioners have enjoyed phenomenal results. Given the documented success of Buffett's performance and the simplicity of his methodology, the question we must ask is: Why haven't more investors—professionals and individuals alike—applied his approach?

The answer, I believe, is twofold. It is linked partly to how society at large processes new ideas, and partly to how we as individuals embrace or resist change. For the first, we turn to Thomas Kuhn.

Kuhn, who died in 1996, was a physicist turned philosopher. His 1962 masterpiece, *The Structure of Scientific Revolutions*, is considered one of the most, if not *the* most, influential philosophical works of the latter half of the twentieth century. In this book, which has sold over a million copies, Kuhn described his theory of scientific evolution and introduced the concept of paradigms and the now-familiar phrase: "paradigm shifts."

Kuhn contended that progress in science does not always happen smoothly. Sometimes, it is triggered by crisis—tearing down the intellectual fabric of the prevailing model or paradigm, and then constructing a brand-new model. History gives us many examples; here are but two: The Copernican revolution replaced the idea of Earth's centrality, and Einstein's general theory of relativity unseated Euclidean geometry. In each case, before there was a paradigm shift, explained Kuhn, there was a crisis period. Some people believe that the current intellectual

tug-of-war between broadly diversified portfolios and focus portfolios is such a crisis.

You might think that, in today's world, scientists would readily accept new and even contradictory information and then work collegially to construct a new paradigm. Nothing could be further from the truth, said Kuhn. "Though they [the proponents of the current paradigm] may begin to lose faith and then consider alternatives, they do not renounce the paradigm that has led them into crisis."²⁴ They tenaciously hold on to the old paradigm because they have invested so much personal intellectual capital in it. Accepting the new would be tantamount to admitting failure, and that is a risk not worth taking.

Something of the same dynamic is at work on the personal level for investors. Individually and collectively, we have become accustomed to one way of thinking about investing, and we are not interested in changing, especially if it means we would have to wait for a payoff. We have been seduced by the very qualities that make investing speculative: we want quicker solutions and quicker rewards. We want to see action today, not tomorrow.

According to Kuhn, the first step in a paradigm shift occurs when an anomaly is introduced. For years, academicians attempted to explain Buffett as an anomaly, or what statisticians call a five-sigma event. In their view, Buffett was so unusual that his success would occur only rarely and could be duplicated only by chance. Some economists used the classic orangutan analogy: If you put enough orangutans in a room, statistically one of them has to be able to pick stocks as well as Buffett. But if that is so, how are we to explain the success of John Maynard Keynes, Phil Fisher, Charlie Munger, Lou Simpson, and Bill Ruane?

A DIFFERENT WAY OF THINKING

Over the past several years, I have had the great fortune to study and write about the investment lessons of Warren Buffett

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and Charlie Munger. I have also had a chance to conduct original research on focus investing, and the front-line experience of managing a focus portfolio. The Legg Mason Focus Trust, which I have run since its inception in 1995, has given me invaluable experience on what it is like to manage a focus portfolio. During these years of interacting with shareholders, clients, consultants, analysts, other portfolio managers, and the financial media, I have learned that focus investors operate in a world far different from the one that dominates the investment industry. The simple truth is: They think *differently*.

Charlie Munger helped me to understand this pattern of thinking by using the very powerful metaphor of *a latticework of metal models*.²⁵ In 1995, Munger delivered a lecture entitled “Investing Expertise as a Subdivision of Elementary, Worldly Wisdom” to Professor Guilford Babcock’s student investment seminar at the University of Southern California School of Business. The lecture, which was reprinted in *Outstanding Investor Digest*, was particularly fun for Charlie because it centered around a topic that he considers especially important: how people achieve true understanding, or what he calls “worldly wisdom.”

Wisdom is not reflected in the simple exercise of compiling and quoting facts and figures. Rather, Munger explains, wisdom is very much about how facts align and combine. He believes that the only way to achieve wisdom is to be able to hang life’s experiences across a broad cross-section of mental models. “You’ve got to have models in your head,” he explained, “and you’ve got to array your experience—both vicarious and direct—on this latticework of models.” (OID)²⁶

The first rule to learn, says Charlie, is that you must carry multiple models in your mind. Not only do you need more than a few, but you need to embrace models from several different disciplines. Becoming a successful investor, he explains, requires a multidisciplinary approach to your thinking.

That approach will put you in a different place from almost everyone else, Charlie points out, because the world is not

multidisciplinary. Business professors typically don't include physics in their lectures, and physics teachers don't talk about biology, and biology teachers don't include mathematics, and mathematics professors don't teach psychology. But Charlie believes we must ignore these "intellectual jurisdictional boundaries" and include all models in our latticework design.

"I think it is undeniably true that the human brain must work in models," says Charlie. "The trick is to have your brain work better than the other person's brain because it understands the most fundamental models—ones that will do the most work per unit." (OID)²⁷

It is clear to me that focus investing does not fit neatly within the narrowly constructed models popularized and used in our investment culture. To receive the full benefit of the focus approach, we will have to add a few more concepts, a few more models, to our thinking. You will never be content with investing until you understand the behavior models that come from psychology. You will not know how to optimize a portfolio without learning the model of statistical probabilities.

The investigation need not be overwhelming. "You don't have to become a huge expert in any one of these fields," explains Charlie. "All you have to do is take the really big ideas and learn them early and learn them well." (OID)²⁸ The exciting part of this exercise, Charlie points out, is the insight that is possible when several models combine and begin operating in the same direction.

The most detailed model that focus investors have to learn is the model for picking stocks and managing portfolios. In the following chapters of this book, these models will be provided to you. Then we need to add just a few more simple models to complete our education. But we are not alone. We have Warren Buffett's and Charlie Munger's wisdom to guide us, and we have their accumulated experience at Berkshire Hathaway. Typically, these two visionaries credit not themselves personally but their organization, which they describe as a "didactic enterprise

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teaching the right systems of thought, of which the chief lessons are that a few big ideas really work.” (OID)²⁹

“Berkshire is basically a very old-fashioned kind of place,” Charlie Munger said, “and we try to exert discipline to stay that way. I don’t mean old-fashion stupid. I mean the eternal verities: basic mathematics, basic horse sense, basic fear, basic diagnosis of human nature making possible predictions regarding human behavior. If you just do that with a certain amount of discipline, I think it’s likely to work out quite well.” (OID)³⁰

