

CHAPTER 1

Introduction

Who wants to be an average investor? We all dream of beating the market and being super investors, and we spend an inordinate amount of time and resources in this endeavor. Consequently, we are easy prey for the magic bullets and the secret formulas offered by salespeople pushing their wares. In spite of our best efforts, though, most of us fail in our attempts to be more than average. Nonetheless, we keep trying, hoping that we can be more like the investing legends—another Warren Buffett, George Soros, or Peter Lynch. We read the words written by and about successful investors, hoping to find in them the key to their stock-picking abilities, so that we can replicate them and become like them.

In our search, though, we are whipsawed by contradictions and anomalies. On one corner of the investment town square stands an adviser, yelling to us to buy businesses with solid cash flows and liquid assets because that's what worked for Buffett. On another corner, another investment expert cautions us that this approach worked only in the old world, and that in the new world of technology we have to bet on companies with great growth prospects. On yet another corner stands a silver-tongued salesperson with vivid charts who presents you with evidence of the charts' capacity to get you in and out of markets at exactly the right times. It is not surprising that facing this cacophony of claims and counterclaims we end up more confused than ever.

In this chapter, we present the argument that to be successful with any investment strategy, you have to begin with an investment philosophy that is consistent at its core and matches not only the markets you choose to invest in but your individual characteristics. In other words, the key to success in investing may lie not in knowing what makes others successful but in finding out more about yourself.

WHAT IS AN INVESTMENT PHILOSOPHY?

An investment philosophy is a coherent way of thinking about markets, how they work (and sometimes do not), and the types of mistakes that you believe consistently underlie investor behavior. Why do we need to make assumptions about investor mistakes? As we will argue, most investment strategies are designed to take advantage of errors made by some or all investors in pricing stocks. Those mistakes themselves are driven by far more basic assumptions about human behavior. To provide an illustration, the rational or irrational tendency of human beings to join crowds can result in price momentum: stocks that have gone up the most in the recent past are more likely to go up in the near future. Let us consider, therefore, the ingredients of an investment philosophy.

Human Frailty

Underlying every investment philosophy is a view about human behavior. In fact, one weakness of conventional finance and valuation has been the short shrift given to behavioral quirks. It is not that conventional financial theory assumes that all investors are rational, but that it assumes that irrationalities are random and cancel out. Thus, for every investor who tends to follow the crowd too much (a momentum investor), we assume there is an investor who goes in the opposite direction (a contrarian), and that their push and pull in prices will ultimately result in a rational price. While this may, in fact, be a reasonable assumption for the very long term, it may not be a realistic one for the short term.

Academics and practitioners in finance who have long viewed the rational investor assumption with skepticism have developed a branch of finance called behavioral finance that draws on psychology, sociology, and finance to try to explain both why investors behave the way they do and the consequences for investment strategies. As we go through this book, examining different investment philosophies, we will try at the outset of each philosophy to explore the assumptions about human behavior that represent its base.

Market Efficiency

A closely related second ingredient of an investment philosophy is the view of market efficiency or inefficiency that you need for the philosophy to be a successful one. While all active investment philosophies make the assumption that markets are inefficient, they differ in their views on what parts of the market the inefficiencies are most likely to show up in and how long

they will last. Some investment philosophies assume that markets are correct most of the time but that they overreact when new and large pieces of information are released about individual firms: they go up too much on good news and down too much on bad news. Other investment strategies are founded on the belief that markets can make mistakes in the aggregate—the entire market can be undervalued or overvalued—and that some investors (mutual fund managers, for example) are more likely to make these mistakes than others. Still other investment strategies may be based on the assumption that while markets do a good job of pricing stocks where there is a substantial amount of information—financial statements, analyst reports, and financial press coverage—they systematically misprice stocks on which such information is not available.

Tactics and Strategies

Once you have an investment philosophy in place, you develop investment strategies that build on the core philosophy. Consider, for instance, the views on market efficiency expounded in the previous section. The first investor, who believes that markets overreact to news, may develop a strategy of buying stocks after large negative earnings surprises (where the announced earnings come in well below expectations) and selling stocks after positive earnings surprises. The second investor, who believes that markets make mistakes in the aggregate, may look at technical indicators (such as cash held by mutual funds or short selling by investors in the stock) to find out whether the market is overbought or oversold and take a contrary position. The third investor, who believes that market mistakes are more likely when information is absent, may look for stocks that are not followed by analysts or owned by institutional investors.

It is worth noting that the same investment philosophy can spawn multiple investment strategies. Thus, a belief that investors consistently overestimate the value of growth and underestimate the value of existing assets can manifest itself in a number of different strategies ranging from a passive one of buying low price-earnings (P/E) ratio stocks to a more active one of buying cheap companies and attempting to liquidate them for their assets. In other words, the number of investment strategies will vastly surpass the number of investment philosophies.

WHY DO YOU NEED AN INVESTMENT PHILOSOPHY?

Most investors have no investment philosophy, and the same can be said about many money managers and professional investment advisers. They

adopt investment strategies that seem to work (for other investors) and abandon them when they do not. Why, you might ask, if this is possible, do you need an investment philosophy? The answer is simple. In the absence of an investment philosophy, you will tend to shift from strategy to strategy simply based on a strong sales pitch from a proponent or perceived recent success. There are three negative consequences for your portfolio:

1. Lacking a rudder or a core set of beliefs, you will be easy prey for charlatans and pretenders, with each one claiming to have found the magic strategy that beats the market.
2. As you switch from strategy to strategy, you will have to change your portfolio, resulting in high transaction costs, and you will pay more in taxes.
3. While there may be strategies that do work for some investors, they may not be appropriate for you, given your objectives, risk aversion, and personal characteristics. In addition to having a portfolio that underperforms the market, you are likely to find yourself with an ulcer or worse.

With a strong sense of core beliefs, you will have far more control over your destiny. Not only will you be able to reject strategies that do not fit your core beliefs about markets, but you will also be able to tailor investment strategies to your needs. In addition, you will be able to get much more of a big picture view of both what it is that is truly different across strategies and what they have in common.

THE BIG PICTURE OF INVESTING

To see where the different investment philosophies fit into investing, let us begin by looking at the process of creating an investment portfolio. Note that this is a process that we all follow—amateur as well as professional investors—though it may be simpler for an individual constructing his or her own portfolio than it is for a pension fund manager with a varied and demanding clientele.

Step 1: Understanding the Client

The process always starts with the investor and understanding his or her needs and preferences. For a portfolio manager, the investor is a client, and the first and often most significant part of the investment process is understanding the client's needs, the client's tax status, and, most importantly,

the client's risk preferences. For an individual investor constructing his or her own portfolio, this may seem simpler, but understanding one's own needs and preferences is just as important a first step as it is for the portfolio manager.

Step 2: Portfolio Construction

The next part of the process is the actual construction of the portfolio, which we divide into three subparts.

The first of these is the decision on how to allocate the portfolio across different asset classes, defined broadly as equities, fixed income securities, and real assets (such as real estate, commodities, and other assets). This *asset allocation decision* can also be framed in terms of investments in domestic assets versus foreign assets, and the factors driving this decision.

The second component is the *asset selection decision*, where individual assets are chosen within each asset class to make up the portfolio. In practical terms, this is the step where the stocks that make up the equity component, the bonds that make up the fixed income component, and the real assets that make up the real asset component are selected.

The final component is *execution*, where the portfolio is actually put together. Here investors must weigh the costs of trading against their perceived needs to trade quickly. While the importance of execution will vary across investment strategies, there are many investors who fail at this stage in the process.

Step 3: Evaluate Portfolio Performance

The final part of the process, and often the most painful one for professional money managers, is performance evaluation. Investing is, after all, focused on one objective and one objective alone, which is to make the most money you can, given your particular risk preferences. Investors are not forgiving of failure and are unwilling to accept even the best of excuses, and loyalty to money managers is not a commonly found trait. By the same token, performance evaluation is just as important to the individual investor who constructs his or her own portfolio, since the feedback from it should largely determine how that investor approaches investing in the future.

These parts of the process are summarized in Figure 1.1, and we will return to this figure to emphasize the steps in the process as we consider different investment philosophies. As you will see, while all investment philosophies may have the same end objective of beating the market, each philosophy will emphasize a different component of the overall process and require different skills for success.

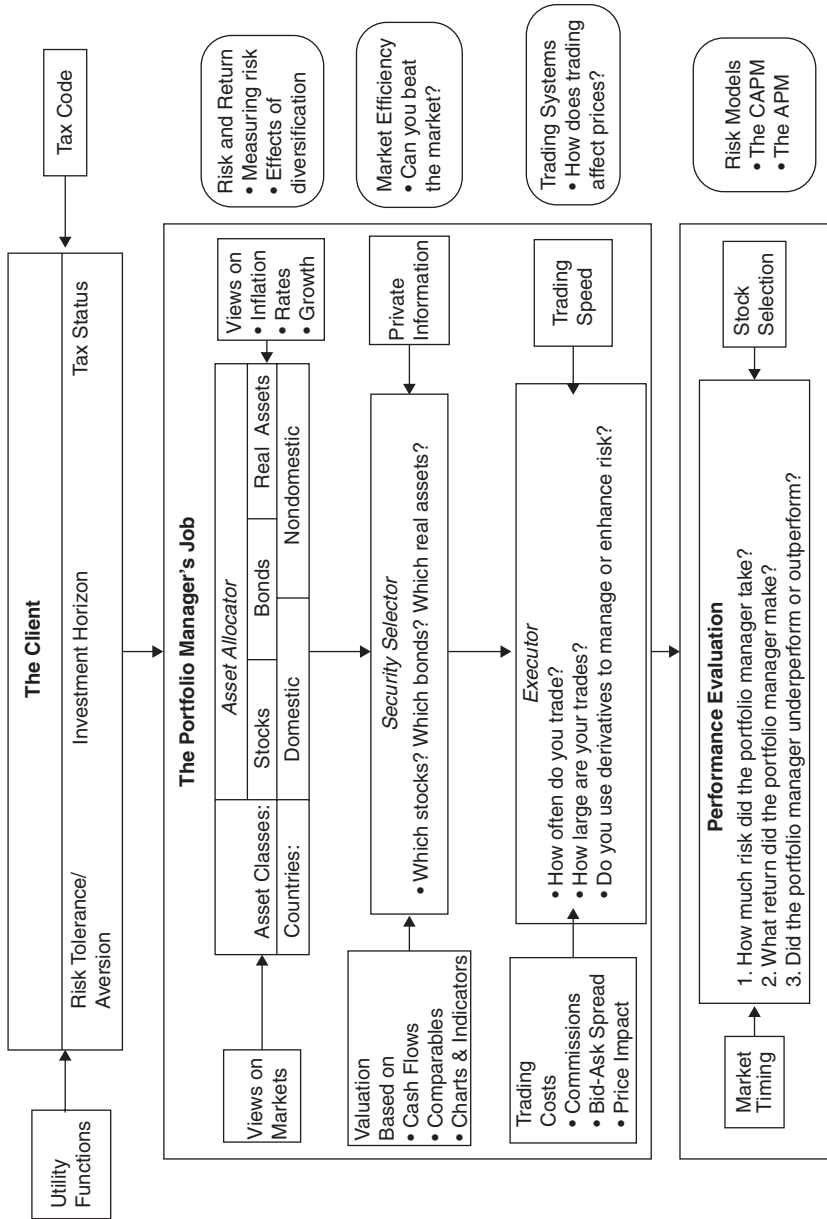


FIGURE 1.1 The Investment Process

CATEGORIZING INVESTMENT PHILOSOPHIES

We present the range of investment philosophies in this section, using the investment process to illustrate each philosophy. While we will leave much of the detail for later chapters, we attempt to present at least the core of each philosophy here.

Market Timing versus Asset Selection

The broadest categorization of investment philosophies is by whether they are based on timing overall markets or finding individual assets that are mispriced. The first set of philosophies can be categorized as *market timing* philosophies, while the second can be viewed as *security selection* philosophies.

Within each, though, are numerous strands that take very different views about markets. Consider market timing. While most of us consider market timing only in the context of the stock market, there are investors who consider market timing to include a much broader range of markets: currency markets, commodities, bond markets, and real estate come to mind. The range of choices among security selection philosophies is even wider and can span charting and technical indicators; fundamentals (earnings, cash flows, or growth); and information (earnings reports, acquisition announcements).

While market timing has allure to all of us (because it pays off so well when you are right), it is difficult to succeed at for exactly that reason. There are all too often too many investors attempting to time markets, and succeeding consistently is very difficult to do. If you decide to pick stocks, how do you choose whether you pick them based on charts, fundamentals, or growth potential? The answer, as we will see in the next section, will depend not only on your views of the market and what works, but also on your personal characteristics.

Activist versus Passive Investing

At a general level, investment philosophies can also be categorized as activist or passive strategies. (Note that activist investing is not the same as active investing.) In a *passive strategy*, you invest in a stock or company and wait for your investment to pay off. Assuming that your strategy is successful, this will come from the market recognizing and correcting a misvaluation. Thus, a portfolio manager who buys stocks with low price-earnings ratios and stable earnings is following a passive strategy. So is an index fund manager, who essentially buys all stocks in the index. In an *activist strategy*,

you invest in a company and then try to change the way the company is run to make it more valuable. Venture capitalists can be categorized as activist investors since they not only take positions in promising businesses but also provide significant inputs into how these businesses are run. In recent years, we have seen investors bring this activist philosophy to publicly traded companies, using the clout of large positions to change the way companies are run. We should hasten to draw a contrast between activist investing and active investing. Any investor who tries to beat the market by picking stocks is viewed as an active investor. Thus, active investors can adopt passive strategies or activist strategies. In the popular vernacular, active investing includes any strategy where you try to beat the market by steering your money to either undervalued asset classes or individual stocks/assets.

Time Horizon

Different investment philosophies require different time horizons. A philosophy based on the assumption that markets overreact to new information may generate short-term strategies. For instance, you may buy stocks right after a bad earnings announcement, hold for a few weeks, and then sell (hopefully at a higher price, as the market corrects its overreaction). In contrast, a philosophy of buying neglected companies (stocks that are not followed by analysts or held by institutional investors) may require a much longer time horizon.

One factor that will determine the time horizon of an investment philosophy is the nature of the adjustment that has to occur for you to reap the rewards of a successful strategy. Passive value investors who buy stocks in companies that they believe are undervalued may have to wait years for the market correction to occur, even if they are right. Investors who trade ahead of or after earnings reports, because they believe that markets do not respond correctly to such reports, may hold the stock for only a few days. At the extreme, investors who see the same (or very similar) assets being priced differently in two markets may buy the cheaper one and sell the more expensive one, locking in arbitrage profits in a few minutes.

Coexistence of Contradictory Strategies

One of the most fascinating aspects of investment philosophy is the coexistence of investment philosophies based on contradictory views of the markets. Thus, you can have market timers who trade on *price momentum* (suggesting that investors are slow to learn from information) and market timers who are *contrarians* (which is based on the belief that markets overreact). Among security selectors who use fundamentals, you can have

value investors who buy value stocks because they believe markets overprice growth, and *growth investors* who buy growth stocks using exactly the opposite justification. The coexistence of these contradictory impulses for investing may strike some as irrational, but it is healthy and may actually be necessary to keep the market in balance. In addition, you can have investors with contradictory philosophies coexisting in the market because of their different time horizons, views on risk, and tax statuses. For instance, tax-exempt investors may find stocks that pay large dividends a bargain, while taxable investors may reject these same stocks because dividends are taxed.

Investment Philosophies in Context

We can consider the differences between investment philosophies in the context of the investment process, described in Figure 1.1. Market timing strategies primarily affect the asset allocation decision. Thus, investors who believe that stocks are undervalued will invest more of their portfolios in stocks than would be justified given their risk preferences. Security selection strategies in all their forms—technical analysis, fundamentals, or private information—center on the security selection component of the portfolio management process. You could argue that strategies that are not based on grand visions of market efficiency but are designed to take advantage of momentary mispricing of assets in markets (such as arbitrage) revolve around the execution segment of portfolio management. It is not surprising that the success of such opportunistic strategies depends on trading quickly to take advantage of pricing errors, and keeping transaction costs low. Figure 1.2 presents the different investment philosophies.

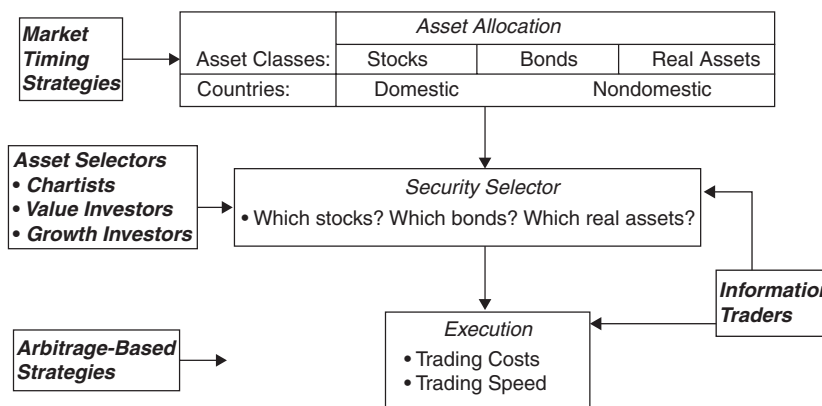


FIGURE 1.2 Investment Philosophies

DEVELOPING AN INVESTMENT PHILOSOPHY

If every investor needs an investment philosophy, what is the process that you go through to come up with such a philosophy? While this entire book is about the process, in this section we can lay out the three steps involved.

Step 1: Understand the Fundamentals of Risk and Valuation

Before you embark on the journey of finding an investment philosophy, you need to get your financial tool kit ready. At the minimum, you should understand:

- How to measure the risk in an investment and relate it to expected returns.
- How to value an asset, whether it is a bond, stock, real estate holding, or business.
- What the ingredients of trading costs are, and the trade-off between the speed of trading and the cost of trading.

We would hasten to add that you do not need to be a mathematical wizard to understand any of these, and we will begin this book with a section dedicated to providing these basic tools.

Step 2: Develop a Point of View about How Markets Work and Where They Might Break Down

Every investment philosophy is grounded in a point of view about human behavior (and irrationality). While personal experience often determines how you view your fellow human beings, before you make your final judgments you should expand this to consider broader evidence from markets on how investors act.

Over the past few decades, it has become easy to test different investment strategies as data becomes more accessible. There now exists a substantial body of research on the investment strategies that have beaten the market over time. For instance, researchers have found convincing evidence that stocks with low price-to-book value ratios have earned significantly higher returns than stocks of equivalent risk but higher price-to-book value ratios. It would be foolhardy not to review this evidence in the process of developing your investment philosophy. At the same time, though, you should keep in mind three caveats about this research:

1. Since they are based on the past, they represent a look in the rearview mirror. Strategies that earned substantial returns in the past may no

longer be viable strategies. In fact, as successful strategies get publicized either directly (in books and articles) or indirectly (by portfolio managers trading on them), you should expect to see them to become less effective.

2. Much of the research is based on constructing hypothetical portfolios, where you buy and sell stocks at historical prices and little or no attention is paid to transaction costs. To the extent that trading can cause prices to move, the actual returns on strategies can be very different from the returns on the hypothetical portfolio.
3. A test of an investment strategy is almost always a joint test of both the strategy and a model for risk. To see why, consider the evidence that stocks with low price-to-book value ratios earn higher returns than stocks with high price-to-book value ratios, with similar risk (at least as measured by the models we use). To the extent that we mismeasure risk or ignore a key component of risk, it is entirely possible that the higher returns are just a reward for the greater risk associated with low price-to-book value stocks.

Since understanding whether a strategy beats the market is such a critical component of investing, we will consider the approaches that are used to test a strategy, some basic rules that need to be followed in doing these tests, and common errors that are made (unintentionally or intentionally) when running such tests. As we look at each investment philosophy, we will review the evidence that is available on strategies that emerge from that philosophy.

Step 3: Find the Philosophy That Provides the Best Fit for You

Once you understand the basics of investing, form your views on human foibles and behavior, and review the evidence accumulated on each of the different investment philosophies, you are ready to make your choice. In our view, there is potential for success with almost every investment philosophy (yes, even charting), but the prerequisites for success can vary. In particular, success may rest on:

- *Your risk aversion.* Some strategies are inherently riskier than others. For instance, venture capital or private equity investing, where you invest your funds in small, private businesses that show promise, is inherently more risky than buying value stocks or equity in large, stable, publicly traded companies. The returns are also likely to be higher. However, more risk-averse investors should avoid the first strategy and focus on the second. Picking an investment philosophy (and strategy)

that requires you to take on more risk than you feel comfortable taking on can be hazardous to your health and your portfolio.

- *The size of your portfolio.* Some strategies require larger portfolios for success, whereas others work only on a smaller scale. For instance, it is very difficult to be an activist value investor if you have only \$100,000 in your portfolio, since firms are unlikely to listen to your complaints. At the other extreme, a portfolio manager with \$100 billion to invest may not be able to adopt a strategy that requires buying small, neglected companies. With such a large portfolio, the portfolio manager would very quickly end up becoming the dominant stockholder in each of the companies and affecting the price every time he or she trades.
- *Your time horizon.* Some investment philosophies are predicated on a long time horizon, whereas others require much shorter time horizons. If you are investing your own funds, your time horizon is determined by your personal characteristics (some of us are more patient than others) and your needs for cash (the greater the need for liquidity, the shorter your time horizon has to be). If you are a professional (an investment adviser or portfolio manager) managing the funds of others, it is your clients' time horizons and cash needs that will drive your choice of investment philosophies and strategies. You are only as long term as your clients allow you to be.
- *Your tax status.* Since such a significant portion of your money ends up going to the tax collectors, taxes have a strong influence on your investment strategies and perhaps even the investment philosophy you adopt. In some cases, you may have to abandon strategies that you find attractive on a pretax basis because of the tax bite that they expose you to.

Thus, the right investment philosophy for you will reflect your particular strengths and weaknesses. It should come as no surprise, then, that investment philosophies that work for some investors do not work for others. Consequently, there can be no one investment philosophy that can be labeled “best” for all investors.

CONCLUSION

An investment philosophy represents a set of core beliefs about how investors behave and how markets work. To be a successful investor, not only do you have to consider the evidence from markets, but you also have to examine your own strengths and weaknesses to come up with an investment philosophy that best fits you. Investors without core beliefs tend to wander from

strategy to strategy, drawn by the anecdotal evidence or recent successes, creating transaction costs and incurring losses as a consequence. Investors with clearly defined investment philosophies tend to be more consistent and disciplined in their investment choices, though success is not guaranteed to them, either.

In this chapter, we considered a broad range of investment philosophies from market timing to arbitrage and placed each of them in the broad framework of portfolio management. We also examined the three steps in the path to an investment philosophy, beginning with the understanding of the tools of investing—risk, trading costs, and valuation; continuing with an evaluation of the empirical evidence on whether, when, and how markets break down; and concluding with a self-assessment to find the investment philosophy that best matches your time horizon, risk preferences, and portfolio characteristics.

EXERCISES

1. Get access to a comprehensive database that covers all or most traded companies in the market and has both accounting numbers for these companies and market data (stock prices and market-based risk measures like standard deviation).
 - a. If you are interested only in U.S. companies, you have lots of choices, with varying costs. You can always use the free data on Yahoo! Finance or similar sites, but they come with restrictions on data definitions and downloads. I use Value Line's online data (cost of about \$1,000 per year in 2011) and have used Morningstar's online data as well (it requires a premium membership costing about \$200 in 2011).
 - b. If you are interested in global companies, you have to be willing to spend more: Capital IQ and Compustat (both S&P products) and FactSet have information on global companies. The good news is that the choices are proliferating and getting more accessible.
2. It will make your life far easier if you are comfortable using a spreadsheet program. I use Microsoft Excel simply because of its ubiquity and power, but there are cheaper alternatives.
3. Also, check out my website (www.damodaran.com) and click on updated data. You will find sector averages for pricing multiples and accounting ratios, and data on stock returns and risk-free rates.

