# Charlie Munger

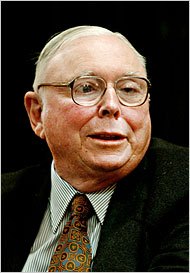
[](http://25iq.files.wordpress.com/2012/10/mungercharlie2.jpg)

Photo credit: [Value Walk](http://www.valuewalk.com/2010/01/charlie-munger-interview-on-bbc/)

More people would benefit from Charlie if his thoughts were more accessible and if he was as prolific a writer as he is a reader.  The best way by far to know Charlie is to read [Poor Charlie’s Almanack.](http://www.poorcharliesalmanack.com/pca.php)

“Charlie Munger is truly the broadest thinker I have ever encountered.”  – Bill Gates

<http://www.sanjaybakshi.net/bfbv/> **Full course on behavioral value investing and Charlie Munger**

**ACADEMIA:**

“Warren once said to me, “I’m probably misjudging academia generally [in thinking so poorly of it] because the people that interact with me have bonkers theories.” …  We’re trying to buy businesses with sustainable competitive advantages at a low – or even a fair price.  The reason the professors teach such nonsense is that if they didn’t], what would they teach the rest of the semester?  [Laughter]  Teaching people formulas that don’t really work in real life is a disaster for the world.” [Source](http://www.tilsonfunds.com/wscmtg04notes.doc)

“There’s a lot wrong [with American universities]. I’d remove 3/4 of the faculty — everything but the hard sciences. But nobody’s going to do that, so we’ll have to live with the defects. It’s amazing how wrongheaded [the teaching is]. There is fatal disconnectedness. You have these squirrelly people in each department who don’t see the big picture.”  [Source](http://www.fool.com/news/foth/2002/foth020515.htm)

“…a different set of incentives from rising in an economic establishment where the rewards system, again, the reinforcement, comes from being a truffle hound. That’s what Jacob Viner, the great economist called it: the truffle hound — an animal so bred and trained for one narrow purpose that he wasn’t much good at anything else, and that is the reward system in a lot of academic departments.” [Source](http://www.loschmanagement.com/Berkshire%20Hathaway/Charlie%20munger/The%20Psychology%20of%20Human%20Misjudgement.htm)

“I think liberal art faculties at major universities have views that are not very sound, at least on public policy issues — they may know a lot of French [however].” [Source](http://www.amazon.com/gp/product/1578643031/104-7644521-2497538?v=glance&n=283155)

**ACCOUNTING:**

“Proper accounting is like engineering. You need a margin of safety. Thank God we don’t design bridges and  airplanes the way we do accounting.”  [Source](http://www.law.stanford.edu/publications/stanford_lawyer/issues/64/sl64.pdf)

“ ‘F.A.S.B’  … ‘Financial Accounts Still Bogus.’ ” [Source](http://www.bluechipinvestorfund.com/munger.html)

“I talked to one accountant, a very nice fellow who I would have been glad to have his family marry into mine.  He said, “What these other accounting firms have done is very unethical.  The [tax avoidance scheme] works best if it’s not found out [by the IRS], so we only give it to our best clients, not the rest, so it’s unlikely to be discovered.  So my firm is better than the others.”  [Laughter]  I’m not kidding.  And he was a perfectly nice man.  People just follow the crowd…Their mind just drifts off in a ghastly way…” [Source](http://www.tilsonfunds.com/wscmtg04notes.doc)

“…accounting [is] the language of practical business life. It was a veryuseful thing to deliver to civilization. I’ve heard it came to civilization through Venice which of course was o­nce the great commercial power in the Mediterranean. However, double-entry bookkeeping was a hell of an invention. And it’s not that hard to understand. But you have to know enough about it to understand its limitations ‑ because although accounting is the starting place, it’s o­nly a crude approximation. And it’s not very hard to understand its limitations. For example, everyone can see that you have to more or less just guess at the useful life of a jet airplane or anything like that. Just because you express the depreciation rate in neat numbers doesn’t make it anything you really know.” [*Source*](http://www.thinkfn.com/en/content/view/52/?id=124)

“You’ll better understand the evil when top audit firms started selling fraudulent tax shelters when I tell you that one told me that they’re better [than the others] because they only sold [the schemes] to their top-20 clients, so that no-one would notice.” [Source](http://www.tilsonfunds.com/brkmtg04notes.doc)

“Creative accounting is an absolute curse to a civilization. One could argue that double-entry bookkeeping was one of history’s great advances. Using accounting for fraud and folly is a disgrace. In a democracy, it often takes a scandal to trigger reform. Enron was the most obvious example of a business culture gone wrong in a long, long time.” [Source](http://www.tilsonfunds.com/motley_berkshire_brkmtg02notes.php3)

“I also want to raise the possibility that there are, in the very long term, “virtue effects” in economics— for instance that widespread corrupt accounting will eventually create bad long term consequences as a sort of obverse effect from the virtue-based boost double-entry book-keeping gave to the heyday of Venice. I suggest that when the financial scene starts reminding you of Sodom and  Gomorrah, you should fear practical consequences even if you like to participate in what is going on.” [Source](http://www.tilsonfunds.com/Mungerwritings2001.pdf#search=%22%20%22charlie%20Munger%22%20Outstanding%20investor%20digest%22\" data-mce-href=)

**ACQUISITIONS:**

“Two thirds of acquisitions don’t work. Ours work because we don’t try to do acquisitions — we wait for no-brainers.”<http://www.tilsonfunds.com/motley_berkshire_brkmtg02notes.php>

“At most corporations if you make an acquisition and it turns out to be a disaster, all the paperwork and presentations that caused the dumb acquisition to be made are quickly forgotten. You’ve got denial, you’ve got everything in the world. You’ve got Pavlovian association tendency. Nobody even wants to even be associated with the damned thing or even mention it. At Johnson & Johnson, they make everybody revisit their old acquisitions and wade through the presentations. That is a very smart thing to do. And by the way, I do the same thing routinely.”  [Source](http://www.loschmanagement.com/Berkshire%20Hathaway/Charlie%20munger/The%20Psychology%20of%20Human%20Misjudgement.htm)

“We tend to buy things — a lot of things — where we don’t know exactly what will happen, but the outcome will be decent.” [Source](http://www.fool.com/news/foth/2002/foth020515.htm)

“We’ve bought business after business because we admire the founders and what they’ve done with their lives. In almost all cases, they’ve stayed on and our expectations have not been disappointed.”  [Source](http://www.fool.com/news/commentary/2003/commentary030509wt.htm)

**ADVERTISING:**

“If you were Proctor & Gamble, you could afford to use this new method of advertising. You could afford the very expensive cost of network television because you were selling so many cans and bottles. Some little guy couldn’t. And there was no way of buying it in part. Therefore, he couldn’t use it. In effect, if you didn’t have a big volume, you couldn’t use network TV advertising which was the most effective technique. So when TV came in, the branded companies that were already big got a huge tail wind. Indeed, they prospered and prospered and prospered until some of them got fat and foolish, which happens with prosperity ‑ at least to some people…” [Source](http://www.thinkfn.com/en/content/view/52/?id=124)

“I’d say 3/4 of advertising works on pure Pavlov. Think how association, pure association, works. Take Coca-Cola company (we’re the biggest share-holder). They want to be associated with every wonderful image: heroics in the Olympics, wonderful music, you name it. They don’t want to be associated with presidents’ funerals and so-forth.”[Source](http://www.loschmanagement.com/Berkshire%20Hathaway/Charlie%20munger/The%20Psychology%20of%20Human%20Misjudgement.htm)

**ADVICE:**

“Just avoid things like racing trains to the crossing, doing cocaine, etc.  Develop good mental habits.” [Source](http://www.tilsonfunds.com/brkmtg04notes.doc)

“A lot of success in life and business comes from knowing what you want to avoid: early death, a bad marriage, etc.” [Source](http://www.fool.com/BoringPort/2000/boringport00051501.htm)

“If you have only a little capital and are young today, there are fewer opportunities than when I was young. Back then, we had just come out of a depression. Capitalism was a bad word. There had been abuses in the 1920s. A joke going around then was the guy who said, ‘I bought stock for my old age and it worked — in six months, I feel like an old man!’ It’s tougher for you, but that doesn’t mean you won’t do well — it just may take more time. But what the heck, you may live longer.” [Source](http://www.fool.com/BoringPort/2000/boringport00051501.htm)

“Spend each day trying to be a little wiser than you were when you woke up. Discharge your duties faithfully and well. Step by step you get ahead, but not necessarily in fast spurts. But you build discipline by preparing for fast spurts… Slug it out one inch at a time, day by day, at the end of the day — if you live long enough — most people get what they deserve.” [Source](http://www.fool.com/news/commentary/2003/commentary030509wt.htm)

**ADVISERS:**

“You can hire your adviser and then just apply a windage factor, like I used to do when I was a rifle shooter. I’d just adjust for so many miles an hour wind. Or you can learn the basic elements of your advisor’s trade. You don’t have to learn very much, by the way, because if you learn just a little then you can make him explain why he’s right.”[Source](http://www.loschmanagement.com/Berkshire%20Hathaway/Charlie%20munger/The%20Psychology%20of%20Human%20Misjudgement.htm)

**AGE:**

”Warren has gotten to be one hell of a lot better investor over the period I’ve known him, so have I.  So the game is to keep learning.  You gotta like the learning process…. there’s an apocryphal story about Mozart.  A 14-year-old came to him and said, ‘I want to learn to be a great composer.’  And Mozart said, ‘You’re too young.’  The young man replied, ‘But I’m 14 years old and you were only eight or nine when you started composing.’  To which Mozart replied, ‘Yes, but I wasn’t running around asking other people how to do it.’ ”  [Source](http://www.tilsonfunds.com/wscmtg04notes.doc" \t "_blank)

“We’re not following the examples of any 40-year-old investors.” [Source](http://www.designs.valueinvestorinsight.com/bonus/bonuscontent/docs/Tilson_2006_BRK_Meeting_Notes.pdf#search=%22Charlie%20munger%20and%20foundation%20and%20croupier%22)

“We get these questions a lot from the enterprising young. It’s a very intelligent question: You look at some old guy who’s rich and you ask, ‘How can I become like you, except faster?’ ” [Source](http://www.fool.com/news/commentary/2003/commentary030509wt.htm)

**ALLOCATION OF CAPITAL:**

“We’re partial to putting out large amounts of money where we won’t have to make another decision.” [Source](http://www.tilsonfunds.com/motley_berkshire_brkmtg01notes.php3)

“I don’t think our successors will be as good as Warren at capital allocation.” [Source](http://www.tilsonfunds.com/motley_berkshire_brkmtg01notes.php3)

**AMERICAN EXPRESS:**

“It would be easier to screw up American Express than Coke or Gillette, but it’s an immensely strong business.” [Source](http://www.fool.com/boringport/2000/boringport000501a.htm)

**ANNUAL MEETINGS:**

“A lot of [corporations’ annual] meetings are set up to avoid groups like you – they’re in inconvenient locations and at inconvenient times – and they hope people like you won’t come.” [Source](http://www.tilsonfunds.com/wscmtg04notes.doc)

**AUCTIONS:**

“Well the open-outcry auction is just made to turn the brain into mush: you’ve got social proof, the other guy is bidding, you get reciprocation tendency, you get deprival super-reaction syndrome, the thing is going away… I mean it just absolutely is designed to manipulate people into idiotic behavior.” [Source](http://www.loschmanagement.com/Berkshire%20Hathaway/Charlie%20munger/The%20Psychology%20of%20Human%20Misjudgement.htm)

“The problem with closed bid auctions is that they are frequently won by people making a technical mistake, as in the case with Shell paying double for Belridge Oil. You can’t pay double the losing bid in an open outcry auction..” [Source](http://www.loschmanagement.com/Berkshire%20Hathaway/Charlie%20munger/The%20Psychology%20of%20Human%20Misjudgement.htm)

**BANKS:**

“Banking has turned out to be better than we thought. We made a few billion [dollars] from Amex while we misappraisal it. My only prediction is that we will continue to make mistakes like that.”  [Source](http://www.tilsonfunds.com/motley_berkshire_brkmtg03notes.php3)

“Financial institutions make us nervous when they’re trying to do well.”  [Source](http://www.tilsonfunds.com/motley_berkshire_brkmtg01notes.php3)

“What’s fascinating . . .is that you could now have a business that might have been selling for $10 billion where the business itself could probably not have borrowed even $100 million. But the owners of that business, because its public, could borrow many billions of dollars on their little pieces of paper- because they had these market valuations. But as a private business, the company itself couldn’t borrow even 1/20th of what the individuals could borrow.”[*Source*](http://fundooprofessor.blogspot.com/2005/11/one-valuation-rule-two-paradoxes.html)

**BANKRUPTCY:**

“I think much of [how bankruptcy is handled] is pretty horrible. It’s a  situation were courts themselves have gone into the business of bidding to attract bankruptcy proceedings…” [Source](http://www.designs.valueinvestorinsight.com/bonus/bonuscontent/docs/Tilson_2006_BRK_Meeting_Notes.pdf#search=%22Charlie%20munger%20and%20foundation%20and%20croupier%22)

**BEHAVIOR:**

“How you behave in one place, will help in surprising ways later.” [Source](http://media.wiley.com/product_data/excerpt/32/04712447/0471244732-1.pdf#search=%22munger%20you%20know%20the%20cliche%20that%20opposites%20attract%22)

“If you rise in life, you have to behave in a certain way. You can go to a strip club if you’re a beer-swilling sand shoveler, but if you’re the Bishop of Boston, you shouldn’t go.” [Source](http://www.fool.com/news/commentary/2003/commentary030509wt.htm)

**BEHAVIORAL ECONOMICS:**

“How could economics not be behavioral? If it isn’t behavioral, what the hell is it?”  [Source](http://www.vinvesting.com/docs/munger/human_misjudgement.html)

“How should the best parts of psychology and economics interrelate in an enlightened economist’s mind?… I think that these behavioral economics…or economists are probably the ones that are bending them in the correct direction. I don’t think it’s going to be that hard to bend economics a little to accommodate what’s right in psychology.”  [Source](http://www.loschmanagement.com/Berkshire%20Hathaway/Charlie%20munger/The%20Psychology%20of%20Human%20Misjudgement.htm)

**BEN FRANKLIN:**

“There is the sheer amount of Franklin’s wisdom… And the talent. Franklin played four instruments. He was the nation’s leading scientist and inventor, plus a leading author, statesman, and philanthropist. There has never been anyone like him.” [Source](http://money.cnn.com/magazines/fortune/fortune_archive/2006/05/29/8378052/index.htm)

**BEN GRAHAM:**

“The idea of a margin of safety, a Graham precept, will never be obsolete. The idea of making the market your servant will never be obsolete. The idea of being objective and dispassionate will never be obsolete. So, Graham had a lot of wonderful ideas.” [Source](http://www.fool.com/news/commentary/2003/commentary030509wt.htm)

“Ben Graham could run his Geiger counter over this detritus from the collapse of the 1930s and find things selling below their working capital per share and so on….  But he was, by and large, operating when the world was in shell shock from the 1930s—which was the worst contraction in the English-speaking world in about 600 years. Wheat in Liverpool, I believe, got down to something like a 600-year low, adjusted for inflation. the classic Ben Graham concept is that gradually the world wised up and those real obvious bargains disappeared. You could run your Geiger counter over the rubble and it wouldn’t click. … Ben Graham followers responded by changing the calibration on their Geiger counters. In effect, they started defining a bargain in a different way. And they kept changing the definition so that they could keep doing what they’d always done. And it still worked pretty well.”  [Source](http://ycombinator.com/munger.html)

**BERKSHIRE:**

“I’m a bull on Berkshire Hathaway. There may be some considerable waiting, but I think there are some good days ahead.” [Source](http://www.tilsonfunds.com/wscmtg05notes.pdf)

“Personally, I think Berkshire will be a lot bigger and stronger than it is. Whether the stock will be a good investment from today’s price is another question. The one thing we’ve always guaranteed is that the future will be a lot worse than the past.” [Source](http://www.fool.com/news/foth/2002/foth020515.htm)

“We stumbled into this two-person format. It would not work if it was just one person. You could have the wittiest, wisest person on earth up there, and people would find it very tiresome. It takes a little interplay of personalities to handle the extreme length of the festival.” [Source](http://money.cnn.com/magazines/fortune/fortune_archive/2006/05/29/8378052/index.htm)

“I don’t think it would work well to have a half-and-half management. We don’t need an operating guy; we have people running the businesses, and the main thing is not to destroy or damage the spirit they have.” [Source](http://www.fool.com/news/commentary/2006/commentary06053101.htm)

“Berkshire has the lowest turnover of any major company in the U.S. The Walton family owns more of Walmart than Buffett owns of Berkshire, so it isn’t because of large holdings. It’s because we have a really unusual shareholder body that thinks of itself as owners and not holders of little pieces of paper.”  [Source](http://www.fool.com/news/commentary/2006/commentary06053004.htm)

“The future returns of Berkshire and Wesco won’t be as good in the future as they have been in the past. The only difference is that we’ll tell you. Today, it seems to be regarded as the duty of CEOs to make the stock go up. This leads to all sorts of foolish behavior. We want to tell it like it is. I’m happy having 90% of my net worth in Berkshire stock. We’re going to try to compound it at a reasonable rate without taking unreasonable risk or using leverage. If we can’t do this, then that’s just too damn bad. The businesses that Berkshire has acquired will return 13% pre-tax on what we paid for them, maybe more. With a cost of capital of 3% — generated via other peoples’ money in the form of float — that’s a hell of a business. That’s the reason Berkshire shareholders needn’t totally despair.Berkshire is not as good as it was in terms of percentage compounding [going forward], but it’s still a hell of a business.” [Source](http://www.fool.com/news/foth/2001/foth010508.htm)

**BETA:**

“Beta and modern portfolio theory and the like – none of it makes any sense to me.” [Source](http://www.fool.com/news/commentary/2004/commentary040507wt.htm)

**BIOLOGY:**

“Common stock investors can make money by predicting the outcomes of practice evolution. You can’t derive this by fundamental analysis — you must think biologically.”[Source](http://www.fool.com/BoringPort/2000/boringport00051501.htm)

“I find it quite useful to think of a free market economy—or partly free market economy—as sort of the equivalent of an ecosystem… ” [Source](http://ycombinator.com/munger.html)

**BLACK-SCHOLES:**

“Black-Scholes is a know-nothing system. If you know nothing about value — only price — then Black-Scholes is a pretty good guess at what a 90-day option might be worth. But the minute you get into longer periods of time, it’s crazy to get into Black-Scholes. For example, at Costco we issued stock options with strike prices of $30 and $60, and Black-Scholes valued the $60 ones higher. This is insane.” [Source](http://www.tilsonfunds.com/motley_berkshire_brkmtg03notes.php)

”Black-Scholes works for short-term options, but if it’s a long-term option and you think you know something [about the underlying asset], it’s insane to use Black-Scholes.” [Source](http://www.tilsonfunds.com/motley_berkshire_brkmtg02notes.php)

**BOARD OF DIRECTORS:**

“A board member should be perfectly willing to leave at any time and willing to make the tough calls.” [Source](http://seekingalpha.com/article/14333)

“The institution of the board of directors of the major American company. Well, the top guy is sitting there, he’s an authority figure. He’s doing asinine things, you look around the board, nobody else is objecting, social proof, it’s okay? Reciprocation tendency, he’s raising the directors fees every year, he’s flying you around in the corporate airplane to look at interesting plants, or whatever in hell they do, and you go and you really get extreme dysfunction as a corrective decision-making body in the typical American board of directors. They only act, again the power of incentives, they only act when it gets so bad it starts making them look foolish, or threatening legal liability to them. That’s Munger’s rule. I mean there are occasional things that don’t follow Munger’s rule, but by and large the board of directors is a very ineffective corrector if the top guy is a little nuts, which, of course, frequently happens.” [Source](http://www.loschmanagement.com/Berkshire%20Hathaway/Charlie%20munger/The%20Psychology%20of%20Human%20Misjudgement.htm)

**BRAIN:**

“I think it is undeniably true that the human brain must work in models. 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 most work per unit.”  LatticeWork, The new Investing quoting OID

“The basic neural network of the brain is there through broad genetic and cultural evolution. And it’s not Fermat/Pascal. It uses a very crude, shortcut type of approximation. It’s got elements of Fermat/Pascal in it. However, it’s not good. So you have to learn in a very usable way this very elementary math and use it routinely in life ‑ just the way if you want to become a golfer, you can’t use the natural swing that broad evolution gave you. You have to learnto have a certain grip and swing in a different way to realize your full potential as a golfer.” [Source](http://www.thinkfn.com/en/content/view/52/?id)

“Man’s imperfect, limited-capacity brain easily drifts into working with what’s easily available to it. And the brain can’t use what it can’t remember or when it’s blocked from recognizing because it is heavily influenced by one or more psychological tendencies bearing strongly on it…” “…the Deep structure of the human mind requires that the way to full scope competency of virtually any kind is learn it all to fluency – like it or not.” [Source](http://www.poorcharliesalmanack.com/pca.php)

**BRANDS:**

“It’s hard to predict what will happen with two brands in a market.  Sometimes they will behave in a gentlemanly way, and sometimes they’ll pound each other.  I know of no way to predict whether they’ll compete moderately or to the death.  If you could figure it out, you could make a lot of money.” [Source](http://www.tilsonfunds.com/wscmtg04notes.doc)

**BRIDGE:**

“The right way to think is the way Zeckhauser plays bridge. It’s just that simple.” [Source](http://72.14.203.104/search?q=cache:3sSZnXLbvQEJ:www.loschmanagement.com/Berkshire%2520Hathaway/Charlie%2520munger/The%2520Psychology%2520of%2520Human%2520Misjudgement.htm+%22charlie+Munger%22+%22the+way+Zeckhauser+plays+bridge%22&hl=en&gl=us&ct=clnk&cd=1)

“Your brain doesn’t naturally know how to think the way Zeckhauser knows how to play bridge. ‘For example’,  people do not react symmetrically to loss and gain. Well maybe a great bridge player like Zeckhauser does, but that’s a trained response. Ordinary people, subconsciously affected by their inborn tendencies…” [Source](http://72.14.203.104/search?q=cache:3sSZnXLbvQEJ:www.loschmanagement.com/Berkshire%2520Hathaway/Charlie%2520munger/The%2520Psychology%2520of%2520Human%2520Misjudgement.htm+%22charlie+Munger%22+%22the+way+Zeckhauser+plays+bridge%22&hl=en&gl=us&ct=clnk&cd=1)

**BUBBLES:**

“[The Internet bubble circa 2000 is] the most extreme in modern capitalism. In the 1930s, we had the worst depression in 600 years. Today is almost as extreme in the opposite way.” [Source](http://www.fool.com/boringport/2000/boringport000501.htm)

“One of the first big bubbles, of course, was the huge and horrible South Sea Bubble in England. And the aftermath was interesting. Many of you probably don’t remember what happened after the South Sea Bubble, which caused an enormous financial contraction, and a lot of pain. They banned publicly traded stock in England for decades.”[*Source*](http://www.tilsonfunds.com/MungerUCSBspeech.pdf)

**BULL MARKETS:**

“Bull markets go to people’s heads. If you’re a duck on a pond, and it’s rising due to a downpour, you start going up in the world. But you think it’s you, not the pond.” [Source](http://www.quotationvault.com/author/Munger_Charlie)

**BUREAUCRACY:**

“The great defect of scale, of course, which makes the game interesting—so that the big people don’t always win—is that as you get big, you get the bureaucracy. And with the bureaucracy comes the territoriality—which is again grounded in human nature. And the incentives are perverse. For example, if you worked for AT&T in my day, it was a great bureaucracy. Who in the hell was really thinking about the shareholder or anything else? And in a bureaucracy, you think the work is done when it goes out of your in-basket into somebody else’s in-basket. But, of course, it isn’t. It’s not done until AT&T delivers what it’s supposed to deliver. So you get big, fat, dumb, unmotivated bureaucracies…. The constant curse of scale is that it leads to big, dumb bureaucracy—which, of course, reaches its highest and worst form in government where the incentives are really awful. That doesn’t mean we don’t need governments—because we do. But it’s a terrible problem to get big bureaucracies to behave.” [*Source*](http://ycombinator.com/munger.html)

“Sears had layers and layers of people it didn’t need. It was very bureaucratic. It was slow to think. And there was an established way of thinking. If you poked your head up with a new thought, the system kind of turned against you. It was everything in the way of a dysfunctional big bureaucracy that you would expect.”[*Source*](http://ycombinator.com/munger.html)

**BUSINESSES:**

“We’ve really made the money out of high quality businesses. In some cases, we bought the whole business. And in some cases, we just bought a big block of stock. But when you analyze what happened, the big money’s been made in the high quality businesses. And most of the other people who’ve made a lot of money have done so in high quality businesses.” [*Source*](http://ycombinator.com/munger.html)

**BUSINESS SCHOOL:**

“I was recently speaking with Jack McDonald, who teaches a course on investing rooted in our principles at Stanford Business School. He said it’s lonely — like he’s the Maytag repairman.” [Source](http://www.fool.com/boringport/2000/boringport00051500.htm)

**BUYING BACK SHARES:**

“A lot of share-buying, not bargain-seeking, is designed to prop stock prices up. Thirty to 40 years ago, it was very profitable to look at companies that were aggressively buying their own shares. They were motivated simply to buy below what it was worth.” [Source](http://www.fool.com/news/commentary/2006/commentary06053004.htm)

**CAPITAL ALLOCATION:**

**“**There are two kinds of businesses: The first earns 12%, and you can take it out at the end of the year. The second earns 12%, but all the excess cash must be reinvested — there’s never any cash. It reminds me of the guy who looks at all of his equipment and says, ‘There’s all of my profit.’ We hate that kind of business.” [Source](http://www.tilsonfunds.com/motley_berkshire_brkmtg03notes.php)

**CAPITALISM:**

“When it gets into these spikes, with shortages and uproar and so forth, people go bananas, but that’s capitalism.” [Source](http://www.kiplinger.com/personalfinance/features/archives/2005/11/munger3.html)

“I regard it as very unfair, but capitalism without failure is like religion without hell.” [Source](http://www.tilsonfunds.com/motley_berkshire_brkmtg02notes.php)

“Capitalism is a pretty brutal place.” [Source](http://ycombinator.com/munger.html)

**CASH:**

“Our cash is speaking for itself.  If we had a lot of wonderful ideas, we wouldn’t have so much cash.” [Source](http://www.tilsonfunds.com/wscmtg04notes.doc)

“There are worse situations than drowning in cash and sitting, sitting, sitting. I remember when I wasn’t awash in cash —and I don’t want to go back.” [Source](http://jianing1112.blogspot.com/2012/07/very-nice-charlie-munger-compilation.html)

**CHANGE:**

“Those who will not face improvements because they are changes, will face changes that are not improvements” [*Source*](http://www.feedblitz.com/f/f.fbz?PreviewFeed=7799)

**CHARACTER:**

“It’s hard to judge the combination of character and intelligence and other things. It’s not at all simple, which explains why we have so many divorces. (Laughter) Think about how much people know about the person they marry, yet so many break up. It’s not easy, it is in some cases. If people are splashing around with money like Dennis Kozlowski, with vodka at parties coming out of some body part, and if it looks like Sodom and Gomorrah, then maybe this isn’t what you’re looking for. (Laughter) But beyond that, it’s hard. If you have some unfortunate experiences while getting that knowledge, well, welcome to the human race. (Laughter)” [Source](http://www.tilsonfunds.com/wscmtg05notes.pdf)

“At Berkshire Hathaway we do notlike to compete against Chinese manufacturers.” <http://www.tilsonfunds.com/motley_berkshire_brkmtg02notes.php>

**CIALDINI:**

“Cialdini does a magnificent job at this, and you’re all going to be given a copy of Cialdini’s book. And if you have half as much sense as I think you do, you will immediately order copies for all of your children and several of your friends. You will never make a better investment.” <http://www.loschmanagement.com/Berkshire%20Hathaway/Charlie%20munger/The%20Psychology%20of%20Human%20Misjudgement.htm>

**CICERO:**

“As I continued through Cicero’s pages, I found much more material celebrating my way of life … ““Cicero’s words also increased my personal satisfaction by supporting my long-standing rejection of a conventional point of view.”  [http://www.fool.com/News/mft/2006/mft06072637.htm](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.fool.com%2fNews%2fmft%2f2006%2fmft06072637.htm)

**CIRCLE OF COMPETENCE:**

“There are a lot of things we pass on. We have three baskets: in, out, and too tough…We have to have a special insight, or we’ll put it in the ‘too tough’ basket. All of you have to look for a special area of competency and focus on that.”  <http://www.fool.com/news/foth/2002/foth020515.htm>

“If you have competence, you pretty much know its boundaries already. To ask the question [of whether you are past the boundary ] is to answer it.”  Poor Charlie’s <http://www.amazon.com/gp/product/1578643031/104-7644521-2497538?v=glance&n=283155>

 “We know the edge of our competency better than most.” That’s a very worthwhile thing.”[ttp://www.designs.valueinvestorinsight.com/bonus/bonuscontent/docs/Tilson\_2006\_BRK\_Meeting\_Notes.pdf#search=%22Charlie%20munger%20and%20foundation%20and%20croupier%22](http://www.designs.valueinvestorinsight.com/bonus/bonuscontent/docs/Tilson_2006_BRK_Meeting_Notes.pdf#search=%22Charlie%20munger%20and%20foundation%20and%20croupier%22)

“Warren and I avoid doing anything that someone else at Berkshire can do better.

You don’t really have a competency if you don’t know the edge of it.” <http://money.cnn.com/magazines/fortune/fortune_archive/2006/05/29/8378052/index.htm>

“Warren and I don’t feel like we have any great advantage in the high-tech sector. In fact, we feel like we’re at a big disadvantage in trying to understand the nature of technical developments in software, computer chips or what have you. So we tend to avoid that stuff, based on our personal inadequacies. Again, that is a very, very powerful idea. Every person is going to have a circle of competence. And it’s going to be very hard to advance that circle. If I had to make my living as a musician…. I can’t even think of a level low enough to describe where I would be sorted out to if music were the measuring standard of the civilization.  So you have to figure out what your own aptitudes are. If you play games where other people have the aptitudes and you don’t, you’re going to lose. And that’s as close to certain as any prediction that you can make. You have to figure out where you’ve got an edge. And you’ve got to play within your own circle of competence.  If you want to be the best tennis player in the world, you may start out trying and soon find out that it’s hopeless—that other people blow right by you. However, if you want to become the best plumbing contractor in Bemidji, that is probably doable by two-thirds of you. It takes a will. It takes the intelligence. But after a while, you’d gradually know all about the plumbing business in Bemidji and master the art. That is an attainable objective, given enough discipline. And people who could never win a chess tournament or stand in center court in a respectable tennis tournament can rise quite high in life by slowly developing a circle of competence—which results partly from what they were born with and partly from what they slowly develop through work.”  [http://ycombinator.com/munger.html](http://ycombinator.com/munger.html%E2%80%9CJust)

“Just as as a man working with his tools should know its limitations, a man working with his cognitive apparatus must know its limitations” <http://www.feedblitz.com/f/f.fbz?PreviewFeed=7799>

“When I run into a paradox I think either I’m a total horse’s ass to have gotten to this point, or I’m fruitfully near the edge of my discipline. It adds excitement to life to wonder which it is.” <http://www.cs.purdue.edu/news/images/STolopka.pdf#search=%22%22Charlie%20munger%22%20and%20quotations%22>

**COLLEAGUES:**

“You know the cliché that opposites attract? “Well, opposites don’t attract. Everybody engaged in complicated work needs colleagues.  Just the discipline of having to put your thoughts in order with somebody else is a very useful thing.” <http://media.wiley.com/product_data/excerpt/32/04712447/0471244732-1.pdf#search=%22munger%20you%20know%20the%20cliche%20that%20opposites%20attract%22>

**COMMITTEES:**

Being controlling owners is key – it would be hard for a committee to make these kinds of decisions. <http://www.tilsonfunds.com/motley_berkshire_brkmtg02notes.php>

**COMMODITIES:**

“ [Sarcastically]: I think we’ve demonstrated our expertise in commodities, if you look at our activities in silver. [Laughter]  …We didn’t get where we are by owning non-interest-bearing commodities.”[http://www.designs.valueinvestorinsight.com/bonus/bonuscontent/docs/Tilson\_2006\_BRK\_Meeting\_Notes.pdf#search=%22Charlie%20munger%20and%20foundation%20and%20croupier%22](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.designs.valueinvestorinsight.com%2fbonus%2fbonuscontent%2fdocs%2fTilson_2006_BRK_Meeting_Notes.pdf%23search%3d%2522Charlie%2520munger%2520and%2520foundation%2520and%2520croupier%2522)

“… we’ve missed the biggest commodity boom in history – and we’ll continue to miss things like this! ”  <http://www.tilsonfunds.com/brkmtg06notes.pdf>

**COMMON SENSE:**

“Organized common (or uncommon) sense — very basic knowledge — is an enormously powerful tool. There are huge dangers with computers. People calculate too much and think too little.”  [http://www.fool.com/news/foth/2002/foth020515.htm](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.fool.com%2fnews%2ffoth%2f2002%2ffoth020515.htm)

“Part of [having uncommon sense] is being able to tune out folly, as opposed to recognizing wisdom.  If you bat away many things, you don’t clutter yourself.”<http://www.tilsonfunds.com/brkmtg06notes.pdf>

“In the corporate world, if you have analysts, due diligence, and no horse sense you’ve just described hell.” <http://www.tilsonfunds.com/motley_berkshire_brkmtg02notes.php>

**COMPENSATION:**

 “It isn’t enough to buy the right business. You’ve also have to have compensationsystem that’s satisfactory to the people running them. At Berkshire Hathaway, we haveno [single] system; we have different systems. They’re very simple and we don’t tend torevisit them very often. It’s amazinghow well it’s worked. We wrote a one-page dealwith Chuck Huggins when we bought See’s and it’s never been touched. We have neverhired a compensation consultant.”  <http://www.tilsonfunds.com/wscmtg05notes.pdf>

I’d rather throw a viper down my shirt front than hire a compensation consultant.  <http://www.grahamanddoddsville.net/wordpress/Files/Gurus/Warren%20Buffett/Berkshire%20Hathaway%20Annual%20Meeting%20Notes%202004.pdf>

Carnegie was always proud that he took very little salary. Rockefeller, Vanderbilt were the same. It was a common culture in a different era. All of these people thought of themselves as the founder. I was delighted to get rid of the pressure of getting fees based on performance. If you are highly conscientious and you hate to disappoint, you will feel the pressure to live up to your incentive fee. There was an enormous advantage [to switching away from taking a percentage of the profits to managing Berkshire, in which their interests as shareholders are exactly aligned with other shareholders]. <http://www.tilsonfunds.com/motley_berkshire_brkmtg03notes.php3>  
  
“CEOs have a duty…to dampen envy and resentment by behaving way more nobly than other people, and way more generously. People should take way less than they are worthy when they are favored by life. People are willing to pay tens of millions of dollars to be U.S. senators. Most of these people would pay to be CEOs….There is a lot to be said for backing off and taking less than their worth.”  <http://blogs.barrons.com/techtraderdaily/2006/06/26/the-wit-and-wisdom-of-charlie-munger/>

“Everywhere there is a large commission, there is a high probability of a ripoff.” <http://www.fool.com/news/commentary/2006/commentary06062914.htm>

It is easy to have fair compensation systems, but about half of companies have grossly unfair systems in which the top people get paid too much.<http://www.fool.com/news/commentary/2006/commentary06052706.htm>

**COMPETITION:**

 “We may well have a competitive advantage buying decent businesses at decent prices. But they won’t be fabulous businesses and fabulous prices. There’s too much competition and money out there, with many buyout specialists.” [http://www.tilsonfunds.com/motley\_berkshire\_wscmtg01notes.php3](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.tilsonfunds.com%2fmotley_berkshire_wscmtg01notes.php3)

“Many markets get down to two or three big competitors—or five or six. And in some of those markets, nobody makes any money to speak of. But in others, everybody does very well.  Over the years, we’ve tried to figure out why the competition in some markets gets sort of rational from the investor’s point of view so that the shareholders do well, and in other markets, there’s destructive competition that destroys shareholder wealth.  If it’s a pure commodity like airline seats, you can understand why no one makes any money. As we sit here, just think of what airlines have given to the world—safe travel, greater experience, time with your loved ones, you name it. Yet, the net amount of money that’s been made by the shareholders of airlines since Kitty Hawk, is now a negative figure—a substantial negative figure. Competition was so intense that, once it was unleashed by deregulation, it ravaged shareholder wealth in the airline business.  Yet, in other fields—like cereals, for example—almost all the big boys make out. If you’re some kind of a medium grade cereal maker, you might make 15% on your capital. And if you’re really good, you might make 40%. But why are cereals so profitable—despite the fact that it looks to me like they’re competing like crazy with promotions, coupons and everything else? I don’t fully understand it.  Obviously, there’s a brand identity factor in cereals that doesn’t exist in airlines. That must be the main factor that accounts for it.   
And maybe the cereal makers by and large have learned to be less crazy about fighting for market share—because if you get even one person who’s hell-bent on gaining market share…. For example, if I were Kellogg and I decided that I had to have 60% of the market, I think I could take most of the profit out of cereals. I’d ruin Kellogg in the process. But I think I could do it.  [http://ycombinator.com/munger.html](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fycombinator.com%2fmunger.html)

“Even bright people are going to have limited, really valuable insights in a very competitive world when they’re fighting against other very bright, hardworking people. And it makes sense to load up on the very few good insights you have instead of pretending to know everything about everything at all times.” [http://ycombinator.com/munger.html](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fycombinator.com%2fmunger.html)

**COMPLEXITY:**

“A rough rule in life is that an organization foolish in one way in dealing with a complex system is all too likely to be foolish in another.”<http://www.tilsonfunds.com/Mungerwritings2001.pdf#search=%22%20%22charlie%20Munger%22%20Outstanding%20investor%20digest%22>

**COMPOUNDING:**

“Understanding both the power of compound return and the difficulty of getting it is the heart and soul of understanding a lot of things.” <http://www.sandmansplace.com/Sandman_Favorite_Quotes.html>

“Never interrupt it unnecessarily”   <http://72.14.203.104/search?q=cache:IuDIHXun74MJ:www.amazon.com/exec/obidos/tg/detail/-/1578643031%3Fv%3Dglance+%22Charlie+Munger%22+%22I+didn%27t+get+to+where+I+am%22&hl=en&gl=us&ct=clnk&cd=1>

Understanding both the power of compound interest and the difficulty of getting it is the heart and soul of understanding a lot of things”  <http://www.feedblitz.com/f/f.fbz?PreviewFeed=7799>

“We’re not crying wolf at how hard it is to compound at the old rates—it can’t be done. Look how tough it is to earn $100 million pretax doing anything; few ever accomplish it. Then $1 billion, the $5 billion, then $10 billion….”  Poor Charlie’s at 77  <http://www.amazon.com/gp/product/1578643031/104-7644521-2497538?v=glance&n=283155>

**CONFIDENCE:**

“I have a black belt in chutzpah. I was born with it. Some people, like some of the women I know, have a black belt in spending. They were born with that. But what they gave me was a black belt in chutzpah.”  [http://www.tilsonfunds.com/MungerUCSBspeech.pdf](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.tilsonfunds.com%2fMungerUCSBspeech.pdf)

**CONFIRMATION BIAS:**

“Most people early achieve and later intensify a tendency to process new and disconfirming information so that any original conclusion remains intact. They become people of whom Philip Wylie observed: “You couldn’t ’t squeeze a dime between what they already know and what  they will never learn.”<http://www.amazon.com/gp/product/1578643031/104-7644521-2497538?v=glance&n=283155>

“The great example of Charles Darwin is he avoided confirmation bias.  Darwin probably changed my life because I’m a biography nut, and when I found out the way he always paid extra attention to the disconfirming evidence and all these little psychological tricks. I also found out that he wasn’t very smart by the ordinary standards of human acuity, yet there he is buried in Westminster Abbey. That’s not where I’m going, I’ll tell you.” <http://www.loschmanagement.com/Berkshire%20Hathaway/Charlie%20munger/The%20Psychology%20of%20Human%20Misjudgement.htm>

“The human mind is a lot like the human egg, and the human egg has a shut-off device. When one sperm gets in, it shuts down so the next one can’t get in. … And of course, if you make a public disclosure of your conclusion, you’re pounding it into your own head.<http://www.loschmanagement.com/Berkshire%20Hathaway/Charlie%20munger/The%20Psychology%20of%20Human%20Misjudgement.htm>

“This is why organizations solicit public pledges. Hell, it’s the reason for the marriage ceremony.”  Talk at Cal Tech, “Bad Judgments, Common Causes, cited in Lowenstein at 169

**CONSULTANTS:**

“I have never seen a management consultant’s report in my long life that didn’t end with the following paragraph: “What this situation really needs is more management consulting.” Never once. I always turn to the last page. Of course Berkshire doesn’t hire them, so I only do this on sort of a voyeuristic basis. Sometimes I’m at a non-profit where some idiot hires one. [Laughter] ”<http://www.loschmanagement.com/Berkshire%20Hathaway/Charlie%20munger/The%20Psychology%20of%20Human%20Misjudgement.htm>

**CONTRARIAN:**

“We have a history when things are really horrible of wading in when no one else will.”   <http://www.fool.com/news/foth/2002/foth020515.htm>

**CORPORATE GOVERNANCE:**

“The system has deteriorated, and the reputation of the system has deteriorated even more than the system,” he said, noting that “a lot of people are mad at corporate governance,” including the kind of white-bread Republicans who should be the system’s biggest supporters. “When even they are mad at Corporate America, “Corporate America has a serious problem.” <http://blogs.barrons.com/techtraderdaily/2006/06/26/the-wit-and-wisdom-of-charlie-munger/>

**COSTCO:**

”I admired the place so much,” Munger says, “that I violated my rules (against sitting on outside boards). It’s hard to think of people who’ve done more in my lifetime to change the world of retailing for good, for added human happiness to the customer.” <http://www.sandiegometro.com/1998/nov/money.html>

**COSTS:**

“We don’t have an isolated group [of senior managers] surrounded by servants. Berkshire’s headquarters is a tiny little suite.  We just came back from Berkshire’s board meeting; it had moved up to the board room of the Kiewit company and [it was so large and luxurious that] I felt uncomfortable .”<http://www.grahamanddoddsville.net/wordpress/Files/Gurus/Warren%20Buffett/Berkshire%20Hathaway%20Annual%20Meeting%20Notes%202004.pdf>

**COST OF CAPITAL:**

“Obviously, consideration of costs is key, including opportunity costs. Of course capital isn’t free. It’s easy to figure out your cost of borrowing, but theorists went bonkers on the cost of equity capital. They say that if you’re generating a 100% return on capital, then you shouldn’t invest in something that generates an 80% return on capital. It’s crazy.”   <http://www.tilsonfunds.com/motley_berkshire_brkmtg01notes.php>

**CRIME:**

“A few public hangings will really change behavior. One of our Presidents said if he could execute three people each year for no cause, it would make it a lot easier to govern. When someone said that’s not enough, he said, “Oh yes it is, because I’d publish the list of people under consideration.” (Laughter) <http://www.tilsonfunds.com/wscmtg05notes.pdf>

**CROWD FOLLY:**

“’Crowd folly’, the tendency of humans, under some circumstances, to resemble lemmings, explains much foolish thinking of brilliant men and much foolish behavior — like investment management practices of many foundations represented here today. It is sad that today each institutional investor apparently fears most of all that its investment practices will be different from practices of the rest of the crowd.”<http://www.tilsonfunds.com/Mungerwritings2001.pdf#search=%22%20%22charlie%20Munger%22%20Outstanding%20investor%20digest%22>

**CULTURE:**

“For many of our shareholders, our stock is all they own, and we’re acutely aware of that. Our culture [of conservatism] runs pretty deep.” [http://www.fool.com/news/foth/2002/foth020515.htm](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.fool.com%2fnews%2ffoth%2f2002%2ffoth020515.htm)

“I think the foundation at Berkshire [Buffett’s stake in Berkshire will pass to the Buffett Foundation upon his death] will be a plus because there will be a continuation of the culture. We’d still take in fine businesses run by people who love them.”  <http://www.tilsonfunds.com/motley_berkshire_brkmtg01notes.php>

Our culture is very old-fashioned, like Ben Franklin or Andrew Carnegie. Can you imagine Andrew Carnegie hiring consultants?! It’s amazing how well this approach still works. A lot of the businesses we buy are kind of cranky and old-fashioned like us.”  [http://www.fool.com/boringport/2000/boringport000501.htm](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.fool.com%2fboringport%2f2000%2fboringport000501.htm)

“If Warren has kept the faith until he’s 75 years old, do you really think he’ll  blow the job of passing that culture along? What could be more important? You all have a lot more things to worry about than the candle at Berkshire going out because some people eventually die.” [http://www.designs.valueinvestorinsight.com/bonus/bonuscontent/docs/Tilson\_2006\_BRK\_Meeting\_Notes.pdf#search=%22Charlie%20munger%20and%20foundation%20and%20croupier%22](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.designs.valueinvestorinsight.com%2fbonus%2fbonuscontent%2fdocs%2fTilson_2006_BRK_Meeting_Notes.pdf%23search%3d%2522Charlie%2520munger%2520and%2520foundation%2520and%2520croupier%2522)

**DEBT:**

“We have monetized houses in this country in a way that’s never occurred before. Ask Joe how he bought a new Cadillac [and he’ll say] from borrowing on his house. We are awash in capital. [Being] awash is leading to very terrible behavior by credit cards and subprime lenders -a very dirty business, luring people into a disadvantageous position. It’s a new way of getting serfs, and it’s a dirty business. We have financial institutions, including those with big names, extending high-cost credit to the least able people. I find a lot of it revolting. Just because it’s a free market doesn’t mean it’s honorable.” <http://www.tilsonfunds.com/wscmtg05notes.pdf>

“Of course I’m troubled by huge consumer debt levels – we’ve pushed consumer credit very hard in the US.  Eventually, if it keeps growing, it will stop growing. As Herb Stein said, “If something cannot go on forever, it will stop.”  When it stops, it may be unpleasant.  Other than Herb Stein’s quote, I have no comment.  But the things that trouble you are troubling me. <http://www.grahamanddoddsville.net/wordpress/Files/Gurus/Warren%20Buffett/Berkshire%20Hathaway%20Annual%20Meeting%20Notes%202004.pdf>

**DECISIONS:**

**“**If you took out our 15 best ideas, most of you wouldn’t be here.”  <http://www.tilsonfunds.com/motley_berkshire_brkmtg01notes.php>

**DECLINING PRICES:**

“Over many decades, our usual practice is that if [the stock of] something we like goes down, we buy more and more. Sometimes something happens, you realize you’re wrong, and you get out. But if you develop correct confidence in your judgment, buy more and take advantage of stock prices.”  <http://www.fool.com/news/foth/2002/foth020515.htm>

**DENIAL:**

“If people tell you what you really don’t want to hear what’s unpleasant—there’s an almost automatic reaction of antipathy. You have to train yourself out of it.” [http://ycombinator.com/munger.html](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fycombinator.com%2fmunger.html)

**DISASTERSs:**

“We don’t think because it’s never happened that it won’t. There’s no actuarial science, it’s rough judgment. We just try to be conservative.” <http://www.tilsonfunds.com/motley_berkshire_brkmtg01notes.php>

**DEFICITS:**

“Generally speaking, it can¹t be good to be running a big current account deficit and a big fiscal deficit and have them both growing. You would be thinking the end there would be a comeuppance.” “[But] it isn’t as though all the other options look wonderful compared to the US. It gives me some feeling that what I regard as fiscal misbehavior on our part could go on some time without paying the price.” <http://us.ft.com/ftgateway/superpage.ft?news_id=fto050720060912107064&page=2>

“We started from such a strong position. It’s not as if the alternatives are all so great. I can understand why people would rather invest in the  U.S. Do you want to be in Europe, where 12-13% of people are unemployed and most 28-year-olds are living at home and being paid by state to do it? Or be in Brazil or Venezuela with the political instability that you fear? It’s not totally irrational that  people still like the U.S., despite its faults. Whatever misbehavior there is could go on quite a long time without a price being paid. “[http://www.designs.valueinvestorinsight.com/bonus/bonuscontent/docs/Tilson\_2006\_BRK\_Meeting\_Notes.pdf#search=%22Charlie%20munger%20and%20foundation%20and%20croupier%22](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.designs.valueinvestorinsight.com%2fbonus%2fbonuscontent%2fdocs%2fTilson_2006_BRK_Meeting_Notes.pdf%23search%3d%2522Charlie%2520munger%2520and%2520foundation%2520and%2520croupier%2522)

**DEFERRED GRATIFICATION:**

“Almost all good businesses engage in ‘pain today, gain tomorrow’ activities.”  <http://www.tilsonfunds.com/motley_berkshire_brkmtg01notes.php>

**DENIAL:**

“If you turn on the television, you’ll find the mothers of the most obvious criminals that man could ever diagnose, and they all think their sons are innocent. That’s simple psychological denial. The reality is too painful to bear, so you just distort it until it’s bearable. We all do that to some extent, and it’s a common psychological misjudgment that causes terrible problems.” <http://www.loschmanagement.com/Berkshire%20Hathaway/Charlie%20munger/The%20Psychology%20of%20Human%20Misjudgement.htm>

**DERIVITIVES:**

“Everyone caved, adopted loose [accounting] standards, and created exotic derivatives linked to theoretical models. As a result, all kinds of earnings, blessed by accountants, are not really being earned. When you reach for the money, it melts away. It was never there. It [accounting for derivatives] is just disgusting. It is a sewer, and if I’m right, there will be hell to pay in due course. All of you will have to prepare to deal with a blow-up of derivative books.  [http://www.fool.com/news/foth/2002/foth020515.htm](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.fool.com%2fnews%2ffoth%2f2002%2ffoth020515.htm)

“No CEO examining books today understands what the hell is going on.”  [http://www.law.stanford.edu/publications/stanford\_lawyer/issues/64/sl64.pdf](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.law.stanford.edu%2fpublications%2fstanford_lawyer%2fissues%2f64%2fsl64.pdf)

“The stupid and dishonest accountants allowed the genie of totally inappropriate accounting to descend on derivatives books. And once this has happened – people get status, etc. – it’s impossible to get it back into the bottle. <http://www.tilsonfunds.com/wscmtg05notes.pdf>

“People don’t think about the consequences of the consequences.  People start by trying to hedge against interest rate changes, which is very difficult and complicated.  Then, the hedges made the results [reported profits] lumpy.  So then they use new derivatives to smooth this.  Well, now you’ve morphed into lying.  This turns into a Mad Hatter’s Party.  This happens to vast, sophisticated corporations.   Somebody has to step in and say, “We’re not going to do it — it’s just too hard… Derivatives are full of clauses that say if one party’s credit gets downgraded, then they have to put up collateral.  It’s like margin – you can go broke.  In attempting to protect themselves, they’ve introduced instability.  Nobody seems to have recognition of what a disaster of a system they’ve created.  It’s a demented system. <http://www.grahamanddoddsville.net/wordpress/Files/Gurus/Warren%20Buffett/Berkshire%20Hathaway%20Annual%20Meeting%20Notes%202004.pdf>

To say accounting for derivatives is  America is a sewer is an insult to sewage.” <http://www.tilsonfunds.com/motley_berkshire_brkmtg02notes.php>

**DIRECTORS:**

“Generally speaking, if you’re counting on outside directors to act [forcefully to protect your interests as a shareholder, then you’re crazy].  As a general rule in  America, boards act only if there’s been a severe disgrace. My friend Joe was asked to be on the board of Northwestern Bell and he jokes that “it was the last thing they ever asked me.”  [Laughter] I think you get better directors when you get directors who don’t need the money.  When it’s half your income and all your retirement, you’re not likely to be very independent.  But when you have money and an existing reputation that you don’t want to lose, then you’ll act more independently.    <http://www.grahamanddoddsville.net/wordpress/Files/Gurus/Warren%20Buffett/Berkshire%20Hathaway%20Annual%20Meeting%20Notes%202004.pdf>

“If mutual fund directors are independent, then I’m the lead character in the [Bolshoi Ballet](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.bolshoi.ru%2fannounces_eng.shtml).”  [Laughter]<http://www.grahamanddoddsville.net/wordpress/Files/Gurus/Warren%20Buffett/Berkshire%20Hathaway%20Annual%20Meeting%20Notes%202004.pdf>

“A director who gets $150,000 per year from a company and needs the money is notindependent.”    <http://www.tilsonfunds.com/wscmtg05notes.pdf>

“I think it would be a great improvement if there were no D&O insurance . The counter-argument is that no-one with any money would serve on a board. But I think net net you’d be better off.” <http://www.tilsonfunds.com/motley_berkshire_brkmtg03notes.php3>

**DISASTERS:**

“Years ago, portfolio insurance was popular. People were selling it as a highly sophisticated way for large institutions to manage money and mitigate risk, and they earned a lot selling it. Then on Oct. 19, 1987, a relatively small amount of money that had been invested in portfolio insurance led to a one-day 22% drop. Each of the individuals who invested in portfolio insurance was intelligent, but in aggregate, they created a doomsday machine. I think the odds of something like this are magnified today compared to the 1980s. I don’t know who will yell “fire,” but when it happens, I’m sure the currency markets will play a role in the race for the door. “<http://www.fool.com/news/commentary/2006/commentary06053101.htm>

**DISCLIPLINE:**

“We have this investment discipline of waiting for a fat pitch. If I was offered the chance to go into business where people would measure me against benchmarks, force me to be fully invested, crawl around looking over my shoulder, etc., I would hate it. I would regard it as putting me into shackles.”<http://www.tilsonfunds.com/motley_berkshire_brkmtg03notes.php3>

**DISCOUNTED CASH FLOW:**

“Warren talks about these discounted cash flows. I’ve never seen him do one.”  [“It’s true,” replied Buffett. “If (the value of a company) doesn’t just scream out at you, it’s too close.”] 1996 Berkshire Hathaway annual meeting <http://www.ndir.com/SI/email/q403.shtml>

**DIVERSIFICATION:**

“The Berkshire-style investors tend to be less diversified than other people. The academics have done a terrible disservice to intelligent investors by glorifying the idea of diversification. Because I just think the whole concept is literally almost insane. It emphasizes feeling good about not having your investment results depart very much from average investment results. But why would you get on the bandwagon like that if somebody didn’t make you with a whip and a gun? <http://www.myinvestmentforum.com/category/sgfunds-forum/interview-with-charlie-munger-t1655.html>

“The idea of excessive diversification is madness.” <http://www.grahamanddoddsville.net/wordpress/Files/Gurus/Warren%20Buffett/Berkshire%20Hathaway%20Annual%20Meeting%20Notes%202004.pdf>

**DIVIDENDS:**

“The total amount paid out in dividends is roughly equal to the amount lost in trading and investment advice, so net dividends to shareholders are zero.  This is a very peculiar way to run a republic.”   <http://www.grahamanddoddsville.net/wordpress/Files/Gurus/Warren%20Buffett/Berkshire%20Hathaway%20Annual%20Meeting%20Notes%202004.pdf>

**DOWNTURNS:**

“If you, like me, lived through 1973-74 or even the early 1990s… There was a waiting list to get OUT of the country club — that’s when you know things are tough. If you live long enough, you’ll see it.” <http://www.tilsonfunds.com/motley_berkshire_brkmtg01notes.php>

“It is an unfortunate fact that great and foolish excess can come into prices of common stocks in the aggregate. They are valued partly like bonds, based on roughly rational projections of use value in producing future cash. But they are also valued partly like Rembrandt paintings, purchased mostly because their prices have gone up, so far.” <http://www.tilsonfunds.com/Mungerwritings2001.pdf#search=%22%20%22charlie%20Munger%22%20Outstanding%20investor%20digest%22>

**EARNINGS:**

“We don’t care about quarterly earnings (though obviously we care about how the business is doing over time) and are unwilling to manipulate in any way to make some quarter look better.” <http://www.grahamanddoddsville.net/wordpress/Files/Gurus/Warren%20Buffett/Berkshire%20Hathaway%20Annual%20Meeting%20Notes%202004.pdf>

“What we don’t like in modern capitalism is the expectations game. It’s not the kissing cousin of evil; it’s the blood brother.” <http://www.tilsonfunds.com/wscmtg05notes.pdf>

“We don’t give a damn about lumpy results. Everyone else is trying to please Wall Street. This is not a small advantage.” [http://www.fool.com/boringport/2000/boringport00051500.htm](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.fool.com%2fboringport%2f2000%2fboringport00051500.htm)

**EBITDA:**

“I think that, every time you saw the word EBITDA [earnings], you should substitute the word “bullshit” earnings.” [http://www.tilsonfunds.com/motley\_berkshire\_brkmtg03notes.php3](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.tilsonfunds.com%2fmotley_berkshire_brkmtg03notes.php3)

**ECONOMICS:**

“Gigantic macroeconomic predictions are something I’ve never made any money on, and neither has Warren ” <http://www.grahamanddoddsville.net/wordpress/Files/Gurus/Warren%20Buffett/Berkshire%20Hathaway%20Annual%20Meeting%20Notes%202004.pdf>

“Economics is in many respects the queen of the soft sciences. It’s expected to be better than the rest. It’s my view that economics is better at the multi-disciplinary stuff than the rest of the soft science. And it’s also my view that it’s still lousy.”  [http://www.tilsonfunds.com/MungerUCSBspeech.pdf](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.tilsonfunds.com%2fMungerUCSBspeech.pdf)

“…Max Planck the great Nobel laureate who found Planck’s Constant, tried once to do economics. He gave it up. Now why did Max Planck, one of the smartest people who ever lived, give up economics? The answer is, he said, “It’s too hard. The best solution you can get is messy and uncertain. “[http://www.tilsonfunds.com/MungerUCSBspeech.pdf](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.tilsonfunds.com%2fMungerUCSBspeech.pdf)

“economics should emulate physics’ basic ethos, but its search for precision in physics–like formulas is almost always wrong in economics.”<http://www.smalla.net/tidbits/quotations/index.shtml>

“Economists get very uncomfortable when you talk about virtue and vice. It doesn’t lend itself to a lot of columns with numbers. But I would argue that there are big virtue effects in economics. I would say that the spreading of double-entry bookkeeping by the Monk, Fra Luce de Pacioli, was a big virtue effect in economics. It made business more controllable, and it made it more honest. <http://www.originaldissent.com/forums/archive/index.php/t-14214.html>

“If you try and talk like this to an economics professor, and I’ve done this three times, they shrink in horror and offense because they don’t like this kind of talk. It really gums up this nice discipline of theirs, which is so much simpler when you ignore second- and third-order consequences.”    <http://72.14.203.104/search?q=cache:eO7qYBw3X78J:www.fool.com/news/commentary/2004/commentary040604wt.htm+%22Charlie+munger%22+transcript&hl=en&gl=us&ct=clnk&cd=1>

**ECONOMIES OF SCALE:**

“On the subject of economies of scale, I find chain stores quite interesting. Just think about it. The concept of a chain store was a fascinating invention. You get this huge purchasing power — which means that you have lower merchandise costs. You get a whole bunch of little laboratories out there in which you can conduct experiments. And you get specialization. If one little guy is trying to buy across 27 different merchandise categories influenced by traveling salesmen, he’s going to make a lot of dumb decisions. But if your buying is done in headquarters for a huge bunch of stores, you can get very bright people that know a lot about refrigerators and so forth to do the buying. The reverse is demonstrated by the little store where one guy is doing all the buying. It’s like the old story about the little store with salt all over its walls. And a stranger comes in and says to the store owner, ‘You must sell a lot of salt.’ And he replies, ‘No, I don’t. But you should see the guy that sells me salt.’ So there are huge purchasing advantages….”  1995 lecture at the  University of Southern California entitled “A Lesson on Elementary, Worldly Wisdom as it Relates to Investment Management & Business.”  [Outstanding Investors Digest](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.oid.com%2f).   [http://www.fool.com/boringport/1999/boringport991020.htm?ref=yhoolnk](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.fool.com%2fboringport%2f1999%2fboringport991020.htm%3fref%3dyhoolnk)

“in terms of which businesses succeed and which businesses fail, advantages of scale are ungodly important. …  In some businesses, the very nature of things is to sort of cascade toward the overwhelming dominance of one firm. And these advantages of scale are so great, for example, that when Jack Welch came into General Electric, he just said, “To hell with it. We’re either going to be # 1 or #2 in every field we’re in or we’re going to be out.”  <http://ycombinator.com/munger.html>

**ECONOMY:**

“I think the main figure that matters to all of us, including people in the media, is: How does GDP per capita grow? And those figures have been very good. There is a huge flux both up and down, so it isn’t like we’re all static in status. What’s important is that pie grows. ” <http://www.fool.com/news/commentary/2006/commentary06052706.htm>

**EDUCATION:**

“I get flack for saying [when I visit a college and give a speech], “This is a nice college, but the really great educator is McDonald’s.” They hate me for saying this and think I’m a slimy creature. But McDonald’s hires people with bad work habits, trains them, and teaches them to come to work on time and have good work habits. I think a lot of what goes on there is better than at Harvard.”  <http://www.tilsonfunds.com/wscmtg05notes.pdf>

“You could argue that [the decline of public schools] is one of the major disasters in our lifetimes. We took one of the greatest successes in the history of the earth and turned it into one of the greatest disasters in the history of the earth.” <http://www.fool.com/news/foth/2001/foth010508.htm>

“The theory of modern education is that you need a generaleducation before you specialize. And I think to some extent, before you’re going to be a great stock picker, you need some general education.” [http://www.thinkfn.com/en/content/view/52/?id=124](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.thinkfn.com%2fen%2fcontent%2fview%2f52%2f%3fid%3d124)

“If you don’t keep learning, other people will pass you by. Temperament alone won’t do it – you need a lot of curiosity for a long, long time.”   <http://www.grahamanddoddsville.net/wordpress/Files/Gurus/Warren%20Buffett/Berkshire%20Hathaway%20Annual%20Meeting%20Notes%202004.pdf>

“To finish first you have to first finish. Don’t get in a position where you go back to go. What’s interesting is that some guy whose grandfather was a lawyer and a judge—hurriedly going to Harvard Law with a wave of veterans—I was willing to go into so many different businesses. I was constantly going right into the other fellow’s business and doing better than the other fellow did. The reason it was possible? Self-education— developing mental discipline, big ideas that really work.”[http://media.wiley.com/product\_data/excerpt/32/04712447/0471244732-1.pdf#search=%22munger%20you%20know%20the%20cliche%20that%20opposites%20attract%22](http://media.wiley.com/product_data/excerpt/32/04712447/0471244732-1.pdf" \l "search=%22munger%20you%20know%20the%20cliche%20that%20opposites%20attract%22)

**EFFICIENT MARKET THEORY:**

“We don’t believe that markets are totally efficient and we don’t believe that widespread diversification will yield a good result.  We believe almost all good investments will involve relatively low diversification. Maybe 2% of people will come into our corner of the tent and the rest of the 98% will believe what they’ve been told.”   <http://www.grahamanddoddsville.net/wordpress/Files/Gurus/Warren%20Buffett/Berkshire%20Hathaway%20Annual%20Meeting%20Notes%202004.pdf>

“Berkshire’s whole record has been achieved without paying one ounce of attention to the efficient market theory in its hard form. And not one ounce of attention to the  descendants of that idea, which came out of academic economics and went into corporate finance and morphed into such obscenities as the capital asset pricing model, which we also paid no attention to. I think you’d have to believe in the tooth fairy to believe that you could easily outperform the market by seven-percentage points per annum just by investing in high volatility stocks.”  [http://www.tilsonfunds.com/MungerUCSBspeech.pdf](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.tilsonfunds.com%2fMungerUCSBspeech.pdf)

“I think it is roughly right that the market is efficient, which makes it very hard to beat merely by being an intelligent investor. But I don’t think it’s totally efficient at all. And the difference between being totally efficient and somewhat efficient leaves an enormous opportunity for people like us to get these unusual records. It’s efficient enough, so it’s hard to have a great investment record. But it’s by no means impossible. Nor is it something that only a very few people can do. The top three or four percent of the investment management world will do fine.”  <http://www.myinvestmentforum.com/category/sgfunds-forum/interview-with-charlie-munger-t1655.html>

“I have a name for people who went to the extreme efficient market theory—which is “bonkers”. It was an intellectually consistent theory that enabled them to do pretty mathematics. So I understand its seductiveness to people with large mathematical gifts. It just had a difficulty in that the fundamental assumption did not tie properly to reality.”  [http://ycombinator.com/munger.html](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fycombinator.com%2fmunger.html)

“The possibility that stock value in aggregate can become irrationally high is contrary to the hard-form “efficient market” theory that many of you once learned as gospel from your mistaken professors of yore. Your mistaken professors were too much influenced by “rational man” models of human behavior from economics and too little by “foolish man” models from psychology and real-world experience.” <http://www.tilsonfunds.com/Mungerwritings2001.pdf#search=%22%20%22charlie%20Munger%22%20Outstanding%20investor%20digest%22>

“Efficient market theory [is]  a wonderful economic doctrine that had a long vogue in spite of the experience of Berkshire Hathaway. In fact one of the economists who won — he shared a Nobel Prize — and as he looked at Berkshire Hathaway year after year, which people would throw in his face as saying maybe the market isn’t quite as efficient as you think, he said, “Well, it’s a two-sigma event.” And then he said we were a three-sigma event. And then he said we were a four-sigma event. And he finally got up to six sigmas — better to add a sigma than change a theory, just because the evidence comes in differently. [Laughter] And, of course, when this share of a Nobel Prize went into money management himself, he sank like a stone.”<http://www.loschmanagement.com/Berkshire%20Hathaway/Charlie%20munger/The%20Psychology%20of%20Human%20Misjudgement.htm>

**ENERGY:**

“I know just enough about  thermodynamics to understand that if it takes too much fossil-fuel energy to create ethanol, that’s a very stupid way to solve an energy problem. [Laughter] ”[http://www.designs.valueinvestorinsight.com/bonus/bonuscontent/docs/Tilson\_2006\_BRK\_Meeting\_Notes.pdf#search=%22Charlie%20munger%20and%20foundation%20and%20croupier%22](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.designs.valueinvestorinsight.com%2fbonus%2fbonuscontent%2fdocs%2fTilson_2006_BRK_Meeting_Notes.pdf%23search%3d%2522Charlie%2520munger%2520and%2520foundation%2520and%2520croupier%2522)

“The interesting thing is the field is so big — it’s enormous. One thing a modern civilization needs is energy.”  <http://72.14.203.104/search?q=cache:U59Ns6D8WZcJ:www.tilsonfunds.com/motley_berkshire_brkmtg03notes.php3+%22charlie+munger%22+%22this+is+a+good+lesson+for+anyone%22&hl=en&gl=us&ct=clnk&cd=1>

**ENVIRONMENT:**

“People always underestimate the ability of earth to increase its carrying capacity.”  <http://www.tilsonfunds.com/motley_berkshire_brkmtg02notes.php>

“The laws of thermodynamic s are such that if the water is getting warmer –  and I believe it is – the energy of the weather is going to go up. ”[http://www.designs.valueinvestorinsight.com/bonus/bonuscontent/docs/Tilson\_2006\_BRK\_Meeting\_Notes.pdf#search=%22Charlie%20munger%20and%20foundation%20and%20croupier%22](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.designs.valueinvestorinsight.com%2fbonus%2fbonuscontent%2fdocs%2fTilson_2006_BRK_Meeting_Notes.pdf%23search%3d%2522Charlie%2520munger%2520and%2520foundation%2520and%2520croupier%2522)

**ENVY:**

“…Missing out on some opportunity never bothers us. What’s wrong with someone getting a little richer than you? It’s crazy to worry about this….” <http://www.tilsonfunds.com/wscmtg05notes.pdf>

“Here’s one truth that perhaps your typical investment counselor would disagree with: if you’re comfortably rich and someone else is getting richer faster than you by, for example, investing in risky stocks, so what?! Someone will always be getting richer faster than you. This is not a tragedy. <http://www.fool.com/BoringPort/2000/boringport00051501.htm>

“We have a higher percentage of the intelligentsia engaged in buying and selling pieces of paper and promoting trading activity than in any past era. A lot of what I see now reminds me of Sodom and Gomorrah. You get activity feeding on itself, envy and imitation. It has happened in the past that there came bad consequences.” <http://money.cnn.com/2005/05/01/news/fortune500/buffett_talks/index.htm>

“Well envy/jealousy made, what, two out of the ten commandments? Those of you who have raised siblings you know about envy, or tried to run a law firm or investment bank or even a faculty? I’ve heard Warren say a half a dozen times, “It’s not greed that drives the world, but envy.” <http://www.loschmanagement.com/Berkshire%20Hathaway/Charlie%20munger/The%20Psychology%20of%20Human%20Misjudgement.htm>

“Suppose, any one of you knew of a wonderful thing right now that you were overwhelmingly confident- and correctly so- would produce about 12% per annum compounded as far as you could see. Now, if you actually had that available, and by going into it you were forfeiting all opportunities to make money faster- there’re a lot of you who wouldn’t like that. But a lot of you would think, “What the hell do I care if somebody else makes money faster?” There’s always going to be somebody who is making money faster, running the mile faster or what have you. So in a human sense, once you get something that works fine in your life, the idea of caring terribly that somebody else is making money faster strikes me as insane.”

“The idea of caring that someone is making money faster [than you are] is one of the deadly sins. Envy is a really stupid sin because it’s the only one you could never possibly have any fun at. There’s a lot of pain and no fun. Why would you want to get on that trolley?” <http://www.fool.com/news/commentary/2003/commentary030509wt.htm>

**ESTATE TAX:**

“Personally, I’m against the estate tax at its current rate, with its rapid rise to 55%.  It hits owners of auto dealers, plumbers, etc. I think the exemption should be raised.  “I have no problem with this rate [for estates] in the hundreds of millions of dollars. I have no problem personally with the estate tax.” <http://www.tilsonfunds.com/motley_berkshire_brkmtg01notes.php>

**ETHICS:**

 “I think you’ll make more money in the end with good ethics than bad. Even though there are some people who do very well, like Marc Rich–who plainly has never had any decent ethics, or seldom anyway. But in the end, Warren Buffett has done better than Marc Rich–in money–not just in reputation.” [http://www.law.harvard.edu/alumni/bulletin/2001/summer/feature\_1-1.html](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.law.harvard.edu%2falumni%2fbulletin%2f2001%2fsummer%2ffeature_1-1.html)

“I think the best single way to teach ethics is by example: take in people who demonstrate in all their daily conduct a good ethical framework.  But if your ethics slip and people are rewarded [nevertheless, then] it cascades downward.  Ethics are terribly important, but best taught indirectly by example.  If you just learn a few rules [by having ethics taught in school] so they can pass the test, it doesn’t do much. But if you see people you respect behaving in a certain way, especially under stress, [that has a real impact]. [   ] “The ethics of Wall Street will always average out to mediocre at best…. This doesn’t mean there aren’t some wonderful, intelligent people on Wall Street — there are, like those in this room — but everyone I know has to fight their own firm [to do the right thing].” [http://www.fool.com/news/foth/2002/foth020515.htm](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.fool.com%2fnews%2ffoth%2f2002%2ffoth020515.htm)

**EVA:**

“I think there’s an awful lot of twaddle and bull$%#\* on EVA. The whole game is to turn retained earnings into more earnings. EVA has ideas about cost of capital that make no sense. Of course, if a company generates high returns on capital and can maintain this over time, it will do well. But the mental system as a whole does not work.” [http://www.fool.com/boringport/2000/boringport000501a.htm](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.fool.com%2fboringport%2f2000%2fboringport000501a.htm)

**EVIL:**

“Avoid evil, particularly if they’re attractive members of the opposite sex.”<http://www.grahamanddoddsville.net/wordpress/Files/Gurus/Warren%20Buffett/Berkshire%20Hathaway%20Annual%20Meeting%20Notes%202004.pdf>

**EXECUTIVES:**

“Today, it seems to be regarded as the duty of CEOs to make the stock go up. This leads to all sorts of foolish behavior. We want to tell it like it is.” <http://netscape.fool.com/news/foth/2001/foth010508.htm?ref=foolwatch>

**EXPECTATIONS:**

“…People need to ask, “How do I play the hand that has been dealt me?” The world is not going to give you extra return just because you want it. You have to be very shrewd and hard working to get a little extra. It’s so much easier to reduce your wants. There are a lot of smart people and a lot of them cheat, so it’s not easy to win. (Nervous laughter)…”  <http://www.tilsonfunds.com/wscmtg05notes.pdf>

“One of the smartest things a person can do is dampen investment expectations, especially with Berkshire. That would be mature and responsible. I like our model and we should do nicely.”  <http://www.tilsonfunds.com/motley_berkshire_brkmtg02notes.php>

“I’ve heard that one-half of the students at elite schools want to go into private equity or hedge funds. They want to keep up with their age cohorts at Goldman. This can’t possibly end well in terms of meeting these expectations. ”[http://www.designs.valueinvestorinsight.com/bonus/bonuscontent/docs/Tilson\_2006\_BRK\_Meeting\_Notes.pdf#search=%22Charlie%20munger%20and%20foundation%20and%20croupier%22](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.designs.valueinvestorinsight.com%2fbonus%2fbonuscontent%2fdocs%2fTilson_2006_BRK_Meeting_Notes.pdf%23search%3d%2522Charlie%2520munger%2520and%2520foundation%2520and%2520croupier%2522)

**EXPERIENCE:**

“If you’re going to be an investor, you’re going to make some investments where you don’t have all the experience you need. But if you keep trying to get a little better over time, you’ll start to make investments that are virtually certain to have a good outcome. The keys are discipline, hard work, and practice. It’s like playing golf — you have to work on it.”  [http://www.fool.com/news/foth/2002/foth020515.htm](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.fool.com%2fnews%2ffoth%2f2002%2ffoth020515.htm)

**EXPERTS:**

“… some important factor doesn’t lose its “share of force” just because some “expert” can better measure other types of force.”   [http://72.14.203.104/search?q=cache:mgSaxC3O1IoJ:www.philanthropyroundtable.org/magazines/1999/march/munger.html+Berkshire+Hathaway%27s+vice+chairman+shreds+the+conventional+wisdom+on+foundation+investing&hl=en&gl=us&ct=clnk&cd=1](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2f72.14.203.104%2fsearch%3fq%3dcache%3amgSaxC3O1IoJ%3awww.philanthropyroundtable.org%2fmagazines%2f1999%2fmarch%2fmunger.html%2bBerkshire%2bHathaway%2527s%2bvice%2bchairman%2bshreds%2bthe%2bconventional%2bwisdom%2bon%2bfoundation%2binvesting%26hl%3den%26gl%3dus%26ct%3dclnk%26cd%3d1)

**EXTRAORDINARY (ONE TIME) CHARGES:**

“If it happens every year like clockwork, what’s so extraordinary about it?” <http://www.fool.com/news/foth/2001/foth010508.htm>

**FACTS:**

“Tthe first rule is that you can’t really know anything if you just remember isolated facts and try and bang ‘em back. If the facts don’t hang together on a latticework of theory, you don’t have them in a usable form…. You may have noticed students who just try to remember and pound back what is remembered. Well, they fail in school and in life.”  [http://ycombinator.com/munger.html](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fycombinator.com%2fmunger.html)

“An idea or a fact is not worth more merely because it’s more available to you.”

**FAILURE:**

It’s a good habit to trumpet your failures and be quiet about your successes.[http://www.designs.valueinvestorinsight.com/bonus/bonuscontent/docs/Tilson\_2006\_BRK\_Meeting\_Notes.pdf#search=%22Charlie%20munger%20and%20foundation%20and%20croupier%22](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.designs.valueinvestorinsight.com%2fbonus%2fbonuscontent%2fdocs%2fTilson_2006_BRK_Meeting_Notes.pdf%23search%3d%2522Charlie%2520munger%2520and%2520foundation%2520and%2520croupier%2522)

You don’t want to be like the motion picture exec who had so many people at his funeral, but they were there just make sure he was dead. Or how about the guy who, at his funeral, the priest said, “Won’t anyone stand up and say anything nice for the deceased?” and finally someone said, “Well, his brother was worse.” [http://www.tilsonfunds.com/motley\_berkshire\_brkmtg03notes.php3](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.tilsonfunds.com%2fmotley_berkshire_brkmtg03notes.php3)

**FLOAT:**

“Growing float at a sizeable rate at low cost is almost impossible — but we intend to do it anyway.”  <http://www.tilsonfunds.com/motley_berkshire_brkmtg02notes.php>

“I’ve been amazed by the growth and cost of our float. It’s wonderful to generate billions of dollars of float at a cost way below Treasury notes.”[http://www.fool.com/boringport/2000/boringport000501.htm](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.fool.com%2fboringport%2f2000%2fboringport000501.htm)

**FOCUS INVESTING:**

“Our investment style has been given a name — focus investing — which implies 10 holdings, not 100 or 400. Focus investing is growing somewhat, but what’s really growing is the unlimited use of consultants to advise on asset allocation, to analyze other consultants, etc. [http://www.fool.com/boringport/2000/boringport00051500.htm](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.fool.com%2fboringport%2f2000%2fboringport00051500.htm)

**FOOD:**

“My idea of a good place to shop is Costco – it has these heavily marbled fillet steaks.  The idea of eating some wheat thing and washing it down with carrot juice has never appealed to me.”  <http://www.grahamanddoddsville.net/wordpress/Files/Gurus/Warren%20Buffett/Berkshire%20Hathaway%20Annual%20Meeting%20Notes%202004.pdf>

**FORECASTS:**

“People have always had this craving to have someone tell them the future.  Long ago, kings would hire people to read sheep guts.  There’s always been a market for people who pretend to know the future.  Listening to today’s forecasters is just as crazy as when the king hired the guy to look at the sheep guts.  It happens over and over and over.”   <http://www.grahamanddoddsville.net/wordpress/Files/Gurus/Warren%20Buffett/Berkshire%20Hathaway%20Annual%20Meeting%20Notes%202004.pdf>

“It’s human nature to extrapolate the recent past into the future, but it’s terrible that managements go along with this.” <http://www.tilsonfunds.com/motley_berkshire_brkmtg01notes.php>

“We have the same problem as everyone else: It’s very hard to predict the future…”  <http://www.fool.com/news/foth/2002/foth020515.htm>

**FOREIGN CURRENCIES:**

“In effect about half our spare cash was stashed in currencies other than the dollar. I consider that a non-event. As it happens it¹s been a very profitable non-event.”<http://us.ft.com/ftgateway/superpage.ft?news_id=fto050720060912107064&page=2>

**FOREIGN INVESTING:**

“As for what we like least, we don’t want kleptocracies. We need a rule of law. If people are stealing from the companies, we don’t need that.”<http://www.fool.com/news/commentary/2006/commentary06062914.htm>

“We have a problem outside the U.S. because we aren’t well known. The reason we could buy Iscar is because [Iscar was] so smart. We weren’t smart enough to find them; they were smart enough to find us.”  <http://www.fool.com/news/commentary/2006/commentary06062914.htm>

“I agree with Peter Drucker that the culture and legal systems of the United States are especially favorable to shareholder interests, compared to other interests and compared to most other countries. Indeed, there are many other countries where any good going to public shareholders has a very low priority and almost every other constituency stands higher in line. ”<http://www.tilsonfunds.com/Mungerwritings2001.pdf#search=%22%20%22charlie%20Munger%22%20Outstanding%20investor%20digest%22>

**FRANCHISES:**

“You’ll find many markets where bottlers of Pepsi and Coke both make a lot of money and many others where they destroy most of the profitability of the two franchises. That must get down to the peculiarities of individual adjustment to market capitalism. I think you ’d have to know the people involved to fully understand what was happening.  <http://www.amazon.com/gp/product/1578643031/104-7644521-2497538?v=glance&n=283155>

**FRAUD:**

“If we mix only a moderate minority share of turds with the raisins each year, probably no one will recognize what will ultimately become a very large collection of turds.” [http://www.bluechipinvestorfund.com/munger.html](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.bluechipinvestorfund.com%2fmunger.html)

“Where you have complexity, by nature you can have fraud and mistakes. You’ll have more of that than in a company that shovels sand from a river and sells it. This will always be true of financial companies, including ones run by governments. If you want accurate numbers from financial companies, you’re in the wrong world.” <http://www.tilsonfunds.com/wscmtg05notes.pdf>

**FUTURE:**

“It’s a rare business that doesn’t have a way worse future than it has a past.” <http://www.fool.com/news/commentary/2006/commentary06053101.htm>

**GAMBLING:**

“I knew a guy who had $5 million and owned his house free and clear. But he wanted to make a bit more money to support his spending, so at the peak of the internet bubble he was selling puts on internet stocks. He lost all of his money and his house and now works in a restaurant. It’s not a smart thing for the country to legalize gambling [in the stock market] and make it very accessible.”  <http://www.tilsonfunds.com/wscmtg05notes.pdf>

“Berkshire in its history has made money betting on sure things. [http://www.tilsonfunds.com/motley\_berkshire\_brkmtg03notes.php3](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.tilsonfunds.com%2fmotley_berkshire_brkmtg03notes.php3)

“You have a lottery where you get your number by lot, and then somebody draws a number by lot, it gets lousy play. You have a lottery where people get to pick their number, you get big play. …People think if they have committed to it, it has to be good. The minute they’ve picked it themselves it gets an extra validity. After all, they thought it and they acted on it. Then if you take the slot machines, you get bar, bar, walnut. And it happens again and again and again. You get all these near misses. Well that’s deprival super-reaction syndrome, and boy do the people who create the machines understand human psychology. And for the high-IQ crowd they’ve got poker machines where you make choices. So you can play blackjack, so to speak, with the machine. It’s wonderful what we’ve done with our computers to ruin the civilization. But at any rate, mis-gambling compulsion is a very, very powerful and important thing. Look at what’s happening to our country: every Indian has a reservation, every river town, and look at the people who are ruined by it with the aid of their stock brokers and others.” <http://www.loschmanagement.com/Berkshire%20Hathaway/Charlie%20munger/The%20Psychology%20of%20Human%20Misjudgement.htm>

 “To me, it’s obvious that the winner has to bet very selectively. It’s been obvious to me since very early in life. I don’t know why it’s not obvious to very many other people.” <http://www.ndir.com/SI/articles/quotes.shtml>

**GM:**

“I have a greater sin to confess to. I once thought GM was a bulletproof  franchise. But we have a method of coping: We just put it in the “too hard” basket. If something is too hard, we move on to something that’s not too hard. What would be more simple?” [http://www.designs.valueinvestorinsight.com/bonus/bonuscontent/docs/Tilson\_2006\_BRK\_Meeting\_Notes.pdf#search=%22Charlie%20munger%20and%20foundation%20and%20croupier%22](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.designs.valueinvestorinsight.com%2fbonus%2fbonuscontent%2fdocs%2fTilson_2006_BRK_Meeting_Notes.pdf%23search%3d%2522Charlie%2520munger%2520and%2520foundation%2520and%2520croupier%2522)

**Gold:**

If you have the opportunities of Berkshire, an investment in gold is dumb. <http://www.tilsonfunds.com/wscmtg05notes.pdf>

**GOVERNMENT:**

“We’re here at an institution [Stanford] founded by a man [Leland Stanford] who bribed Congress to get his railroad franchises…I’m not constantly bewailing the failures of government — it’s not our main problem at all.” <http://paul.kedrosky.com/archives/2006/06/26/the_wit_and_wis.html> 

**GREED:**

 “It’s amazing the way people have sold out. It’s insane.” [http://www.law.stanford.edu/publications/stanford\_lawyer/issues/64/sl64.pdf](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.law.stanford.edu%2fpublications%2fstanford_lawyer%2fissues%2f64%2fsl64.pdf) 

“…all man’s desired geometric progressions, if a high rate of growth is chosen, at last come to grief on a finite earth.  And the social system for man on earth is fair enough, eventually, that almost all massive cheating ends in disgrace.”   [http://www.bluechipinvestorfund.com/munger.html](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.bluechipinvestorfund.com%2fmunger.html)

**GUILT:**

“Economic systems work better when there’s an extreme reliability ethos. And the traditional way to get a reliability ethos, at least in past generations in America, was through religion. The religions instilled guilt. … And this guilt, derived from religion, has been a huge driver of a reliability ethos, which has been very helpful to economic outcomes for man.”  [http://www.tilsonfunds.com/MungerUCSBspeech.pdf](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.tilsonfunds.com%2fMungerUCSBspeech.pdf) 

**HEALTHCARE:**

“I think that if you have a single payer system and an opt-out for people who want to pay more [for better service, etc.], I think it would be better – and I think we’ll eventually get there.  It wouldn’t be better at the top – [our current system] is the best in the world at the top.  But the waste in the present system is awesome and we do get some very perverse incentives.”<http://www.grahamanddoddsville.net/wordpress/Files/Gurus/Warren%20Buffett/Berkshire%20Hathaway%20Annual%20Meeting%20Notes%202004.pdf>

“The quality of the medical care delivered, including the pharmaceutical industry, has improved a lot. I don’t think it’s crazy for a rich country like the US to spend 15% of GDP on healthcare, and if it rose to 16-17%, it’s not a big worry.”  [http://www.tilsonfunds.com/motley\_berkshire\_brkmtg03notes.php3](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.tilsonfunds.com%2fmotley_berkshire_brkmtg03notes.php3)

**HEDGE FUNDS:**

“It’s amazing the brainpower being drawn into the hedge fund industry.  When I was young, guys in the investment business were mediocre at best – they had eastern [East Coast] tailoring and didn’t know very much.  Now, it’s a cascade of brainpower.  Collectively, they add nothing to the GNP.  Indeed, they’re adding costs, collectively.  If you take the money invested in common stocks, and then subtract the 2% per year that goes out in investment management costs and frictional trading costs, that’s more than companies pay in dividends.  It’s more than the twin deficits.  This would fit very well into  Alice in Wonderland: pay dividends of X and pay the same amount to investment managers and advisors.” <http://www.grahamanddoddsville.net/wordpress/Files/Gurus/Warren%20Buffett/Berkshire%20Hathaway%20Annual%20Meeting%20Notes%202004.pdf>

“I don’t think there’s any business that we’ve bought that would have sold itself to a hedge fund. There’s a class of businesses that doesn’t want to deal with private-equity and hedge funds…thank God.”  <http://www.tilsonfunds.com/wscmtg05notes.pdf>

“You ask a heard hedge fund operator why the charge 2 and 20, and they say because I can’t get 3 and 30, he says. “[For hedge funds], it’s not about thinking what is fair and right — but merely how much can I get. It’s a ghastly culture … there will be terrible scandal in due course”<http://paul.kedrosky.com/archives/2006/06/26/the_wit_and_wis.html>

**HIRING:**

“This is a good life lesson: getting the right people into your system is the most important thing you can do.”  <http://www.tilsonfunds.com/wscmtg05notes.pdf>

**HONESTY:**

“I think track records are very important. If you start early trying to have a perfect one in some simple thing like honesty, you’re well on your way to success in this world.” Poor Charlie’s  <http://www.amazon.com/gp/product/1578643031/104-7644521-2497538?v=glance&n=283155>

“Bernie Ebbers and Ken Lay were caricatures – they were easy to spot.  They were almost psychopaths.  But it’s much harder to spot problems at companies like Royal Dutch [Shell].” <http://www.grahamanddoddsville.net/wordpress/Files/Gurus/Warren%20Buffett/Berkshire%20Hathaway%20Annual%20Meeting%20Notes%202004.pdf>

“Well in the history of the See’s Candy Company they always say, “I never did it before, and I’m never going to do it again.” And we cashier them. It would be evil not to, because terrible behavior spreads. ”<http://72.14.203.104/search?q=cache:3sSZnXLbvQEJ:www.loschmanagement.com/Berkshire%2520Hathaway/Charlie%2520munger/The%2520Psychology%2520of%2520Human%2520Misjudgement.htm+%22charlie+Munger%22+%22the+way+Zeckhauser+plays+bridge%22&hl=en&gl=us&ct=clnk&cd=1>

**HURDLE RATES:**

“We’re guessing at our future opportunity cost. Warren is guessing that he’ll have the opportunity to put capital out at high rates of return, so he’s not willing to put it out at less than 10% now. But if we knew interest rates would stay at 1%, we’d change. Our hurdles reflect our estimate of future opportunity costs.”   <http://www.tilsonfunds.com/motley_berkshire_brkmtg03notes.php3>

**IDEAS:**

“It’s not the bad ideas that do you in, but the good ones.” <http://www.fool.com/news/foth/2000/foth000907.htm>

“Our ideas are so simple that people keep asking us for mysteries when all we have are the most elementary ideas”  <http://www.feedblitz.com/f/f.fbz?PreviewFeed=7799>

**INDEPENDENCE:**

“Like Warren, I had a considerable passion to get rich. “Not because I wanted Ferraris– I wanted the independence. I desperately wanted it.  I thought it was undignified to have to send invoices to other people. I don’t know where I got that notion from, but I had it.’ From  Buffett , The making of an American Capitalist, Roger Lowenstein  at page 75.  “I wanted to get rich so I could be independent, like Lord John Maynard Keynes.”  <http://www.amazon.com/gp/product/1578643031/104-7644521-2497538?v=glance&n=283155>

**INSURANCE:**

“I’m glad we have insurance, though it’s not a no-brainer, I’m warning you. We have to be smart to make this work.”  <http://www.fool.com/news/foth/2002/foth020515.htm>

**IMMIGRATION:**

“…I’m very pleased when the smartest people come [to theU.S.] and almost never pleased when the very bottom of the mental barrel comes in….” <http://www.grahamanddoddsville.net/wordpress/Files/Gurus/Warren%20Buffett/Berkshire%20Hathaway%20Annual%20Meeting%20Notes%202004.pdf>

“We have never had the will to  enforce the immigration laws. What you see is what you’ll continue to get.” [http://www.designs.valueinvestorinsight.com/bonus/bonuscontent/docs/Tilson\_2006\_BRK\_Meeting\_Notes.pdf#search=%22Charlie%20munger%20and%20foundation%20and%20croupier%22](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.designs.valueinvestorinsight.com%2fbonus%2fbonuscontent%2fdocs%2fTilson_2006_BRK_Meeting_Notes.pdf%23search%3d%2522Charlie%2520munger%2520and%2520foundation%2520and%2520croupier%2522)

**INCENTIVES:**

“His bread I eat, his song I sing.”  <http://www.bluechipinvestorfund.com/munger.html>“Expect hogs to eat a lot more in the presence of a lot of hog wash.”<http://blogs.barrons.com/techtraderdaily/2006/06/26/the-wit-and-wisdom-of-charlie-munger/>

“If you want good behavior, don’t pay on a commission basis. Our judges aren’t paid so much a case. We keep them pretty well isolated with a fixed salary. Judges in this whole thing have come out pretty well – there have been relatively few scandals. ” <http://www.tilsonfunds.com/wscmtg05notes.pdf>

“I think I’ve been in the top 5% of my age cohort all my life in understanding the power of incentives, and all my life I’ve underestimated it. And never a year passes but I get some surprise that pushes my limit a little farther. ”<http://www.loschmanagement.com/Berkshire%20Hathaway/Charlie%20munger/The%20Psychology%20of%20Human%20Misjudgement.htm>

**INDEX FUNDS:**

“Our standard prescription for the know-nothing investor with a long-term time horizon is a no-load index fund. I think that works better than relying on your stock broker. The people who are telling you to do something else are all being paid by commissions or fees. The result is that while index fund investing is becoming more and more popular, by and large it’s not the individual investors that are doing it. It’s the institutions.”  <http://www.myinvestmentforum.com/category/sgfunds-forum/interview-with-charlie-munger-t1655.html>

“[With] closet indexing….you’re paying a manager a fortune and he has 85% of his assets invested parallel to the indexes. If you have such a system, you’re being played for a sucker.”  <http://www.tilsonfunds.com/wscmtg05notes.pdf>

“stock brokers, in toto, will do so poorly that the index fund will do better.” <http://www.grahamanddoddsville.net/wordpress/Files/Gurus/Warren%20Buffett/Berkshire%20Hathaway%20Annual%20Meeting%20Notes%202004.pdf>

“One could imagine a period like Japan 13 years ago, however, in which indexing over time wouldn’t work.”<http://www.tilsonfunds.com/motley_berkshire_brkmtg02notes.php>

**INFLATION:**

“One of the great defenses if you’re worried about inflation is not to have a lot of silly needs in your life – if you don’t need a lot of material goods.”  <http://www.grahamanddoddsville.net/wordpress/Files/Gurus/Warren%20Buffett/Berkshire%20Hathaway%20Annual%20Meeting%20Notes%202004.pdf>

“I think democracies are prone to inflation because politicians will naturally spend [excessively] – they have the power to print money and will use money to get votes.  If you look at inflation under the Roman Empire, with absolute rulers, they had much greater inflation, so we don’t set the record.  It happens over the long-term under any form of government.”  <http://www.grahamanddoddsville.net/wordpress/Files/Gurus/Warren%20Buffett/Berkshire%20Hathaway%20Annual%20Meeting%20Notes%202004.pdf>

“I see almost no change in the price of the composite product that flows through Costco  I don’t feel sorry for the people who pay $27 million for an 8,000-square-foot condo in Manhattan. So inflation comes in places.”[http://www.designs.valueinvestorinsight.com/bonus/bonuscontent/docs/Tilson\_2006\_BRK\_Meeting\_Notes.pdf#search=%22Charlie%20munger%20and%20foundation%20and%20croupier%22](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.designs.valueinvestorinsight.com%2fbonus%2fbonuscontent%2fdocs%2fTilson_2006_BRK_Meeting_Notes.pdf%23search%3d%2522Charlie%2520munger%2520and%2520foundation%2520and%2520croupier%2522)

**INTEREST RATES:**

“Neither Warren nor I have any record of making large profits from interest rate bets. That being said, all intelligent citizens of this republic think a bit about this. In my lifetime, I’ve seen interest rates range from 1% to 20%. We try to operate so that really extreme interest rates in either direction wouldn’t be too bad for us. When interest rates are in a middle range, as they are now, we’re agnostic.”  [http://www.fool.com/BoringPort/2000/boringport00051501.htm](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.fool.com%2fBoringPort%2f2000%2fboringport00051501.htm)

**INTRINSIC VALUE:**

“If you buy something because it’s undervalued, then you have to think about selling it when it approaches your calculation of its intrinsic value. That’s hard. But if you buy a few great companies, then you can sit on your $%@. That’s a good thing.”  <http://www.fool.com/boringport/2000/boringport000501.htm>

“The basic concept of value to a private owner and being motivated when you’re buying and selling securities by reference to intrinsic value instead of price momentum – I don’t think that will ever be outdated.”  <http://72.14.203.104/search?q=cache:7GV1CjDlhk8J:www.capitalideasonline.com/forum/read.php%3Ff%3D3%26i%3D300%26t%3D105+%22Charlie+Munger%22+%22a+great+business+at+a+fair+price%22&hl=en&gl=us&ct=clnk&cd=6>

“like the stocks of both Berkshire and Wesco to trade within hailing distance of what we think of as intrinsic value. When it runs up, we try to talk it down.  That’s not at all common in Corporate America, but that’s the way we act.”   <http://www.fool.com/news/commentary/2003/commentary030509wt.htm>

**INVESTING: :**

“Investing is where you find a few great companies and then sit on your ass.” Berkshire Hathaway’s 2000 Shareholder Meeting <http://www.ticonline.com/archives_quotes.html>

“The investment game is getting more and more competitive.”  <http://www.tilsonfunds.com/motley_berkshire_brkmtg01notes.php>

“An investment decision in the common stock of a company frequently involves a whole lot of factors interacting … the one thing that causes the most trouble is when you combine a bunch of these together, you get this lollapalooza effect.” <http://www.loschmanagement.com/Berkshire%20Hathaway/Charlie%20munger/The%20Psychology%20of%20Human%20Misjudgement.htm>

“It’s not given to human beings to have such talent that they can just know everything all the time. But it is given to human beings who work hard at it – who look and sift the world for a mispriced bet – that they can occasionally find one. And the wise ones bet keenly when the world offers that opportunity. They bet big when they have the odds. And the rest of the time, they don’t. It’s just that simple.”  **OID**, May 5, 1995

“If (investing) weren’t a little difficult, everybody would be rich.”  Damn Right! Behind the Scenes with Berkshire Hathaway Billionaire Charlie Munger, Janet Lowe John Wiley &Sons,  2003 <http://www.wiley.com/WileyCDA/WileyTitle/productCd-0471446912,descCd-tableOfContents.html>

To us, investing is the equivalent of going out and betting against the pari-mutuel system. We look for a horse with one chance in two of winning, and that pays three to one. In other words, we’re looking for a mispriced gamble. That’s what investing is, and you have to know enough to know whether the gamble is mispriced.” <http://72.14.203.104/search?q=cache:sVtHPKWG-bwJ:www.wedgecapital.com/documents/WW2Q05.pdf+%22Charlie+Munger%22+%22to+us,+investing+is+the+equivalent+of%22&hl=en&gl=us&ct=clnk&cd=1>

**INVESTMENT BANKS:**

“The general culture of investment banking has deteriorated over the years. We did a $6 million deal years ago for Diversified Retailing and we were rigorously and intelligently screened. They bankers cared and wanted to protect their clients. The culture now is that anything that can be sold for a profit will be. ‘Can you sell it?’ is the moral test, and that’s not an adequate test.”  <http://www.tilsonfunds.com/motley_berkshire_brkmtg02notes.php>

“The interesting thing about it to me is the mindset. With all these “helpers”  running around, they talk about doing deals. We talk about welcoming partners. The  guy doing deals, he wants to do a deal and then unwind it in the near future. It’s totally opposite for us. We like to build lasting relationships. I think our system will work  better in the long term than flipping deals. I think there are so many of them [helpers] that they’ll get in ea h other’s way. I don’t  think they’ll make enough money to meet their expectations, by flipping, flipping, flipping.” [http://www.designs.valueinvestorinsight.com/bonus/bonuscontent/docs/Tilson\_2006\_BRK\_Meeting\_Notes.pdf#search=%22Charlie%20munger%20and%20foundation%20and%20croupier%22](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.designs.valueinvestorinsight.com%2fbonus%2fbonuscontent%2fdocs%2fTilson_2006_BRK_Meeting_Notes.pdf%23search%3d%2522Charlie%2520munger%2520and%2520foundation%2520and%2520croupier%2522)

“Warren talked to guy at an investment bank and asked how they made their money. He said, “Off the top, off the bottom, off both sides and in the middle.” ”[http://www.designs.valueinvestorinsight.com/bonus/bonuscontent/docs/Tilson\_2006\_BRK\_Meeting\_Notes.pdf#search=%22Charlie%20munger%20and%20foundation%20and%20croupier%22](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.designs.valueinvestorinsight.com%2fbonus%2fbonuscontent%2fdocs%2fTilson_2006_BRK_Meeting_Notes.pdf%23search%3d%2522Charlie%2520munger%2520and%2520foundation%2520and%2520croupier%2522)

**IPOs:**

“It is entirely possible that you could use our mental models to find good IPOs to buy.  There are countless IPOs every year, and I’m sure that there are a few cinches that you could jump on.  But the average person is going to get creamed.  So if you’re talented, good luck. IPOs are too small for us, or too high tech, so we won’t understand them.  So, if Warren’s looking at them, I don’t know about it.”  <http://www.grahamanddoddsville.net/wordpress/Files/Gurus/Warren%20Buffett/Berkshire%20Hathaway%20Annual%20Meeting%20Notes%202004.pdf>

**IQ:**

“A lot of people with high IQs are terrible investors because they’ve got terrible temperaments. And that is why we say that having a certain kind of temperament is more important than brains. You need to keep raw irrational emotion under control. You need patience and discipline and an ability to take losses and adversity without going crazy. You need an ability to not be driven crazy by extreme success.”   <http://www.myinvestmentforum.com/category/sgfunds-forum/interview-with-charlie-munger-t1655.html>

“A money manager with an IQ of 160 and thinks it’s 180 will kill you,” he said. “Going with a money manager with an IQ of 130 who thinks its 125 could serve you well.”[http://sanfrancisco.bizjournals.com/sanfrancisco/stories/1996/10/21/newscolumn6.html](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fsanfrancisco.bizjournals.com%2fsanfrancisco%2fstories%2f1996%2f10%2f21%2fnewscolumn6.html)

“The hedge fund known as “Long Term Capital Management” collapsed last fall through overconfidence in its highly leveraged methods, despite I.Q.’s of its principals that must have averaged 160. Smart people aren’t exempt from professional disasters from overconfidence. Often, they just run aground in the more difficult voyages they choose, relying on their self-appraisals that they have superior talents and methods.” [http://72.14.203.104/search?q=cache:mgSaxC3O1IoJ:www.philanthropyroundtable.org/magazines/1999/march/munger.html+Berkshire+Hathaway%27s+vice+chairman+shreds+the+conventional+wisdom+on+foundation+investing&hl=en&gl=us&ct=clnk&cd=1](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2f72.14.203.104%2fsearch%3fq%3dcache%3amgSaxC3O1IoJ%3awww.philanthropyroundtable.org%2fmagazines%2f1999%2fmarch%2fmunger.html%2bBerkshire%2bHathaway%2527s%2bvice%2bchairman%2bshreds%2bthe%2bconventional%2bwisdom%2bon%2bfoundation%2binvesting%26hl%3den%26gl%3dus%26ct%3dclnk%26cd%3d1)

“You need to have a passionate interest in why things are happening. That cast of mind, kept over long periods, gradually improves your ability to focus on reality. If you don’t have the cast of mind, you’re destined for failure even if you have a high IQ.”  <http://www.tilsonfunds.com/motley_berkshire_brkmtg02notes.php>

“A foreign correspondent, after talking to me for a while, once said: “You don’t seem smart enough to be so good at what you’re doing. Do you have an  explanation?” [http://www.designs.valueinvestorinsight.com/bonus/bonuscontent/docs/Tilson\_2006\_BRK\_Meeting\_Notes.pdf#search=%22Charlie%20munger%20and%20foundation%20and%20croupier%22](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.designs.valueinvestorinsight.com%2fbonus%2fbonuscontent%2fdocs%2fTilson_2006_BRK_Meeting_Notes.pdf%23search%3d%2522Charlie%2520munger%2520and%2520foundation%2520and%2520croupier%2522)

“When we were young, there weren’t very many smart people in the investment world. You should have seen the people in the bank trust departments.  Now, there are armies of smart people at private investment funds, etc . If there were a crisis now, there would be a lot more people with a lot of money ready to take advantage.” [http://www.designs.valueinvestorinsight.com/bonus/bonuscontent/docs/Tilson\_2006\_BRK\_Meeting\_Notes.pdf#search=%22Charlie%20munger%20and%20foundation%20and%20croupier%22](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.designs.valueinvestorinsight.com%2fbonus%2fbonuscontent%2fdocs%2fTilson_2006_BRK_Meeting_Notes.pdf%23search%3d%2522Charlie%2520munger%2520and%2520foundation%2520and%2520croupier%2522)

“It is remarkable how much long-term advantage people like  [Warren Buffettand myself] have gotten by trying to be consistently not stupid, instead of trying to be  very intelligent.” Damn Right! Behind the Scenes with Berkshire Hathaway Billionaire Cha lie Munger, Janet Lowe John Wiley &Sons,  2003<http://www.wiley.com/WileyCDA/WileyTitle/productCd-0471446912,descCd-tableOfContents.html>

**JUDGMENT:**

“Although I am very interested in the subject of human misjudgment — and lord knows I’ve created a good bit of it — I don’t think I’ve created my full statistical share, and I think that one of the reasons was I tried to do something about this terrible ignorance I left the Harvard Law School with.”<http://www.loschmanagement.com/Berkshire%20Hathaway/Charlie%20munger/The%20Psychology%20of%20Human%20Misjudgement.htm>

**KOREA:**

“I live surrounded by Koreans in L.A. I would regard Korean culture and what they’ve created as one of the most remarkable in the history of capitalism. We don’t think it’s an accident that Iscar discovered  Korea. If you try to find 10 countries better than Korea … you won’t get through one hand. We are huge admirers of Korea.”<http://www.fool.com/news/commentary/2006/commentary06062914.htm>

**LAWYERS:**

“…With Congress and the S.E.C. so heavily peopled by lawyers, and with lawyers having been so heavily involved in drafting financial disclosure documents now seen as bogus, there was a new “lawyer” joke every week.  One such was:  “The butcher says ‘the reputation of lawyers has fallen dramatically’, and the check-out clerk replies: “How do you fall dramatically off a pancake?…’” [http://www.bluechipinvestorfund.com/munger.html](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.bluechipinvestorfund.com%2fmunger.html)

“The lawyers have escaped most criticism [and undeservedly so].  The tax shelters [were approved by lawyers, who got paid huge commissions to do so] and every miscreant had a high-falutin’ lawyer at his side.  Why don’t more law firms vote with their feet and not take clients who have signs on them that say, “I’m a skunk and will be hard to handle?”  I’ve noticed that firms that avoid trouble over long periods of time have an institutional process that tunes bad clients out.  Boy, if I were running a law firm, I’d want a system like that because a lot of firms have a lot of bad clients.”   <http://www.grahamanddoddsville.net/wordpress/Files/Gurus/Warren%20Buffett/Berkshire%20Hathaway%20Annual%20Meeting%20Notes%202004.pdf>

“[Lawyers who file class-action securities suits]  is not a group you would want to marry into your family. “That said, more than half the time the people being sued by the Lerach firm are guilty of outrageous conduct. The problem is, they don’t mind (suing) the other half. They are an equal opportunity litigator.” <http://www.sfgate.com/cgi-bin/article.cgi?f=/c/a/2004/06/22/BUGRK79OT81.DTL>

“Accounting incomes were reduced by discrepancy [ but] “the net amount paid by lawyers for lawyerly discrepancy is close to zippo. In this case, the goddess of justice was blind.” <http://blogs.barrons.com/techtraderdaily/2006/06/26/the-wit-and-wisdom-of-charlie-munger/>

**LEGAL SYSTEM:**

“The definition of hell in the legal system is: endless due process and no justice; (in the corporate world) it would be: endless due diligence and no horse sense.”  – 2002 Berkshire Hathaway Shareholder Meeting  <http://www.ticonline.com/archives_quotes.html>

**LEADERSHIP:**

“There are always  people who will be better at some thing than you are. You have to learn to be a follower before you become a leader.”  **Damn Right!**Behind the Scenes with Berkshire Hathaway Billionaire Cha lie Munger, Janet Lowe John Wiley &Sons,  2003 <http://www.wiley.com/WileyCDA/WileyTitle/productCd-0471446912,descCd-tableOfContents.html>

“We want very good leaders who have a lot of power,” he said, “and we want to delegate a lot of power to those leaders….It’s crazy not to distribute power to people with the most capacity and diligence…Every time I see an opportunity to choose somebody, the second best guy is just awful compared to the guy we hire. Usually the decision is a no-brainer. We have to give power to the people who can wield it efficiently in serious game of survival.”  <http://blogs.barrons.com/techtraderdaily/2006/06/26/the-wit-and-wisdom-of-charlie-munger/>

**LEARNING:**

“We all are learning, modifying, or destroying ideas all the time. Rapid destruction of your ideas when the time is right is one of the most valuable qualities you can acquire. You must force yourself to consider arguments on the other side. If you can’t state arguments against what you believe better than your detractors, you don’t know enough.” [http://news.morningstar.com/article/article.asp?id=169398](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fnews.morningstar.com%2farticle%2farticle.asp%3fid%3d169398)

“The game is to keep learning, and I don’t think people are going to keep learning who don’t like the learning process.” <http://www.jolconsulting.com/updocuments/details_2.pdf#search=%22%22Charlie%20Munger%22%20%20%22life%20is%20just%20one%20damn%22%22>

“The name of the game is continuing to learn. Even if you’re very well trained and have some natural aptitude, you still need to keep learning”<http://www.feedblitz.com/f/f.fbz?PreviewFeed=7799>

**LEVERAGE (SEE ALSO DEBT):**

**“**Berkshire’s past record has been almost ridiculous. If Berkshire had used even half the leverage of, say, Rupert Murdoch, it would be five times its current size.” <http://www.fool.com/news/foth/2001/foth010508.htm>

**LEVERAGED BUY OUTS:**

“In the LBO field there is a buried “covariance” with marketable equities, toward disaster in generally bad business conditions, and competition is now extremely intense.”[http://72.14.203.104/search?q=cache:mgSaxC3O1IoJ:www.philanthropyroundtable.org/magazines/1999/march/munger.html+Berkshire+Hathaway%27s+vice+chairman+shreds+the+conventional+wisdom+on+foundation+investing&hl=en&gl=us&ct=clnk&cd=1](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2f72.14.203.104%2fsearch%3fq%3dcache%3amgSaxC3O1IoJ%3awww.philanthropyroundtable.org%2fmagazines%2f1999%2fmarch%2fmunger.html%2bBerkshire%2bHathaway%2527s%2bvice%2bchairman%2bshreds%2bthe%2bconventional%2bwisdom%2bon%2bfoundation%2binvesting%26hl%3den%26gl%3dus%26ct%3dclnk%26cd%3d1)

**LIES:**

“Lou Vincenti [former Chairman of Wesco], who used to sit here, said, “If you tell the truth, you don’t have to remember your lies.”  <http://www.grahamanddoddsville.net/wordpress/Files/Gurus/Warren%20Buffett/Berkshire%20Hathaway%20Annual%20Meeting%20Notes%202004.pdf>

**LIFE:**

 “You have to realize the truth of biologist Julian Huxley’s idea that ‘Life is just one damn relatedness after another’ “So you must have the models, and you must see the relatedness and the effects from the relatedness.”  [http://www.jolconsulting.com/updocuments/details\_2.pdf#search=%22%22Charlie%20Munger%22%20%20%22life%20is%20just%20one%](http://www.jolconsulting.com/updocuments/details_2.pdf#search=%22%22Charlie%20Munger%22%20%20%22life%20is%20just%20one%20damn%22%22)

**LIQUIDITY:**

“I think the notion that liquidity of tradable common stock is a great contributor to capitalism is mostly twaddle.  The liquidity gives us these crazy booms, so it has as many problems as virtues.”   <http://www.grahamanddoddsville.net/wordpress/Files/Gurus/Warren%20Buffett/Berkshire%20Hathaway%20Annual%20Meeting%20Notes%202004.pdf>

**LITIGATION:**

 “Litigation is notoriously time-consuming, inefficient, costly and unpredictable.”  Lowenstein at 217

**LOYALTY:**

“There are exceptional loyalties and there are old fashion ideas about how you get loyalties, and after all the auditorium is full of people who have co-owned shares with the managers for many decades, and in many cases they co-invested when everyone was young and obscure. Also when you come back to a place like that you are celebrating old loyalties, and of course the basic idea behind so much of Berkshire is the old fashioned idea that the best way to get loyalty is to deserve loyalty.”

**LUCK:**

“Well, some of our success we predicted and some of it was fortuitous. [Regardless,] like most human beings, we took a bow. (Laughter)” <http://www.tilsonfunds.com/wscmtg05notes.pdf>

**MANAGEMNET:**

“I think corporate managers should learn to be better investors because it would make them better managers.”  <http://www.tilsonfunds.com/wscmtg05notes.pdf>

“Understanding how to be a good investor makes you a better business manager and vice versa.” <http://www.myinvestmentforum.com/category/sgfunds-forum/interview-with-charlie-munger-t1655.html>

“We don’t train executives, we find them. If a mountain stands up like Everest, you don’t have to be a genius to figure out that it’s a high mountain.”[http://www.designs.valueinvestorinsight.com/bonus/bonuscontent/docs/Tilson\_2006\_BRK\_Meeting\_Notes.pdf#search=%22Charlie%20munger%20and%20foundation%20and%20croupier%22](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.designs.valueinvestorinsight.com%2fbonus%2fbonuscontent%2fdocs%2fTilson_2006_BRK_Meeting_Notes.pdf%23search%3d%2522Charlie%2520munger%2520and%2520foundation%2520and%2520croupier%2522)

“Our success has come from the lackof oversight we’ve provided, and our success will continue to be from a lack of oversight. (Laughter) But if you’re going to provide minimal oversight, you have to buy carefully. It’s a different model from GE’s. GE’s works – it’s just very different from ours.” <http://www.tilsonfunds.com/wscmtg05notes.pdf>

” …management matters…. I do not think it takes a genius to understand that Jack Welch was a more insightful person and a better manager than his peers in other companies….you do get an occasional opportunity to get into a wonderful business that’s being run by a wonderful manager. And, of course, that’s hog heaven day. If you don’t load up when you get those opportunities, it’s a big mistake.” averaged out, betting on the quality of a business is better than betting on the quality of management. In other words, if you have to choose one, bet on the business momentum, not the brilliance of the manager. But, very rarely, you find a manager who’s so good that you’re wise to follow him into what looks like a mediocre business.”   [http://ycombinator.com/munger.html](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fycombinator.com%2fmunger.html)“Good businesses can survive a little bad management.”<http://www.fool.com/news/foth/2000/foth000907.htm>

**MANAGEMNET FEES:**

“All the equity investors, in total, will surely bear a performance disadvantage per annum equal to the total croupiers’ costs they have jointly elected to bear. This is an inescapable fact of life. And it is also inescapable that exactly half of the investors will get a result below the median result after the croupiers’ take, which median result may well be somewhere between unexciting and lousy.”  [http://72.14.203.104/search?q=cache:mgSaxC3O1IoJ:www.philanthropyroundtable.org/magazines/1999/march/munger.html+Master%27s+Class:+Berkshire+Hathaway%27s+vice+chairman+shreds+the+conventional+wisdom+on+foundation+investing+-+By+Charles+Munger+(Philanthropy+Magazine+March+1999)&hl=en&gl=us&ct=clnk&cd=1](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2f72.14.203.104%2fsearch%3fq%3dcache%3amgSaxC3O1IoJ%3awww.philanthropyroundtable.org%2fmagazines%2f1999%2fmarch%2fmunger.html%2bMaster%2527s%2bClass%3a%2bBerkshire%2bHathaway%2527s%2bvice%2bchairman%2bshreds%2bthe%2bconventional%2bwisdom%2bon%2bfoundation%2binvesting%2b-%2bBy%2bCharles%2bMunger%2b%28Philanthropy%2bMagazine%2bMarch%2b1999%29%26hl%3den%26gl%3dus%26ct%3dclnk%26cd%3d1)

“Why would you want to invest with a guy whose thought process says, “If a second layer of fees is good, then let’s add a third layer.” <http://www.grahamanddoddsville.net/wordpress/Files/Gurus/Warren%20Buffett/Berkshire%20Hathaway%20Annual%20Meeting%20Notes%202004.pdf>

“If a foundation, or other investor, wastes 3% of assets per year in unnecessary, nonproductive investment costs in managing a strongly rising stock portfolio, it still feels richer, despite the waste, while the people getting the wasted 3%, “febezzelers” though they are, think they are virtuously earning income. The situation is functioning like undisclosed embezzlement without being self-limited. Indeed, the process can expand for a long while by feeding on itself. And all the while what looks like spending from earned income of the receivers of the wasted 3% is, in substance, spending from a disguised “wealth effect” from rising stock prices. ”  [http://www.tilsonfunds.com/Mungerwritings2001.pdf#search=%22%20%22charlie%20Munger%22%20Outstanding%20investor%20digest%22](http://www.tilsonfunds.com/Mungerwritings2001.pdf" \l "search=%22%20%22charlie%20Munger%22%20Outstanding%20investor%20digest%22)

**MARGIN OF SAFETY:**

“In engineering, people have a big margin of safety. But in the financial world, people don’t give a damn about safety. They let it balloon and balloon and balloon. It’s aided by false accounting.  [http://www.tilsonfunds.com/motley\_berkshire\_brkmtg03notes.php3](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.tilsonfunds.com%2fmotley_berkshire_brkmtg03notes.php3)

**MARRIAGE:**

What’s the best way to get a good spouse? The best single way is to deserve a good spouse because a good spouse is by definition not nuts.” <http://www.fool.com/news/commentary/2003/commentary030509wt.htm>

**MATH:**

“If you want to understand science, you have to understand math.  In business, if you’re enumerate, you’re going to be a klutz.  The good thing about business is that you don’t have to know any higher math….” <http://www.grahamanddoddsville.net/wordpress/Files/Gurus/Warren%20Buffett/Berkshire%20Hathaway%20Annual%20Meeting%20Notes%202004.pdf>

“There is bound to be a regression toward the mean.”   <http://money.cnn.com/magazines/moneymag/moneymag_archive/1997/07/01/228497/index.htm>

“Even in pure mathematics they can’t remove all paradox, and the rest of us should also recognize we are going to have to endure a lot of paradox, like it or not.<http://www.tilsonfunds.com/Mungerwritings2001.pdf#search=%22%20%22charlie%20Munger%22%20Outstanding%20investor%20digest%22>

Without numerical fluency, in the part  of life most of us  inhabit, you arelike a one-legged  man in an ass-kicking contest.”  Damn Right! Behind the Scenes with Berkshire Hathaway Billionaire Cha lie Munger, Janet Lowe john Wiley &Sons,  2003 <http://www.wiley.com/WileyCDA/WileyTitle/productCd-0471446912,descCd-tableOfContents.html> and <http://www.economist.com/media/globalexecutive/damn_right_e_02.pdf#search=%22%20%22charlie%20Munger%22%20army%20and%20playing%20poker%22>

**MENTAL MODELS: :**

“You need a different checklist and different mental models for different companies. I can never make it easy by saying, ‘Here are three things.’ You have to derive it yourself to ingrain it in your head for the rest of your life.” [http://www.fool.com/news/foth/2002/foth020515.htm](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.fool.com%2fnews%2ffoth%2f2002%2ffoth020515.htm)

For some odd reason, I had an early and extreme multidisciplinary cast of mind. I couldn’t stand reaching for a small idea in my own discipline when there was a big idea right over the fence in somebody else’s discipline. So I just grabbed in all directions for the big ideas that would really work. Nobody taught me to do that; I was just born with that yen.  [http://www.tilsonfunds.com/MungerUCSBspeech.pdf](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.tilsonfunds.com%2fMungerUCSBspeech.pdf)

“You must know the big ideas in the big disciplines, and use them routinely — all of them, not just a few. Most people are trained in one model — economics, for example — and try to solve all problems in one way. You know the old saying: to the man with a hammer, the world looks like a nail. This is a dumb way of handling problems.” [http://www.fool.com/BoringPort/2000/boringport00051501.htm](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.fool.com%2fBoringPort%2f2000%2fboringport00051501.htm)

“If you skillfully follow the multidisciplinary path, you will never wish to come back. It would be like cutting off your hands”  <http://www.feedblitz.com/f/f.fbz?PreviewFeed=7799>

**MICROSOFT:**

Every business tries to turn this year’s success into next year’s greater success. It’s hard for me to see why  Microsoft  is sinful to do this. If it’s a sin, then I hope all of Berkshire Hathaway’s subsidiaries are sinners. …Someone whose salary is paid by U.S. taxpayers is happy to dramatically weaken the one place where we’re winning big?!”  [http://www.fool.com/boringport/2000/boringport000501a.htm](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.fool.com%2fboringport%2f2000%2fboringport000501a.htm)

**MISPRICED BETS:**

 “… we came to this notion of finding a mispriced bet and loading up when we were very confident that we were right….”  [http://ycombinator.com/munger.html](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fycombinator.com%2fmunger.html)

**MISTAKES:**

“The more hard lessons you can learn vicariously rather than through your own hard experience, the better.”  <http://www.grahamanddoddsville.net/wordpress/Files/Gurus/Warren%20Buffett/Berkshire%20Hathaway%20Annual%20Meeting%20Notes%202004.pdf>

“Although I am very interested in the subject of human misjudgment — and lord knows I’ve created a good bit of it — I don’t think I’ve created my full statistical share” [http://www.vinvesting.com/docs/munger/human\_misjudgement.html](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.vinvesting.com%2fdocs%2fmunger%2fhuman_misjudgement.html)

“Since mistakes of omission don’t appear in the financial statements, most people don’t pay attention to them.  We rub our noses in mistakes of omission – as we just did. <http://www.grahamanddoddsville.net/wordpress/Files/Gurus/Warren%20Buffett/Berkshire%20Hathaway%20Annual%20Meeting%20Notes%202004.pdf>

“The most extreme mistakes inBerkshire’s history have been mistakes of omission. We saw it, but didn’t act on it. They’re huge mistakes — we’ve lost billions. And we keep doing it. We’re getting better at it. We never get over it.” There are two types of mistakes: 1) doing nothing; what Warren calls “sucking my thumb” and 2) buying with an eyedropper things we should be buying a lot of.” <http://www.tilsonfunds.com/motley_berkshire_brkmtg01notes.php>

After nearly making a terrible mistake not buying See’s, we’ve made this mistake many times. We are apparently slow learners. These opportunity costs don’t show up on financial statements, but have cost us many billions.  [http://www.tilsonfunds.com/motley\_berkshire\_brkmtg03notes.php3](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.tilsonfunds.com%2fmotley_berkshire_brkmtg03notes.php3)

“Chris Davis [of the Davis funds] has a temple of shame. He celebrates the things they did that lost them a lot of money. What is also needed is a temple of shame squared for things you didn’t do that would have made you rich. Forgetting your mistakes is a terrible error if you are trying to improve your cognition. Reality doesn’t remind you. Why not celebrate stupidities in both categories?”  [http://news.morningstar.com/article/article.asp?id=169398](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fnews.morningstar.com%2farticle%2farticle.asp%3fid%3d169398)

There’s no way that you can live an adequate life without [making ] many mistakes.  <http://www.poorcharliesalmanack.com/pdf/page228.pdf>

“Our biggest mistakes, were things we didn’t do, companies we didn’t buy.”<http://money.cnn.com/magazines/moneymag/moneymag_archive/1998/07/01/244582/index.htm>

**MOATS:**

Kellogg’s and Campbell’s moats have also shrunk due to the increased buying power of supermarkets and companies like Wal-Mart. The muscle power of Wal-Mart and Costco has increased dramatically.” <http://www.tilsonfunds.com/motley_berkshire_brkmtg01notes.php>

“How do you compete against a true fanatic? You can only try to build the best possible moat and continuously attempt to widen it.”  Poor Charlie’s at 59 <http://www.amazon.com/gp/product/1578643031/104-7644521-2497538?v=glance&n=283155>

**MONEY:**

There are a lot of things in life way more important than money. All that said, some people do get confused. I play golf with a man who says, ” What good is health? You can’t buy money with it.”  <http://media.wiley.com/product_data/excerpt/32/04712447/0471244732-1.pdf#search=%22munger%20you%20know%20the%20cliche%20that%20opposites%20attract%22>

**MONEY MANAGEMENT:**

“It’s my guess that something like 5% of GDP goes to money management and itsattendant friction. I define it broadly – annuities, incentive pay, all trading, etc. Nobody else has used figures that high, but that’s my guess. Worst of all, the people doing this are among the best and the brightest. Hundreds and thousands of engineers, etc. are going into hedge funds and investment banking. That is notan intelligent allocation of the brainpower of the civilization.  <http://www.tilsonfunds.com/wscmtg05notes.pdf>

I think money management is a low calling relative to being a surgeon. I don’t like the percentage of our GDP and brainpower and professional effort that’s in money management. I don’t think it’s a good thing for our country, and don’t expect it to end well. The present era has no comparable precedent in the history of capitalism when so many people are trading pieces of paper. We have a higher proportion of the intelligent sections of society involved in buying and selling bits of paper and trying to make money doing it. There are more people doing thisthan at any time in history. A lot of this reminds me of Sodom and Gomorrah.  <http://www.tilsonfunds.com/wscmtg05notes.pdf>

The general systems of money management [today] require people to pretend to do something they can’t do and like something they don’t. It’s a terrible way to spend your life, but it’s very well paid.  [http://www.tilsonfunds.com/motley\_berkshire\_brkmtg03notes.php3](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.tilsonfunds.com%2fmotley_berkshire_brkmtg03notes.php3)

“It’s natural that you’d have more brains going into money management. There are so many huge incomes in money management and investment banking — it’s like ants to sugar. There are huge incentives for a man to take up money management as opposed to, say, physics, and it’s a lot easier.” <http://www.tilsonfunds.com/motley_berkshire_brkmtg01notes.php>

I think the reason why we got into such idiocy in investment management is best illustrated by a story that I tell about the guy who sold fishing tackle. I asked him, “My God, they’re purple and green. Do fish really take these lures?” And he said, “Mister, I don’t sell to fish.” Investment managers are in the position of that fishing tackle salesman.[http://ycombinator.com/munger.html](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fycombinator.com%2fmunger.html)

In investment management today, everybody wants not only to win, but to have a yearly outcome path that never diverges very much from a standard path except on the upside. Well, that is a very artificial, crazy construct. That’s the equivalent in investment management to the custom of binding the feet of Chinese women. [http://ycombinator.com/munger.html](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fycombinator.com%2fmunger.html)

I think a select few—a small percentage of the investment managers—can deliver value added. But I don’t think brilliance alone is enough to do it. I think that you have to have a little of this discipline of calling your shots and loading up—you want to maximize your chances of becoming one who provides above average real returns for clients over the long pull.  But I’m just talking about investment managers engaged in common stock picking. I am agnostic elsewhere. I think there may well be people who are so shrewd about currencies and this, that and the other thing that they can achieve good long term records operating on a pretty big scale in that way. But that doesn’t happen to be my milieu. I’m talking about stock picking in American stocks.  [http://ycombinator.com/munger.html](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fycombinator.com%2fmunger.html)

The whole concept of the house advantage is an interesting one in modern money management. The terms of the managers of the private partnerships look a lot like the take of the croupier at Monte Carlo, only greater. [http://www.designs.valueinvestorinsight.com/bonus/bonuscontent/docs/Tilson\_2006\_BRK\_Meeting\_Notes.pdf#search=%22Charlie%20munger%20and%20foundation%20and%20croupier%22](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.designs.valueinvestorinsight.com%2fbonus%2fbonuscontent%2fdocs%2fTilson_2006_BRK_Meeting_Notes.pdf%23search%3d%2522Charlie%2520munger%2520and%2520foundation%2520and%2520croupier%2522)

**MORALS:**

Once you start doing something bad, then it’s easy to take the next step – and in the end, you’re a moral sewer.  <http://www.grahamanddoddsville.net/wordpress/Files/Gurus/Warren%20Buffett/Berkshire%20Hathaway%20Annual%20Meeting%20Notes%202004.pdf>

We believe there should be a huge area between everything you should do and everything you can do without getting into legal trouble.  I don’t think you should come anywhere nearthat line.  We don’t deserve much credit for this.  It helps us make more money.  I’d like to believe that we’d behave well even if it didn’t work.  But more often, we’ve made extra money from doing the right thing.  Ben Franklin said I’m not moral because of it’s the right thing to do – but because it’s the best policy. <http://www.grahamanddoddsville.net/wordpress/Files/Gurus/Warren%20Buffett/Berkshire%20Hathaway%20Annual%20Meeting%20Notes%202004.pdf>

We don’t claim to have perfect morals, but at least we have a huge area of things that, while legal, are beneath us.  We won’t do them.  Currently, there’s a culture in America that says that anything that won’t send you to prison is OK.  <http://www.grahamanddoddsville.net/wordpress/Files/Gurus/Warren%20Buffett/Berkshire%20Hathaway%20Annual%20Meeting%20Notes%202004.pdf>

“With so much money riding on reported numbers, human nature is to manipulate them. And with so many doing it, you get Serpico effects, where everyone rationalizes that it’s okay because everyone else is doing it. It is always thus.” <http://www.fool.com/BoringPort/2000/boringport00051501.htm>

“The old culture had come out of poverty, out of English customs,” he said. “People did not have the vast sense of entitlement, that they were entitled to be rich. People were damned glad to have a decent job where they might advance.”  <http://blogs.barrons.com/techtraderdaily/2006/06/26/the-wit-and-wisdom-of-charlie-munger/>

It is not always recognized that, to function best, morality should sometimes appear unfair, like most worldly outcomes. The craving for perfect fairness causes a lot of terrible problems in system function. Some systems should be made deliberately unfair to individuals because they’ll be fairer on average for all of us. I frequently cite the example of having your career over, in the Navy, if your ship goes aground, even if it wasn’t your fault. I say the lack of justice for the one guy that wasn’t at fault is way more than made up by a greater justice for everybody when every captain of a ship always sweats blood to make sure the ship doesn’t go aground. Tolerating a little unfairness to some to get a greater fairness for all is a model I recommend to all of you.  <http://www.originaldissent.com/forums/archive/index.php/t-14214.html>

The cash register did more for human morality than the Congregational Church. It was a really powerful phenomenon to make an economic system work better, just as, in reverse, a system that can be easily defrauded ruins a civilization. A system that’s very hard to defraud, like a cash register, helped the economic performance of a civilization by reducing vice, but very few people within economics talk about it in those terms.  <http://www.originaldissent.com/forums/archive/index.php/t-14214.html>

**MR. MARKET:**

“Ben Graham [had] his concept of “Mr. Market”. Instead of thinking the market was efficient, he treated it as a manic-depressive who comes by every day. And some days he says, “I’ll sell you some of my interest for way less than you think it’s worth.” And other days, “Mr. Market” comes by and says, “I’ll buy your interest at a price that’s way higher than you think it’s worth.” And you get the option of deciding whether you want to buy more, sell part of what you already have or do nothing at all. To Graham, it was a blessing to be in business with a manic-depressive who gave you this series of options all the time. That was a very significant mental construct….” [http://ycombinator.com/munger.html](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fycombinator.com%2fmunger.html)

**MODELS:**

“the great economist Keynes, “Better to be roughly right than precisely wrong.”<http://www.loschmanagement.com/Berkshire%20Hathaway/Charlie%20munger/The%20Psychology%20of%20Human%20Misjudgement.htm>

**MUTIUAL FUNDS:**

“Mutual funds charge 2% per year and then brokers switch people between funds, costing another 3-4 percentage points.  The poor guy in the general public is getting a terrible product from the professionals.  I think it’s disgusting.  It’s much better to be part of a system that delivers value to the people who buy the product.  But if it makes money, we tend to do it in this country.”<http://www.grahamanddoddsville.net/wordpress/Files/Gurus/Warren%20Buffett/Berkshire%20Hathaway%20Annual%20Meeting%20Notes%202004.pdf>

“this mutual fund study is roughly right, it raises huge questions about foundation wisdom in changing investment managers all the time as mutual fund investors do. If the extra lag reported in the mutual fund study exists, it is probably caused in considerable measure by folly in constant removal of assets from lagging portfolio managers being forced to liquidate stockholdings, followed by placement of removed assets with new investment managers that have high-pressure, asset-gaining hoses in their mouths  <http://www.tilsonfunds.com/Mungerwritings2001.pdf#search=%22%20%22charlie%20Munger%22%20Outstanding%20investor%20digest%22>

**NEWSPAPERS:**

“For years I have read the morning paper and harrumphed. There’s a lot to harrumph about now.”[http://www.law.stanford.edu/publications/stanford\_lawyer/issues/64/sl64.pdf](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.law.stanford.edu%2fpublications%2fstanford_lawyer%2fissues%2f64%2fsl64.pdf)

It is way less certain to be a wonderful business in the future. The threat is alternative mediums of information. Every newspaper is scrambling to parlay their existing advantage into dominance on the Internet. But it is way less sure [that this will occur] than the certainty 20 years ago that the basic business would grow steadily, so there’s more downside risk. The perfectly fabulous economics of this business could become grievously impaired.” [http://www.fool.com/BoringPort/2000/boringport00051501.htm](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.fool.com%2fBoringPort%2f2000%2fboringport00051501.htm)

**OBJECTIVITY:**

The life of Darwin demonstrates how a turtle may outrun a hare, aided by extreme objectivity, which helps the objective person end up like the only player without a blindfold in a game of Pin the Tail on the Donkey. [http://www.poorcharliesalmanack.com/pdf/page146.pdf](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.poorcharliesalmanack.com%2fpdf%2fpage146.pdf)

**OPPORTUNITIES:**

The general assumption is that it must be easy to sit behind a desk and people will bring in one good opportunity after another — this was the attitude in venture capital until a few years ago. This was not the case at all for us — we scrounged around for companies to buy. For 20 years, we didn’t buy more than one or two per year. …It’s fair to say that we were rooting around. There were no commissioned salesmen. Anytime you sit there waiting for a deal to come by, you’re in a very dangerous seat.  
[http://www.tilsonfunds.com/motley\_berkshire\_brkmtg03notes.php3](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.tilsonfunds.com%2fmotley_berkshire_brkmtg03notes.php3)

**OPPORTUNITY COSTS:**

If you take the best text in economics by Mankinaw, he says intelligent people make decisions based on opportunity costs — in other words, it’s your alternatives that matter. That’s how we make all of our decisions. The rest of the world has gone off on some kick — there’s even a cost of equity capital. A perfectly amazing mental malfunction. [http://www.tilsonfunds.com/motley\_berkshire\_brkmtg03notes.php3](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.tilsonfunds.com%2fmotley_berkshire_brkmtg03notes.php3)

“There is this company in an emerging market that was presented to Warren. His response was, ‘I don’t feel more comfortable buying that than I do of adding to Wells Fargo.’ He was using that as his opportunity cost. No one can tell me why I shouldn’t buy more Wells Fargo. Warren is scanning the world trying to get his opportunity cost as high as he can so that his individual decisions are better.”[http://news.morningstar.com/article/article.asp?id=169398](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fnews.morningstar.com%2farticle%2farticle.asp%3fid%3d169398)

Finding a single investment that will return 20% per year for 40 years tends to happen only in dreamland. In the real world, you uncover an opportunity, and then you compare other opportunities with that. And you only invest in the most attractive opportunities. That’s your opportunity cost. That’s what you learn in freshman economics. The game hasn’t changed at all. That’s why Modern Portfolio Theory is so asinine. <http://www.fool.com/news/commentary/2006/commentary06060104.htm>

Opportunity cost is a huge filter in life. If you’ve got two suitors who are really eager to have you and one is way the hell better than the other, you do not have to spend much time with the other. And that’s the way we filter out buying opportunities”<http://www.feedblitz.com/f/f.fbz?PreviewFeed=7799>

**OVERCONFIDENCE:**

Most people who try it don’t do well at it.  But the trouble is that if even 90% are no good, everyone looks around and says, “I’m the 10%.”<http://www.grahamanddoddsville.net/wordpress/Files/Gurus/Warren%20Buffett/Berkshire%20Hathaway%20Annual%20Meeting%20Notes%202004.pdf>

“..in the 5th century B. C. Demosthenes noted that: “What a man wishes, he will believe.” And in self-appraisals of prospects and talents it is the norm, as Demosthenes predicted, for people to be ridiculously over-optimistic. For instance, a careful survey in Sweden showed that 90 percent of automobile drivers considered themselves above average. And people who are successfully selling something, as investment counselors do, make Swedish drivers sound like depressives. Virtually every investment expert’s public assessment is that he is above average, no matter what is the evidence to the contrary.”  [http://72.14.203.104/search?q=cache:mgSaxC3O1IoJ:www.philanthropyroundtable.org/magazines/1999/march/munger.html+Berkshire+Hathaway%27s+vice+chairman+shreds+the+conventional+wisdom+on+foundation+investing&hl=en&gl=us&ct=clnk&cd=1](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2f72.14.203.104%2fsearch%3fq%3dcache%3amgSaxC3O1IoJ%3awww.philanthropyroundtable.org%2fmagazines%2f1999%2fmarch%2fmunger.html%2bBerkshire%2bHathaway%2527s%2bvice%2bchairman%2bshreds%2bthe%2bconventional%2bwisdom%2bon%2bfoundation%2binvesting%26hl%3den%26gl%3dus%26ct%3dclnk%26cd%3d1)

“[GEICO] got to thinking that, because they were making a lot of money, they knew everything. And they suffered huge losses. All they had to do was to cut out all the folly and go back to the perfectly wonderful business that was lying there.  <http://ycombinator.com/munger.html>

**PANIC:**

“When you have a huge convulsion, like a fire in this auditorium right now, you do get a lot of weird behavior. If you can be wise [during such h times, you’ll profit]. [http://www.designs.valueinvestorinsight.com/bonus/bonuscontent/docs/Tilson\_2006\_BRK\_Meeting\_Notes.pdf#search=%22Charlie%20munger%20and%20foundation%20and%20croupier%22](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.designs.valueinvestorinsight.com%2fbonus%2fbonuscontent%2fdocs%2fTilson_2006_BRK_Meeting_Notes.pdf%23search%3d%2522Charlie%2520munger%2520and%2520foundation%2520and%2520croupier%2522)

**PASSION:**

What matters most: passion or competence that was born in? Berkshire is full of people who have a peculiar passion for their own business. I would argue passion is more important than brain power. [http://www.tilsonfunds.com/motley\_berkshire\_brkmtg03notes.php3](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.tilsonfunds.com%2fmotley_berkshire_brkmtg03notes.php3)

**PATIENCE:**

“Most people are too fretful, they worry to much.  Success means being very patient, but aggressive when it’s time.”   <http://www.grahamanddoddsville.net/wordpress/Files/Gurus/Warren%20Buffett/Berkshire%20Hathaway%20Annual%20Meeting%20Notes%202004.pdf>

“If you took the top 15 decisions out, we’d have a pretty average record.   It wasn’t hyperactivity, but a hell of a lot of patience.  You stuck to your principles and when opportunities came along, you pounced on them with vigor.  With all that vigor, you only made a decision every two years.  We do more deals now, but it happened with a relatively few decisions and staying the course for decades and holding our fire until something came along worth doing.” <http://www.grahamanddoddsville.net/wordpress/Files/Gurus/Warren%20Buffett/Berkshire%20Hathaway%20Annual%20Meeting%20Notes%202004.pdf>

“We just keep our heads down and handle the headwinds and tailwinds as best we can, and take the result after a period of years.” [http://www.law.harvard.edu/alumni/bulletin/2001/summer/feature\_1-1.html](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.law.harvard.edu%2falumni%2fbulletin%2f2001%2fsummer%2ffeature_1-1.html)

We just throw some decisions into the “too hard” file and go onto others.  [http://www.tilsonfunds.com/brkmtg05notes.pdf](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.tilsonfunds.com%2fbrkmtg05notes.pdf)

We don’t feel some compulsion to swing. We’re perfectly willing to wait for something decent to come along.” “We’re rich in relation to the business that we’re doing.  “In certain periods, we have a hell of a time finding places to invest our money. We are in such a period.”  <http://www.tilsonfunds.com/motley_berkshire_brkmtg01notes.php>

The art of waiting without tiring of waiting.”  <http://72.14.203.104/search?q=cache:sVtHPKWG-bwJ:www.wedgecapital.com/documents/WW2Q05.pdf+%22Charlie+Munger%22+%22to+us,+investing+is+the+equivalent+of%22&hl=en&gl=us&ct=clnk&cd=1>

“It is occasionally possible for a tortoise, content to assimilate proven insights of his best predecessors, to out run hares which seek originality or don’t wish to be left out of some crowd folly which ignores the best work of the past. This hap pens as the tortoise stumbles on some particularly effective way to apply the best previous work, or simply avoids standard calamities. We try more to profit by always remembering the obvious than from grasping the esoteric. It is remarkable how much long-term advantage people like us have gotten by trying to be consistently not stupid, instead of trying to be very intelligent.”

**PEOPLE:**

“When you have doubts about a person, you can pass,” he said. “There’s enough nice people to interface with.”[http://sanfrancisco.bizjournals.com/sanfrancisco/stories/1996/10/21/newscolumn6.html](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fsanfrancisco.bizjournals.com%2fsanfrancisco%2fstories%2f1996%2f10%2f21%2fnewscolumn6.html)

“You know the cliché’ that opposites attract? Well, opposites don’t attract. Psychological experiments prove that’s it’s people who are alike that are attracted to each other. Our minds [his and Buffett’s] work in very much the same way.”  [http://www.metnews.com/opinion/persp-munger.htm](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.metnews.com%2fopinion%2fpersp-munger.htm)

“It’s amazing how few times over the decades we’ve have to remove a person — far less than other companies. It’s not that we’re soft or foolish, it’s that we’re wiser and luckier. Most people would look back and say their worst mistake was not firing someone soon enough. [http://www.fool.com/boringport/2000/boringport00051500.htm](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.fool.com%2fboringport%2f2000%2fboringport00051500.htm)

**PERFORMANCE**:

“Don’t confuse correlation and causation. Almost all great records eventually dwindle…” [http://www.tilsonfunds.com/motley\_berkshire\_wscmtg01notes.php3](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.tilsonfunds.com%2fmotley_berkshire_wscmtg01notes.php3)

**PESSIMISM:**

“Is there such thing as a cheerful pessimist? That’s what I am.” <http://www.fool.com/news/foth/2001/foth010508.htm>

**PHIL FISHER:**:

“I always like it when someone attractive to me agrees with me, so I have fond memories of Phil Fisher.  The idea that it was hard to find good investments, so concentrate in a few, seems to me to be an obviously good idea.  But 98% of the investment world doesn’t think this way. <http://www.grahamanddoddsville.net/wordpress/Files/Gurus/Warren%20Buffett/Berkshire%20Hathaway%20Annual%20Meeting%20Notes%202004.pdf>

**PHILANTHROPY:**

**“**those of us who have been very fortunate have a duty to give back. Whether one gives a lot as one goes along as I do or a little and then a lot [when one dies] as  Warren does is a matter of personal preference. I would hate to have people ask me for money all day long.  <http://www.tilsonfunds.com/motley_berkshire_brkmtg03notes.php3>

“Is anyone really surprised that Warren, who is the ultimate embodiment of concentrated decision-making power, picked somebody [Bill and Melinda Gates] who he thinks is like him in many important ways? It was a noble and sensible decision.” <http://paul.kedrosky.com/archives/2006/06/26/the_wit_and_wis.html>

**PHYSICS:**

“The tradition of always looking for the answer in the most fundamental way available — that is a great tradition, and it saves a lot of time in this world.” Damn Right, page 34  <http://www.wiley.com/WileyCDA/WileyTitle/productCd-0471446912,descCd-tableOfContents.html>

**PLANNING:**

“There has never been a master plan.  Anyone who wanted to do it, we fired because it takes on a life of its own and doesn’t cover new reality.  We want people taking into account new information.” <http://www.grahamanddoddsville.net/wordpress/Files/Gurus/Warren%20Buffett/Berkshire%20Hathaway%20Annual%20Meeting%20Notes%202004.pdf>

“Strategic plans cause more dumb decisions than anything else in America.”  [http://sanfrancisco.bizjournals.com/sanfrancisco/stories/1996/10/21/newscolumn6.html](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fsanfrancisco.bizjournals.com%2fsanfrancisco%2fstories%2f1996%2f10%2f21%2fnewscolumn6.html)

**POKER:**

“Life in part is like a poker game, wherein you have to learn to quit sometimes when holding a much loved hand.”  [http://www.poorcharliesalmanack.com/pdf/page228.pdf](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.poorcharliesalmanack.com%2fpdf%2fpage228.pdf)

“Playing poker in the Army and as a young lawyer  honed my business skills … What  you have to learn is to fold early when the odds are against you, or if  you have a big edge, back it heavily because you don’t get a big edge often.”  **Damn Right!**Behind the Scenes with Berkshire Hathaway Billionaire Cha lie Munger, Janet Lowe john Wiley &Sons,  2003 <http://www.wiley.com/WileyCDA/WileyTitle/productCd-0471446912,descCd-tableOfContents.html>

**POOR CHARLIE’S ALMANACK:**

“This book was a crazy thing to have done, and not everyone will like it, but what the hell.”  <http://www.poorcharliesalmanack.com/recommendations.html>

**PRICE:**

“We bought a doomed textile mill [Berkshire Hathaway] and a California S&L [Wesco] just before a calamity. Both were bought at a discount to liquidation value.”<http://www.tilsonfunds.com/motley_berkshire_brkmtg01notes.php>

“Wrigley is a great business, but that doesn’t solve the problem. Buying great businesses at advantageous prices is very tough.”<http://www.tilsonfunds.com/motley_berkshire_brkmtg01notes.php>

“If you can buy the best companies, over time the pricing takes care of itself.” – (**OID**)“The investment game always involves considering both quality and price, and the trick is to get more quality than you pay for in price. It’s just that simple. **Damn Right!**Behind the Scenes with Berkshire Hathaway Billionaire ChaRlie Munger, Janet Lowe john Wiley &Sons,  2003 <http://www.wiley.com/WileyCDA/WileyTitle/productCd-0471446912,descCd-tableOfContents.html>

**PRICING POWER:**

“There are actually businesses, that you will find a few times in a lifetime, where any manager could raise the return enormously just by raising prices—and yet they haven’t done it. So they have huge untapped pricing power that they’re not using. That is the ultimate no-brainer. … Disney found that it could raise those prices a lot and the attendance stayed right up.  So a lot of the great record of Eisner and Wells … came from just raising prices at Disneyland and Disneyworld and through video cassette sales of classic animated movies… At Berkshire Hathaway, Warren and I raised the prices of See’s Candy a little faster than others might have. And, of course, we invested in Coca-Cola—which had some untapped pricing power. And it also had brilliant management. So a Goizueta and Keough could do much more than raise prices. It was perfect.” [http://ycombinator.com/munger.html](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fycombinator.com%2fmunger.html)

**PRIORITIES:**

“Trying to prioritize among things we’re unlikely to do is pretty fruitless.” <http://www.grahamanddoddsville.net/wordpress/Files/Gurus/Warren%20Buffett/Berkshire%20Hathaway%20Annual%20Meeting%20Notes%202004.pdf>

**PREDICTIONS:**

Berkshire is in the business of making easy predictions  If a deal looks too hard, the partners simply shelve it.”<http://money.cnn.com/magazines/fortune/fortune_archive/2006/05/29/8378052/index.htm>

 “We’re the tortoise that has outrun the hare because it chose the easy predictions. <http://www.fool.com/news/commentary/2006/commentary06062914.htm>

**PREPARATION:**

“Opportunity comes to the prepared mind.”  <http://72.14.203.104/search?q=cache:IuDIHXun74MJ:www.amazon.com/exec/obidos/tg/detail/-/1578643031%3Fv%3Dglance+%22Charlie+Munger%22+%22I+didn%27t+get+to+where+I+am%22&hl=en&gl=us&ct=clnk&cd=1>

“a lot of opportunities in life tend to last a short while, due to some temporary inefficiency… For each of us, really good investment opportunities aren’t going to come along too often and won’t last too long, so you’ve got to be ready to act and have a prepared mind.”  <http://www.fool.com/news/commentary/2003/commentary030509wt.htm>

**PRIVATE EQUITY:**

“In the 1930s, there as a stretch here you could borrow more against the real estate than you could sell it for. I think that’s hat’s going on in today’s private-equity world.” [http://www.designs.valueinvestorinsight.com/bonus/bonuscontent/docs/Tilson\_2006\_BRK\_Meeting\_Notes.pdf#search=%22Charlie%20munger%20and%20foundation%20and%20croupier%22](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.designs.valueinvestorinsight.com%2fbonus%2fbonuscontent%2fdocs%2fTilson_2006_BRK_Meeting_Notes.pdf%23search%3d%2522Charlie%2520munger%2520and%2520foundation%2520and%2520croupier%2522)

**PROBLEMS:**

“Some people seem to think there’s no trouble just because it hasn’t happened yet. If you jump out the window at the 42nd floor and you’re still doing fine as you pass the 27th floor, that doesn’t mean you don’t have a serious problem.” <http://money.cnn.com/2005/05/01/news/fortune500/buffett_talks/index.htm>

“Let me know what your problem is, and I will try to make it more difficult for you.”  <http://blogs.barrons.com/techtraderdaily/2006/06/26/the-wit-and-wisdom-of-charlie-munger/> 

**PROSPECT THEORY**:

“I mean people are really crazy about minor decrements down. And then, if you act on them, then you get into reciprocation tendency, because you don’t just reciprocate affection, you reciprocate animosity, and the whole thing can escalate. And so huge insanities can come from just subconsciously over-weighing the importance of what you’re losing or almost getting and not getting.”<http://www.loschmanagement.com/Berkshire%20Hathaway/Charlie%20munger/The%20Psychology%20of%20Human%20Misjudgement.htm>

**PROSPECTUS:**

“Any time anybody offers you anything with a big commission and a 200-page prospectus, don’t buy it. Occasionally, you’ll be wrong if you adopt “Munger’s Rule”. However, over a lifetime, you’ll be a long way ahead—and you will miss a lot of unhappy experiences .”[http://ycombinator.com/munger.html](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fycombinator.com%2fmunger.html)

**PSYCHOLOGY:**

“The elementary part of psychology ‑ the psychology of misjudgment, as I call it ‑ is a terribly important thing to learn. There are about 20 little principles. And they interact, so it gets slightly complicated. But the guts of it is unbelievably important. Terribly smart people make totally bonkers mistakes by failing to pay heed to it. In fact, I’ve done it several times during the last two or three years in a very important way. You never get totally over making silly mistakes. There’s another saying that comes from Pascal which I’ve always considered o­ne of the really accurate observations in the history of thought. Pascal said in essence, “The mind of man at o­ne and the same time is both the glory and the shame of the universe.”  [http://www.thinkfn.com/en/content/view/52/?id=124](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.thinkfn.com%2fen%2fcontent%2fview%2f52%2f%3fid%3d124)

**PUBLIC COMPANY:**

“…the cost of being a publicly traded stock has gone way, way up. It doesn’t make sense for a little company to be public anymore. A lot of little companies are going private to be rid of these burdensome requirements….”  <http://www.tilsonfunds.com/wscmtg05notes.pdf>

**PURPOSE:**

“That I’ve profited from being shrewd with money is not by itself satisfying to me. To atone, I teach and try to set an example. I would hate it if the example of my life caused people to pursue the passive ownership of pieces of paper. I think lives so spent are disastrous lives. I think it’s a better career if you help build something. I wish I’d built more, but I was cursed at being so good at stock picking. ‘The man is the prisoner of his talents.’ You can laugh, but I’ll bet this room is full of people who are prisoners of their talents. It tends to be the human condition.”  <http://www.tilsonfunds.com/motley_berkshire_brkmtg01notes.php>

**RATIONALITY:**

“Rationality is not just something you do so that you can make more money, it is a binding principle. Rationality is a really good idea. You must avoid the nonsense that is conventional in one’s own time. It requires developing systems of thought that improve your batting average over time.”  <http://news.morningstar.com/article/article.asp?id=169398>

“We have a high moral responsibility to be rational.”   <http://money.cnn.com/magazines/fortune/fortune_archive/2006/05/29/8378052/index.htm>

“The manipulation still works even though you know you’re doing it. And I’ve seen that done by one person to another. I drew this beautiful woman as my dinner partner a few years ago, and I’d never seen her before. Well, she’s married to prominent Angelino, and she sat down next to me and she turned her beautiful face up and she said, “Charlie,” she said, “What one word accounts for your remarkable success in life?” And I knew I was being manipulated and that she’d done this before, and I just loved it. I mean I never see this woman without a little lift in my spirits. And by the way I told her I was rational.”  <http://www.loschmanagement.com/Berkshire%20Hathaway/Charlie%20munger/The%20Psychology%20of%20Human%20Misjudgement.htm>

**READING:**

“We read a lot.  I don’t know anyone who’s wise who doesn’t read a lot.  But that’s not enough: You have to have a temperament to grab ideas and do sensible things.  Most people don’t grab the right ideas or don’t know what to do with them.”    <http://www.grahamanddoddsville.net/wordpress/Files/Gurus/Warren%20Buffett/Berkshire%20Hathaway%20Annual%20Meeting%20Notes%202004.pdf>

“In my whole life, I have known no wise people (over a broad subject matter area) who didn’t read all the time – none, zero. You’d be amazed at how much Warren reads – at how much I read. My children laugh at me. They think I’m a book with a couple of legs sticking out.”  <http://www.amazon.com/gp/product/1578643031/104-7644521-2497538?v=glance&n=283155>

  “…by regularly reading business newspaper and magazines I am exposed to an enormous amount of material at the micro level..  I find that what I see going on there pretty much informs me about what’s happening at the macro level.”   <http://www.amazon.com/gp/product/1578643031/104-7644521-2497538?v=glance&n=283155> 

**REAL ESTATE:**

“We don’t have big advantages — no special competence — so we spend almost no time on it.” <http://www.tilsonfunds.com/motley_berkshire_brkmtg02notes.php>

“REITs are way more suitable for individual shareholders than for corporate shareholders. And Warren has enough residue from his old cigar-butt personality that when people became disenchanted with the REITs and the market price went down to maybe a 20% discount from what the companies could be liquidated for, he bought a few shares with his personal money. So it’s nice that Warren has a few private assets with which to pick up cigar butts in memory of old times – if that’s what keeps him amused.” – 1999 Wesco Annual Meeting  <http://www.ticonline.com/archives_quotes.html>

**REGULATION:**

“In our early days, we tended to overestimate the difficulties of regulation.  We refrained by buying the stocks of television stations because we thought it was peculiar that someone could ask to have the government pull your license any year – and the government could do it.” <http://www.grahamanddoddsville.net/wordpress/Files/Gurus/Warren%20Buffett/Berkshire%20Hathaway%20Annual%20Meeting%20Notes%202004.pdf>

“How often does it happen that someone who was an intimate member of an industry is really the right person to clean it up?” “Will anybody be as tough as I’d like to see? The answer is no.”

**REGRET:**

“I don’t spend much time  regretting the past, once I’ve taken my lesson from it. I don’t dwell on it.”  Damn Right!Behind the Scenes with Berkshire Hathaway Billionaire Cha lie Munger, Janet Lowe john Wiley &Sons,  2003 <http://www.wiley.com/WileyCDA/WileyTitle/productCd-0471446912,descCd-tableOfContents.html>

**REINSURANCE:**

 “Reinsurance is not as much of a commodity business as it might appear. There’s such a huge time lag between when the policy is written and when it is paid that the customer has to evaluate the insurer’s future willingness and ability to pay. We have a reputational advantage, though it’s not as big as it should be.” <http://www.fool.com/boringport/2000/boringport000501.htm>

“Our record in the past if you average it out has been quite respectable. Why shouldn¹t we use our capital strength?” “We’d be out of our minds if we wrote weather insurance on the opinion global warming would have no effect at all.”  <http://us.ft.com/ftgateway/superpage.ft?news_id=fto050720060912107064&page=2>

**RESPONSIBILITY:**

“But if you rise high in a corporation or elsewhere in life, you have a duty to be anexemplar – you have a duty to take less than you deserve, to set an example. This goes all the way back to Athens. ” [http://www.tilsonfunds.com/wscmtg05notes.pdf](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.tilsonfunds.com%2fwscmtg05notes.pdf)

**RETURNS:**

“If I’m wrong (about future stock market returns being in the mid-single digits), it could be for a bad reason. Stocks partly sell like bonds, based on expectations of future cash streams, and partly like Rembrandts, based on the fact that they’ve gone up in the past and are fashionable,” Munger said. “If they trade more like Rembrandts in the future, then stocks will rise (at double digits), but they will have no anchors. In this case, it’s hard to predict how far, how high and how long it will last.” <http://www.findarticles.com/p/articles/mi_m5072/is_22_23/ai_75455080>

“Well, the questioner came from Singapore which has perhaps the best economic record in the history of developing an economy and therefore he referred to 15% per annum as modest. It’s not modest–it’s arrogant. Only someone from Singapore would call it modest. ” 1997 Berkshire Hathaway Annual Meeting<http://www.ticonline.com/archives_quotes.html>

“Warren said [at the Berkshire annual meeting] that he hoped to do modestly better than the market. 15% would be a hell of a number, so the target is the 6-15% range. You’re in the same boat we are.”  <http://www.tilsonfunds.com/motley_berkshire_brkmtg01notes.php>

“The normal expectancy of the average investor — for example, the pension funds of AT&T or IBM — is 6% for a long time.”<http://www.tilsonfunds.com/motley_berkshire_brkmtg01notes.php>

“The average result has to be the average result. By definition, everybody can’t beat the market. As I always say, the iron rule of life is that only 20% of the people can be in the top fifth. That’s just the way it is.”  [http://ycombinator.com/munger.html](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fycombinator.com%2fmunger.html)

**REVENGE:**

“I don’t think vengeance is much good.”<http://www.loschmanagement.com/Berkshire%20Hathaway/Charlie%20munger/The%20Psychology%20of%20Human%20Misjudgement.htm>

**RISK:**

“Using [a stock’s] volatility as a measure of risk is nuts. Risk to us is 1) the risk of permanent loss of capital, or 2) the risk of inadequate return. Some great businesses have very volatile returns – for example, See’s [a candy company owned by Berkshire] usually loses money in two quarters of each year – and some terrible businesses can have steady results” “I know a man named John Arriaga. After he graduated from Stanford, he started to develop properties around Stanford. There was no better time to do it then when he did. Rents have gone up and up. Normal developers would borrow and borrow. What John did was gradually pay off his debt, so when the crash came and 3 million of his 15 million square feet of buildings went vacant, he didn’t bat an eyebrow. The man deliberately took risk out of his life, and he was glad not to have leverage. There is a lot to be said that when the world is going crazy, to put yourself in a position where you take risk off the table. We might all consider imitating John.” [http://news.morningstar.com/article/article.asp?id=169398](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fnews.morningstar.com%2farticle%2farticle.asp%3fid%3d169398)

“This is an amazingly sound place. We are more disaster-resistant than most other places. We haven’t pushed it as hard as other people would have pushed it. I don’t want to go back to Go. I’ve been to Go. A lot of our shareholders have a majority of their net worth in Berkshire, and they don’t want to go back to Go either.”<http://www.fool.com/news/foth/2001/foth010508.htm>

**ROLE MODEL:**

“Early Charlie Munger is a horrible career model for the young because not enough was delivered to civilization in return for what was wrested from capitalism. And other similar career models are even worse.”  [http://72.14.203.104/search?q=cache:mgSaxC3O1IoJ:www.philanthropyroundtable.org/magazines/1999/march/munger.html+Berkshire+Hathaway%27s+vice+chairman+shreds+the+conventional+wisdom+on+foundation+investing&hl=en&gl=us&ct=clnk&cd=1](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2f72.14.203.104%2fsearch%3fq%3dcache%3amgSaxC3O1IoJ%3awww.philanthropyroundtable.org%2fmagazines%2f1999%2fmarch%2fmunger.html%2bBerkshire%2bHathaway%2527s%2bvice%2bchairman%2bshreds%2bthe%2bconventional%2bwisdom%2bon%2bfoundation%2binvesting%26hl%3den%26gl%3dus%26ct%3dclnk%26cd%3d1)

“I feel that by getting rich in the way I did, I think my own example has hurt my own country.”  <http://www.tilsonfunds.com/wscmtg05notes.pdf>

“Ben Franklin and Samuel Johnson, he credits their wisdom for his success. “They were both utterly brilliant men. And powerful communicators. Both have helped me all the way through life. Their lessons are easy to assimilate.”  [http://www.law.harvard.edu/alumni/bulletin/2001/summer/feature\_1-1.html](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.law.harvard.edu%2falumni%2fbulletin%2f2001%2fsummer%2ffeature_1-1.html)

“Whoever makes you smarter a little earlier in life makes you better,”  [http://seekingalpha.com/article/14114](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fseekingalpha.com%2farticle%2f14114" \t "_blank)

**SALES:**

“…If you take sales presentations and brokers of commercial real estate and businesses… I’m 70 years old, I’ve never seen one I thought was even within hailing distance of objective truth…. ‘incentive-caused bias,’ causes this terrible abuse. And many of the people who are doing it you would be glad to have married into your family compared to what you’re otherwise going to get….” <http://www.loschmanagement.com/Berkshire%20Hathaway/Charlie%20munger/The%20Psychology%20of%20Human%20Misjudgement.htm>

**SEC:** “The SEC does way more good than harm – the last thing I would do is get rid of the SEC…if accounting were thoroughly fixed, a lot of other sins would go away. We’re paying a huge price for deterioration of accounting.”  <http://blogs.barrons.com/techtraderdaily/2006/06/26/the-wit-and-wisdom-of-charlie-munger/>

**SEE’S CANDY:**

 “See’s candy company was the first high-quality business we ever bought,”  [http://sanfrancisco.bizjournals.com/sanfrancisco/stories/1996/10/21/newscolumn6.html](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fsanfrancisco.bizjournals.com%2fsanfrancisco%2fstories%2f1996%2f10%2f21%2fnewscolumn6.html" \t "_blank)

 If See’s Candy had asked $100,000 more [in the purchase price; Buffett chimed in, “$10,000 more”], Warren and I would have walked — that’s how dumb we were. Ira Marshall said you guys are crazy — there are some things you should pay up for, like quality businesses and people. You are underestimating quality. We listened to the criticism and changed our mind. This is a good lesson for anyone: the ability to take criticism constructively and learn from it. If you take the indirect lessons we learned from See’s, you could say Berkshire was built on constructive criticism. Now we don’t want any more today. [http://www.tilsonfunds.com/motley\_berkshire\_brkmtg03notes.php3](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.tilsonfunds.com%2fmotley_berkshire_brkmtg03notes.php3)

 “It takes almost no capital to open a new See’s candy store. We’re drowning in capital of our own that has almost no cost. It would be crazy to franchise stores like some capital-starved pancake house. We like owning our own stores as a matter of quality control.”  <http://www.tilsonfunds.com/motley_berkshire_brkmtg01notes.php>

**SCIENCE:**

“It’s very useful to have a good grasp of all the big ideas in hard and soft science. A, it gives perspective. B, it gives a way for you to organize and file away experience in your head, so to speak.”  <http://www.myinvestmentforum.com/category/sgfunds-forum/interview-with-charlie-munger-t1655.html>

**SHAREHOLDERS:**

“We like our current shareholders and don’t want to entice anyone to become one.  It would help current shareholders to hear our CEOs [of the Berkshire operating subsidiaries], but we promised them they could spend 100% of their time on their business.  We place no impediments on them running their businesses.  Many have expressed to me how happy they are that they don’t have to spend 25% of time on activities they didn’t like.” <http://www.grahamanddoddsville.net/wordpress/Files/Gurus/Warren%20Buffett/Berkshire%20Hathaway%20Annual%20Meeting%20Notes%202004.pdf>

**SHORT SALE:**

“It’s dangerous to short stocks.” <http://www.tilsonfunds.com/motley_berkshire_brkmtg02notes.php>

“Being short and seeing a promoter take the stock up is very irritating. It’s not worth it to have that much irritation in your life.” <http://www.tilsonfunds.com/motley_berkshire_brkmtg01notes.php>

“It would be one of the most irritating experiences in the world to do a lot of work to uncover a fraud and then at have it go from X to 3X and at h the crooks happily partying with your money while you’re meeting margin calls. Why would you want to go within hailing distance of that? [Laughter]“ [http://www.designs.valueinvestorinsight.com/bonus/bonuscontent/docs/Tilson\_2006\_BRK\_Meeting\_Notes.pdf#search=%22Charlie%20munger%20and%20foundation%20and%20croupier%22](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.designs.valueinvestorinsight.com%2fbonus%2fbonuscontent%2fdocs%2fTilson_2006_BRK_Meeting_Notes.pdf%23search%3d%2522Charlie%2520munger%2520and%2520foundation%2520and%2520croupier%2522)

**SIZE:**

“Size will hurt returns. Look at Berkshire Hathaway – the last five things Warren  has done have generated returns that are splendid by historical standards, but now give him $100 billion in assets and measure outcomes across all of it, it doesn’t look so good. We can only buy big positions, and the only time we can get big positions is during a horrible period of decline or stasis. That really doesn’t happen very often.”  <http://www.tilsonfunds.com/wscmtg05notes.pdf>

“All large aggregations of capital eventually find it hell on earth to grow and thus find a lower rate of return.”  [http://www.fool.com/news/foth/2002/foth020515.htm](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.fool.com%2fnews%2ffoth%2f2002%2ffoth020515.htm)”

It took us months of buying all the Coke stock we could to accumulate $1 billion worth — equal to 7% of the company. It’s very hard to accumulate major positions.”<http://www.tilsonfunds.com/motley_berkshire_brkmtg01notes.php>

**SOCIAL MOBILITY:**

“If the same family were always on the bottom, then you’d have big resentments. But if DuPonts go down and Pampered Chef up, [that’s good]. That much churn makes people think the system is fairer. Buffett: We don’t like churn now, but we liked it more 30-40 years ago.” [http://www.tilsonfunds.com/motley\_berkshire\_brkmtg03notes.php3](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.tilsonfunds.com%2fmotley_berkshire_brkmtg03notes.php3)

**SOCIAL SECURITY:**

“…Social Security is amazing how we’ve run it. It’s inflation protected. It’s easy to sneer at it, but it’s one of the most successful government programs ever. It’s low cost and encourages work. People say if you never change the revenue base, it’ll run out of money. But if 10 years from now, the country is 30-40% richer, why not use a higher percentage of GDP to pay people? Young people benefit too – the money is paid to people who might be moving in with them. (Laughter) Everybody’s going to get older, but also richer, so why wouldn’t you spend a higher percentage of GDP on them? Why is that so unthinkable? I’ll tell you what’s unthinkable: that so many people are that stupid! (Laughter)…”  <http://www.tilsonfunds.com/wscmtg05notes.pdf>

“Regarding the demographic trend called Baby Boomers, it’s peanuts compared to the trend of economic growth.  Over the last century, [our] GNP is up seven times.  This was not caused by Baby Boomers, but by the general success of capitalism and the march of technology.  Those trends were so favorable that little blips in the birth rate were not that significant.  We can keep social peace as long as GNP rises 3% annually – this can pay for spending by politicians.  If we ever got to stasis [no growth], then with all the promises, you’d get real tensions between the generations.  The Baby Boomers would exacerbate it, but the real cause would be lack of growth.”   <http://www.grahamanddoddsville.net/wordpress/Files/Gurus/Warren%20Buffett/Berkshire%20Hathaway%20Annual%20Meeting%20Notes%202004.pdf>

I think the Republicans are out of their cotton-pickin’ minds to be taking on this issue at this time. The thought that more of our GDP will be going to the elderly over time is not anathema to me. Social Security is very successful. Apart from disability – a small part – there’s almost no fraud; it’s hard to fake being dead. (Laughter) It rewards work, it’s low cost. It’s one of the most successful government programs ever. For the current administration, which needs to face down North Korea and Iran, deal with Iraq, etc., to waste political capital on this twaddle…  [http://www.tilsonfunds.com/brkmtg05notes.pdf](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.tilsonfunds.com%2fbrkmtg05notes.pdf" \t "_blank)

“Of course if we don’t change anything, Social Security will run low on funds. But if we grow, then it’s child’s play to [deal with this problem]. And it’s crazy to think we’d freeze the amount we’d pay to the elderly. Social Security is a low -overhead, efficient program.” [http://www.designs.valueinvestorinsight.com/bonus/bonuscontent/docs/Tilson\_2006\_BRK\_Meeting\_Notes.pdf#search=%22Charlie%20munger%20and%20foundation%20and%20croupier%22](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.designs.valueinvestorinsight.com%2fbonus%2fbonuscontent%2fdocs%2fTilson_2006_BRK_Meeting_Notes.pdf%23search%3d%2522Charlie%2520munger%2520and%2520foundation%2520and%2520croupier%2522)

**STATISTICS:**

[What was] … worked out in the course of about o­ne year between Pascal and Fermat… is not that hard to learn.  What is hard is to get so you use it routinely almost everyday of your life. The Fermat/Pascal system is dramatically consonant with the way that the world works. And it’s fundamental truth. So you simply have to have the technique….At Harvard Business School, the great quantitative thing that bonds the first ‑ year class together is what they call decision tree theory. All they do is take high school algebra and apply it to real life problems. And the students love it. They’re amazed to find that high school algebra works in life….By and large, as it works out, people can’t naturally and automatically do this. If you understand elementary psychology, the reason they can’t is really quite simple: The basic neural network of the brain is there through broad genetic and cultural evolution. And it’s not Fermat/Pascal. It uses a very crude, shortcut ‑ type of approximation. It’s got elements of Fermat/Pascal in it. However, it’s not good.So you have to learn in a very usable way this very elementary math and use it routinely in life ‑ just the way if you want to become a golfer, you can’t use the natural swing that broad evolution gave you. You have to learn to have a certain grip and swing in a different way to realize your full potential as a golfer.  If you don’t get this elementary, but mildly unnatural, mathematics of elementary probability into your repertoire, then you go through a long life like a o­ne‑legged man in an ass‑kicking contest. You’re giving a hugeadvantage to everybody else.”   [http://www.thinkfn.com/en/content/view/52/?id=124](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.thinkfn.com%2fen%2fcontent%2fview%2f52%2f%3fid%3d124)

“I’m not sure that I can even pronounce the Poisson distribution. But I know what a Gaussian or normal distribution looks like and I know that events and huge aspects of reality end up distributed that way. So I can do a rough calculation.  But if you ask me to work out something involving a Gaussian distribution to ten decimal points, I can’t sit down and do the math. I’m like a poker player who’s learned to play pretty well without mastering Pascal. And by the way, that works well enough. But you have to understand that bell shaped curve at least roughly as well as I do.”  [http://ycombinator.com/munger.html](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fycombinator.com%2fmunger.html)

“Practically everybody (1) overweighs the stuff that can be numbered, because it yields to the statistical techniques they’re taught in academia, and (2) doesn’t mix in the hard-to-measure stuff that may be more important. That is a mistake I’ve tried all my life to avoid, and I have no regrets for having done that.”

**STOCKS:**

“You must value the business in order to value the stock.” <http://www.amazon.com/gp/product/1578643031/104-7644521-2497538?v=glance&n=283155>

“[In picking stocks] You really have to know a lot about business. You have to know a lot about competitive advantage. You have to know a lot about the maintainability of competitive advantage. You have to have a mind that quantifies things in terms of value. And you have to be able to compare those values with other values available in the stock market.” <http://www.myinvestmentforum.com/category/sgfunds-forum/interview-with-charlie-munger-t1655.html>

“The number one idea, is to view a stock as an ownership of the business [and] to judge the staying quality of the business in terms of its competitive advantage. Look for more value in terms of discounted future cash flow than you’re paying for. Move only when you have an advantage. It’s very basic. You have to understand the odds and have the discipline to bet only when the odds are in your favor.” [http://www.law.harvard.edu/alumni/bulletin/2001/summer/feature\_1-1.html](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.law.harvard.edu%2falumni%2fbulletin%2f2001%2fsummer%2ffeature_1-1.html)

“It would be nice if this [finding really cheap stocks] happened all the time. Unfortunately, it doesn’t.” <http://www.tilsonfunds.com/wscmtg05notes.pdf>

“To some extent, stocks are like Rembrandts. They sell based on what they’ve sold in the past. Bonds are much more rational. No-one thinks a bond’s value will soar to the moon.” “Imagine if every pension fund in America bought Rembrandts. Their value would go up and they would create their own constituency.”  <http://www.tilsonfunds.com/motley_berkshire_brkmtg01notes.php>

**STOCK EXCHANGES:**

“I think we have lost our way when people like the [board of] governors and the CEO of the NYSE fail to realize they have a duty to the rest of us to act as exemplars. You do not want your first-grade school teacher to be fornicating on the floor or drinking alcohol in the closet and, similarly, you do not want your stock exchange to be setting the wrong moral example.”  <http://money.cnn.com/2005/05/01/news/fortune500/buffett_talks/index.htm>

**STOCK MARKETS:**

“The model I like—to sort of simplify the notion of what goes on in a market for common stocks—is the pari-mutuel system at the racetrack. If you stop to think about it, a pari-mutuel system is a market. Everybody goes there and bets and the odds change based on what’s bet. That’s what happens in the stock market. “

**STOCK PICKING**:

“It’s not given to human beings to have such talent that they can just know everything about everything all the time. But it is given to human beings who work hard at it—who look and sift the world for a mispriced be—that they can occasionally find one. And the wise ones bet heavily when the world offers them that opportunity. They bet big when they have the odds. And the rest of the time, they don’t. It’s just that simple.”  [http://ycombinator.com/munger.html](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fycombinator.com%2fmunger.html)“Stock-picking is like gambling: those who win well, seldom bet, but when they do, they bet heavily.”

**STOCK OPTIONS:**

“Quoting Demosthenes, ‘For what each man wishes, that he also believes to be true.’ I would rather make money playing a piano in a whorehouse than arguing that no cost is incurred when employees are paid in stock options instead of cash. I am not kidding.”  [http://www.law.stanford.edu/publications/stanford\_lawyer/issues/64/sl64.pdf](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.law.stanford.edu%2fpublications%2fstanford_lawyer%2fissues%2f64%2fsl64.pdf)

**SUNK COSTS:**

“Failure to handle psychological denial is a common way for people to go broke. You’ve made an enormous commitment to something.You’ve poured effort and money in.  And the more you put in, the more that the whole consistency principle makes you think,” Now it has to work. If I put in just a little more, then it ’all work…. People go broke that way —because they can ’t stop,rethink,and say,” I can afford to write this one off and live to fight again.  I don’t have to pursue this thing as an obsession —in a way that will break me.”  [http://www.poorcharliesalmanack.com/pdf/page228.pdf](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.poorcharliesalmanack.com%2fpdf%2fpage228.pdf)

**SYNERGIES:**

“The reason we avoid the word ‘synergy’ is because people generally claim more synergistic benefits than will come. Yes, it exists, but there are so many false promises.Berkshire is full of synergies — we don’t avoid synergies, just claims of synergies.”<http://www.fool.com/news/foth/2001/foth010508.htm>

**TALENT:**

“I think we have some special talents. That being said, I think it’s dangerous to rely on special talents — it’s better to own lots of monopolistic businesses with unregulated prices. But that’s not the world today. We have made money exercising our talents and will continue to do so.”  <http://www.fool.com/news/foth/2002/foth020515.htm>

**TAXES:**

“The tax code gives you an enormous advantage if you can find some things you can just sit with.” <http://www.myinvestmentforum.com/category/sgfunds-forum/interview-with-charlie-munger-t1655.html>

“We don’t have any miraculous way of avoiding taxes at Wesco and Berkshire.”  <http://www.tilsonfunds.com/motley_berkshire_brkmtg01notes.php>

“My attitude toward taxes is that if I were running the world, we’d have a very substantial consumption tax, and the tax on earned income would be 40% at the top and taxes on long-term capital gains would be 20%.  And by the accident of history, we’re not that far away from where we ought to be.  I love consumption taxes – they’re so effective.  That that’s why conservatives hate them – they work and the government gets a lot of money to spend.  In New Zealand, there’s a national 10% consumption tax.  Is it so bad to have to pay 10% extra if you go out for a nice meal or charter a plane?  I don’t worry about the miser who accumulates money and dies with it.  What harm is he doing?   A 50% corporate tax rate would be too high.  …I’m not in favor of doing away with the 50% estate tax on people like me, but there should be a big exemption.  Someone who builds a small business shouldn’t be whacked, but there’s nothing wrong with saying give 50% to society when you die if you’ve done really well.” <http://www.grahamanddoddsville.net/wordpress/Files/Gurus/Warren%20Buffett/Berkshire%20Hathaway%20Annual%20Meeting%20Notes%202004.pdf>

“Even if you assume that the whole economy would work better had we never had double taxation, having the envy and resentment of the richest paying low or no taxes screams of injustice. You have to have a fair system.”  [http://www.tilsonfunds.com/motley\_berkshire\_brkmtg03notes.php3](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.tilsonfunds.com%2fmotley_berkshire_brkmtg03notes.php3)

“If you’re going to buy something which compounds for 30 years at 15% per annum and you pay one 35% tax at the very end, the way that works out is that after taxes, you keep 13.3% per annum.  In contrast, if you bought the same investment, but had to pay taxes every year of 35% out of the 15% that you earned, then your return would be 15% minus 35% of 15%—or only 9.75% per year compounded. So the difference there is over 3.5%. And what 3.5% does to the numbers over long holding periods like 30 years is truly eye-opening….”   [http://ycombinator.com/munger.html](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fycombinator.com%2fmunger.html)

“…in terms of business mistakes that I’ve seen over a long lifetime, I would say that trying to minimize taxes too much is one of the great standard causes of really dumb mistakes. I see terrible mistakes from people being overly motivated by tax considerations. Warren and I personally don’t drill oil wells. We pay our taxes. And we’ve done pretty well, so far. Anytime somebody offers you a tax shelter from here on in life, my advice would be don’t buy it.”  [http://ycombinator.com/munger.html](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fycombinator.com%2fmunger.html)

**TEACHING:**

“To atone, I teach and try to set an example…I love spreading this stuff around. Just because it’s trite doesn’t mean it isn’t right. In fact, I like to say, ‘If it’s trite, it’s right.’” <http://www.tilsonfunds.com/motley_berkshire_brkmtg01notes.php>

“I don’t have too much interest in teaching other people how to get rich. And that isn’t because I fear the competition or anything like that — Warren has always been very open about what he’s learned, and I share that ethos. My personal behavior model is Lord Keynes: I wanted to get rich so I could be independent, and so I could do other things like give talks on the intersection of psychology and economics. I didn’t want to turn it into a total obsession.”<http://www.loschmanagement.com/Berkshire%20Hathaway/Charlie%20munger/The%20Psychology%20of%20Human%20Misjudgement.htm>

“We only want what success we can get despite encouraging others to share our general views about reality.”  <http://www.tilsonfunds.com/Mungerwritings2001.pdf#search=%22%20%22charlie%20Munger%22%20Outstanding%20investor%20digest%22>

**TECHNOLOGY:**

“For society, the Internet is wonderful, but for capitalists, it will be a net negative. It will increase efficiency, but lots of things increase efficiency without increasing profits. It is way more likely to make American businesses less profitable than more profitable.  This is perfectly obvious, but very little understood.”[http://www.fool.com/boringport/2000/boringport000501.htm](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.fool.com%2fboringport%2f2000%2fboringport000501.htm)

 “Soros couldn’t bear to see others make money in the technology sector without him, and he got killed. It doesn’t bother us at all.” [http://www.fool.com/boringport/2000/boringport000501a.htm](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.fool.com%2fboringport%2f2000%2fboringport000501a.htm)

“In Gillette’s case, they keep surfing along new technology which is fairly simple by the standards of microchips. But it’s hard for competitors to do. So they’ve been able to stay constantly near the edge of improvements in shaving.”  [http://ycombinator.com/munger.html](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fycombinator.com%2fmunger.html)

“If the technology hadn’t changed, [newspapers would] still be great businesses. Network TV [in its heyday,] anyone could run and do well. If Tom Murphy as running it, you’d do very well, but even your idiot nephew could do well.  Fortunately, carbide cutting tools [such as those made by Iscar] don’t have these types of substitutes.”[http://www.designs.valueinvestorinsight.com/bonus/bonuscontent/docs/Tilson\_2006\_BRK\_Meeting\_Notes.pdf#search=%22Charlie%20munger%20and%20foundation%20and%20croupier%22](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.designs.valueinvestorinsight.com%2fbonus%2fbonuscontent%2fdocs%2fTilson_2006_BRK_Meeting_Notes.pdf%23search%3d%2522Charlie%2520munger%2520and%2520foundation%2520and%2520croupier%2522)

The great lesson in microeconomics is to discriminate between when technology is going to help you and when it’s going to kill you. And most people do not get this straight in their heads. But a fellow like Buffett does.  For example, when we were in the textile business, which is a terrible commodity business, we were making low-end textiles—which are a real commodity product. And one day, the people came to Warren and said, “They’ve invented a new loom that we think will do twice as much work as our old ones.”  And Warren said, “Gee, I hope this doesn’t work because if it does, I’m going to close the mill.” And he meant it.  What was he thinking? He was thinking, “It’s a lousy business. We’re earning substandard returns and keeping it open just to be nice to the elderly workers. But we’re not going to put huge amounts of new capital into a lousy business.”  
And he knew that the huge productivity increases that would come from a better machine introduced into the production of a commodity product would all go to the benefit of the buyers of the textiles. Nothing was going to stick to our ribs as owners.  That’s such an obvious concept—that there are all kinds of wonderful new inventions that give you nothing as owners except the opportunity to spend a lot more money in a business that’s still going to be lousy. The money still won’t come to you. All of the advantages from great improvements are going to flow through to the customers. Conversely, if you own the only newspaper in Oshkosh and they were to invent more efficient ways of composing the whole newspaper, then when you got rid of the old technology and got new fancy computers and so forth, all of the savings would come right through to the bottom line. In all cases, the people who sell the machinery—and, by and large, even the internal bureaucrats urging you to buy the equipment—show you projections with the amount you’ll save at current prices with the new technology. However, they don’t do the second step of the analysis which is to determine how much is going stay home and how much is just going to flow through to the customer. I’ve never seen a single projection incorporating that second step in my life. And I see them all the time. Rather, they always read: “This capital outlay will save you so much money that it will pay for itself in three years.”  So you keep buying things that will pay for themselves in three years. And after 20 years of doing it, somehow you’ve earned a return of only about 4% per annum. That’s the textile business. And it isn’t that the machines weren’t better. It’s just that the savings didn’t go to you.  The cost reductions came through all right. But the benefit of the cost reductions didn’t go to the guy who bought the equipment. It’s such a simple idea. It’s so basic. And yet it’s so often forgotten.  Then there’s another model from microeconomics which I find very interesting. When technology moves as fast as it does in a civilization like ours, you get a phenomenon which I call competitive destruction. You know, you have the finest buggy whip factory and all of a sudden in comes this little horseless carriage. And before too many years go by, your buggy whip business is dead. You either get into a different business or you’re dead—you’re destroyed. It happens again and again and again.  And when these new businesses come in, there are huge advantages for the early birds. And when you’re an early bird, there’s a model that I call “surfing”—when a surfer gets up and catches the wave and just stays there, he can go a long, long time. But if he gets off the wave, he becomes mired in shallows…. [http://ycombinator.com/munger.html](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fycombinator.com%2fmunger.html)

“there are all kinds of wonderful new inventions that give you nothing as owners except the opportunity to spend a lot more money in a business that’s still going to be lousy. The money still won’t come to you. All of the advantages from great improvements are going to flow through to the customers.”

**THINKING:**

“Any year that passes in which you don’t destroy one of your best loved ideas is a wasted year.” <http://www.grahamanddoddsville.net/wordpress/Files/Gurus/Warren%20Buffett/Berkshire%20Hathaway%20Annual%20Meeting%20Notes%202004.pdf>

 “The ethos of not fooling yourself is one of the best you could possibly have. It’s powerful because it’s so rare.”  [http://www.fool.com/news/foth/2002/foth020515.htm](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.fool.com%2fnews%2ffoth%2f2002%2ffoth020515.htm)

“We both insist on a lot of time being available almost every day to just sit and think. That is very uncommon in American business. We read and think. So Warren and I do more reading and thinking and less doing than most people in business. We do that because we like that kind of a life. But we’ve turned that quirk into a positive outcome for ourselves.  <http://www.myinvestmentforum.com/category/sgfunds-forum/interview-with-charlie-munger-t1655.html>

“It is, of course, irritating that extra care in thinking is not all good but actually introduces extra error. But most good things have undesired “side effects,” and thinking is no exception. The best defense is that of the best physicists, who systematically criticize themselves to an extreme degree, using a mindset described by Nobel laureate Richard Feynman as follows: “The first principle is that you must not fool yourself and you’re the easiest person to fool.”  [http://72.14.203.104/search?q=cache:mgSaxC3O1IoJ:www.philanthropyroundtable.org/magazines/1999/march/munger.html+Berkshire+Hathaway%27s+vice+chairman+shreds+the+conventional+wisdom+on+foundation+investing&hl=en&gl=us&ct=clnk&cd=1](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2f72.14.203.104%2fsearch%3fq%3dcache%3amgSaxC3O1IoJ%3awww.philanthropyroundtable.org%2fmagazines%2f1999%2fmarch%2fmunger.html%2bBerkshire%2bHathaway%2527s%2bvice%2bchairman%2bshreds%2bthe%2bconventional%2bwisdom%2bon%2bfoundation%2binvesting%26hl%3den%26gl%3dus%26ct%3dclnk%26cd%3d1)

“Warren spends 70 hours a week thinking about investing  <http://www.tilsonfunds.com/motley_berkshire_brkmtg01notes.php>

“Invert, always invert.”  <http://www.poorcharliesalmanack.com/intro3.html>

“People calculate too much and think too little.” <http://money.cnn.com/magazines/moneymag/moneymag_archive/2002/07/01/324974/index.htm>

“The ethical rule is from Samuel Johnson who believed that maintenance of easily removable ignorance by a responsible office holder was treacherous malfeasance in meeting moral obligation. The prudential rule is that underlying the old Warner & Swasey advertisement for machine tools: “The man who needs a new machine tool, and hasn’t bought it, is already paying for it”. The Warner & Swasey rule also applies, I believe, to thinking tools. If you don’t have the right thinking tools, you, and the people you seek to help, are already suffering from your easily removable ignorance.”<http://www.tilsonfunds.com/Mungerwritings2001.pdf#search=%22%20%22charlie%20Munger%22%20Outstanding%20investor%20digest%22>

**THRIFT:**

 “This room contains many people pretty well stricken by expired years — in my generation or the one following. We tend to believe in thrift and avoiding waste as good things, a process that has worked well for us. It is paradoxical and disturbing to us that economists have long praised foolish spending as a necessary ingredient of a successful economy. <http://www.tilsonfunds.com/Mungerwritings2001.pdf#search=%22%20%22charlie%20Munger%22%20Outstanding%20investor%20digest%22>

**TRUST:**

“…Everybody likes being appreciated and treated fairly, and dominant personalities who are capable of running a business like being trusted. A kid trusted with the key to the computer room said, “It’s wonderful to be trusted.” That’s how we operate Berkshire – a seamless web of deserved trust. We get rid of the craziness, of people checking to make sure it’s done right. When you get a seamless web of deserved trust, you get enormous efficiencies. … Every once in a while, it doesn’t work, not because someone’s evil but because somebody drifts to inappropriate behavior and then rationalizes it….”  <http://www.tilsonfunds.com/wscmtg05notes.pdf>

**UNITED STATES:**

“…Over the long term, the eclipse rate of great civilizations being overtaken is 100%. So you know how it’s going to end. (Laughter) I’m more optimistic about the staying power of what’s good in this country. But just because you have a wonderful spouse doesn’t mean you should treat her badly. You have the feeling that some of the old virtues [that made this country great] are lessening. But there’s so much good and so much strength left…” [Source](http://www.tilsonfunds.com/wscmtg05notes.pdf)

“I still prefer this country, and so does Warren.  But we’re both troubled deeply by the twin deficits [trade and budget].  [Bad] Things can go on for a long time, starting from our [wealthy] base and especially if other counties have things wrong with them, so it’s a very complex subject.” [Source](http://www.tilsonfunds.com/wscmtg04notes.doc)

“I believe that we are at or near the apex of a great civilization….In 50-100 years, if we’re a poor third to some countries in Asia, I wouldn’t be surprised. If I had to bet, the part of the world that will do best will be Asia.” [Source](http://www.tilsonfunds.com/wscmtg04notes.doc)

“It’s crazy to assume that what’s happening in Argentina and Japan is inconceivable here. It’s not.” [Source](http://www.tilsonfunds.com/motley_berkshire_brkmtg02notes.php)

**VALUES:**

“While no real money came down, my family gave me a good education and a marvelous example of how people should behave, and in the end that was more valuable than money. Being surrounded by the right values from the beginning is an immense treasure. Warren had that.  It even has a financial advantage.” [Source](http://www.wiley.com/WileyCDA/WileyTitle/productCd-0471446912,descCd-tableOfContents.html)

**VALUE INVESTING:**

“The whole concept of dividing it up into ‘value’ and ‘growth’ strikes me as twaddle. It’s convenient for a bunch of pension fund consultants to get fees prattling about and a way for one advisor to distinguish himself from another. But, to me, all intelligent investing is value investing.” [Source](http://covestreetcapital.com/Blog/?p=319)

“All intelligent investing is value investing.” [Source](http://www.fool.com/news/foth/2000/foth001107.htm)

**VENTURE CAPITAL**“Harvard and Yale concentrated with venture capitalists that got the best calls and brainpower. Very few firms made most of the money, and they made it in just a few periods. Everyone else returned between mediocre and lousy. When returns happened, envy rippled through institutional money management. The amount invested in venture capital went up 10 times post-1999. That later money was lost very quickly. It will happen again. I don’t know anyone who successfully resists this stuff. It becomes a new orthodoxy.” [Source](http://news.morningstar.com/article/article.asp?id=169398)

**VICTIMIZATION:**“Whenever you think something or some person is ruining your life, it’s you. A victimization mentality is so debilitating.” [Source](http://www.tilsonfunds.com/motley_berkshire_wscmtg01notes.php)

**WARREN BUFFETT:**

“It is true that Warren had a touch of brain block from working under Ben Graham and making a ton of money – it’s hard to switch from something that’s worked so well.  But if Charlie Munger had never lived, the Buffett record would still be pretty much what it is.”  [Source](http://www.tilsonfunds.com/wscmtg04notes.doc)

“I think the top guy won’t be as smart as Warren. But it’s silly to complain: ‘What kind of world is this that gives me Warren Buffett for 40 years and then some bastard comes along who’s worse?’ [Laughter] ” [Source](http://25iq.com/quotations/charlie-munger/www.designs.valueinvestorinsight.com/bonus/bonuscontent/docs/Tilson_2006_BRK_Meeting_Notes.pdf#search=%22Charlie%20munger%20and%20foundation%20and%20croupier%22)

“Speaking for the Munger heirs, I hope they continue to ring the last drop of  good out of Warren.” [Source](http://www.designs.valueinvestorinsight.com/bonus/bonuscontent/docs/Tilson_2006_BRK_Meeting_Notes.pdf#search=%22Charlie%20munger%20and%20foundation%20and%20croupier%22)

“I call myself the assistant cult leader…” [Source](http://www.law.harvard.edu/alumni/bulletin/2001/summer/feature_1-1.html)

“I’ve been associated with Warren so long, I thought I’d be just a footnote.” [Source](http://media.wiley.com/product_data/excerpt/32/04712447/0471244732-1.pdf#search=%22munger%20you%20know%20the%20cliche%20that%20opposites%20attract%22)

“I think there’s some mythology in this idea that I’ve been this great enlightener of Warren. He hasn’t needed much enlightenment. But we know more now than five years ago.” [Source](http://www.tilsonfunds.com/motley_berkshire_brkmtg03notes.php)

“It’s hard to believe that he’s getting better with each passing year. It won’t go on forever, but Warren is actually improving. It’s remarkable: Most almost-72-year-old men are not improving, but Warren is.”[*Source*](http://www.fool.com/news/commentary/2003/commentary030509wt.htm)

“The most common concern investors seem to have about Berkshire is, “What happens when Buffett dies?” Munger acknowledged that “if he were gone, we couldn’t invest the money as well as Warren,” but noted that “the place is drowning in money — we have great business pounding out money. If the stock went down, Berkshire could buy it back. There’s no reason to think it will go to hell in a bucket, and I think there’s reason to believe it could go on quite well. I’d be horrified if it isn’t bigger and better over time, even after Warren dies.” [Source](http://www.fool.com/news/commentary/2003/commentary030509wt.htm)

**WEALTH:**

“We’ve had the most massive creation of wealth for people a lot younger than those who formerly got wealth in the history of the world. The world is full of young people who really want to get rich, and  [when I left school] nobody thought it was a reasonable possibility.” [Source](http://www.law.harvard.edu/alumni/bulletin/2001/summer/feature_1-1.html)

“I have concluded that most PhD economists under appraise the power of the common-stock-based “wealth effect”, under current extreme conditions.. “wealth effects” involve mathematical  puzzles that are not nearly so well worked out as physics theories and never can be. …what has happened inJapan … has shaken up academic economics, as it obviously should, creating  strong worries about recession from “wealth effects” in reverse.” [Source](http://www.tilsonfunds.com/Mungerwritings2001.pdf#search=%22%20%22charlie%20Munger%22%20Outstanding%20investor%20digest%22)

**WESCO:**

“Wesco had a market capitalization of $40 million when we bought it [in the early 1970s]. It’s $2 billion now. It’s been a long slog to a perfectly respectable outcome — not as good as Berkshire Hathaway or Microsoft, but there’s always someone in life who’s done better.”  [Source](http://www.fool.com/boringport/2000/boringport00051500.htm)

“Our approach has worked for us. Look at the fun we, our managers, and our shareholders are having. More people should copy us. It’s not difficult, but it looks difficult because it’s unconventional — it isn’t the way things are normally done. We have low overhead, don’t have quarterly goals and budgets or a standard personnel system, and our investing is much more concentrated than average. It’s simple and common sense.”  [Source](http://www.fool.com/boringport/2000/boringport00051500.htm)

“You shouldn’t buy Wesco stock instead of Berkshire’s.”  [Source](http://www.fool.com/news/foth/2001/foth010508.htm)

**WISDOM:**

“You don’t have to have perfect wisdom to get very rich – just a bit better than average over a long period of time.” [*Source*](http://www.tilsonfunds.com/brkmtg05notes.pdf)

“If you get into the mental habit of relating what you’re reading to the basic structure of the underlying ideas being demonstrated, you gradually accumulate some wisdom.”[Source](http://seattleclouds.com/myapplications/thinkvalue/ThinkValue/DamnRightBook.html)

“What is elementary, worldly wisdom? Well, the first rule is that you can’t really know anything if you just remember isolated facts and try and bang ‘em back. If the facts don’t hang together o­n a latticework of theory, you don’t have them in a usable form. You’ve got to have modelsin your head. And you’ve got to array your experience ‑ both vicarious and direct ‑ o­n this latticework of models. You may have noticed students who just try to remember and pound back what is remembered. Well, they fail in school and in life. You’ve got to hang experience o­n a latticework of models in your head. What are the models? Well, the first rule is that you’ve got to have multiplemodels ‑ because if you just have o­ne or two that you’re using, the nature of human psychology is such that you’ll torturereality so that it fits your models, or at least you’ll think it does. You become the equivalent of a chiropractor who, of course, is the great boob in medicine. It’s like the old saying, “To the man with o­nly a hammer, every problem looks like a nail.” And of course, that’s the way the chiropractor goes about practicing medicine. But that’s a perfectly disastrous way to think and a perfectly disastrous way to operate in the world. So you’ve got to have multiple models. And the models have to come from multiple disciplines ‑ because all the wisdom of the world is not to be found in o­ne little academic department. That’s why poetry professors, by and large, are so unwise in a worldly sense. They don’t have enough models in their heads. So you’ve got to have models across a fair array of disciplines. You may say, ‘My God, this is already getting way too tough.’ But, fortunately, it isn’tthat tough ‑ because 80 or 90 important models will carry about 90% of the freight in making you a worldly ‑ wise person. And, of those, o­nly a mere handful really carry very heavy freight.” [Source](http://www.thinkfn.com/en/content/view/52/?id=124)

“Acquire worldly wisdom and adjust your behavior accordingly. If your new behavior gives you a little temporary unpopularity with your peer group … then to hell with them.”  [Source](http://www.amazon.com/exec/obidos/ASIN/1578643031/consciousinve-20/104-7644521-2497538)

**WORK:**

“The way to win is to work, work, work, work and hope to have a few insights…. And you’re probably not going to be smart enough to find thousands in a lifetime. And when you get a few, you really load up. It’s just that simple.”  [Source](http://ycombinator.com/munger.html)

“Why should it be easy to do something that, if done well,  two or three times, will make your family rich for life?”  [Source](http://www.goodreads.com/author/quotes/762.Roger_Lowenstein) (Roger Lowenstein citing the Economist, “December 5, 1992, Beating the Market; Yes it can be done.)

**WORRY:**

“I think there’s something to be said for developing the disposition to own stocks without fretting.”  [Source](http://www.tilsonfunds.com/motley_berkshire_brkmtg03notes.php)

“We fret way earlier than other people. We left a lot of money on the table through early fretting. It’s the way we are — you’ll just have to live with it.”  [Source](http://www.fool.com/news/foth/2001/foth010508.htm)

**P.S. Munger & Bratton speak on Optimal Investments:**

Munger: You say there is some vaguely established view in economics as to what is an optimal dividend policy or an optimal investment? Professor William Bratton of the Rutgers-Newark School of Law: I think we all know what an optimal investment is. Munger: No, I do not. At least not as these people use the term. Bratton: I don’t know it when I see it but in theory, if I knew it when I saw it this conference would be about me and not about Warren Buffett. Munger: What is the break point where a business becomes sub-optimal or when an investment becomes sub-optimal? Bratton: When the return on the investment is lower than the cost of capital. Munger: And what is the cost of capital? Bratton: Well, that’s a nice one and I would… Munger: Well, it’s only fair, if you’re going to use the cost of capital, to say what it is. Bratton: I would be interested in knowing, we’re talking theoretically. Munger: No, I want to know what the cost of capital is in the model. Bratton: In the model? It will just be stated. Munger: Where? Out of the forehead of Job or something? Bratton: That is correct. Munger: Well, some of us don’t find this too satisfactory. Bratton: I said, you’d be a fool to use it as a template for real world investment decision making. We’re only trying to use a particular perspective on human behavior to try to explain things. Munger: But if you explain things in terms of unexplainable sub-concepts, what kind of an explanation is that?Bratton: It’s a social science explanation. You take for what it’s worth. Munger: Do you consider it understandable for some people to regard this as gibberish? Bratton: Perfectly understandable, although I do my best to teach it. Munger: Why? Why do you do this? Bratton: It’s in my job description. Munger: Because other people are teaching it, is what you’re telling me. [Source](http://theinvestmentsblog.blogspot.com/2009/09/charlie-munger-prof-william-bratton.html)

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## 5 THOUGHTS ON “CHARLIE MUNGER”

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**Charlie Munger on The Psychology of Human Misjudgment**

[*4*](http://25iq.com/2013/02/02/charlie-munger-on-the-psychology-of-human-misjudgment/#comments)

“…the brain should be using the simple probability mathematics of Fermat and Pascal applied to all reasonably obtainable and correctly weighted items of information that are of value in predicting outcomes…”  Charlie Munger <http://www.rbcpa.com/Mungerspeech_june_95.pdf>

To cope with information and computation overload, humans have developed simple “rules of thumb” called “heuristics” which  allow them to make decisions.  It would be great if people could do what Charlie describes above, but it is just not possible.  Decision making heuristics are sometimes beneficial and sometimes not.  Catching a fly ball in a baseball games involves a heuristic which works very well.  Really skillful people who know their limitations well can sometimes use heuristics to their advantage including his partner Warren Buffett and Ajit Jain.  Munger points out:

“There is a close collaboration between Warren and Ajit Jain. I’ve known both a long long time and if there are two better people on this earth to do this [super cat underwriting], I don’t know who they are. We can’t guarantee results, but they’ve done fine — in fact, more than fine.  Sometimes they will do things where it’s a straight Pascalian calculation — the odds are x and we get paid at a rate that give us better odds than Las Vegas. The reason other people won’t do it is because if they’re wrong, it’ll be a big money loss, but Berkshire can handle a big number loss. I’m quite comfortable watching those two people do it.  I wish I could do it, but I can’t. It’s reasonable heuristics by two tough, sharp-minded men.”  <http://www.tilsonfunds.com/motley_berkshire_wscmtg03notes.php>

Unfortunately, particularly in the context of human activities that are not really part of our evolutionary past (such as investing), heuristics can produce boneheaded mistake after mistake.  Zeckhauser, who Charlie Munger admires greatly for his decision making processes in bridge, writes that “individuals tend to extrapolate heuristics from situations where they make sense to those where they do not.”  Charlie notes:

“bias [arises] from the non-mathematical nature of the human brain in its natural state as it deal with probabilities employing crude heuristics, and is often misled”   <http://www.rbcpa.com/Mungerspeech_june_95.pdf>

Why does this happen?

“The simple truth is that we aren’t adapted to face the world as it is today. We evolved in a very different environment, and it is that ancestral evolutionary environment that governs the way in which we think and feel. We can learn to push our minds into alternative ways of thinking, but it isn’t easy as we have to overcome the limits to learning posed by self-deception. In addition, we need to practice the reframing of data into more evolutionary familiar forms if we are to process it correctly.”  James Montier <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=373321>

“Sometimes heuristics are good for making decisions, while at other times heuristics are bad for making decisions. The reason for this mixed or nuanced answer is namely heuristics act faster than rational deliberation, but precisely because of their speed, heuristics can mislead us into systematic errors in making decisions”.  Huang  <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=474661>

Some of Charlie’s most powerful writing consists of a narrative list of the various dysfunctional heuristics that impact human decision making.   Munger’s writing and speaking in not as academic as others like Dan Ariely, Daniel Kahneman, James  Montier and Michael Mauboussin (see generally   <http://www.theatlantic.com/business/archive/2013/01/the-irrational-consumer-why-economics-is-dead-wrong-about-how-we-make-choices/267255/>   ), but he is often more amusing and practical.  He is certainly more direct in many cases.  For a great graphic see:  This is your brain on behavioural economics <http://www.ritholtz.com/blog/2013/01/this-is-your-brain-on-behavioural-economics/>

As was discussed previously in this series of blog posts, investing is less than a zero sum game due to expenses. If you are buying an investment someone else is selling and vice versa.  Someone is by definition wrong.  If the other person does not understand behavioral economics and you do, that is a potential edge.  As a professor at Colombia business school noted recently:  “There is a lot of behavioral finance confirming Ben Graham’s original judgment.”<http://www4.gsb.columbia.edu/valueinvesting/news/item/7232425/Greenwald%3A+How+to+Beat+the+Market+with+Discipline>#

The essay in **Poor Charlie’s Almanack** is his most recent and comprehensive version of what he calls “The Psychology of Human Misjudgment.”   There is not much point in rewriting what Charlie says in different words, but perhaps I can find more recent examples that are informative and/or amusing.

1. “**Reward and Punishment Super-response Tendency”**

“almost everyone thinks he fully recognizes how important incentives and disincentives are in changing cognition and behavior. But this is not often so. For instance, I think I’ve been in the top five percent of my age cohort almost all my adult life in understanding the power of incentives, and yet I’ve always underestimated that power. Never a year passes but I get some surprise that pushes a little further my appreciation of incentive superpower.”  Munger

Structuring compensation incentives is critical. For example, it is surprising how many people fail to recognize how performance suffers if you pay someone in advance.  As was noted in an earlier post in this series, Munger and Buffet delegate most management activity, but they keep compensation decisions from themselves.

It is easy to find examples of how improper incentives are, in Munger’s words, “damaging civilization.”  A current example of this problem is raised by Nassim Taleb

“… instead of relying on thousands of meandering pages of regulation, we should enforce a basic principle of “skin in the game” when it comes to financial oversight: “The captain goes down with the ship; every captain and every ship.” In other words, nobody should be in a position to have the upside without sharing the downside, particularly when others may be harmed.” <http://www.fooledbyrandomness.com/sais.pdf>

Investment bankers who spend their days creating and selling toxic derivatives have long since abandoned their moral principles driven by the financial incentives that motivate their actions. The Libor rigging scandal is just one recent example.

On the positive side, stock options can motive people to work to create new value in a start up like nothing else really. The idea that a person can win the lottery like an early Instagram employee is a powerful motivator (which is not fully rational but this is getting to another heuristic). Unfortunately, that incentive can go too far and people can end up living in their parent’s basement due to overinvestment in a technology sector.

**2.       Liking/Loving Tendency**

Munger is pointing out that people tend to ignore or deny the faults of people they love and even distort facts to facilitate that love. There are obviously positive aspects to this tendency for society, but they rarely have place in making investment decisions.  You may like or even love your friend, but that does not mean that you should trust him or her with your money.  I suspect that Charlie is saying that one needs to be particularly careful with decisions when you like/love someone. Rihanna getting back together with Chris Brown seems fraught with risk. ;-)

**3.** **Disliking/Hating Tendency**

This is of course the inverse of the previous tendency. Munger is clear that life is too short to do business with people you don’t like.  Charlie advises: “Avoid evil, particularly if they’re attractive members of the opposite sex.”<http://www.grahamanddoddsville.net/wordpress/Files/Gurus/Warren%20Buffett/Berkshire%20Hathaway%20Annual%20Meeting%20Notes%202004.pdf>

That someone is “family” does not mean they fall outside of the dislike/hating tendency.  Munger quotes Buffett in this section: “a major difference between rich and poor people is that the rich people can spend more of their time suing their relatives.”  Again, being extra careful in your decision making process when you dislike someone seems to be the suggestion from Charlie. Stay rational.

**4.       Doubt-Avoidance Tendency**

Particularly in the face of stress or puzzlement people tend to remove any doubt that might interfere with a decision.  It is in Munger’s words: “counterproductive for a prey animal that is threatened by a predictor to take a long time in deciding what to do.”  Munger feels this tendency can express itself in religion. As another example: What were Madoff’s investors thinking when month after month they received financial statements that were positive with little volatility?  A blogger puts it this way in reviewing one of Munger’s favorite books (*Influence* by Cialdini):  “Faced with vast amounts of data and a shortage of time we opt for simplicity, and focus on a few salient signals which generally work.” <http://www.psyfitec.com/2011/09/robert-cialdini-and-weapons-of.html>

**5.       Inconsistency-Avoidance Tendency**

“The brain of man conserves programing spaces by being reluctant to change.” Munger

Munger believes that if you combine Doubt-Avoiding Tendency with a desire to resist any change in that conclusion, ugly things can result.  An example might be DEC which refused to recognize that the personal computer was a threat to its business.  Steve Wozniak has said that HP turned down making the Apple I five times.

A positive example of how this heuristic might operate may be found in how very young company founders who are not wedded to old ideas can sometimes create disruptive business more easily.  Mark Twain’s statement comes to mind on this tendency:  “All you need in this life is ignorance and confidence; then success is sure.”  Twain should have added that 19 people adopting that approach will lose everything and one might strike it rich, but that is another set of topics (e.g., optionality; survivor bias).

**6.       Curiosity Tendency**

I have a hard time with Munger’s description on this one when it comes to downside risk.  He describes curiosity as something good for society. There must be some flip side that I he does not reveal along the lines of “curiosity kills the cat.”  Perhaps he is referring to the tycoon who is curious to see whether he or she can finally be the person to make a profit in the airline business. Kingfisher in India is a recent example of a company that is in trouble due to excessive curiosity related to airlines.   Richard Branson may have a very fine airline in Virgin in terms of quality, but profitability is elusive. Buffett himself jokes that he has a 1-800 number he calls which will talk him out of investing in airlines whenever he gets the urge.

**7.       Kantian Fairness Tendency**

“modern acculturated man displays and expects from others a lot of fairness”  Munger

All in all, this tendency seems a very good thing.  In terms of generating dysfunction, perhaps Charlie is referring to how humans will act irrationally to punish those who are not fair.  A leading blogger on the psychology of investing writes:  “Economists for a long time took the view that people would accept any offer made to them as long as they were better off, yet many studies have shown that this isn’t true and that people will reject offers they view as unfair.”   <http://www.psyfitec.com/2011/09/robert-cialdini-and-weapons-of.html>

**8.       Envy/Jealousy Tendency**

The dangers of envy are a frequent Munger topic.  How can I improve on the master?

 “The idea of caring that someone is making money faster [than you are] is one of the deadly sins. Envy is a really stupid sin because it’s the only one you could never possibly have any fun at. There’s a lot of pain and no fun. Why would you want to get on that trolley?”  <http://www.fool.com/news/commentary/2003/commentary030509wt.htm>

“…Missing out on some opportunity never bothers us. What’s wrong with someone getting a little richer than you? It’s crazy to worry about this….”  <http://www.tilsonfunds.com/wscmtg05notes.pdf>

“Here’s one truth that perhaps your typical investment counselor would disagree with: if you’re comfortably rich and someone else is getting richer faster than you by, for example, investing in risky stocks, so what?! Someone will always be getting richer faster than you. This is not a tragedy.  <http://www.fool.com/BoringPort/2000/boringport00051501.htm>

“We have a higher percentage of the intelligentsia engaged in buying and selling pieces of paper and promoting trading activity than in any past era. A lot of what I see now reminds me of Sodom and Gomorrah. You get activity feeding on itself, envy and imitation. It has happened in the past that there came bad consequences.” <http://money.cnn.com/2005/05/01/news/fortune500/buffett_talks/index.htm>

“Well envy/jealousy made, what, two out of the ten commandments? Those of you who have raised siblings you know about envy, or tried to run a law firm or investment bank or even a faculty? I’ve heard Warren say a half a dozen times, “It’s not greed that drives the world, but envy.” <http://www.loschmanagement.com/Berkshire%20Hathaway/Charlie%20munger/The%20Psychology%20of%20Human%20Misjudgement.htm>

**9.       Reciprocation Tendency**

People behave irrationally when they feel the need to reciprocate. That’s why the Hare Krishna fundraiser gives away a flower when he or she approaches.  A professor writes:

“When we are given a gift, we feel indebted to the giver, often feel uncomfortable with this indebtedness, and feel compelled to cancel the debt…often against our better judgment. The rule of reciprocation is widespread across human cultures, suggesting that it is fundamental to creating interdependencies on which societies, cultures, and civilizations are built. In effect, the rule of reciprocation assures that someone can give something away first, with the relative assurance that this initial gift will eventually be repaid–nothing is lost.” <http://www.media-studies.ca/articles/influence.htm>

As one example, Munger notes:

“…people are really crazy about minor decrements down. And then, if you act on them, then you get into reciprocation tendency, because you don’t just reciprocate affection, you reciprocate animosity, and the whole thing can escalate. And so huge insanities can come from just subconsciously over-weighing the importance of what you’re losing or almost getting and not getting.”<http://www.loschmanagement.com/Berkshire%20Hathaway/Charlie%20munger/The%20Psychology%20of%20Human%20Misjudgement.htmv>

**10.   Influence-from-Mere Association Tendency**

Humans can easily be misled by mere association.  Munger writes in Poor Charlie’s Almanack: responsive behavior, creating a new habit, is directly triggered by reward previously bestowed.”  He goes on to write about a range of phenomena that arise from this tendency like Persian Messenger Syndrome (AKA “shoot the messenger”).

“Think how association, pure association, works. Take Coca-Cola company (we’re the biggest share-holder). They want to be associated with every wonderful image: heroics in the Olympics, wonderful music, you name it. They don’t want to be associated with presidents’ funerals and so-forth.”

<http://www.loschmanagement.com/Berkshire%20Hathaway/Charlie%20munger/The%20Psychology%20of%20Human%20Misjudgement.htm>

“At most corporations if you make an acquisition and it turns out to be a disaster, all the paperwork and presentations that caused the dumb acquisition to be made are quickly forgotten. You’ve got denial, you’ve got everything in the world. You’ve got Pavlovian association tendency. Nobody even wants to even be associated with the damned thing or even mention it. At Johnson & Johnson, they make everybody revisit their old acquisitions and wade through the presentations. That is a very smart thing to do. And by the way, I do the same thing routinely.”

<http://www.loschmanagement.com/Berkshire%20Hathaway/Charlie%20munger/The%20Psychology%20of%20Human%20Misjudgement.htm>

The next blog post in this series about Munger’s Methods’ will discuss Munger’s 15 other tendencies.

# How thinking like Charlie Munger may have saved my life

[*2*](http://25iq.com/2013/02/09/how-thinking-like-charlie-munger-may-have-saved-my-life/#comments)

This is a continuation of my previous blog posts on “the Psychology of Human Misjudgment,” which is Charlie Munger’s description of dysfunctional decision making heuristics.  Munger writes:

“…tendencies are probably much more good than bad. Otherwise, they wouldn’t be there, working pretty well for man, given his condition and his limited brain capacity. So the tendencies can’t be simply washed out automatically, and shouldn’t be. Nevertheless, the psychological thought system described, when properly understood and used, enables the spread of wisdom and good conduct and facilitates the avoidance of disaster. Tendency is not always destiny, and knowing the tendencies and their antidotes can often help prevent trouble that would otherwise occur.”  *Poor Charlie’s Almanack*

Here is a personal example of potentially dysfunctional heuristics at work.  For a few months I had been having slight pain in my biceps near my elbows.  My doctor said it was probably an injury from lifting weights.  One night about four weeks ago I was sleeping soundly when I was jolted awaked by much more significant bilateral pain in both of my biceps.  I immediately thought:  “I am having a heart attack; I need to get to an emergency room.”   I woke my wife and asked her to get dressed quickly and to get in the car.  As we were driving to the hospital the painful sensations in my biceps started to go away.  It was at that point that I believe I started telling myself a story about the pain in my arms not really being from a heart attack.   I am sure I was subconsciously thinking: “I have a busy schedule next week. I can’t afford to have a heart attack right now.  This pain is probably nothing.  I probably just hurt myself in the gym. Who gets bicep pain with a heart attack and no chest pain?”  I then said to my wife:  “Maybe we should go home.”  My wife insisted we go to the emergency room.  I might have argued with her, but at that moment I reminded myself about Munger and Buffett’s approach to risk:

“Take the probability of loss times the amount of possible loss from the probability of gain times the amount of possible gain. That is what we’re trying to do. It’s imperfect, but that’s what it’s all about.”

<http://beta.fool.com/danielsparks/2012/12/14/berkshire-hathaways-downside-protection/18950/>

Going to the emergency room emergency room for tests on my heart function was clearly wise since the amount of possible loss was so massive even if the probability was small (which it was not given the symptoms).  After thinking about this formula I no longer argued with my wife about going to the emergency room.  In this case rationality (and my wife) overcame psychological denial, over-optimism and other negative decision making heuristics.  It turned out that my pain was from a small heart attack and three days later I was in the operating room for a triple bypass.

You might say: “Well that was stupid.” Yes it was very stupid.  But the reality is that we all do things like this every single day by telling ourselves false stories to avoid the truth.  Even if you spend a lot of time with behavioral economics you can only improve your skills on the margin. You will always make mistakes.  Nobel Prize winner Daniel Kahneman, who has spent his life researching behavioral economics, has said: “Except for some effects that I attribute mostly to age, my intuitive thinking is just as prone to overconfidence, extreme predictions, and the planning fallacy.”  <http://chronicle.com/article/The-Anatomy-of-Influence/129688/>   Just because you can’t be perfect does not mean you can’t get marginally better at avoiding mistakes and have an edge in the market over people who do not understand Munger’s tendencies and other aspects of behavioral economics.

Here are the remaining 15 of Munger’s tendencies not covered in the previous blog post:

**11. Simple, Pain-Avoiding Psychological Denial**

As I drove to the hospital I was in significant danger of falling prey to “psychological denial” that night I had the heart attack.  Munger has his own example of psychological denial:

“This first really hit me between the eyes when a friend of our family had a super-athlete, super-student son who flew off a carrier in the north Atlantic and never came back, and his mother, who was a very sane woman, just never believed that he was dead. And, of course, if you turn on the television, you’ll find the mothers of the most obvious criminals that man could ever diagnose, and they all think their sons are innocent. That’s simple psychological denial. The reality is too painful to bear, so you just distort it until it’s bearable. We all do that to some extent, and it’s a common psychological misjudgment that causes terrible problems.

<http://www.rbcpa.com/Mungerspeech_june_95.pdf>

Was I avoiding psychological denial whenever I ordered a bacon cheeseburger in the years leading up to my heart problem given I am genetically predisposed to the condition?  You decide. We all need friends and colleagues who can help us find the truth.  Sometimes we all need a cold rhetorical slap in the face from a friend or significant other. By definition you don’t have perspective on yourself.

In an investing context, smart investors should have known that Bernard Madoff generating consistent positive returns was not possible month after month. But the investor liked the result so much that they went into psychological denial mode.

“Failure to handle psychological denial is a common way for people to go broke.”  <http://boundedrationality.wordpress.com/quotes/charlie-munger/>

**12. Excessive Self-Regard Tendency**

Munger likes to talk about the fact that way more than half of Swedish drivers think they are above average drivers.  Thinking your IQ is higher than it is potentially a big problem. Thinking that your IQ is a bit lower than it actually is can be a good thing says Munger.

“We don’t like complexity and we distrust other systems and think it many times leads to false confidence. The harder you work, the more confidence you get. But you may be working hard on something that is false. We’re so afraid of that process so we don’t do it.” <http://www.valueinvestingworld.com/2012/05/charlie-munger-quote-complexity-and.html>

Unfortunately, some people think that only others are overconfident:

“… the trouble is that if even 90% are no good, everyone looks around and says, “I’m the 10%.”<http://www.grahamanddoddsville.net/wordpress/Files/Gurus/Warren%20Buffett/Berkshire%20Hathaway%20Annual%20Meeting%20Notes%202004.pdf>

Companies are not immune from this excessive self-regard tendency, including Berkshire portfolio companies:

 “[GEICO] got to thinking that, because they were making a lot of money, they knew everything. And they suffered huge losses. All they had to do was to cut out all the folly and go back to the perfectly wonderful business that was lying there. <http://ycombinator.com/munger.html>

**13. Overoptimism Tendency**

In driving to the hospital I surely did not want to find I had heart disease.  I suspect that I was thinking too optimistically that I had merely injured my biceps.  I wanted to not have a medical problem, so I told myself a story that was contrary to the evidence I possessed.  Munger describes the phenomenon:

“..in the 5th century B. C. Demosthenes noted that: “What a man wishes, he will believe.” And in self-appraisals of prospects and talents it is the norm, as Demosthenes predicted, for people to be ridiculously over-optimistic. For instance, a careful survey in Sweden showed that 90 percent of automobile drivers considered themselves above average. And people who are successfully selling something, as investment counselors do, make Swedish drivers sound like depressives. Virtually every investment expert’s public assessment is that he is above average, no matter what is the evidence to the contrary.”  <http://72.14.203.104/search?q=cache:mgSaxC3O1IoJ:www.philanthropyroundtable.org/magazines/1999/march/munger.html+Berkshire+Hathaway%27s+vice+chairman+shreds+the+conventional+wisdom+on+foundation+investing&hl=en&gl=us&ct=clnk&cd=1>

As I said above, even experts who spend their lives studying behavioral economics can prey to this problem. Daniel Khaneman writes:

“One of our biases is that we can ignore the lessons of experience. A group of people compiling a report will estimate they can do it in a year, even though every other similar report has taken comparable groups five years. … “When I started the book I told Richard Thaler (the author of Nudge) that I had 18 months to finish it. He laughed hysterically and said, ‘You have written about that, haven’t you? It’s not going to work the way you expect’.” How long did it take you, I ask. “Four years, and it was very painful.” <http://forums.udacity.com/questions/10006251/no-fooling-nobel-winning-economist-daniel-kahneman>

**14. Deprival Superreaction Tendency**

In the language of behavioral economics, this tendency is called loss aversion.  Mauboussin writes:

“One of prospect theory’s most important contributions to finance is loss aversion, the idea that for most people, losses loom larger than corresponding gains. 7 The empirical evidence suggests we feel losses about two to two-and-a-half times more than we feel gains. Loss aversion is a clear-cut deviation from expected utility theory.” <http://www.capatcolumbia.com/MM%20LMCM%20reports/Aver%20and%20Aversion.pdf>

A good example of loss aversion at work can be found in the world of golf. A blogger writes:

“Research shows that even professional golfers display loss aversion. They do significantly better when putting to save par than when putting to make a birdie. Indeed, neuroscientists have found that loss aversion is wired into the human brain. And not just the human brain — monkeys are averse to losses, as well.” <http://www.bloomberg.com/news/2012-12-24/people-hate-losses-and-that-affects-u-s-budget-talks.html>

Football coaches punt too often in games for the same reason.

Munger advocates that people try to train their minds so as to overcome the tendency to the extent possible:  

“Your brain doesn’t naturally know how to think the way Zeckhauser knows how to play bridge. ‘For example’, people do not react symmetrically to loss and gain. Well maybe a great bridge player like Zeckhauser does, but that’s a trained response.” <http://www.rbcpa.com/Mungerspeech_june_95.pdf>

Investors sell their stocks too early and hold on to their losers to long for the same reason.  Selling a stock that is way down and taking the loss is really hard for people who have not trained themselves to avoid this tendency.  Do venture capitalists to often put more money into companies that they have invested in already even though they would no do so it it was a new investment?

People too often would rather fail conventionally than succeed unconventionally. Munger:

“I mean people are really crazy about minor decrements down. … huge insanities can come from just subconsciously over-weighing the importance of what you’re losing or almost getting and not getting.”<http://www.loschmanagement.com/Berkshire%20Hathaway/Charlie%20munger/The%20Psychology%20of%20Human%20Misjudgement.htm>

**15. Social-Proof Tendency**

Humans have a natural tendency to herd.  Bernard Madoff was a master at using social-proof tendency  to get investors to give him their money.  He worked hard to make sure that only successful people were a part of his Ponzi scheme.   Professor Cialdini has an essay on how Madoff used social proof here:  <http://www.influenceatwork.com/wp-content/uploads/2012/02/Madoff_by_Cialdini.pdf>

Social proof is a bedrock cause of bubbles that occur in the investing world as well as the path dependence which creates power laws. Using a classic Munger  inversion apprapoch: if you see a power law, there is very likely social proof lurking behind it somewhere.

Munger has his own example from the corporate world:

“Big-shot businessmen get into these waves of social proof. Do you remember some years ago when one oil company bought a fertilizer company, and every other major oil company practically ran out and bought a fertilizer company? And there was no more damned reason for all these oil companies to buy fertilizer companies, but they didn’t know exactly what to do, and if Exxon was doing it, it was good enough for Mobil, and vice versa. I think they’re all gone now, but it was a total disaster”<http://www.rbcpa.com/Mungerspeech_june_95.pdf>

**16. Contrast-Mis-reaction Tendency**

Munger writes:

“Because the nervous system of man does not naturally measure in absolute scientific units, it must instead rely on something simpler. The eyes have a solution that limits their programming needs: the contrast in what is seen is registered. And as in sight, so does it go, largely, in the other senses. Moreover, as perception goes, so goes cognition. The result is man’s Contrast-Mis-reaction Tendency. Few psychological tendencies do more damage to correct thinking. Small-scale damages involve instances such as man’s buying an overpriced $1,000 leather dashboard merely because the price is so low compared to his concurrent purchase of a $65,000 car. Large-scale damages often ruin lives, as when a wonderful woman having terrible parents marries a man who would be judged satisfactory only in comparison to her parents. Or as when a man takes wife number two who would be appraised as all right only in comparison to wife number one.”   *Poor Charlie’s Almanack*

Here is a blogger’s interpretation of this tendency:

“‘Contract-Misreaction’ causes people to take actions which are potentially detrimental, because they appear insignificant or appear positive when compared to other actions. Munger uses an analogy of the human eyes to illustrate how this tendency works: humans only see items which contrast with their environment. In the same way, humans find it difficult to differentiate perceptions where there is little in the way of contrast. For example, a man may buy a $1,000 leather dashboard, even if overpriced, when considered in combination with the fact that the vehicle cost is a much larger $65,000.

While the above example is a relatively minor one, Munger points to some examples where this tendency can have detrimental and long-lasting effects. In business, Munger has seen marketers use this practice to their advantage. Real-estate brokers may show clients awful properties at inflated prices for the purpose of closing a sale on merely a bad property at a merely partially inflated price. This practice is also seen frequently in mainstream advertising, with service/product providers asserting a phony price for a product and then promptly offering a ‘discount’ to a lower price. Munger argues that even though consumers recognize this practice, it still works! Therefore, being aware of psychological ploys does not prove to be a perfect defense!” <http://www.barelkarsan.com/2009/07/psychology-of-human-misjudgement_12.html>

**17. Stress-Influence Tendency**

Munger thinks people under stress can make big mistakes as well as have life altering experiences:

“Here, my favorite example is the great Pavlov. He had all these dogs in cages, which had all been conditioned into changed behaviors, and the great Leningrad flood came and it just went right up and the dog is in a cage. And the dog had as much stress as you can imagine a dog ever having. And the water receded in time to save some of the dogs, and Pavlov noted that they’d had a total reversal of their conditioned personality.” <http://www.rbcpa.com/Mungerspeech_june_95.pdf>

**18. Availability-Misweighing Tendency**

“The great algorithm to remember in dealing with this tendency is simple: An idea or a fact is not worth more merely because it is easily available to you.” <http://markettorrent.com/topic/8171?page=9>

A blogger describes the problem here:

“When making decisions, people tend to be influenced by what can be readily remembered. Vivid, much-publicized events are easily recalled. Stock market crashes are vivid, highly publicized events. Long periods of steady market advance are less vivid and less publicized. The result is that people over-emphasize crashes and exaggerate risk. An adviser can provide more balanced information in order to overcome negative perceptions arising from the availability bias.” <http://www.fpanet.org/journal/BetweentheIssues/LastMonth/Articles/ABehavioralViewofHowPeopleMakeFinancialDecisions/>

**19. Use-It-or-Lose-It Tendency**

“All skills attenuate with disuse. I was a whiz at calculus until age twenty, after which the skill was soon obliterated by total nonuse.”  *Poor Charlie’s Almanack*

This one is pretty simple. Skill degrades unless it is practiced.  For example, flying an airplane is not something you want to do once in a while.  If you are not flying often or sting in a simulator often, you should not be flying.

**20. Drug-Misinfluence Tendency**

This tendency is self-explanatory. Everyone makes mistakes, but Munger has said often that staying away from the really big mistakes like cocaine is vital.

“We’ve all seen so much [drug abuse], but it’s interesting how it’ll always cause this moral breakdown if there’s any need, and it always involves massive denial.”  <http://www.rbcpa.com/Mungerspeech_june_95.pdf>

**21. Senescence-Misinfluence Tendency**

This is another self-explanatory tendency.  Senility happens, but you can slow it with activity.  Munger:

“some people remain pretty good in maintaining intensely practiced old skills until late in life, as one can notice in many a bridge tournament…. Continuous thinking and learning, done with joy, can somewhat help delay what is inevitable.”   Poor Charlie’s Almanack

**22. Authority-Misinfluence Tendency**

People tend to follow people who they believe are authorities.  Munger cites the Nazi madness as an example. Then there are the Milgram experiments in which people are told to shock others and they comply since they person giving the command is wearing a lab coat and looks official.

Munger gives this example of the tendency :

“You get a pilot and a co-pilot. The pilot is the authority figure. They don’t do this in airplanes, but they’ve done it in simulators. They have the pilot do something where the co-pilot, who’s been trained in simulators a long time — he knows he’s not to allow the plane to crash — they have the pilot to do something where an idiot co-pilot would know the plane was going to crash, but the pilot’s doing it, and the co-pilot is sitting there, and the pilot is the authority figure. 25% of the time the plane crashes. I mean this is a very powerful psychological tendency.”  <http://www.rbcpa.com/Mungerspeech_june_95.pdf>

**23. Twaddle Tendency**

The definition of “twaddle” is: “speech or writing which is silly or not true; nonsense.” What Charlie is saying here is that people tend to spend a lot of time on meaningless activities that accomplish little or nothing.  In Munger’s view people too often confuse twaddle with importance and value.  Here’s one example from Munger:

“The whole concept of dividing it up into ‘value’ and ‘growth’ strikes me as twaddle. It’s convenient for a bunch of pension fund consultants to get fees prattling about and a way for one adviser to distinguish himself from another. But, to me, all intelligent investing is value investing – acquiring more than you are paying for. You must value the business in order to value the stock.” <http://www.ticonline.com/archives_quotes.html>

Most of the talking heads on financial TV are dishing out twaddle.  Of course, the hardest thing is to spot when you are telling yourself twaddle since the easiest person to fool is yourself.

**24. Reason-Respecting Tendency**

What Munger calls “compliance professionals” know that it is possible to get people to act against their interest as long as they are given a reason even if it is silly. Munger:

“Unfortunately, Reason-Respecting Tendency is so strong that even a person’s giving of meaningless or incorrect reasons will increase compliance with his orders and requests. This has been demonstrated in psychology experiments wherein “compliance practitioners” successfully jump to the head of the lines in front of copying machines by explaining their reason: “I have to make some copies.” This sort of unfortunate byproduct of Reason-Respecting Tendency is a conditioned reflex, based on a widespread appreciation of the importance of reasons. And, naturally, the practice of laying out various claptrap reasons is much used by commercial and cult “compliance practitioners” to help them get what they don’t deserve.”  *Poor Charlie’s Almanack*

**25. Lollapalooza Tendency – The Tendency to Get Extreme Confluences of Psychological Tendencies Acting in Favor of a Particular Outcome**

All of the tendencies described above interact with each other in ways that can make the whole of the effect greater than the sum of the parts.  This is a classic signature of complex adaptive systems.  What asked what caused “the current economic mess” Munger replied:

“It was a lollapalooza event – a confluence of causes that is how complex systems work.”  <http://www.valueplays.net/wp-content/uploads/The-Best-of-Charlie-Munger-1994-2011.pdf>

Sometimes this lollapalooza tendency can be used for good purposes.  As  Munger points out:

“The system of Alcoholics Anonymous: a 50% no-drinking rate outcome when everything else fails? It’s a very clever system that uses four or five psychological systems at once toward, I might say, a very good end.”  <http://www.tilsonfunds.com/mungerpsych>

But of course an evil cult can use the same techniques.

Another example Munger cites of a lollapalooza tendency involves open outcry auctions:

“Well the open-outcry auction is just made to the brain into mush: you’ve got social proof, the other guy is bidding, you get reciprocation tendency, you get deprival super-reaction syndrome, the thing is going away… I mean it just absolutely is designed to manipulate people into idiotic behavior.”   <http://www.valueinvestingworld.com/2010/02/psychology-at-home-auction.html>

Buffett’s advice for these open outcry auctions is simple: “Don’t go”.

Charlie believes that this lollapalooza tendency is often encountered in investing:

“An investment decision in the common stock of a company frequently involves a whole lot of factors interacting … the one thing that causes the most trouble is when you combine a bunch of these together, you get this lollapalooza effect.” <http://www.loschmanagement.com/Berkshire%20Hathaway/Charlie%20munger/The%20Psychology%20of%20Human%20Misjudgement.htm>

In the book *Poor Charie’s Almanack*  Munger describes an airline manufacturer that ran tests that resulted in numerous injuries which were a classic example of lollapalooza tendency.  Munger:

“… it’s a combination: authorities told you to do it. He told you to make it realistic. You’ve decided to do it. You’d decided to do it twice. Incentive-caused bias.  If you pass you save a lot of money. You’ve got to jump this hurdle before you can sell your new airliner. Again, three, four, five of these things work together and it turns human brains into mush. And maybe you think this doesn’t happen in picking investments? If so, you’re living in a different world than I am.” <http://www.tilsonfunds.com/mungerpsych>

Perhaps the best way to sum up Munger’s view of these tendencies, is to just quote Charlie responding to people who think that economists can assume that people are rational:

“How could economics not be behavioral? If it isn’t behavioral, what the hell is it?”<https://twitter.com/mungerisms/status/154735076549201920>

P.s.,   I am not sure where I will take this series of blog posts on Munger from here.  I might cover a few specific topics of interest to Charlie.  Or not.   TBD.

# Charlie Munger on the Importance of Worldly Wisdom and Consistently not being Stupid

[*6*](http://25iq.com/2013/01/27/charlie-munger-on-the-importance-of-worldly-wisdom-and-consistently-not-being-stupid/#comments)

“I think part of the popularity of Berkshire Hathaway is that we look like people who have found a trick.  It’s not brilliance.  It’s just avoiding stupidity.” <http://www.scribd.com/fullscreen/110302239?access_key=key-28dmiqkoda00xd7b7mae>

**A Lattice of Mental Models**

Understanding how humans make decisions is critical for any investor.  Unless careful attention is devoted to decision making processes the brain can be a **mistake-making machine**.

“It is remarkable how much long-term advantage people like  [Warren Buffett and myself] have gotten by trying to be consistently not stupid, instead of trying to be  very intelligent.” <http://www.wiley.com/WileyCDA/WileyTitle/productCd-0471446912,descCd-tableOfContents.html>

One way to “be less stupid” is to adopt what Charlie calls a “lattice of mental models” approach to evaluating decisions.  He believes that by using a range of different “models” from different disciplines like psychology, history, mathematics, physics, biology and economics, a person can use the combined output to produce something he calls “Worldly Wisdom.”

Munger’s method is to first assemble all the relevant facts and then apply a rational process to produce an analysis of those facts and an investing thesis. To increase the probability that the process is actually rational Munger applies multiple models from various disciplines like psychology, mathematics, statistics history, physics, biology and economics searching for sources of human misjudgment. It is in effect a form of “double/multiple check” on the investing process.  Munger believes that by going over your decision making process carefully using these additional “filters” from many disciplines you can more consistently “not be stupid”.  You will always make some bone-headed mistakes even if you are careful, but Munger’s process is designed to decrease the probability of mistakes.

Munger refers to this approach to problem solving as a:

“2 track analysis: what are the factors that really govern the interests involved here rationally considered (i.e. macro and micro level economic factors) and what are the subconscious influences where the brain at a subconscious level is automatically forming conclusions (i.e. influences from instincts, emotions, cravings, and so on)”

“what are the factors that really govern the interests involved rationally considered (i.e. macro and micro level economic factors) and what are the subconscious influences where the brain at a subconscious level is automatically” <http://moneyarchive.wordpress.com/2008/09/07/the-charlie-munger-checklists/>

Munger believes that it is critical for a person think broadly since to not do so is to invite mistakes.

“The theory of modern education is that you need a general education before you specialize. And I think to some extent, before you’re going to be a great stock picker, you need some general education.” <http://www.thinkfn.com/en/content/view/52/?id=124>

In creating his “lattice of mental models” approach Munger took his cue from Benjamin Franklin a renaissance man/polymath who he admires greatly.

In the language of Philip Tetlock <http://en.wikipedia.org/wiki/The_Hedgehog_and_the_Fox>, Munger is a “fox” (knows a little about a lot) by nature rather than a “hedgehog” (knows a lot about very little).  In terms of “foxes” that one may encounter in life Charlie is someone truly special. Bill Gates has said about Charlie:  “Charlie Munger is truly the broadest thinker I have ever encountered.”

What an investor is dealing with when making investing decisions is a nest of “complex adaptive systems” which makes his or her job genuinely hard. This means, says Munger:

“An investment decision in the common stock of a company frequently involves a whole lot of factors interacting … the one thing that causes the most trouble is when you combine a bunch of these together, you get this lollapalooza effect.” <http://www.loschmanagement.com/Berkshire%20Hathaway/Charlie%20munger/The%20Psychology%20of%20Human%20Misjudgement.htm>

If one adopts the model of “complex adaptive systems” one accepts the idea that there are many things that can not be modeled with certainty.  In Charlie’s view it is better to have common sense and be Worldly Wise than futz around with a lot of models that are precisely wrong rather than approximately right.  Munger:  “People calculate too much and think too little.” [http://www.fool.com/news/foth/2002/foth020515.htm](https://mail.microsoft.com/OWA/redir.aspx?URL=http%3a%2f%2fwww.fool.com%2fnews%2ffoth%2f2002%2ffoth020515.htm)

**Worldly Wisdom**

Charlie’s breadth of knowledge is something that is naturally part of his character but also something that he intentionally cultivates.  To know nothing about an important subject is to invite problems.

“What is elementary, worldly wisdom? Well, the first rule is that you can’t really know anything if you just remember isolated facts and try and bang ‘em back. If the facts don’t hang together on a latticework of theory, you don’t have them in a usable form. You’ve got to have models in your head. And you’ve got to array your experience ‑ both vicarious and direct ‑ on this latticework of models. You may have noticed students who just try to remember and pound back what is remembered.”<http://www.amazon.com/exec/obidos/ASIN/1578643031/consciousinve-20/104-7644521-2497538>

Munger illustrates this idea by pointing out that many professionals often think only about their own discipline and think that whatever it is that they do for a living will cure all problems.  A nutritionist may feel as if she can cure anything for example. Or a chiropractor may believe he can cure depression.  Munger calls this “man with a hammer” syndrome since to such a person “everything looks like nail” even though it may not be a nail.

Charlie has said many times that someone who is really smart but has devoted all their time to being an expert in a narrow area may actually be dangerous to themselves and others.  One example of this are most macroeconomists who think they understand the economy but are disasters in investing their own portfolios.  As another example, marketing experts may think that most everything can be solved via that discipline. Financiers tend to think similarly about their own profession.  Too many people believe what they do at work is hard and what others do is easy.

Charlie believes that the best approach to dealing with this set of problems can be found in adopting a multidisciplinary approach.

“you’ve got to have multiple models.  And the models have to come from multiple disciplines ‑ because all the wisdom of the world is not to be found in one little academic department. That’s why poetry professors, by and large, are so unwise in a worldly sense. They don’t have enough models in their heads. …   You may say, ‘My God, this is already getting way too tough.’ But, fortunately, it isn’t that tough ‑ because 80 or 90 important models will carry about 90% of the freight in making you a worldly ‑ wise person. And, of those, only a mere handful really carry very heavy freight.” <http://www.amazon.com/exec/obidos/ASIN/1578643031/consciousinve-20/104-7644521-2497538>

Munger believes that by learning to recognize certain dysfunctional decision making processes an investor can learn to make fewer mistakes.  As was noted in the first post in this series mistakes can’t be eliminated. The best one can hope for is to reduce their frequency and hopefully magnitude.  Charlie:

“Man’s imperfect, limited-capacity brain easily drifts into working with what’s easily available to it. And the brain can’t use what it can’t remember or when it’s blocked from recognizing because it is heavily influenced by one or more psychological tendencies bearing strongly on it…” “…the deep structure of the human mind requires that the way to full scope competency of virtually any kind is learn it all to fluency – like it or not.”  <http://www.poorcharliesalmanack.com/pca.php>

To sum up is blog post it is useful I think to just quote Charlie on the benefits of his approach:

“I constantly see people rise in life who are not the smartest, sometimes not even the most diligent, but they are learning machines. They go to bed every night a little wiser than they were when they got up and boy does that help, particularly when you have a long run ahead of you.…so if civilization can progress only with an advanced method of invention, you can progress only when you learn the method of learning. Nothing has served me better in my long life than continuous learning. I went through life constantly practicing (because if you don’t practice it, you lose it) the multi-disciplinary approach and I can’t tell you what that’s done for me. It’s made life more fun, it’s made me more constructive, it’s made me more helpful to others, and it’s made me enormously rich. You name it, that attitude really helps.”  <http://www.valueinvestingworld.com/2007/05/charlie-munger-usc-law-school.html>

In blog posts to follow I will try to apply “Munger’s methods” to a series to specific problems. For example, in looking at a decision:  are there dysfunctional decision making heuristics from psychology that may have caused an error?  As another example, Charlie likes to use a model from Algebra and “invert” to find a solution for problems.  Looking for models to explain mistakes so one can accumulate “Worldly Wisdom” is actually lots of fun. It is like a puzzle to be solved.

Charlie likes checklists.

“You need a different checklist and different mental models for different companies. I can never make  
it easy by saying, ‘Here are three things.’ You have to derive it yourself to ingrain it in your head for the rest of your life.”<http://investdigest.blogspot.com/2006/02/charlie-mungers-investing-mental.html>

His most comprehensive checklist can be found in Poor’s Charlie Almanack  <http://www.amazon.com/Poor-Charlies-Almanack-Wisdom-Charles/dp/1578643031>  which is reproduced below.  Some of the topics have been covered to date and some have not.  I hope to get to most if not all of them eventually.

**Risk** – All investment evaluations should begin by measuring risk, especially reputational

* Incorporate an appropriate margin of safety
* Avoid dealing with people of questionable character
* Insist upon proper compensation for risk assumed
* Always beware of inflation and interest rate exposures
* Avoid big mistakes; shun permanent capital loss –

**Independence** “Only in fairy tales are emperors told they are naked”

* Objectivity and rationality require independence of thought
* Remember that just because other people agree or disagree with you doesn’t make you right or wrong – the only thing that matters is the correctness of your analysis and judgment
* Mimicking the herd invites regression to the mean (merely average performance)

**Preparation** “The only way to win is to work, work, work, work, and hope to have a few insights”

* Develop into a lifelong self-learner through voracious reading; cultivate curiosity and strive to become a little wiser every day
* More important than the will to win is the will to prepare
* Develop fluency in mental models from the major academic disciplines
* If you want to get smart, the question you have to keep asking is “why, why, why?”

**Intellectual humility** – Acknowledging what you don’t know is the dawning of wisdom

* Stay within a well-defined circle of competence
* Identify and reconcile disconfirming evidence
* Resist the craving for false precision, false certainties, etc.
* Above all, never fool yourself, and remember that you are the easiest person to fool –

**Analytic rigor** – Use of the scientific method and effective checklists minimizes errors and omissions

* Determine value apart from price; progress apart from activity; wealth apart from size
* It is better to remember the obvious than to grasp the esoteric
* Be a business analyst, not a market, macroeconomic, or security analyst
* Consider totality of risk and effect; look always at potential second order and higher level impacts
* Think forwards and backwards – Invert, always invert –

**Allocation** – Proper allocation of capital is an investor’s number one job

* Remember that highest and best use is always measured by the next best use (opportunity cost)
* Good ideas are rare – when the odds are greatly in your favor, bet (allocate) heavily
* Don’t “fall in love” with an investment – be situation-dependent and opportunity-driven –

**Patience** – Resist the natural human bias to act

* “Compound interest is the eighth wonder of the world” (Einstein); never interrupt it unnecessarily
* Avoid unnecessary transactional taxes and frictional costs; never take action for its own sake
* Be alert for the arrival of luck
* Enjoy the process along with the proceeds, because the process is where you live –

**Decisiveness** – When proper circumstances present themselves, act with decisiveness and conviction

* Be fearful when others are greedy, and greedy when others are fearful
* Opportunity doesn’t come often, so seize it when it comes
* Opportunity meeting the prepared mind; that’s the game –

**Change** – Live with change and accept unremovable complexity

* Recognize and adapt to the true nature of the world around you; don’t expect it to adapt to you
* Continually challenge and willingly amend your “best-loved ideas”
* Recognize reality even when you don’t like it – especially when you don’t like it –

**Focus** – Keep things simple and remember what you set out to do

* Remember that reputation and integrity are your most valuable assets – and can be lost in a heartbeat
* Guard against the effects of hubris (arrogance) and boredom
* Don’t overlook the obvious by drowning in minutiae (the small details)
* Be careful to exclude unneeded information or slop: “A small leak can sink a great ship”
* Face your big troubles; don’t sweep them under the rug  [checklist from<http://www.valueinvestingworld.com/2007/12/investing-principles-checklist-from.html> quoting Poor Charlie’s Almanack]

# Charlie Munger on Investment Concentration versus Diversification

**Active versus Passive Investing**

Charlie’s advice to other people on investing is very different depending on the nature of the investor.

“Our standard prescription for the **know-nothing** investor with a long-term time horizon is a no-load index fund.”<http://www.myinvestmentforum.com/category/sgfunds-forum/interview-with-charlie-munger-t1655.html>

What is a **“know nothing”** investor? The answer is simple for Charlie:  a no-nothing investor is someone who does not understand the economics of the specific business in question. As was pointed out in the last blog post, to understand the value of an investment, you must understand the value of the underlying business since a share of stock is merely a proportional ownership interest in a business. If you are thinking about price of the stock and not the value of the business you are not an investor believes Munger.  Occasionally some academic will claim that Munger and Buffett only know how to buy  valuable companies at great prices.  This is a moronic academic analysis of Munger and Buffett’s market outperformance (alpha) since that \*is\* investing.

Buffett makes it clear that being a know-nothing investor is nothing to be ashamed about. Know-nothing investors can know a lot about a lot.  Sports, politics, science even some aspects of business can be the forte of a know-nothing investor.

“By periodically investing in an index fund, for example, the **know-nothing** investor can actually outperform most investment professionals. Paradoxically, when ‘dumb’ money acknowledges its limitations, it ceases to be dumb.” <http://berkshireruminations.blogspot.com/2007/12/thoughts-on-index-investing.html>

“Most investors, both institutional and individual, will find that the best way to own common stocks is through an index fund that charges minimal fees. Those following this path are sure to beat the net results (after fees and expenses) delivered by the great majority of investment professionals.”

<http://www.berkshirehathaway.com/letters/1996.html>

Think about what this means. You can decide to become a long-term investor in the United States/global economy and not spend much time understanding the economics of specific businesses. You can spend that time engaged in things that interest you like skiing, sleeping or watching TV instead. Josh Brown lays it out cleanly here:

“… Prior to comparing your returns to this or that index and then tearing out your hair over them, **ask yourself whether or not it should matter.** If you are speculating for the sake of speculation, by all means, grade yourself. If you are running a fund, then you won’t need to grade yourself because you are already being judged as we speak. [Only 39% of active managers beat their benchmarks](http://www.ritholtz.com/blog/2013/01/fund-manager-performance-vs-the-sp/)in 2o12, which means more than half of the fund industry is under this microscope now and the light in their faces is a harsh one. Not a pleasant place to be.

And never mind comparing yourself to an index, it’s hard enough to [keep up with this orange cat](http://m.guardiannews.com/money/2013/jan/13/investments-stock-picking) from London named ‘Orlando’ who took on a gaggle of supposed market-beating fund managers:

By the end of September the professionals had generated £497 of profit compared with £292 managed by Orlando. But an unexpected turnaround in the final quarter has resulted in the cat’s portfolio increasing by an average of 4.2% to end the year at £5,542.60, compared with the professionals’ £5,176.60.

This cat, a fucking ginger no less, threw a chew toy at the stock table pages of the Financial Times and beat guys with decades of experience and unlimited research at their fingertips.”   <http://www.thereformedbroker.com/2013/01/15/chasing-the-cat/>

The most important thing people need to know in making this decision is their own limitations. As a previous post explained, Charlie believes that not making big mistakes is a huge determinant of whether you will have financial success in life. By understanding your limitations you will make fewer mistakes.

What Warren Buffett is talking about is the question of whether a person should be an “active” or a” passive” investor – concepts he learned from Benjamin Graham:

“The determining trait of the enterprising [active] investor is his willingness to devote time and care to the selection of securities that are both sound and more attractive than the average. Over many decades, an enterprising investor of this sort could expect a worthwhile reward for his extra skill and effort in the form of a better average return than that realized by the **passive**investor.”  <http://blogs.cfainstitute.org/investor/about-us/ben-graham/>

Being an active investor and somehow outperforming the market**after** fees and expenses sounds good, but the catch is that being a successful active investor requires a massive amount of time and work.  If you don’t enjoy it, why do it?

Even more importantly, if you are provably not good at it, why do it? If you keep track of your active investing results over the years and you are failing to match the indexes, what is that telling you?  An active investor who does not keep written track of their results **after** fees and expenses and compares that to “being the market” instead is at big risk of fooling themselves.  Charlie says that Richard Feynman was right that the easiest person to fool is yourself, and that especially applies to investing skill/results.

Munger agrees with Buffett that index funds make the most sense for almost all investors. Whether they know it or not most all investors should be passive investors. Some people try to escape from this trap by saying essentially: “I can be smart about picking other people who will outperform market via active investing.”  Relying on a stock broker to be an active investor on your behalf is no solution says Charlie since “stock brokers, in toto, will do so poorly that the index fund will do better.”

<http://www.grahamanddoddsville.net/wordpress/Files/Gurus/Warren%20Buffett/Berkshire%20Hathaway%20Annual%20Meeting%20Notes%202004.pdf>

**EMH**

If you are not a**passive** investor, you must beat the market **after** fees and expenses. As John Brown notes above, being an **active**investor and accomplishing that is nontrivially hard to do.

It is at this point that the debate about the so-called “efficient market hypothesis” (“EMH”) raises its ugly head. Munger’s view on EMH are clear:

“I think it is roughly right that the market is efficient, which makes it very hard to beat merely by being an intelligent investor. But I don’t think it’s totally efficient at all. And the difference between being totally efficient and somewhat efficient leaves an enormous opportunity for people like us to get these unusual records. It’s efficient enough, so it’s hard to have a great investment record. But it’s by no means impossible. Nor is it something that only a very few people can do. The top three or four percent of the investment management world will do fine.”  <http://www.myinvestmentforum.com/category/sgfunds-forum/interview-with-charlie-munger-t1655.html>

The paradox facing the ordinary investor is that usually only the biggest investors (e.g., big pension funds, university endowments and the very wealthy) get access to the top three to four percent investment management. This problem for the ordinary investor is reflected in an old Groucho Marx joke:  you don’t want to hire an investment manager that would take you for a client!

Why is the EMF theory so widely advocated?   Academics love EMH  because they can claim that they have mathematics-based formulas which can predict the future even though the underlying assumptions (borrowed from physics) are provably false.  For a professor, the ability to create beautiful mathematics is important since it means that they are less likely to be teased by physicists in the faculty club.  Life is infinitely more interesting for an academic if they can create beautiful mathematics in their papers.

Munger:

“I have a name for people who went to the extreme efficient market theory—which is “bonkers.” It was an intellectually consistent theory that enabled them to do pretty mathematics. So I understand its seductiveness to people with large mathematical gifts. It just had a difficulty in that the fundamental assumption did not tie properly to reality.”  <http://ycombinator.com/munger.html>

In future posts I will describe Munger’s his views on why behavioral economics invalidates key premises of EMH. They are numerous and detailing them will be more fun that the blog posts made to date by this author.  Munger:

“The possibility that stock value in aggregate can become irrationally high is contrary to the hard-form “efficient market” theory that many of you once learned as gospel from your mistaken professors of yore. Your mistaken professors were too much influenced by “rational man” models of human behavior from economics and too little by “foolish man” models from psychology and real-world experience.” <http://www.tilsonfunds.com/Mungerwritings2001.pdf#search=%22%20%22charlie%20Munger%22%20Outstanding%20investor%20digest%22>

Munger likes to make fun of a few specific economists who have taken their academic theories into the real world and failed in spectacular fashion:

“Efficient market theory [is] a wonderful economic doctrine that had a long vogue in spite of the experience of Berkshire Hathaway. In fact one of the economists who won — he shared a Nobel Prize — and as he looked at Berkshire Hathaway year after year, which people would throw in his face as saying maybe the market isn’t quite as efficient as you think, he said, “Well, it’s a two-sigma event.” And then he said we were a three-sigma event. And then he said we were a four-sigma event. And he finally got up to six sigmas — better to add a sigma than change a theory, just because the evidence comes in differently. [Laughter] And, of course, when this share of a Nobel Prize went into money management himself, he sank like a stone.”

<http://www.loschmanagement.com/Berkshire%20Hathaway/Charlie%20munger/The%20Psychology%20of%20Human%20Misjudgement.htm>

Charlie as similar feelings about other aspects of much of academically generated financial theory:

“Berkshire’s whole record has been achieved without paying one ounce of attention to the efficient market theory in its hard form. And not one ounce of attention to the descendants of that idea, which came out of academic economics and went into corporate finance and morphed into such obscenities as the capital asset pricing model, which we also paid no attention to. I think you’d have to believe in the tooth fairy to believe that you could easily outperform the market by seven-percentage points per annum just by investing in high volatility stocks.”  <http://www.tilsonfunds.com/MungerUCSBspeech.pdf>

The problems which arise due to people thinking that they can be successful active investors are huge and made worse due to one a dysfunctional heuristic in particular (more on this later) known simply as “overconfidence”:

“Most people who try [investing] don’t do well at it.  But the trouble is that if even 90% are no good, everyone looks around and says, “I’m the 10%.” <http://www.grahamanddoddsville.net/wordpress/Files/Gurus/Warren%20Buffett/Berkshire%20Hathaway%20Annual%20Meeting%20Notes%202004.pdf>

The list of dysfunctional heuristics is a long and winding road.

**Closet indexing**

One of the saddest cases in investing happens when someone thinks they are active investor but the reality is that they have invested in so many stocks that they have become “closet indexers.” Munger points out the ugliness simply:

“[With] closet indexing … you’re paying a manager a fortune and he has 85% of his assets invested parallel to the indexes. If you have such a system, you’re being played for a sucker.”  <http://www.tilsonfunds.com/wscmtg05notes.pdf>

On this point,  to understand Munger it is best to look again at his wonderful essay which compares investing to betting at a horse racing track:

“the one thing that all those winning betters in the whole history of people who’ve beaten the pari-mutuel system have is quite simple. They bet very seldom. It’s not given to human beings to have such talent that they can just know everything about everything all the time. But it is given to human beings who work hard at it—who look and sift the world for a mispriced bet — that they can occasionally find one. And the wise ones bet heavily when the world offers them that opportunity. They bet big when they have the odds. And the rest of the time, they don’t. It’s just that simple.

That is a very simple concept. And to me it’s obviously right—based on experience not only from the pari-mutuel system, but everywhere else. And yet, in investment management, practically nobody operates that way. We operate that way—I’m talking about Buffett and Munger. And we’re not alone in the world. But a huge majority of people have some other crazy construct in their heads. And instead of waiting for a near cinch and loading up, they apparently ascribe to the theory that if they work a little harder or hire more business school students, they’ll come to know everything about everything all the time.  To me, that’s totally insane. The way to win is to work, work, work, work and hope to have a few insights.” <http://ycombinator.com/munger.html>

If you want to go deeper on the closet indexing issue I suggest you read Mauboussin as usual (when in doubt read Mauboussin is my rule of thumb): <https://www.lmcm.com/905988.pdf>  More discussion can be found here: <http://online.barrons.com/article/SB50001424052748703792204578221972943824046.html?mod=bol_share_tweet#articleTabs_article%3D2>

**Concentration is Key for the Active Investor**

Munger is clearly a devotee of concentrating his investments since he is not a know-nothing investor.

“The idea of excessive diversification is madness.” <http://www.grahamanddoddsville.net/wordpress/Files/Gurus/Warren%20Buffett/Berkshire%20Hathaway%20Annual%20Meeting%20Notes%202004.pdf>

“Wide diversification, which necessarily includes investment in mediocre businesses, only guarantees ordinary results.”<http://investingcaffeine.com/2009/12/02/more-eggs-in-basket-may-crack-portfolio/>

Seth Klarman believes: “The number of securities that should be owned to reduce portfolio risk is not great; as few as ten to fifteen holdings usually suffice.”

Jason Zweig adds:

 “A conventional rule of thumb, supported by the results of Bloomfield, Leftwich, and Long 1977, is that a portfolio of 20 stocks attains a large fraction of the total benefits of diversification. … however, that the increase in idiosyncratic risk has increased the number of stocks needed to reduce excess standard deviation to any given level.” <http://kuznets.fas.harvard.edu/~campbell/papers/clmx.pdf>

“Even the great investment analyst Benjamin Graham urged “adequate though not excessive diversification,” which he defined as between 10 and about 30 securities.” [http://online.wsj.com/article/SB10001424052748704533904574548003614347452.htm](http://online.wsj.com/article/SB10001424052748704533904574548003614347452.html)

Munger chimes in:

“The Berkshire-style investors tend to be less diversified than other people. The academics have done a terrible disservice to intelligent investors by glorifying the idea of diversification. Because I just think the whole concept is literally almost insane. It emphasizes feeling good about not having your investment results depart very much from average investment results. But why would you get on the bandwagon like that if somebody didn’t make you with a whip and a gun? <http://www.myinvestmentforum.com/category/sgfunds-forum/interview-with-charlie-munger-t1655.html>

Seth Klarman points out that it is better to know **a lot** about 10-15 companies that to know just a little about many stocks.  When it comes to diversification vs. concentration Charlie feels like the Maytag repair man:

 “I always like it when someone attractive to me agrees with me, so I have fond memories of Phil Fisher.  The idea that it was hard to find good investments, so concentrate in a few, seems to me to be an obviously good idea.  But 98% of the investment world doesn’t think this way.

<http://www.grahamanddoddsville.net/wordpress/Files/Gurus/Warren%20Buffett/Berkshire%20Hathaway%20Annual%20Meeting%20Notes%202004.pdf>

The number of stocks a person can realistically follow and understand the economics of the specific business better than the market is significantly less than 20.  The idea that a dentist working full time in his or her profession is going to pick technology stocks better than the market after fees and expenses is silly. A UPS driver is hoping to the same thing with a health care stock?   Remember the task is not just to pick a quality company, but to find a mispriced bet.

The same principles apply to Angel investors who “spray and pray” investments at every start up they can find. Smart VCs and Angels investors make a lot of bets but in a relative sense they are still concentrated.   A big VC fund may make 40 bets in a fund and the outcome for the funs may rest on two or three massive financial home runs, but each of the 40 bets must have optionality.  To many companies VCs think they can just invest in 4o0 companies regardless of whether they have optionality.

**Summary:**

You may recall from an economics class or reading that markets are “efficient.” This means  markets take all the available information and create a price for the good or service.  The market is often right about that price, but is not always right.  It is possible, by finding an area in which you are particularly competent, to find an investment that is being offered to you for substantially less than it is worth. Not a little less than what it is worth mind you, but substantially less than it is worth. “How much is substantially less than it is worth?” you may ask.  The price should be so good that it is screaming out at you to buy it.  “How often is this likely to happen?” It may happen once or twice in a year or twice in a month and then not again for two or three years. As an example, the VC Fred Wilson is said to have made no investments at all in 2012.  Sometimes that happens if you stick to your principles.

It is important to note that mispriced investments will happen more often that once or twice a year as a whole, but the only mispriced investment that is important to you is one that falls within an area in which you are very competent. The smaller the area in which you apply your time and effort to being competent, the more likely is that you will genuinely spot the opportunities. If you try to be competent in all areas and you will never be smart enough to find these investment opportunities.

“We don’t believe that markets are totally efficient and we don’t believe that widespread diversification will yield a good result.  We believe almost all good investments will involve relatively low diversification. Maybe 2% of people will come into our corner of the tent and the rest of the 98% will believe what they’ve been told.”   <http://www.grahamanddoddsville.net/wordpress/Files/Gurus/Warren%20Buffett/Berkshire%20Hathaway%20Annual%20Meeting%20Notes%202004.pdf>

My next post will be: “**Charlie Munger on the Importance of Consistently  
not being Stupid.”**

# Charlie Munger on Margin of Safety (the Fourth Essential Filter)

[*5*](http://25iq.com/2013/01/02/charlie-munger-on-margin-of-safety-the-fourth-essential-filter/#comments)

“No matter how wonderful [a business] is, it’s not worth an infinite price. We have to have a price that makes sense and gives a margin of safety considering the normal vicissitudes of life.”  Charlie Munger <http://www.psyfitec.com/2009/10/buffett-and-munger-on-bbc.html>

**Are you an Investor or a Speculator?**

Anyone who wants to understand Charlie Munger must understand this:  If you are buying a share of stock, the investing process is the same as if you were buying a business since a share of stock is just a partial stake in a business.  For example, a share of IBM stock is just a small share of IBM’s overall business.  If you do not follow this approach in Charlie’s view you are a “speculator” and not an “investor.”

Charlie is a firm believer in what Benjamin Graham once said:

“An investment operation is one which, upon thorough analysis, **promises safety** of principal and an adequate return.  Operations not meeting these requirements are speculative.”  <http://en.wikipedia.org/wiki/Benjamin_Graham>

Buffett has his own version:

“If you’re an investor, you’re looking on what the asset is going to do, if you’re a speculator, you’re commonly focusing on what the price of the object is going to do, and that’s not our game.”

<http://en.wikiquote.org/wiki/Warren_Buffett>

The objective of a “speculator” is to make predictions about the psychology of large masses of people, which if you are both smart and experienced is a sobering thought.   How good are you at predicting what people will do once assembled into a mob?  The big danger here is that you just end up following the crowd and doing what Munger talks about here:   “Mimicking the herd invites regression to the mean (merely average performance).” <http://www.scribd.com/doc/68337347/Charlie-Munger-Investment-Principles> If you are not going to do any better than average, what’s the point of doing any works to outperform an index fund (more on this on the next post?  Seth Klarman writes:  “If you can’t beat the market, be the market.” (Margin of Safety,  p.  212).

As an example, people who “day trade” stocks using goofy charts and other voodoo-like practices are speculators.  You will hear them talk about how the market “behaves” rather than what the value of a given stock may be. To guess about market “behavior” based on a chart is just that: a guess!  Speculators are focused on **price** whether it may be an old baseball card or share of stock.  Seth Klarman writes in his book Margin of Safety: “Technical analysis is based on the presumption that that past share prices meanderings, rather than underlying business value, hold the key to future stock prices.” Talking heads on cable TV barking out recommendations to buy X and Sell Y as if they were on ESPN Sports Center are speculators/entertainers and are not investors.  People who trade on inside information are actually investors, albeit ones that may go jail if caught.  Some people who call themselves traders only succeed in doing so because they have better information or are taking the other side of trades with “muppets” being sold down the river via false advice.

Keynes put it this way:  “Speculation:  The activity of forecasting the psychology of the market.”  Keynes went on to say the speculator must think about what others are thinking about, what others are thinking about the market, [repeat].   In a Keynesian beauty contest judges are told not to pick the most beautiful woman but instead to pick the contestant they think the other judges will choose as the most beautiful.  The winner of such a contest may be very different than the winner of a traditional beauty contest.  Keynes wrote about such a contest:

“It is not a case of choosing those [faces] that, to the best of one’s judgment, are really the prettiest, nor even those that average opinion genuinely thinks the prettiest. We have reached the third degree where we devote our intelligences to anticipating what average opinion expects the average opinion to be.  And there are some, I believe, who practice the fourth, fifth and higher degrees.”  General Theory of Employment Interest and Money, 1936.  <http://en.wikipedia.org/wiki/Keynesian_beauty_contest>

Much of what went on in the IPOs of Facebook, Zynga and Groupon was a Keynesian Beauty contest:  people were trying to guess what other people thought about what other people thought [repeat] about when these stocks would correct with everyone trying to get out just in time.  Facebook, Zynga and Groupon investors were trying to “time” when the stock would fall even though the clock had “no hands” and so it was impossible to “time” the exit.

**Mispriced Bets**

Charlie Munger’s best essay and arguably the one that made him most famous is entitled:   “*A Lesson on Elementary, Worldly Wisdom as It Relates to Investment Management & Business*” and it can be found at <http://ycombinator.com/munger.html>   In this wonderful essay (very much worth reading in full) is a long passage which includes this language: “The model I like—to sort of simplify the notion of what goes on in a market for common stocks—is the pari-mutuel system at the racetrack… Everybody goes there and bets and the odds change based on what’s bet.  That’s what happens in the stock market.

Any damn fool can see that a horse carrying a light weight with a wonderful win rate and a good post position etc., etc. is way more likely to win than a horse with a terrible record and extra weight and so on and so on.  But if you look at the odds, the bad horse pays 100 to 1, whereas the good horse pays 3 to 2. Then it’s not clear which is statistically the best bet using the mathematics of Fermat and Pascal….”   <http://ycombinator.com/munger.html>

It is worth pointing out that value investing inherently is at odds with the “efficient market hypothesis” (more on that in the next blog post).  In the real world, sometimes stocks are underpriced and sometime they are overpriced.  To say that Facebook, for example, had an “efficient” price the day it went public and then a far lower price a short time after the stock substantially dropped in price is to defy common sense.  During the first few months Facebook had a **value** that did not change very much, but the **price** changed a lot.  Price does not always equal value.  Anyone who invested through the Internet bubble in 2001 as I did and who still thinks markets are \*always\* efficient is bonkers.

**Business Necessarily Involves Risk, Uncertainty and Ignorance**

When you make an investment the laws of probability apply since the decisions involves risk, uncertainty and ignorance (more on this in a later post too, but to jump ahead read: <http://www.hks.harvard.edu/fs/rzeckhau/InvestinginUnknownandUnknowable.pdf>).  If you are making “bets” on stocks and “the house” has the odds in their favor you are gambling/speculating.   If you have the odds in your favor you are instead “investing.”   It should be not a surprise that many successful investor and business people are experts at poker and bridge. Some of them, like Charlie Ergen, were once card counters in Las Vegas. Successful business people don’t really gamble since their \*big\* bets happen when the odds are substantially in their favor.

Many people make the mistake of assuming that buying a quality company ensures safety.  Samsung may be a quality company with an attractive business, but that alone is not enough since the price you pay for a share of stock matters.  Facebook may be an important company with lots of page views to put advertising on, but it is not worth an infinite price.  Howard Marks puts it best:

“Most investors think quality, as opposed to price, is the determinant of whether something’s risky. But high quality assets can be risky, and low quality assets can be safe. It’s just a matter of the price paid for them…. Elevated popular opinion, then, isn’t just the source of low return potential, but also of high risk.” <http://ivanhoff.com/2012/12/27/high-quality-assets-can-be-risky-and-low-quality-assets-can-be-safe/>

Similarly, just because the price of share of stock in a company is beaten down from formerly high levels does not make it “safe” to buy.  As an example, HP is way off its value of a few years ago, but that alone does not necessarily make the purchase of the stock “safe” in terms of a Margin of Safety.

The “Margin of Safety” concept is about making it likely that you have the odds significantly in your favor by trying to find a substantial cushion in terms of the odds.  Munger does not believe that this happens very often, particular when it is in your Circle of Competence and the other investing filters are in place.  Since finding a significantly mispriced bet does not happen very often, when it does happen you should bet \*big\*.  Charlie believes that this means most of the time an investor should be sitting on their “rear end” reading and talking to people.  Munger has said:  “Investing is where you find a few great companies and then sit on your ass.”<http://wealthymatters.com/2011/02/12/charlie-mungers-quotes-mungerisms/>    Buying and selling stocks for its own sake (e.g., to stay busy)  is a very bad idea.

“It’s not given to human beings to have such talent that they can just know everything about everything all the time. But it is given to human beings who work hard at it – who look and sift the world for a mispriced bet – that they can occasionally find one. And the wise ones bet heavily when the world offers them that opportunity. They bet big when they have the odds. And the rest of the time they don’t. It’s just that simple.”  <http://ycombinator.com/munger.html>

One truism about investing is this: for you to find a significant mistake, someone else must be making a mistake too.  Seth Klarman writes:

“Investors operate within what is for the most part a zero-sum game. While it is true that the value of all companies usually increases over time with economic growth, market outperformance by one investor is necessarily offset by another’s underperformance.”<http://budfox.blogspot.com/2012/11/seth-klarman-goes-nuts-on-fed-in-his_6.html>

In other words, when you are investing you are searching for \*significant” mistakes made by others.  And when you find a \*significant\* mistake, you bet big.

**Everyone Makes Mistakes (No Exceptions).**

The first post in this series was about the inevitable mistakes people make.  Everyone makes mistakes.  If you think you don’t make mistakes, you are in dire need of psychological counseling on that issue alone.   Donald Trump would be one example of someone who needs psychological help on this point at least.

What you are trying to do when making an investment is to find a mispriced bet.  What Margin of Safety is all about is finding a \*significantly\* mispriced bet.  When you look at the current price of a stock like Apple, do you see a significant mistake being made by the market in terms of the price it is offering you at that moment? Charlie puts it this way:

“[Ben Graham developed this] concept of “Mr. Market.” Instead of thinking the market was efficient; he treated it as a manic-depressive who comes by every day. And some days he says, “I’ll sell you some of my interest for way less than you think it’s worth.” And other days, “Mr. Market” comes by and says, “I’ll buy your interest at a price that’s way higher than you think its worth.” And you get the option of deciding whether you want to buy more, sell part of what you already have or do nothing at all. To Graham, it was a blessing to be in business with a manic-depressive who gave you this series of options all the time.” <http://ycombinator.com/munger.html>

When the investor faces the challenge of investing he or she faces risk, uncertainty and ignorance. Seth Klarman writes:

“A margin of safety is achieved when securities are purchased at prices sufficiently below underlying value to allow for human error, bad luck, or extreme volatility in a complex, unpredictable and rapidly changing world.” <http://www.marketfolly.com/2012/04/notes-from-seth-klarmans-margin-of.html#ixzz2FqyYTIon>

The bad news for some people in all of this is that investing is hard.  But the good news is also that investing is hard and if you have the right temperament and are willing to do the necessary work the process can be fun.  As Charlie has said:

“If (investing) weren’t a little difficult, everybody would be rich.” <http://www.wiley.com/WileyCDA/WileyTitle/productCd-0471446912,descCd-tableOfContents.html>

To better deal with inevitable mistakes we all make as human beings, Charlie believes that you should have built into the process a “margin” of sufficient size which ensures that even if mistakes happen the outcome will be “adequate” as Ben Graham describes.  Graham called this a “Margin of Safety.”  When you are thinking about buying shares of, for example, Cisco, do you see a value of those shares which is 20-25% less than actual value?  If you see a significant discount from value in the current price of an investment, you have a Margin of Safety.

**Margin of Safety has evolved since Graham**

What Graham did in applying this Margin of Safety concept in his era was quite different than the way Buffett and Munger use it today.  In the aftermath of the depression Graham was spending most of his time looking for companies “worth more dead than alive.” These “cigar butt” companies were more common at that time, but as years passed and they more or less disappeared.  Buffett, encouraged by Munger, began to apply the same principle to companies that were of high quality and the process worked just as well.  Munger:

“Ben Graham followers… started defining a bargain in a different way. And they kept changing the definition so that they could keep doing what they’d always done. And it still worked pretty well.”   <http://ycombinator.com/munger.html>

Munger believes that process in a financial transaction is similar to processes that exist in engineering:

“In engineering, people have a big margin of safety. But in the financial world, people don’t give a damn about safety. They let it balloon and balloon and balloon. It’s aided by false accounting.  <http://www.tilsonfunds.com/motley_berkshire_brkmtg03notes.php3>

If you are building a bridge as the designer you want to make sure that it is significantly stronger than necessary to deal with the very worst case.  Buffett wrote once:  “When you build a bridge, you insist it can carry 30,000 pounds, but you only drive 10,000 trucks across it.  And the same principle works in investing.”  Charlie thinks investing should be similar.  The first rule of investing is:  don’t make big financial mistakes. The second rule is the same as the first rule.

The size of the minimum Margin of Safety should vary with the magnitude of the risk involved. In his fantastic new book Michael Mauboussin writes:

“As Graham noted, the margin of safety ‘is available for absorbing the effect of miscalculations or worse than average luck.’ The size of the gap between price and value tells you how you’re your margin of safety is. As Grahaham says, the margin of safety goes down as the price goes up. In other words, make you margin of safety as large as possible.” *The Success Equation* at 169.  <http://www.amazon.com/The-Success-Equation-Untangling-Investing/dp/1422184234>

In terms of the size of the Margin of Safety, Munger and Buffett like the amount to be so big that they need not do any math other than in their heads:

Munger:  “Warren often talks about these discounted cash flows, but I’ve never seen him do Buffett:   “It’s sort of automatic. It ought to just kind of scream at you that you’ve got this huge margin of safety.” <http://wealthymatters.com/2011/02/12/charlie-mungers-quotes-mungerisms/>

Munger talks once about the concept of Margin of Safety in describing Buffett’s one time mentor Benjamin Graham in this way:

“Graham had this concept of value to a private owner—what the whole enterprise would sell for if it were available. And that was calculable in many cases.  Then, if you could take the stock price and multiply it by the number of shares and get something that was one third or less of sellout value, he would say that you’ve got a lot of edge going for you. Even with an elderly alcoholic running a stodgy business, this significant excess of real value per share working for you means that all kinds of good things can happen to you. You had a huge margin of safety—as he put it—by having this big excess value going for you.”  <http://ycombinator.com/munger.html>

Since nothing is certain in investing, the best approach is to think probabilistically.  Michael Mauboussin says it best:

“Margin of safety can be restated as a discount to expected value. Expected value is a function of the weighted probability of potential outcomes.”   <http://people.stern.nyu.edu/adamodar/pdfiles/eqnotes/marginofsafety.pdf>

“[One] way to cope with noise is to think probabilistically. The basic idea is to intelligently consider value outcomes and their associated probabilities. These probabilities and outcomes allow you to determine an expected value, and you want to buy at a substantial discount to that value. That discount is what Ben Graham would call “margin of safety.” His message about margin of safety is just one of Graham’s enduring lessons.”  <http://seekingalpha.com/article/163743-interview-michael-mauboussin-chief-investment-strategist-legg-mason-capital-management>

**Valuation**

In determining the value of a business people make many different mistakes.  One reason why so many mistakes are made is that both a business and an economy are unpredictable complex adaptive systems (more on that later).  Another reason is that promoters can tell tall very convincing stores and many investor buy into the false narrative to their detriment.

The starting point in the process is setting a valuation.   At his core, Munger believes:

“You must value the business in order to value the stock.” <http://www.valuewalk.com/charlie-munger-page/>

In setting a value Munger and Buffet don’t swallow the stores of promoters that sing songs and tell tall tales about EBITDA and non-GAAP “earnings.”  They like genuine free cash flow.  Munger:

“There are two kinds of businesses: The first earns 12%, and you can take it out at the end of the year. The second earns 12%, but all the excess cash must be reinvested — there’s never any cash. It reminds me of the guy who looks at all of his equipment and says, “There’s all of my profit.” We hate that kind of business.” <http://www.tilsonfunds.com/motley_berkshire_brkmtg03notes.php3>

Warren Buffett describes the valuation investing process in this simple way:

“Though this … cannot be calculated with engineering precision, it can in some cases be judged with a degree of accuracy that is useful.  The primary factors bearing upon this evaluation are:

     1) The certainty with which the long-term economic   characteristics of the business can be evaluated;

     2) The certainty with which management can be evaluated,  both as to its ability to realize the full potential of  the business and to wisely employ its cash flows;

     3) The certainty with which management can be counted on to channel the rewards from the business to the shareholders rather than to itself;

     4) The purchase price of the business;

     5) The levels of taxation and inflation that will be experienced and that will determine the degree by which an investor’s purchasing-power return is reduced from his gross return.” <http://www.berkshirehathaway.com/letters/1993.html>

Each of these points made by Buffett on valuation deserves its own blog post, so I will leave it at that for now.  But the important point is (1) to have the discipline to do the work; (2) realize that mistakes will inevitably be made; and (3) build in a Margin of Safety.  In doing this analysis people like Buffett are very conservative:

 “We think about worst cases all the time and we add on a big margin of safety. We don’t want to go back to ‘Go.'” <http://articles.chicagotribune.com/2012-05-05/news/sns-rt-berkshiremeeting-highlights2l1e8g52t9-20120505_1_vice-chairman-charlie-munger-berkshire-meeting-berkshire-hathaway>

 Warren Buffett has views on company valuation which echo Munger’s:

“Growth is always a component in the calculation of value, constituting a variable whose importance can range from negligible to enormous and whose impact can be negative as well as positive.”

<http://alephblog.com/2011/10/20/value-versus-growth/>

“Growth benefits investors only when the business in point can invest at incremental returns that are enticing – in other words, only when each dollar used to finance the growth creates over a dollar of long term market value. In the case of a low-return business requiring incremental funds, growth hurts the investor.”  <http://www.buffettsecrets.com/company-growth.htm>

In terms of valuing a company and its relation of Margin of Safety, I like a definition Michael Mauboussin once set out in an interview:

“Value, to me, is the present value of future cash flows, which would be relevant for any financial asset – present value of future cash flows. Value would be buying something for substantially less than what it’s worth, based on that stream of cash flows.  It’s as simple as that.  And the margin of safety, of course, reflects the distance…”   <http://www.forbes.com/sites/steveforbes/2011/07/11/steve-forbes-interview-michael-mauboussin-professor-and-investor/>

To which Mauboussin adds:

“A margin of safety- a concept attributable to Ben Graham- exists when an investor can purchase a stock well below its intrinsic value.  Buffett defines intrinsic value in no uncertain terms:  ‘it is the discounted value of the cash that can be taken out of a business during its remaining life.’”

<http://people.stern.nyu.edu/adamodar/pdfiles/eqnotes/marginofsafety.pdf>

Every so often someone will say that the ideas of people like Munger are old-fashioned.  One such case was during the 1999-2001 Internet stock bubble and that did not turn out well for people who doubted these principles.  Some promoters did well during that bubble, but that it another subject entirely.    Munger believes the Margin of Safety idea is timeless:

“The idea of a margin of safety, a Graham precept, will never be obsolete. The idea of making the market your servant will never be obsolete. The idea of being objective and dispassionate will never be obsolete. So, Graham had a lot of wonderful ideas.” (Wesco Annual  Meeting 2003) <http://wealthymatters.com/2011/02/12/charlie-mungers-quotes-mungerisms/>

**Summing Up**

As I did in the last chapter I will leave it to one person to summarize the ideas set out in this post.   James Montier:

“Valuation is the closest thing to the law of gravity that we have in ﬁnance. It is the primary determinant of long-term returns. However, the objective of investment (in general) is not to buy at fair value, but to purchase with a margin of safety. This reﬂects that any estimate of fair value is just that: an estimate, not a precise ﬁgure, so the margin of safety provides a much-needed cushion against errors and misfortunes. When investors violate [this principle] by investing with no margin of safety, they risk the prospect of the permanent impairment of capital.”  <http://theguruinvestor.com/2011/05/20/the-seven-immutable-laws-of-investing/>

Charlie Munger’s summary of all the four investing filters is to the point:

“The number one idea is to view a stock as an ownership of the business and to judge the staying quality of the business in terms of its competitive advantage. Look for more value in terms of discounted future cash-flow than you are paying for. Move only when you have an advantage.”  <http://www.peregrineinvest.com/whatwedo.aspx?spid=109675&Title=Investing%20Words%20of%20Wisdom>

It’s so simple! Most financial advisors try to make the investing process complex since otherwise they would have nothing to sell.  Of course, that the process is simple does not mean the process is not hard work or fun for some people .  The next post in this series will discuss whether people should be active or passive investors and whether diversification or concentration of investments makes sense in each case.

# Charlie Munger on Management with Talent and Integrity (The Third Essential Filter) Delegate, but not Everything

With only a little over 20 people working at Berkshire, Buffett and Munger must leave it to the managers to run the businesses in the portfolio since they don’t have the staff to do otherwise.   This is, of course, by choice since what the two men love most is investing. Munger has said:

“We have extreme centralization at headquarters where a single person makes all the capital allocation decisions, and we have decentralization among our operations without a big bureaucracy. That’s the Berkshire Hathaway model.” <http://mungerisms.blogspot.com/2010/05/charlie-munger-on-how-hed-make-volckler.html>

An investor like Munger finds his “comparative advantage” in investing rather than “making sure the trains run on time” like Matt Rose of Burlington Northern.  Of course, what Matt Rose does as a “trains run on time” manager is not only invaluable, but essential.  Munger says this about See’s candy and  delegation:

“There are a lot of people who would have bought it and would have screwed it up. They would have thought that headquarters knows best.”  <http://bit.ly/Ug9yV9>

When Munger and Buffett do engage in company management, they focus on two tasks:

**1. Capital Allocation**

Management of the businesses within Berkshire is extremely decentralized, but the management of cash is extremely centralized.   The primary management activity at Berkshire is capital allocation. Charlie writes:

“Proper allocation of capital is an investor’s number one job”   Poor Charlie’s Almanack (p. 63)

Buffett’s view is no different:

“Charles T. Munger, Berkshire Hathaway’s vice-chairman, and I really have only two jobs… One is to attract and keep outstanding managers to run our various operations. The other is capital allocation.”   <http://www.economist.com/node/12677005>

Munger has pointed out that capital allocation should not be combined or confused with what is essentially what he calls “gambling at a casino” as is the case with many large investment banks.  Charlie has said publicly that he “makes Paul Volcker look like a sissy” when it comes to investment banking reform:

“I would separate derivatives from the basic bridges of civilization. We don’t want civilization contaminated by extreme speculation. I’d ban all the derivatives trading except for metals and commodities. The new stuff is a marvelous gambling game. It swamps any commercial transactions that are needed. Gambling does not become wonderful just because it pertains to commerce. It’s a casino.” <http://theinvestmentsblog.blogspot.com/2010/05/if-i-were-lee-kwan-yew.html>

 2. **Compensation Systems**

This task is not as simple as it might seem since the Berkshire managers in many cases are rich and have little financial need to work.  For this reason, Munger and Buffett select managers who love what they do enough that financial motivation is only part of the reason they love the work they do.  The best place to see this philosophy set out s in the Berkshire “Owner’s Manual” at:<http://www.berkshirehathaway.com/owners.html>

Munger believes compensation systems are important- too important to delegate:

“It isn’t enough to buy the right business. You’ve also have to have compensation system that’s satisfactory to the people running them. At Berkshire Hathaway, we have no [single] system; we have different systems. They’re very simple and we don’t tend to revisit them very often. It’s amazing how well it’s worked. We wrote a one-page deal with Chuck Huggins when we bought See’s and it’s never been touched. We have never hired a compensation consultant.”  <http://www.tilsonfunds.com/wscmtg05notes.pdf>

“A man does not deserve huge amounts of pay for creating tiny spreads on huge amounts of money. Any idiot can do it. And, as a matter of fact, many idiots do do it.”  <http://12valuestocks.com/2012/06/best-value-investment-quotes/>

“I’d rather throw a viper down my shirt front than hire a compensation consultant.”  <http://www.grahamanddoddsville.net/wordpress/Files/Gurus/Warren%20Buffett/Berkshire%20Hathaway%20Annual%20Meeting%20Notes%202004.pdf>

As an example, a manager like Mark Hurd might do very well with Larry Ellison keeping watch, but manage the company to maximize his compensation to the detriment of the company if supervised by a weak board of directors.

Micro-managing what their CEOs do is not in the Berkshire playbook:

“In any big business, you don’t worry whether someone is doing something wrong,  you worry about whether it’s big and whether it’s material. You can do a lot to mitigate bad behavior, but you simply can’t prevent it altogether.”  <http://gongol.com/research/berkshire/2012/>

Of course, fear of micromanagement is not a reason to abdicate responsibility as Scott McNealy did with Jonathan Schwartz at Sun.  A board of directors letting a parade of managers run down a business is not justified by a fear of micromanagement either.  Should Leo Apotheker have been given the freedom to buy Autonomy? No.   Buffett writes: “A managerial “wish list” will not be filled at shareholder  expense” at Berkshire. <http://www.berkshirehathaway.com/owners.html> This raises the Institutional  imperative problem that will be discussed later in this series.  As Buffett has written:

“[M]any managerial [princes] remain serenely confident about the future potency of their kisses – even after their        corporate backyards are knee-deep in unresponsive toads.”

<http://emlab.berkeley.edu/~ulrike/Papers/OCmergers_Final_JFEformat_20feb2008.pdf>

“the heads of many companies are not skilled in capital allocation.  Their inadequacy is not surprising.  Most  bosses rise to the top because they have excelled in an area such  as marketing, production, engineering, administration or,  sometimes, institutional politics. Once they become CEOs, they face new responsibilities.  They now must make capital allocation decisions, a critical job that  they may have never tackled and that is not easily mastered.  …CEOs who recognize their lack of capital-allocation skills  (which not all do) will often try to compensate by turning to  their staffs, management consultants, or investment bankers.  Charlie and I have frequently observed the consequences of such “help.” On balance, we feel it is more likely to accentuate the capital-allocation problem than to solve it.  In the end, plenty of unintelligent capital allocation takes  
place in corporate America. (That’s why you hear so much about ‘restructuring.’)”<http://www.berkshirehathaway.com/letters/1987.html>

Delegation to the extent practiced by Munger and Buffett only works if you follow this rule says Munger:

“Our success has come from the lack of oversight we’ve provided, and our success will continue to be from a lack of oversight.  But if you’re going to provide minimal oversight, you have to buy carefully. It’s a different model from GE’s.  GE’s works – it’s just very different from ours.”  <http://www.tilsonfunds.com/wscmtg05notes.pdf>

Buying a “turn-around” business like Sears is not an example of a Berkshire approach despite what was claimed by investor Eddie Lampert.  The idea that Lampert would be “the next Warren Buffett” was and is baffling given their different styles as investors.

**Better to Have a Great Moat than a Great Manager (But Get Both When You Can)**

Munger would rather have a great moat than great managers, but would love to have both so he as a greater margin of safety.  “Good jockeys will do well on good horses, but not on broken down nags” quips Buffett.  For example, both the New England textile business and the department stores that Berkshire owned had very competent managers, but the underlying businesses the managers had to run were lodged in quicksand.  Ron Johnson who formerly was in charge of Apple’s retail operations  may be a great manager of a retail business, but JC Penny’s reputation as a lousy business seems likely to make the critical difference in terms of a financial result. Lots of really great managers will do poorly running startup because the distribution of financial returns  in venture capital is a power law distribution.

Munger admits there are rare exceptions to the moat rule:

“So you do get an occasional opportunity to get into a wonderful business that’s being run by a wonderful manager.  And, of course, that’s hog heaven day.  If you don’t load up when you get those opportunities, it’s a big mistake.  … Averaged out, betting on the quality of business is better than betting on the quality of management.  In other words, if you have to choose one, bet on the business momentum, not the brilliance of the manager.  But, very rarely, you find a manager who’s so good that you’re wise to follow him into what looks like a mediocre business.” <http://ycombinator.com/munger.html>

**The Only Duty of Management is to “Widen” the Moat:**

In typical fashion Charlie gets right to the point here:

“The only duty of corporate executive is to widen the moat. We must make it wider. Every day is to widen the moat. We gave you a competitive advantage, and you must leave us the moat. There are times when it is too tough. But duty should be to widen the moat. I can see instance after instance where that isn’t what people do in business. One must keep their eye on ball of widening the moat, to be a steward of the competitive advantage that came to you. A General in England said, ‘Get you the sons your fathers got, and God will save the Queen.’ At Hewlett Packard, your responsibility is to train and deliver a subordinate who can succeed you. It is not all that complicated – all that mumbo jumbo. We make bricks in Texas which use the same process as in Mesopotamia.”

<http://mungerisms.blogspot.com/2009/08/2008-annual-meeting-notes.html>

Munger wants managers of the business who have “an ownership mentality” toward the business, not just the attitude of manager.

“Carnegie was always proud that he took very little salary. Rockefeller, Vanderbilt were the same. It was a common culture in a different era. All of these people thought of themselves as the founder. I was delighted to get rid of the pressure of getting fees based on performance. If you are highly conscientious and you hate to disappoint, you will feel the pressure to live up to your incentive fee. There was an enormous advantage [to switching away from taking a percentage of the profits to managing Berkshire, in which their interests as shareholders are exactly aligned with other shareholders].”<http://www.tilsonfunds.com/motley_berkshire_brkmtg03notes.php3>

Munger and Buffet want managers with what Nassim Taleb calls “skin in the game.” They hate situations in which the result is:  “heads managers win and tails managers do not lose.” They want risk and benefits to be symmetrical.  For Munger the presence of the right incentives for manager is critical. Buffett adds that he wants to see managers have: “a major portion of their net worth invested in the  company. We eat our own cooking.”

Munger also fears bureaucracy and Berkshire works hard to prevent it from lowering returns.  Munger:

“For example, if you worked for AT&T in my day, it was a great bureaucracy. Who in the hell was really thinking about the shareholder or anything else? And in a bureaucracy, you think the work is done when it goes out of your in-basket into somebody else’s in-basket. But, of course, it isn’t. It’s not done until AT&T delivers what it’s supposed to deliver. So you get big, fat, dumb, unmotivated bureaucracies…. The constant curse of scale is that it leads to big, dumb bureaucracy—which, of course, reaches its highest and worst form in government where the incentives are really awful. That doesn’t mean we don’t need governments—because we do. But it’s a terrible problem to get big bureaucracies to behave.” <http://ycombinator.com/munger.html>

**Management Already In Place with Integrity**

Munger has made it clear that integrity is just as significant an investment filter as talent. When Munger buys a company or makes an investment he wants both:

“We would vastly prefer a management in place with a lot of integrity and talent.” <http://www.youtube.com/watch?v=3XlBrohrIUc>

“Remember that reputation and integrity are your most valuable assets – and can be lost in a heartbeat.” <http://12valuestocks.com/2012/06/best-value-investment-quotes/>

“I think track records are very important. If you start early trying to have a perfect one in some simple thing like honesty, you’re well on your way to success in this world.” <http://12valuestocks.com/2012/06/best-value-investment-quotes/>

“When you mix raisins with turds, they are still turds.”  <http://12valuestocks.com/2012/06/best-value-investment-quotes/>

“All investment evaluations should start by measuring risk, especially reputational.” Poor Charlie’s Almanack (p. 61)

“Avoid dealing with people of questionable character.” Poor Charlie’s Almanack (p. 61)

As was noted in the earlier post on mistakes, no one is perfect, including Charlie says Charlie:

“[I know] of a company with a great culture and a great business and he and Warren admire the guy who runs the company. But, the man just made an awful acquisition. …  you have to be willing to be disappointed by managers. All managers are going to drift.  If [we] could be so wrong as to buy Dexter Shoes then we should not be surprised that others make acquisition mistakes. If you are not frustrated by what you see, you don’t understand it.”<http://www.watheeqa.com/App_Themes/watheeqa/pdf/Conversation%20with%20Charlie%20Munger.pdf>

It is harder to spot a lack of integrity than many people imagine. Munger:

“Bernie Ebbers and Ken Lay were caricatures – they were easy to spot.  They were almost psychopaths.  But it’s much harder to spot problems at companies like Royal Dutch [Shell].”<http://www.grahamanddoddsville.net/wordpress/Files/Gurus/Warren%20Buffett/Berkshire%20Hathaway%20Annual%20Meeting%20Notes%202004.pdf>

The David Sokol case involving Berkshire is interesting to think about. <http://www.berkshirehathaway.com/news/MAR3011.pdf>   Why would someone so rich like Sokol take an action that involved relatively little money as potential gain?  That very rich people fall from grace in a huge way over small amounts of money defies easy explanation.  Why take a risk that has small upside and massive downside like DennisKozlowski  the former head of Tyco did in trying to avoid sales taxes on some art?   As an analogy:  Why cheat on a spouse with prostitutes when you are in a position of power like Eliot Spitzer?  The answer, of course, is that humans are often emotional rather than logical and understand statistics in a dysfunctional way.  Munger has said that if you think this sort of thing is easily explainable, you do not understand the problem.  Complexity, risk, uncertainty and ignorance are impossible to avoid.

At a small scale reading how to respond when a lack of integrity is uncovered, Munger has said:

“Well in the history of the See’s Candy Company they always say, “I never did it before, and I’m never going to do it again.” And we cashier them. It would be evil not to, because terrible behavior spreads.” <http://72.14.203.104/search?q=cache:3sSZnXLbvQEJ:www.loschmanagement.com/Berkshire%2520Hathaway/Charlie%2520munger/The%2520Psychology%2520of%2520Human%2520Misjudgement.htm+%22charlie+Munger%22+%22the+way+Zeckhauser+plays+bridge%22&hl=en&gl=us&ct=clnk&cd=1>

 Regarding where to draw the line, Munger points out

“We think there should be a huge area between what you’re willing to do and what you can do without significant risk of criminal penalty or causing losses. We believe you shouldn’t go anywhere near that line. You ought to have an internal compass. So there should be all kinds of things you won’t do even though they are perfectly legal. That’s the way we try to operate.” <http://www.fusioninvesting.com/2011/04/david-sokols-honesty-is-the-question/>

Munger makes it clear that he has no desire to buy an otherwise “good” business and they try to find someone to run it:

“We don’t train executives, we find them. If a mountain stands up like Everest, you don’t have to be a genius to figure out that it’s a high mountain.”<http://www.designs.valueinvestorinsight.com/bonus/bonuscontent/docs/Tilson_2006_BRK_Meeting_Notes.pdf#search=%22Charlie%20munger%20and%20foundation%20and%20croupier%22>

The two investors are not interested in investing in a company “turnaround,” since they “seldom actually do.  Charlie hopes that the moat of the company he is investing in is strong enough to survive bad management.  As was discussed in a previous post in this series,  Charlie  would prefer to have a moat that is so strong that it could survive if the company was run by “an idiot nephew.”   Neither Buffett nor Munger is going to buy a business and “let” some friend or relative “run it.” But if they hypothetically did, they would hope that it would still perform adequately as a business due to the moat.

**The Rare Exceptions to the Moat Rule**

Occasionally Munger and Buffett find a person who they can bet on who has such superior talent that they really don’t need much of a moat (regarding moats see my previous post). This situation is rare, but it does happen.

 “Occasionally, you’ll find a human being who’s so talented that he can do things that  ordinary skilled mortals can’t. I would argue that Simon Marks – who was second generation in Marks & Spencer of England – was such a man. Patterson was such a man at National Cash Register. And Sam Walton was such a man. These people do come along – and in many cases, they’re not all that hard to identity. If they’ve got a reasonable hand – with the fanaticism and intelligence and so on that these people generally bring to the party – then management can matter much. However, averaged out, betting on the quality of a business is better than betting on the quality of management. In other words, if you have to choose one, bet on the business momentum, not the brilliance of the manager. But, very rarely, you find a manager who’s so good that you’re wise to follow him into what looks like a mediocre business.” <http://www.valueplays.net/wp-content/uploads/The-Best-of-Charlie-Munger-1994-2011.pdf>

Sometimes, as is the case with Berkshire itself, it is worthwhile to bet on a superior manager.  Charlie has said:

“There are people- very few- worth paying up to get in with for a long term advantage’.   <http://bitly.com/RzDIys>

Buffett has pointed out that the talents of Ajit Jain in the reinsurance business are just such a case. Buffett said at the most recent Berkshire meeting:  “Ajit Jain has created tens of billions of dollars in value for this company out of nothing but brain and hard work. “ That is high praise indeed since there is no mention of any moat in that business.  Wells Fargo as has previously been mentioned is also described by Munger and Buffett as a company that relies mostly on management instead of a moat.  I would disagree since I think being “too big to fail” like Wells Fargo is a form of moat since it gives them an artificially low cost of capital. The CEO of Wells thinks his business is all about execution:

“We always say we could leave our strategic plan on an airplane, somebody could pick it up, and it wouldn’t matter. It’s all about execution.”   <http://management.fortune.cnn.com/2012/11/26/wells-fargo-stumpf/>

Certainly the way Wells Fargo “cross-sells” to existing customers  in order to lower the cost to acquire new business is about great execution, but the bank in my view starts from a base of “too big to fail” which is a moat.

Charlie feels that the management of a company like Costco is a case in which management adds to the company moat. Charlie is a huge fan of Costco’s  James Sinegal for example.  But Munger clearly feels that companies which have managers like Costco are not easy to find.

“I think it’s dangerous to rely on special talents — it’s better to own lots of monopolistic businesses with unregulated prices. But that’s not the world today. We have made money exercising our talents and will continue to do so. I’m glad we have insurance, though it’s not a no-brainer, I’m warning you. We have to be smart to make this work.”  <http://www.valueplays.net/wp-content/uploads/The-Best-of-Charlie-Munger-1994-2011.pdf>

Munger also believes that a skilled manager can sometimes find a relatively safe market niche in some cases:

“I find it quite useful to think of a free-market economy – or partly free market economy – as sort of the equivalent of an ecosystem.  Just as animals flourish in niches, people who specialize in some narrow niche can do very well.”<http://www.thepracticalway.com/2010/12/20/quotes-charlie-munger/>

This strategy is similar to what Professor Michael Porter calls “differentiation.”  It can be workable, but is inherently riskier to find a haven from competition in a niche than to have a moat (it is better to have both).  An example of a niche market where Munger and Buffett find a gem of a management team is Iscar:

“Judging the management at a company like Iscar is easy—those people are enormously talented and wonderful. But, there aren’t many managements like that and few people with the incentive of such intensity.” <http://www.watheeqa.com/App_Themes/watheeqa/pdf/Conversation%20with%20Charlie%20Munger.pdf>

“The reason I got so high on it so fast was that the people are so outstandingly talented. The idea of being in business with them just struck me worth straining for. We didn’t know when we were young which things to stretch for, but by the time we reached Iscar, which we never would have bought when we were young, we knew to stretch for the right people. It’s a hell of a business. Everything is right there. Isn’t it good that we keep learning? Better late than never.” [http://www.tilsonfunds.com/Whitney%20Tilson’s%20notes%20from%20the%202007%20Wesco%20annual%20meeting-5-9-07.pdf](http://www.tilsonfunds.com/Whitney%20Tilson's%20notes%20from%20the%202007%20Wesco%20annual%20meeting-5-9-07.pdf)

This post is getting beyond my self-imposed limit so I will let Bill Gates summarize the Munger/Buffett  management philosophy:

“[Warren’s] penchant for long-term investments is reflected in another aphorism: “You should invest in a business that even a fool can run, because someday a fool will.” He doesn’t believe in businesses that rely for their success on every employee being excellent. Nor does he believe that great people help all that much when the fundamentals of a business are bad. He says that when good management is brought into a fundamentally bad business, it’s the reputation of the business that remains intact. Warren installs strong managers in the companies Berkshire owns, and tends to leave them pretty much alone. His basic proposition to managers is that to the degree that a company spins off cash, which good businesses do, the managers can trust Warren to invest it wisely. He doesn’t encourage managers to diversify. Managers are expected to concentrate on the businesses they know well so that Warren is free to concentrate on what he does well: invest.”  <http://money.cnn.com/magazines/fortune/fortune_archive/1996/02/05/207334/index.htm>

The next post in this series on 25IQ is about Munger’s Methods:  **Charlie Munger on Margin of Safety  (The Fouth  Essential filter).**

# Charlie Munger on “Circle of Competence” (The Second Essential Filter)

[*7*](http://25iq.com/2012/12/22/charlie-munger-on-circle-of-competence-the-second-essential-filter/#comments)

 “We have to deal in things that we are capable of understanding.” Charlie Munger  <http://www.youtube.com/watch?v=3XlBrohrIUc>

**“An Investor’s got to know His or Her Limitations” (Apologies to Clint Eastwood in *Dirty Harry*)**

Charlie believes that investors who get outside of what he calls their “Circle of Competence” can easily find themselves in big trouble.  Within a Circle of Competence a given investor has expertise and knowledge that gives him or her significant advantage over the market in evaluating an investment.

The idea behind the Circle of Competence filter is so simple it is embarrassing to say it out loud: when you do not know what you are doing, it is riskier than when you do know what you are doing.  What could be simpler?  And yet humans often don’t do this.  For example, the otherwise smart doctor or dentist is easy prey for the promoter selling cattle limited partnerships or securities in a company that makes technology for the petroleum industry.

Really smart people fall prey to this problem. As an example, if you lived through the first Internet bubble like I did you saw literally insane behavior from people who were highly intelligent.  Munger has pointed out that even one of the world’s greatest investors stepped outside of his Circle Competence during the bubble:

“Soros couldn’t bear to see others make money in the technology sector without him, and he got killed.”<http://everythingwarrenbuffett.blogspot.com/2009/02/motley-fool-notes-from-2000-berkshire.html>

In many cases so-called “old money” became so upset at Internet  nouveau riche talking about their money and possessions, they jumped in to the market for technology stocks at the worst time possible, with disastrous  results.

Professors who leave their university can make similar mistakes.  Charlie has talked about the Nobel Prize winner who left academia to help found Long Term Capital Management:   “[When] one of the economists who… shared a Nobel Prize … went into money management himself, he sank like a stone.”  Larry Summers, who is a very intelligent and capable person in Charlie’s view, made a huge mistake investing Harvard’s cash account alongside the endowment leaving exposing the university to a huge liquidity risk. That decision by Larry Summers was clearly outside of his Circle of Competence and both he and the university paid the price. As a more current example, a talented venture capitalist who is within his or her circle of competence may not do as well running a macro hedge fund.

One way to think about what Munger is trying to achieve with this Circle of Competence filter is this: if you make fewer mistakes, your investment performance will be better.  So invest in areas where you are competent.  Why would you buy more of X which you know little about when you can buy Y (or more of Y) which is right in your Circle of Competence?  The Circle of Competence approach is in part a form of opportunity costs analysis which will be discussed later in this series of posts.

Munger argues:

“[Warren and I only look at industries and companies which we have a core competency in. Every person has to do the same thing. You have a limited amount of time and talent and you have to allocate it smartly.”<http://www.watheeqa.com/App_Themes/watheeqa/pdf/Conversation%20with%20Charlie%20Munger.pdf>

The value of specialization is, of course, at work here too. Munger in an interview put it this way:

“Warren and I have skills that could easily be taught to other people. One skill is knowing the edge of your own competency. It’s not a competency if you don’t know the edge of it. And Warren and I are better at tuning out the standard stupidities. We’ve left a lot of more talented and diligent people in the dust, just by working hard at eliminating standard error.”<http://mungerisms.blogspot.com/2009/08/stanford-lawyer.html>

The investor Li Lu describes how Charlie arrives at this approach:

“When Charlie thinks about things, he starts by inverting. To understand how to be happy in life, Charlie will study how to make life miserable; to examine how  a business becomes big and strong, Charlie first studies how businesses decline and die; most people care more about how to succeed in the stock market, Charlie is most concerned about why most have failed in the stock market. His way of thinking comes from the saying in the farmer’s philosophy: I want to know is where I’m going to die, so I will never go there.”

<http://blog.enochko.com/2010/06/my-teacher-charlie-munger-english.html>

To make wise decisions, stay away from domains where you will make unwise decisions.

By applying this filter, Munger is trying hard to limit his investing to areas in which he has a significant advantage in terms of competence and not just a basic understanding.  Munger has talked several times in the past about a man who had “managed to corner the market in shoe buttons- a really small market but he had it all.” That’s an extreme example of a very narrow Circle of Competence. The areas in which you might have a Circle of Competence will hopefully be significantly larger than just shoe buttons.  But if you try to expand that Circle of Competence too far, it can have disastrous results.  Li Lu writes about how Charlie has described this “Mungearian” view to him:

“The true insights a person can get in life are still very limited, so correct decision-making must necessarily be confined to your ‘Circle of Competence.’ A ‘competence’ that has no defined borders cannot be called a true competence.” <http://blog.enochko.com/2010/06/my-teacher-charlie-munger-english.html>

In the book *Snowball* Alice Schroeder argues that Buffett:  “believed in what he called the Circle of Competence,  drew a line around himself, and stayed within the three subjects with which he would be recognized as absolutely expert: money, business and his own life. “(P25)  I find Schroder’s conclusion that Buffett and Munger apply the Circle of Competence rule broadly outside of investing to be unconvincing,  especially since Charlie in particular has strong opinions on just about everything.   Warren may be more circumspect about offering his opinions on everything that Charlie, but the topics that are off limits for Buffett at a Berkshire shareholder’s meeting have not been tightly defined to those three topics in the past. When Charlie does express his opinion on a subject like modern academia he does not have money on the table and the Circle of Competence concept does not provide the same restraining effect as when money is involved.

Staying within a Circle of Competence is obviously not rocket science, but it is hard to do when you meet a slick promoter who is highly skilled at telling stories.  This is a case where emotional intelligence, which is very different than IQ, becomes critically important.  Humans love stories since it causes them to suspend disbelief.  Madoff and Ken Lay were  story tellers.  I put this problem in the form of a tweet recently:

“Promoters know muppets love narrative & actual facts detract from desired state of suspended disbelief. Circle of Competence…”

Munger’s advice on why staying within your Circle of Competence is important is direct as is usual:

 “You have to figure out what your own aptitudes are. If you play games where other people have the aptitudes and you don’t, you’re going to lose. And that’s as close to certain as any prediction that you can make. You have to figure out where you’ve got an edge.  And you’ve got to play within your own Circle of Competence.”  <http://www.ritholtz.com/blog/2012/02/a-lesson-on-elementary-worldly-wisdom-as-it-relates-to-investment-management-business/>

Too many investors confuse familiarity with competence.   For example, that a given person may fly on airlines a lot does not mean that they understand the airline industry well enough to be competent as an investor in that industry.  Using Facebook, that does not make you qualified to invested in a social media start up.  If you have not taken a deep dive into the business of a company and its value chain/industry, and you nevertheless decide to invest in that company, you are asking for trouble.

It’s important to ask yourself whether you have a personality that fits with the qualities needed to make your own investment decisions that involve individual stocks bonds and other investments.   Do you enjoy reading extensively about companies you may invest in and their industries? Are you going to be happy spending hours each month doing so?  Or would you rather spend that time playing golf or watching sports on TV?  Do you find doing the work to make yourself a wise investor is fun?  Do you spend more time researching a refrigerator than the stocks you buy?  Is doing due diligence on an investment the sort of thing that makes you genuinely happy.  Or is it like a root canal?

There are some people who know very well how to stay within the Circle of Competence and the Berkshire CEO list has way more than its fair share of these people.  For example, Buffett cites Rose Blumkin of Furniture Mart as a person who fully understands the dimensions of her capabilities:

“[If] you got about two inches outside the perimeter of her Circle of Competence, she didn’t even talk about it.  She knew exactly what she was good at, and she had no desire to kid herself about those things.”  (Snowball at  495).

Knowing the boundaries of your Circle of Competence is critically important.  In Munger’s opinion, if you have to ask the question whether something is within your Circle of Competence, you have already answered your question.  He feels that the answer should be obvious:

“If you have competence, you pretty much know its boundaries already. To ask the question [of whether you are past the boundary] is to answer it.”  <http://www.poorcharliesalmanack.com/pdf/page53.pd> f

Buffett talks about that fact that knowing where the perimeter of your Circle of Competence may be is far more important than the size of your circle.  If you are only competent in spots and stay in those spots you can do just fine, argues Munger.

**Overconfidence, Over-optimism and other Dysfunctional Heuristics**

Why do people invest outside their Circle of Competence?  The answer can be found in what Charlie calls dysfunctional “mental models” which will be discussed in detail in a later post in this series on Munger’s Methods.  As a taste of that what Munger is talking about, I can’t resist inserting on quotation which describes just one dysfunctional overconfidence heuristic:

“In the 5th century B. C. Demosthenes noted that: “What a man wishes, he will believe.” And in self-appraisals of prospects and talents it is the norm, as Demosthenes predicted, for people to be ridiculously over-optimistic. For instance, a careful survey in Sweden showed that 90 percent of automobile drivers considered themselves above average. And people who are successfully selling something, as investment counselors do, make Swedish drivers sound like depressives. Virtually every investment expert’s public assessment is that he is above average, no matter what is the evidence to the contrary.”

<http://72.14.203.104/search?q=cache:mgSaxC3O1IoJ:www.philanthropyroundtable.org/magazines/1999/march/munger.html+Berkshire+Hathaway%27s+vice+chairman+shreds+the+conventional+wisdom+on+foundation+investing&hl=en&gl=us&ct=clnk&cd=1>

Berkshire itself has sometimes failed to properly apply the Circle of Competence filter as has its portfolio companies.  As was explained in the first post in this series, Berkshire makes mistakes like everyone else.  Buffet arguably was out of his Circle of Competence in the 1960s when he bought the department stores and then bought Associated Cotton Shops which sold women’s dresses.  Dexter Shoes is another case where Berkshire wandered outside its Circle of Competence and was badly burned as a result

One example of a Berkshire portfolio straying from its Circle of Competence principle happened in the case of their most profitable insurance company according to Munger.

“[GEICO] got to thinking that, because they were making a lot of money, they knew everything. And they suffered huge losses. All they had to do was to cut out all the folly and go back to the perfectly wonderful business that was lying there.” <http://ycombinator.com/munger.html>

Munger himself may have fallen prey to this with his investment in BYD as was discussed in a previous post in this series.  Did Charlie really know enough about BYD for it to fall within his Circle of Competence?  How is BYD not a technology Company?  All Berkshire companies use technology, but BYD is trying to solve technology problems that are core to its business.  It can be argued in investing in BYD Charlie was just having a lot of fun in an exotic country and got carried away.

In using a Circle of Competence filter,  Munger is trying to invest only when he has an unfair advantage.  Otherwise, he wants to do nothing (which most people find very hard to do).

“The game of investing is one of making better predictions about the future than other people. How are you going to do that? One way is to limit your tries to areas of competence. If you try to predict the future of everything, you attempt too much.”<http://www.normanrentrop.de/de/gefunden/index_20602.html>

In short, Charlie is looking for betting odds which are **substantially**in his favor when making an investment.  And when he finds such a situation, he bets big.  Otherwise he doesn’t bet.  It’s that simple.  A future post in this series on Munger’s Methods will deal with just that basic idea.

What is critical in following this approach is patience:

“We have this investment discipline of waiting for a fat pitch. If I was offered the chance to go into business where people would measure me against benchmarks, force me to be fully invested, crawl around looking over my shoulder, etc., I would hate it. I would regard it as putting me into shackles.” <http://www.tilsonfunds.com/motley_berkshire_brkmtg03notes.php3>

Doing nothing is a very hard thing for most people to do.  People for some reason think there is a bonus of some sort for activity in investing when there most certainly is not.  In fact, there is a penalty on being overactive due to costs and expenses.

**A Clear View of a Low Downside and a Big Upside**

Munger does not like situations where there is a “close” investment decision  to make.

“There are a lot of things we pass on. We have three baskets:  in, out, and too tough… We have to have a special insight, or we’ll put it in the ‘too tough’ basket. All of you have to look for a special area of competency and focus on that.” <http://www.fool.com/news/foth/2002/foth020515.htm>

And certainly, Munger would not invest in anything with a big downside and little upside.  One of the best ways I have ever heard the idea behind Charlie’s philosophy expressed  was by the famed investor Sam Zell.

“Listen, business is easy. If you’ve got a low downside and a big upside, you go do it. If you’ve got a big downside and a small upside, you run away. The only time you have any work to do is when you have a big downside and a big upside.”<http://www.latimespressmen.com/showthread.php?p=1525>

In terms of finance theory, what a smart investor is looking for is “optionality.” Nassim Taleb puts what the smart investor is looking for in this way: “Payoffs [which] follow a power law type of statistical distribution, with big, near unlimited upside but because of optionality, limited downside.” Venture capitalists who are “antifragile” benefit from optionality. Investment  bankers, who are “fragile” still are able to do this by being too big to fail and therefore socializing the big downside tail risk (i.e., get the taxpayers to pick up the losses from tail risk).

Charlie and Buffett want the financial upside to be big and clear enough that they can do the math in their heads.  Munger said at a Berkshire meeting once:

“Warren talks about these discounted cash flows. I’ve never seen him do one.”  [“It’s true,” replied Buffett. “If (the value of a company) doesn’t just scream out at you, it’s too close.”] 1996 Berkshire Hathaway Annual Meeting<http://www.ndir.com/SI/email/q403.shtml>

Of course, Buffett and Munger can do more mathematics in their heads that an average person can do on a calculator, but the point remains.  Munger and Buffett want the mentally computable math to be overpoweringly clear and positive.  Bill Gates has said on this point:

“… being good with numbers doesn’t necessarily correlate with being a good investor. Warren doesn’t outperform other investors because he computes odds better. That’s not it at all. Warren never makes an investment where the difference between doing it and not doing it relies on the second digit of computation. He doesn’t invest–take a swing of the bat–unless the opportunity appears unbelievably good.”  <http://money.cnn.com/magazines/fortune/fortune_archive/1996/02/05/207334/index.htm>

**Technology Investments and the Circle of Competence**

The technology sector is one area which Munger and Buffett have avoided since they feel they don’t understand the business well enough to predict where it will be many years down the road.  Munger received his first taste in the technology business when he bought into an oscilloscope company early in his investing career.  His top scientist was hired away by a venture capitalist and then magnetic tape came along and made things even worse.  Charlie has said the entire experience nearly made him “go broke.”

Munger’s reluctance to invest in the technology sector is not a new phenomenon:

“Warren and I don’t feel like we have any great advantage in the high-tech sector.  In fact, we feel like we’re at a big disadvantage in trying to understand the nature of technical developments in software, computer chips or what have you. So we tend to avoid that stuff, based on our personal inadequacies. Again, that is a very, very powerful idea. Every person is going to have a Circle of Competence. And it’s going to be very hard to advance that circle. If I had to make my living as a musician – I can’t even think of a level low enough to describe where I would be sorted out to if music were the measuring standard of the civilization.”<http://ycombinator.com/munger.html>

Berkshire recently bought a significant stake in IBM, but in that case the company has really transitioned from a technology company to a provider of services.   Munger has said that “IBM is easier to understand than Google or Apple.  It is a bit ironic that Berkshire invested in IBM given that Charlie said in 1994:

“In terms of blowing it, IBM is some example. Those were brilliant, disciplined people. But there was enough turmoil in technological change that IBM got bounced off the wave after “surfing” successfully for 60 years. And that was some collapse—an object lesson in the difficulties of technology and one of the reasons why Buffett and Munger don’t like technology very much. We don’t think we’re any good at it, and strange things can happen.”   <http://ycombinator.com/munger.html>

Munger’s personal decision regarding does not mean that the technology sector is not right for other people who do have a Circle of Competence that includes technology.  When asked recently about where they would start their career over again if they were just starting out today both Munger and Buffett answered: technology (one of them added energy as an alternative).

Technology presents additional challenges since uncertainty is high and the speed of innovation faster.     Buffett has said: “Predicting the long-term economics of companies that operate in fast-changing industries is simply far beyond our perimeter.”  In my view an investor can cope with that difference by being careful about his or her Circle of Competence within technology. To know a lot about graphics chips is not necessarily to know much about wireless data for example.   To think otherwise is to tempt fate.  As Clint Eastwood asked in the movie *Dirty Harry* if you break the Circle of Competence rule:   “You’ve got to ask yourself one question:  Do I feel lucky? Well, do ya, punk?”

**Learn Continuously:  Read, Read, Read**

“You don’t have to pee on an electric fence to learn not to do it” said Munger on one occasion.  At the most recent Berkshire meeting he quipped: “Learning from other people’s mistakes is much more pleasant.  The best way to do this is simple:  When in doubt, read so you can learn vicariously.  Charlie loves to talk about the importance of reading:

“In my whole life, I have known no wise people (over a broad subject matter area) who didn’t read all the time – none, zero. You’d be amazed at how much Warren reads – at how much I read. My children laugh at me. They think I’m a book with a couple of legs sticking out.”  <http://www.quoteswise.com/charlie-munger-quotes-2.html>

We read a lot.  I don’t know anyone who’s wise who doesn’t read a lot.”  <http://www.tilsonfunds.com/brkmtg04notes.doc>

“Develop into a lifelong self-learner through voracious reading; cultivate curiosity and strive to become a little wiser every day.” <http://www.valuewalk.com/charlie-munger-page/>

The other related point is: success is a lousy teacher.  Sometimes what seems like success was mostly luck. On that I suggest you read Mauboussin’s book The Success Equation .  <http://www.amazon.com/Success-Equation-Untangling-Business-Investing/dp/1422184234/ref=la_B001HCX42G_1_1?ie=UTF8&qid=1354820111&sr=1-1>

The next post in this series on *25IQ* is about Munger’s Methods:  **Charlie Munger on Management With Talent and Integrity (The Third Essential Filter)**

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**Charlie Munger on Moats (First of the Four Essential Filters)**

[*13*](http://25iq.com/2012/12/06/charlie-munger-on-moats-first-of-the-four-essential-filters/#comments)

If there is anything fundamental about what Charlie Munger has learned about business it is this:

“The difference between a good business and a bad business it is that good businesses throw up one easy decision after another. The bad businesses throw up painful decisions time after time.”  <http://bit.ly/S5iN7K>

Why do some businesses create easy decisions?  The answer lies in microeconomics: if there is no significant “barrier to entry” which creates what Harvard Business School Professor Michael Porter calls a “sustainable competitive advantage” (a “moat” in Berkshire parlance), competition will cause return on investment for that business to drop to opportunity cost and there will be no economic profit for the producer.  The analogy they use at Berkshire is that the business itself is the equivalent of the “castle” and the value of that castle will be determined by the strength of the “moat.”

The need for a business to have a “moat” is so strong that Munger has made it one of the **“four essential filters”** he uses in deciding whether to invest in a given business. The **four essential filters** are:

1. A business with a moat,
2. A business that can be understood by the investor,
3. Management in place with integrity and talent, and
4. A business that can be bought at an attractive price that gives an attractive margin of safety.  <http://www.psyfitec.com/2009/10/buffett-and-munger-on-bbc.html>

Before examining each of these **four essential filters** one-by one, it is important to point out that these **“four skills”** below which relate to moats are very different that the **four essential filters** themselves:

1. **Creating a moat** which is something that people like Ray Kroc, Sam Walton Estee Lauder, Mary Kay Ash and Bill Gates have accomplished. Moat creation requires superior management skill always combined with some degree of luck.  It is theoretically possible to acquire a moat with no management talent and just luck but I can’t think of an example of this ever happening. Sometimes people who are fantastic managers who have the ability to create a moat have very poor skills when it comes to investing. Stock promoters love these people since they are big targets for scams.
2. **Identifying a moat that others have created**which is something that people like Charlie Munger and Warren Buffett can do.  Munger admits that he and Warren Buffett buy moats rather than build them since building them is not something they do particularly well.  In addition to a moat Charlie insists that there be a talented management team already in place. For an investor who buys moats instead of creating one, the existence of a moat has special value since they can sometimes survive financially even if management talent does not deliver as expected or if they leave the business.
3. **Identifying a startup that may acquire a moat before it is evident**which is something that some venture capitalists can do at a sufficiently high level of probability that they can generate an attractive return on capital overall. This skill is very rare as evidenced by the fact that the distribution of returns in venture capital is a power law. Moats that emerge from complex adaptive systems like an economy are hard to spot since a moat is something that greater than the sum of the parts emerging from something else that is greater than the sum of its parts. In contrast, a moat being destroyed is easier to spot since it is a process of something transforming into nothing.
4. **Describing a moat in academic terms which**is something that someone like Michael Porter can do. Why this is a rare talent in academia is a puzzle. The reason for this is that simple theories are not the sort of things that will get a person a tenured faculty position. This essay could go on for many pages quoting Munger railing about deficiencies in academia.  Here are just two:

“I was recently speaking with Jack McDonald, who teaches a course on investing rooted in our principles at Stanford Business School. He said it’s lonely — like he’s the Maytag repairman.”  <http://www.fool.com/boringport/2000/boringport00051500.htm> “

Warren once said to me, “I’m probably misjudging academia generally [in thinking so poorly of it] because the people who interact with me have bonkers theories.” … We’re trying to buy businesses with sustainable competitive advantages at a low – or even a fair price.  The reason the professors teach such nonsense is that if they didn’t], what would they teach the rest of the semester?”

<http://www.tilsonfunds.com/motley_berkshire_wescomeetings.php>  (2004)

Each of these four skills which relate to moats is very different and it is unusual for a person to have all four skills. Many people just have one. More importantly, well over 90% of the population of the world has none of these skills. Tragically for them, the population that thinks they have this set of skills is far higher than 10%.  For society, this overconfidence is valuable since “even a blind squirrel finds a nut once in a while” via luck.

Merely because a person can identify that a given company has a moat does not mean that they have any ability to create a moat as a manager. At the 2012 Berkshire meeting Munger admitted that the brand-based moats which Berkshire has are bought rather than created.  The ability to spot a moat that someone else created is very different from the ability to create a moat, believes Munger.  You don’t need to know how to make hamburgers to spot that McDonald’s’ has a moat, but don’t try to build a business like McDonald’s without the abilities that Ray Kroc had.

At the 2012 Berkshire meeting Charlie said:

“We buy barriers. Building them is tough… Our great brands aren’t anything we’ve created. We’ve bought them. If you’re buying something at a huge discount to its replacement value and it is hard to replace, you have a big advantage. One competitor is enough to ruin a business running on small margins.” <http://gongol.com/research/berkshire/2012/>

Sometimes great managers can transition to become great venture capitalists and sometimes not.  As another example, Michael Porter has done a great job taking some fundamental ideas from microeconomics and introducing it to business schools, but I would not give him five cents to start a business or invest money on my behalf. Perhaps he is a good manager or investor but I have zero data to indicate that this might be true other than he has described some important principles in an academic way.

Recently someone argued on a blog that because some academics affiliated with Michael Porter’s theory on sustainable competitive advantage do not have the management skill required to create a moat themselves, that “sustainable competitive advantage simply doesn’t exist” other than created by government regulation. <http://www.forbes.com/sites/stevedenning/2012/11/20/what-killed-michael-porters-monitor-group-the-one-force-that-really-matters/>  First and most importantly, as will be explained below, the test of whether a moat exist is quantitative (it is a 100% math-based test). The simple of mathematics reveals that many companies have moats in many sectors of the economy that have existed for many years.  Second, as I have explained above, not everyone has all**four skills** that relate to moats. That a team of academics can’t create a moat does not mean sustainable competitive advantage does not exist. The act of successfully creating a moat is a rare event. Berkshire’s portfolio of companies alone (e.g., See’s Candies) proves that moats are sustainable for a very long time. Google and Oracle are just two of many companies that have generated **sustained** profitability that meets the test for a moat.

The blogger’s own thesis is that companies should continuously innovate instead. That Porter’s work would not support the need to constantly innovate, create new value or disrupt your own business is a baffling conclusion. The two issues are orthogonal.  The thesis that Clayton Christensen’s work invalidates the work of his fellow professor at Harvard Business School Michael Porter is simply false. That profit is **hard**to sustain does not mean that it is **impossible** to sustain. Nowhere does Michael Porter say that a moat can be maintained forever.

The blogger’s thesis also suffers in that it has no predictive power.  It is consistent with the sort of promotion that you see around hyped IPOs. “It’s disruptive!” is not a substitute for profit unless your goal is to flip the business to someone else.   Disruption alone without anything behind it is the management equivalent of EBITDA.

Clayton Christensen’s work around disruptive innovation is super important and wise (you will see links to it below), but don’t kid yourself that disruption without a moat will necessarily lead to actual GAAP profit.  Disruption is a fantastic place to look for profit whether the business is a startup or an established business, but sometimes profit is just not there.  If you don’t have a moat somewhere and are unable to flip your company to a greater fool or a company that is already profitable who needs it for defensive reasons, you will soon fall prey to the only unforgivable sin in business: running out of cash. Giving away everything for free while generating zero profit is at best an interim strategy or a description of the Java business model that Sun adopted.

Do some companies create something so disruptive that benefits consumers so much that someone must buy that service or product to stay competitive even though it generates no incremental profit?  Absolutely. But in such a case only consumers benefit since only positive outcome is the creation of**consumer** surplus. **Producer**surplus for that disruptive innovation can be zero or less than zero. That is part of the reason why capitalism benefits consumers. To offer a “loss leader” you must in the medium term at least have a base business that generates a profit that is tied to that loss. But I am getting ahead of myself.  You can read more on disruption in a futurepost.

Returning to the discussion of the four essential filters, whether a business has a durable moat is without question the most important filter for an investor like Charlie whose chosen profession is buying moats. For example, Charlie describes a moat in three different ways immediately below, each emphasizing the importance of the moat being able to maintain itself over time.

“We have to have a business with some inherent characteristics that give it a **durable competitive advantage**.”<http://www.youtube.com/watch?v=3XlBrohrIUc>

“The number one idea is to view a stock as an ownership of the business and to judge the **staying quality** of the business in terms of its **competitive advantage**.” <http://www.valuewalk.com/charlie-munger-page/>

“We’re trying to buy businesses with **sustainable competitive advantages** at a low – or even a fair price.”

Charlie may reference another of the four essential filters in a statement but invariably the requirement of a moat is present in his statement. My belief is that of the four filters, nothing is more essential than moat. The second filter is about reducing the number of mistakes made and filters three and four essentially layer on a “margin of safety” when making an investment. In other words, moats are the foundation of Munger’s investment process and methodology.  Everything starts with the moat (or lack of a moat) for Charlie because he does not create moats, he buys them.

**Components of a Moat:**

Munger has not explained his theories on what causes a moat as comprehensively as Warren Buffett, but he has made some comments that point people in the right direction.  In addition there are all the companies in the Berkshire portfolio that illustrate what a moat is, like Geico, Burlington Northern, See’s Candies.

The primary components of a moat that Charlie has talked about are as follows:

**1. Supply-Side Economies of Scale**

There are two types of “economies of scale” and the first is supply-side economies of scale.  A large firm that is part of an oligopolistic market will generate  significant supply-side economies of scale in its production of goods and services as per-unit costs fall with increasing output.  Due to factors like the difficulty of managing large firms, economies of scale ar exhausted well before those firms from dominate the entire market.” The economists Varian and Shapiro in their book *Information Rules* write about supply-side economies of scale via an example: “Despite its supply-side economies of scale, General Motors never grew to take over the entire automobile market.”

Samsung is reaping the benefits of supply-side economies of scale as does Intel. Clayton Christensen argues that the worship false accounting gods like RONA have caused many companies to outsource tasks like the semiconductor fabrication and lose important supply- side economies.  He argues that outsourcing has harmed many companies in the long-term even though in the short-term it may have seemed wise. <http://gartner.mediasite.com/mediasite/play/9cfe6bba5c7941e09bee95eb63f769421d>

In Charlie’s view Wal-Mart has massive supply-side economies of scale through its investments in distribution and other systems. These and other Wal-Mart investments have given the company a moat. Wal-Mart also possesses a high degree of operational effectiveness which adds it its profitability. Like Wal-Mart companies which operate huge steel plants and shipyards can have supply-side economies of scale. Markets like these tend to end up as part of an oligopoly since supply-side advantages only go so far to consolidate an industry.

Munger described two different supply-side economies of scale below:

“On the subject of economies of scale, I find chain stores quite interesting. Just think about it. The concept of a chain store was a fascinating invention. You get this huge purchasing power — which means that you have lower merchandise costs. You get a whole bunch of little laboratories out there in which you can conduct experiments. And you get specialization. If one little guy is trying to buy across 27 different merchandise categories influenced by traveling salesmen, he’s going to make a lot of dumb decisions. But if you’re buying is done in headquarters for a huge bunch of stores, you can get very bright people who know a lot about refrigerators and so forth to do the buying. The reverse is demonstrated by the little store where one guy is doing all the buying. So there are huge purchasing advantages.

Some [supply-side advantages] come from simple geometry. If you’re building a great circular tank, obviously as you build it bigger, the amount of steel you use in the surface goes up with the square and the cubic volume goes up with the cube. So as you increase the dimensions, you can hold a lot more volume per unit area of steel. There are all kinds of things like that where the simple geometry – the simple reality – gives you an advantage of scale.”  <http://ycombinator.com/munger.html>

Munger explains below how changes that have taken place in the advertising industry, which perhaps explain why Procter & Gamble has started to struggle more than it has in the past in delivering the same level of profitability:

“You can get advantages of scale from TV advertising. When TV advertising first arrived – when talking color pictures first came into our living rooms – it was an unbelievably powerful thing. And in the early days, we had three networks that had whatever it was – say 90% of the audience. Well, if you were Procter & Gamble, you could afford to use this new method of advertising. You could afford the very expensive cost of network television because you were selling so damn many cans and bottles. Some little guy couldn’t. And there was no way of buying it in part. Therefore, he couldn’t use it. In effect, if you didn’t have a big volume, you couldn’t use network TV advertising – which was the most effective technique. So when TV came in, the branded companies that were already big got a huge tail wind.”  <http://ycombinator.com/munger.html>

This may also explain in part why Berkshire has dropped its stake in Johnson and Johnson to very low levels. Johnson and Johnson has been a lagging performer for Berkshire and is now out of favor with Munger and Buffett.

Although Berkshire was a bit late to appreciate the attractiveness to an investor of the railroad business, Munger and Buffett clearly value the moat that supply-side economies scale creates in the railroad business.  A new competitor in the railroad business is highly unlikely.  As the public roads deteriorate as the United States underinvests in infrastructure and energy prices rise, railroads will get even more competitive.  Munger has said:

“Do you know what it would cost to replace Burlington Northern today? We are not going to build another transcontinental. And those assets are valuable, have utility. Now they want to raise diesel prices on trucks. … We finally realized that railroads now have a huge competitive advantage, with double stacked rail cars, guided by computers, moving more and more production from China, etc. They have a big advantage over truckers in huge classes of business. <http://www.valueplays.net/wp-content/uploads/The-Best-of-Charlie-Munger-1994-2011.pdf>

Railroads are interesting in that long ago they were a growth industry that both created great fortunes and great busts in the aftermath of that success. There were times in history when railroads were very lousy investments.

Regarding the impact of supply-side economies of scale Charlie has pointed out:

“In some businesses, the very nature of things cascades toward the overwhelming dominance of one firm. It tends to cascade to a winner take all result. And these advantages of scale are so great, for example, that when Jack Welch came into General Electric, he just said, ‘to hell with it. We’re either going to be number one or two in every field we’re in or we’re going to be out’. That was a very tough-minded thing to do, but I think it was a correct decision if you’re thinking about maximizing shareholder wealth.”

Berkshire has recently sold nearly all of its shares in GE, which is a reminder that moats come and go as time passes and conditions change.  People who follow Munger and Buffett might have laughed not too long ago if someone were to have predicted that GE would lose favor with Berkshire.

**2. Demand-side Economies of Scale (Network Effects):**

Demand-side economies of scale (also known as “network effects”) result when a product or service becomes more valuable as more people use it. Unlike supply-side economies of scale, network effects can be (1) nonlinear and (2) continue to accrue to benefit the company for far longer. Given a choice between supply-side economies of scale and demand-side economies of scale, it is preferable to have the latter. Varian and Shapiro in their book *Information Rules* write:  “Unlike the supply-side economies of scale, demand-side economies of scale don’t dissipate when the market gets large enough.”

eBay, Craigslist, Twitter, Facebook and other multi-sided markets have demand-side economies of scale that operate on their behalf. My view is that ESPN also has demand-side economies of scale, most notable for Sports Center, since the more people who watch the ESPN channels, the more valuable the channels are to each user since those particular images will be the basis of discussion for sports fanatics.  Fox and other sports channels just can’t replicate that demand side effects since when someone says “did you see X do Y in the Z game?” If you watched Fox version of Sports Center, you may not have seen the particular video clip.

Google has at least two beneficial demand-side economies of scale (one for search and one for advertising targeting) that are mutually reinforcing that give it a strong moat according. Munger has said:

“Google has a huge new moat. In fact I’ve probably never seen such a wide moat.”  <http://seekingalpha.com/article/140485-would-buffett-consider-google-a-great-investment>

“I don’t know how you displace Google but a lot of the other companies will have competitive troubles.” <http://www.investingdaily.com/11313/google-up-13-on-great-earnings-and-google-is-facebook-in-trouble>

Some companies have both demand and supply-side economies of scale. Amazon has both supply-side and demand-side economies of scale and they reinforce each other. For example, the more people who provide comments on Amazon the more valuable it becomes to other users due to demand-side economies. Amazon also has huge advantages on warehouses and the supply chain on the supply-side.

There are both weak and strong supply-side demand-side economies of scale and they fall along a continuum in terms of relative strength.  Most companies have both supply-side and demand-side economies.  The “holy grail” for an entrepreneur is demand-side economies of scale that can cause a market to “tip” and give almost the entire market to one company. The reality is that most demand-side economies do not cause a market to “tip.” For example, GM’s cars were better to a degree at one point since the more people who owned the cars, the easier auto parts were to get, but weak demand-side economies like that were not strong enough to make the market “tip.”

If a market does “tip” and a competitor is the one to reap those benefits, things can go really wrong, really fast. For example, MySpace started to monetize before the social networking market “tipped” and MySpace paid the price and Facebook reaped the rewards.  Facebook held off monetizing until its moat was secure.  Zuckerberg was patient about waiting for the market to tip and Rupert Murdoch was not.

One illustrative example can be found in the cement industry. Cemex’s cement business gets better the more trucks it has in play in a given geographic area. The service gets cheaper with supply-side scale due to lower COGS (e.g., less gas consumed), it gets better (faster delivery times) due to demand-side economies.  And that combination of supply and demand-side economies creates a barrier to entry that helps Cemex.

Which came first, the faster supply of cement to contractors due to more plants (the egg) or greater demand from contractors due to faster delivery times (the chicken)?  I believe  Cemex intentionally created an egg, knowing there would be greater demand for the service.  This solution to the “chicken and egg” problem is typical in multi-sided markets. However, in this case the Cemex demand-side economies were not strong enough to make their market for cement tip.

My thesis about Chinese restaurants is similar: When you have more customers for Chinese food, the food turns over faster and so it is fresher and better, holding the level of cooking constant. More customers for Chinese food not only lowers cost of goods sold (COGS) since they buy in volume, but increases quality.   But a market like this is not going to tip

As another example, Costco is a better value the more its “store geographic scope” and density increases since I can, for example, use it when visiting relative in another state. Costco also has supply-side economies of scale. Since a market like Costco is in is not going to tip and so oligopoly is likely.

It could be argued that Cemex, GM and Chinese restaurants with high volumes have some demand-side economies of scale in addition to their supply-side economies of scale.   But the demand-side economies are not strong enough to tip to one dominant supplier. Lots of other industries are similar. Credit card markets did not tip enough to prevent multiple providers.  Car rentals did not tip and are instead an oligopoly.

Supply-side economies of scale can be really powerful. The jet turbine makers have  supply-side advantages that makes them very profitable. Are there advantages to customers of easier access to parts if they buy a Rolls Royce jet turbine that might create some demand-side benefits? Sure. But can China open its checkbook and create a new jet engine competitor? I think so. In the case of jet turbines supply-side benefits are strong,  but demand-side benefits are weak.

American Express is another company in the Berkshire portfolio with demand-side economies of scale since the more merchants accept their card the more valuable the service gets and the more people who use the card the more valuable the services is for merchants. Munger continues to believe American Express has a moat despite the rise of upstarts like Square.

“It would be easier to screw up American Express than Coke or Gillette, but it’s an immensely strong business.”  <http://www.fool.com/boringport/2000/boringport000501a.htm>

Visa has a similar moat to American Express as does PayPal.  But challengers like Square may change the game enough to take significant share.  eBay’s moat is definitely demand-side driven on its original business as well.

A company having beneficial network effects is only one dimension that impacts profit. Sometimes network effects are there but the market is small since it is a niche. Amazon’s market is bigger and that matters greatly in terms of the market capitalization it can generate. Some network effects are very strong like Google’s and sometimes they are weaker like for web sites that crowd source reviews which contain a lot of noise that is hard to automate out.

**3. Brand**

At the 2011 meeting of Wesco held just before it was merged into Berkshire Hathaway, Munger admitted that he and Buffett really did not understand the value of a brand until they bought See’s Candies.  The two investors found after they bought See’s Candies they could regularly raise prices and customers did not seem to care. Buffett and Munger call this ability “pricing power.” Munger notes that before See’s Candies:

“We didn’t know the power of a good brand. Over time we just discovered that we could raise prices 10% a year and no one cared. Learning this changed Berkshire. It was really important.”  <http://theinvestmentsblog.blogspot.com/2011/07/final-wesco-meeting-morning-with.htm>

See’s Candies is also a great A/B test on brand power. To illustrate, if you grew up in a home that bought See’s Candies (mostly on the West Coast, especially in California) and experiences around that candy have very favorable associations, you will pay more for that boxed candy brand.

Someone who grew up in the east cost of the United States is going to shop for boxed candy and not attribute much value to the brand since they do not have those same experiences. For this reason, See’s has found it hard to expand regionally and has done so very slowly..

See’s Candies can also only sell so much candy at that price given the choices it has made. People don’t usually go to a See’s Candies store because they are hungry for food.  The box/gift candy business is very seasonal. What See’s sells is not just food, but rather an experience.  See’s generates losses two quarters a year and makes all its profit in the other two quarters around three holidays.

Buffett talks about the fact that building some brands took many decades:

“When you were a 16-year-old, you took a box of candy on your first date with a girl and gave it either to her parents or to her.  I California the girls slap you when you bring Russell Stover, and kiss you when you bring See’s.”… “I don’t think See’s means anything to people on the East Coast, where people are also exposed to higher-end chocolate products.”  <http://management.fortune.cnn.com/2012/08/22/sees-candies-buffett-berkshire/>

While some of the power of a brand can come from taste, modern “flavor” firms can replicate most any taste.  Trade dress and presentation of a good or service matters more than ever. A lot of Tiffany’s brand power is the blue box the jewelry comes in. Coke made a massive mistake thinking it was flavor in a blind taste test that mattered when it introduced the New Coke. When the taste test is not blind Coke wins and when it is blind Coke does not win.  Munger said once about the New Coke episode:

“[Coke spent] 100 years getting people to believe that trademark had all these intangible values too. And people associate it with a flavor…. Pepsi was within weeks of coming out with old Coke in a Pepsi bottle, which would’ve been the biggest fiasco in modern times. Perfect insanity.” <http://www.rbcpa.com/Mungerspeech_june_95.pdf>

Although it is not currently doing as well financially as it has in the past, Charlie has admired Procter & Gamble since:

“They just make a fortune on some of the body products. Some of these brands, I mean, if you can make something that actually improves the skin, wow. That’s the last thing people will give up”. <http://management.fortune.cnn.com/2012/08/22/buffett-munger-berkshire>

As was noted above, it can be argued that TV does not give Procter & Gamble the same benefits supply-side economies in television since post Internet there are so many ways to advertise that do not require supply-side scale. The argument would be that smaller firms and store brands are making big inroads by using new forms of marketing and Procter & Gamble suffers from that new competition as their brand is weakened.

As another example, Charlie said once that customer loyalty to Costco is a big part of their moat:

“If you get hooked on going to Costco with your family, you’ll go there for the rest of your life.”    <http://bitly.com/YsZny5>

I am skeptical that “getting hooked” is a brand advantage and instead suspect that Costco’s moat is more about great business execution by Costco plus supply-side economies of scale. The Costco brand is valuable, but not enough by itself to fully explain its profitability. Most moats are caused by multiple factors. Clayton Christensen  makes a very powerful argument that companies like Costco, Zara and Ikea create a moat by integrating around “a job” that a customer need to get done. You can hear Clayton make that argument here in this video:  <http://gartner.mediasite.com/mediasite/play/9cfe6bba5c7941e09bee95eb63f769421d> It sounds similar to arguments that Michael Porter makes about the value of integration of all the aspects of what a company does, but around a task. Perhaps Berkshire believes that this is a source of a moat for Well Fargo.

A moat powered by a brand is something very different from one created via supply-side economies of scale. For example, Warren Buffett has said that for a company like Disney when the brand is mentioned in conversation “you have something in your mind.”  He adds:

“How would you try to create a brand that competes with Disney?  Coke is a brand associated with people being happy around the world. That is what you want to have in a business. That is the moat. You want that moat to widen.”  <http://investdigest.blogspot.com/2005/12/untapped-pricing-power-and-share-of.html>

One company that is puzzling is the eyeglass maker Luxottica’s (brands like Ray-Ban, Oakley, Persol and other major brands). How that eyeglass company can have that much market share since it has so many brands is unusual. There must be supply-side economies that are driving that business. I just don’t see any real significant demand-side economies that might explain Luxottica’s level of success. Could is be that they reap a lot of benefits from organization around a job a customer need to get done.  Perhaps, but that seems to be a stretch.

Brands of course can fail over time. Put a luxury brand on a table or shelf in Costco as some have done and that luxury brand is damaged. License it too broadly and the brand is also damaged. Buffett and Munger see attracted to brand that they use in their own lives.  See’s and Dairy Queen are just two examples.

Some brands incur problems with their brand that are completely self-inflected. Buffett went on to say about one his most favorite brands:

“Take See’s candy. You cannot destroy the brand of See’s candy. Only See’s can do that. You have to look at the brand as a promise to the customer that we are going to offer the quality and service that is expected. We link the product with happiness. You don’t see See’s candy sponsoring the local funeral home. We are at the Thanksgiving Day Parades though.” <http://www.buffettfaq.com/>

Regarding brand power, the two Berkshire leaders have often cited Wrigley’s as a brand that creates strong moat. Munger has pointed out:

“The informational advantage of brands is hard to beat.   And your advantage of scale can be an informational advantage. If I go to some remote place, I may see Wrigley chewing gum alongside Glotz’s chewing gum. Well, I know that Wrigley is a satisfactory product, whereas I don’t know anything about Glotz’s. So if one is $.40 and the other is $.30, am I going to take something I don’t know and put it in my mouth – which is a pretty personal place, after all – for a lousy dime? So, in effect, Wrigley, simply by being so well-known, has advantages of scale – what you might call an informational advantage.

Everyone is influenced by what others do and approve.   Another advantage of scale comes from psychology. The psychologists use the term “social proof”. We are all influenced – subconsciously and to some extent consciously – by what we see others do and approve. Therefore, if everybody’s buying something, we think it’s better. We don’t like to be the one guy who’s out of step. Again, some of this is at a subconscious level and some of it isn’t. Sometimes, we consciously and rationally think, “Gee, I don’t know much about this. They know more than I do. Therefore, why shouldn’t I follow them?” All told, your advantages can add up to one tough moat.”  <http://www.valueplays.net/wp-content/uploads/The-Best-of-Charlie-Munger-1994-2011.pdf>

A very important test for Buffett and Munger  in determining the strength of a brand- based moat is whether a competitor can replicate or weaken the moat with a massive checkbook. As just one example, here is what Buffett said about Coke at the 2012 Berkshire meeting: “If you gave me $10, $20, $30 billion to knock off Coca-Cola, I couldn’t do it.”

Firms like Nike and BMW each have brands that help maintain their moat that were hard to get and super valuable to have. The creation of a great brand is a rare thing and requires considerable skill and arguably a big dose of luck as well.  Charlie has pointed out: “China has great companies already. Just not great brand names yet.”  I would quibble with Munger’s conclusion in that the Huawei brand is already strong already in certain business markets.  And Chinese firms ZTE and Huawei are making brand inroads in mobile phones. China will in my view surely have many strong global brands over the long-term.

**4. Regulation:**

There are certain businesses which have created a competence with regard to regulation that is so high that regulation actually serves as a barrier to entry/moat for their competitors.  Rather than helping consumers in these cases on a net basis regulations can end up protecting producers and creating a moat.  For example, some people believe banks have created such a powerful layer of regulatory expertise that the regulators have become “captured” by the industry they regulate.  There are a number of professional; guilds like lawyers who have been able to use regulation to limit supply.

For Berkshire, the regulation-driven moat that Moody’s had in the bond rating business was a big attraction. To issue bonds regulators actually require that the issuer get an opinion from a very small number of bond rating firms which means the rating firms Moody’s, S&P and Fitch have a moat. Fannie and Freddie also had regulatory created moats, but the result for them in the end was not good.

When regulation disappears, it often becomes quickly evident that it was a major factor in industry profitability. You find out who is otherwise swimming naked when the regulatory-driven moat disappears. For example, said Munger:

“[Airline] Competition was so intense that, once it was unleashed by deregulation, ravaged shareholder wealth in the airline business”<http://www.valueplays.net/wp-content/uploads/The-Best-of-Charlie-Munger-1994-2011.pdf>

Munger once described airlines as “marginal cost with wings.” <http://bitly.com/RzDIys> People talk about Virgin Airlines having a great brand and better service, but where are the profits?  How long will it be before other airlines begin to imitate the Emirates strategy?  Where is the barrier to entry for an airline?  You can lease jets and gates. Munger and Buffett have said repeatedly over the years that they hate a commodity business. They learned this lesson the hard way by investing in firms like the New England textile manufacturer that gave Berkshire its name. Buffett ignores insurance lines that are commodities as another example

Returning to the subject of regulatory capture, Berkshire invests so much money in Well Fargo is interesting since arguably the sorts of banking that Wells Fargo does is a commodity business. It can be argued that Wells Fargo benefits from regulation since it is “too big to fail” and therefore has a lower cost of capital than it would otherwise which gives it a moat. We will discuss Wells Fargo again in a future post when the subject of management is covered.

**5. Patents and Intellectual Property**

Companies which have been granted a patent or other type of intellectual property by a government have in effect been given a legal monopoly. While the justifications for doing so are not the subject of this discussion, this barrier to entry can create a substantial moat for the holder of the intellectual property. Munger has said:

“… In microeconomics, of course, you’ve got the concept of patents, trademarks, exclusive franchises and so forth. Patents are quite interesting. When I was young, I think more money went into patents than came out. Judges tended to throw them out – based on arguments about what was really invented and what relied on prior art. That isn’t altogether clear. But they changed that. They didn’t change the laws. They just changed the administration – so that it all goes to one patent court. And that court is now very much more pro-patent. So I think people are now starting to make a lot of money out of owning patents. But trademarks and franchises have always been great. Trademarks, of course, have always made people a lot of money. A trademark system is a wonderful thing for a big operation if it’s well-known.”  <http://www.valueplays.net/wp-content/uploads/The-Best-of-Charlie-Munger-1994-2011.pdf>

Qualcomm is an example of a company which has created a moat mostly via intellectual property. Qualcomm has so many patents and has managed to get them embedded inside enough important wireless industry standards which have their own demand-side economies of scales, that the company has created a substantial moat.

One example of a company that Berkshire values higher due to intellectual property patents is Lubrizol. Initially Buffett said:

“It struck me as a business I didn’t know anything about initially. You know, you’re talking about petroleum additives… Are there competitive moats, is there ease of entry, all that sort of thing. I did not have any understanding of that at all initially. And I talked to Charlie a few days later…and Charlie says, ‘I don’t understand it either.’” <http://advisoranalyst.com/glablog/tag/cnbc-interview/>

But eventually Buffett was won over and made the Lubrizol purchase.

“I decided there’s probably a good size moat on this. They’ve got lots and lots of patents, but more than that they have a connection with customers.”  <http://advisoranalyst.com/glablog/tag/cnbc-interview/>

At the 2011 Berkshire meeting Buffet reiterated that he decided to go ahead since he thought that the more than 1,600 patents held by Lubrizol would give the company “a durable competitive advantage.”

Another example of intellectual property proving its value for Munger occurred in the 1970s when Russell Stover Candies started to open stores in markets served by See’s Candies with very similar appearance.  The use of the distinctive “trade dress” of See’s Candies was enough of a violation of the law that Munger was able through threat of litigation to get agreement from Russell Stover Candies to stop what they were doing and the moat was proven to be durable.

**The Nature of Competition and Moats:**

In Charlie’s view, even if you currently have a good business that does not mean you will have it for very long. This puts the durability of a given moat at risk. The process of what Joseph Schumpeter called “competitive destruction” is as powerful as anything in business.  Having a moat is the only way to fight against the tide of competitive destruction.

Michael Mauboussin, in what is arguably the best essay ever on moats, writes:

“Companies generating high economic returns will attract competitors willing to take a lesser, albeit still attractive, return which will drive down aggregate industry returns to the opportunity cost of capital.”<http://www.capatcolumbia.com/Articles/measuringthemoat.pdf>

For example, if you open a successful clothing store that success will attract imitators and competitors. Through a process of “competitive destruction” some clothing stores will adapt and survive and thrive and others will fail.   The consumer wins because the products and services offered to them get better and better. But this is a painful process for an investor since the outcome can be highly uncertain. It is also the hardest part for a businessperson since failure is an essential part of capitalism.

Given the inevitability of relentless competition, the question to ask is according to Munger:

“How do you compete against a true fanatic? You can only try to build the best possible moat and continuously attempt to widen it.”  Poor Charlie’s Almanack at 59;  <http://www.scribd.com/doc/76907884/MOATS-abridged-1-5-70-chapters-a-preview>

Jim Sinegal of Costco is just such a fanatic which is why Charlie serves on their board.  The founder of Nebraska Furniture Mart “Mrs. B” would be another fanatic. Charlie loves the management team at Iscar. Going down the list of Berkshire CEOs reveals a long list of fanatics.

That moats are hard to create and usually deteriorate over time is one very important reason why capitalism works. What happens over time is so-called “producer surplus” is transferred into “consumer surplus”. Charlie describes the competitive process and why it benefits consumers as follows:

“The major success of capitalism is its ability to drench business owners in feedback and allocate talent efficiently. If you have an area with 20 restaurants, and suddenly 18 are out of business, the remaining two are in good, capable hands. Business owners are constantly being reminded of benefits and punishments. That’s psychology explaining economics.” <http://www.fool.com/investing/general/2011/07/02/charlie-mungers-thoughts-on-the-world-part-1.aspx>

Munger’s views on the nature of business competition are Darwinian: Capitalism does not pull its punches in markets that are genuinely competitive:

“Over the very long-term, history shows that the chances of any business surviving in a manner agreeable to a company’s owners are slim at best.” <http://www.valuewalk.com/charlie-munger-page/>

“Capitalism is a pretty brutal place.”  <http://ycombinator.com/munger.html>

When it comes to moats, durability matters. Munger wants to avoid a business that has a moat today, but is gone tomorrow. Some moats atrophy gradually over time and some much more quickly. This is not a completely new phenomenon. As Ernest Hemingway once said in his book *The Sun Also Rises*, a business can go bankrupt in two ways: gradually and then suddenly. The speed of moat destruction has accelerated over time due to advances in technology and the way it spreads information. For some people this increase in speed can at times be disorienting. For example, the speed at which a companies like Kodak or Nortel lost their moats has been shocking to many investors who grew up mostly in another era.

The speed at which a moat disappears should not be confused with cases where a company never had a moat at all like Groupon.  Hype about a sales “boiler room” selling coupons online is not a moat. Instead, that is an example of crowd folly (social proof + fake scarcity). Did Zygna ever have a moat or did it just evaporate quickly? It is hard to say. Sometimes causes are hard to tease apart. Facebook definitely has a moat, but once it ceased letting Zynga acquire customers cheaply by leveraging the Facebook moat, the tide arguably turned against Zynga.  “To borrow someone’s moat is not to have a moat” might be the lesson of Zynga, since what is borrowed can be taken away.

How long your moat lasts is called your “Competitive Advantage Period” (CAP) writes Michael Mauboussin. <http://www.capatcolumbia.com/Articles/FoFinance/Fof1.pdf>  The speed of moat dissipation will be different in each case and need not be constant.  The rate at which a moat atrophies is similar to what academics call “fade” argues Mauboussin.

Even the very best companies can see competition make their moats shrink or even disappear. Charlie has said:

“Frequently, you’ll look at a business having fabulous results. And the question is, ‘How long can this continue?’ Well, there’s only one way I know to answer that. And that’s to think about why the results are occurring now – and then to figure out what could cause those results to stop occurring.”  <http://bitly.com/S5iN7K>

Sometimes what shrinks a moat is a shift of what Michael Porter has called “the Five Forces”. <http://hbr.org/2008/01/the-five-competitive-forces-that-shape-strategy/ar/1> One such force is the power of distributors in a value chain:

“Kellogg’s and Campbell’s moats have also shrunk due to the increased buying power of supermarkets and companies like Wal-Mart. The muscle power of Wal-Mart and Costco has increased dramatically.”<http://www.tilsonfunds.com/motley_berkshire_brkmtg01notes.php3>

When someone, such as a downstream distributor, takes a bigger slice of the amount of profit in the “profit pool,” bad things can happen if you are upstream. Whether that happens will depend on who has more bargaining power in that supply chain.

A blogger in an essay discussed above recently argued that the **Five Forces** do not matter since consumers have more power. Consumers are one of the **Five Forces** so the argument is even at that level deeply misguided. Suppliers are also a potential problem. Try arguing that the **Five Forces** do not matter to the many music subscription companies that went bust due to the wholesale transfer pricing power of music suppliers.  A restaurant owner who has had a landlord triple their rent knows very well that supplier bargaining power can be a huge problem. Yes, delighting customers is super important, no that does not help if your sole supplier is raising wholesale prices to take your profit.

Sometimes it is buyers that have the ability to “holdup” the seller and sometimes it is the reverse depending on who has the bargaining power. Every aspect of a given business can be made worse if some firm or person in the value has more bargaining power.  As an example, big movie stars have had huge wholesale transfer pricing power over the movie business value chain ever since the Hollywood studio system ended.

Newspapers are a good example of an industry which once had a fantastic moat, which is now in decline. Unfortunately for newspapers, changes in technology have been taking down their moat in rather dramatic fashion.  Charlie:

“The perfectly fabulous economics of this [newspaper] business could become grievously impaired.”<http://www.fool.com/BoringPort/2000/boringport00051501.htm>

Munger saw this deterioration before many other people did, mostly likely because Berkshire owned newspaper properties like *The Washington Post* and *The Buffalo News*. Berkshire has not given up on all types of newspapers. Papers that cover local news, particularly in a city with a strong sense of community are still attractive for Berkshire even in 2012.  They said at the 2012 Berkshire meeting that they may buy more newspapers. These small city newspaper purchases  seems to me like a Ben Graham “cigar butt” style investment and for that reason a reversion to an old investing style. But Berkshire have a \*lot\* of cash to put to work and only so many quality businesses to buy.  Too much cash is, as some people say “A high quality problem.” Munger adds: “Excess cash in an advantage, not a disadvantage”.  As a pool of investment dollars gets bigger it gets harder to find companies to buy or invest in that have a moat.  In this sense size works against investment performance.  More than one fund manager has suffered from this problem since the tendency is to ignore the need for a strong moat so you can get large amounts of money put to work.

Kodak is a company which once had a strong moat and then began to lose it in dramatic fashion. Munger describes the competitive destruction that hit the photography business:

“What happened to Kodak is a natural outcome of competitive capitalism.” <http://www.businessinsider.com/munger-on-buffetts-cancer-the-fed-berkshires-investment-strategy-2012-5#ixzz2CB0ay5jG>

It is true that what happened to Kodak was rough, but the full story according to Munger should take into account that there was a part of Kodak that did have a moat and will survive:

“People think the whole thing failed, but they forget that Kodak didn’t really go broke, because Eastman Chemical did survive as a prosperous company and they spun that off.” <http://management.fortune.cnn.com/2012/08/22/buffett-munger-berkshire>

Why did Eastman Chemical survive? Most probably Eastman survived due to supply-side economies of scale and intellectual property. Kodak probably has some great patents for chemically-based photography too. But in the case of Kodak and photography the entire process changed to digital and the Kodak moat was swiftly gone.

Research in Motion losing its Blackberry moat is another example of competitive destruction. Will they recover? The challenge the Blackberry faces is substantial. Once a feedback loop turns negative, it is hard for any company to regain what it once had.  What builds you up can tear you down.  And if the ride up was nonlinear, it is very possible that the ride down will be nonlinear as well.

As another example, Munger has said that department stores in downtown areas once had a very strong moat given economies of scale and a central location near mass transit.  But then the way people lived started to change as cars became more affordable and people migrated to suburbs with shopping centers.  The arrival of Amazon.com has further damaged the moat of the big-box retailers of all kinds whether in the city or the suburbs.

**How Can the Quality of the Moat be Quantified?**

The test of whether you have a moat with a given company is**quantitative** (i.e., it’s a math-based test).  If (1) you are earning profits that are greater than your weighted average cost of capital (WACC) and (2) that level of profitability has maintained for some reasonable period measured in years, you have a strong moat.  If the size of the positive difference between ROIC and WACC is large and if that “spread” is persistent over time, your moat is relatively strong. Mauboussin is the one to read on this as is usual.  The essay: *Measuring the Moat* at <http://www.capatcolumbia.com/Articles/measuringthemoat.pdf> is a classic. Exactly how long the moat must be persistent to meet this test is an interesting question. If it is not a period of at least two years you are taking a significant risk. Five years of supporting data give you more certainty that you moat is sustainable. For a look at this see:

What determines whether a business a company has a moat is **qualitative** (e.g., supply-side and demand-side economies of scale, brand, regulation and intellectual property) but how you test to determine the strength of your moat is **quantitative**(i.e., it’s a mathematical exercise). Mathematical formulas won’t tell you how to get a moat but they can help prove that you have one, at least for now.

A company like Salesforce.com has not yet passed this quantitative test since management has been running their business at a loss or a tiny profit. Management at Salesforce.com can argue that they are doing this intentionally which seem to be true.  But until Salesforce.com proves that it can pass the moat test with evidence that the mathematics satisfy the test, the assertion that the company has a moat is an unproven thesis. In other words, whether Salesforce.com has significant pricing power right now is just a theory.  Until GAAP profit margins rise and stay high for a significant period the jury is still out.  Any claims that prop0fiost have been earned  non-GAAP basis or that the business generated or EBITDA (jokingly referred to by many people as “earnings before everything bad”) should be ignored. On this Munger has said: “I don’t even like to hear the word EBTDA.”  He suggests inserting the word “bullshit” whenever you hear the term EBITDA

Spotting the existence of a moat that has not been fully taken advantage of by its current ownership in terms of raising prices can be profitable for an investor buying that business.  Warren Buffett points out:

“There are actually businesses, that you will find a few times in a lifetime, where any manager could raise the return enormously just by raising prices—and yet they haven’t done it. So they have huge untapped pricing power that they’re not using. That is the ultimate no-brainer. … Disney found that it could raise those prices a lot and the attendance stayed right up. So a lot of the great record of Eisner and Wells … came from just raising prices at Disneyland and Disneyworld and through video cassette sales of classic animated movies… At Berkshire Hathaway, Warren and I raised the prices of See’s candy a little faster than others might have. And, of course, we invested in Coca-Cola—which had some untapped pricing power. And it also had brilliant management. So a Goizueta and Keough could do much more than raise prices. It was perfect.”  <http://ycombinator.com/munger.html>

Starting with See’s Candies, Munger and Buffett learned that when you have a great moat (in this case driven by a powerful but primarily regional brand), the business can raise prices to improve profitability. On the December 29 of the year that they bought See’s prices were raised 20-30 cents a pound.  They also learned that some brands translate less well to new markets and there is a limit on how many stores one can profitably build in a given geographic area.

Buffett has said that Kellogg’s has at times pushed their pricing too far and damaged their moat.  Buffet believes that they didn’t have the moat they thought they had versus General Mills and other major breakfast cereal competitors.

At a very practical level the discussion above illustrates that there are some rules of thumb one can use to test the strength of a moat. At the top of the list is whether the business has pricing power. For example, if you must hold a prayer meeting before you try to raise prices, then you don’t have much of a moat, if any, argues Buffett.

Finally, it should be emphasized that is nothing sinister about the term “moat.” Business is, by its very nature, a competitive process.  Even a small restaurant selling barbecue can have a moat. A company that has a return on capital significantly greater than their opportunity cost over time has a moat whether they know it or not. That’s enough about moats for now.  The next post will be about**Munger’s Investment Filters Two and Three: Circle of Competence and Management with Integrity and Talent.**

# Charlie Munger on Mistakes

**MUNGER’S METHODS**

**Chapter 1:   The Difference between a Good Business and a Bad Business**

**Mistakes**

Charlie Munger learned about business in the best way possible: by making mistakes and being successful actually being in business. Reading about business is vital Charlie has said many times, but there is no substitute for wading in and actually taking the plunge as a business manager or owner.  It is through the process of making mistakes and having success in the real world and getting feedback from the market that you can learn and establish sound business judgment.

Making mistakes is, of course, inevitable. After all, as Einstein once said, anyone who has never made a mistake (if there is such a person) has never tried anything new. Munger advises that people strive to make \*new\* mistakes and learn as a consequence:

“There’s no way that you can live an adequate life without many mistakes.  In fact, one trick in life is to get so you can handle mistakes. Failure to handle psychological denial is a common way for people to go broke.”

<http://boundedrationality.wordpress.com/quotes/charlie-munger/>

“I don’t want you to think we have any way of learning or behaving so you won’t make mistakes.

<http://boundedrationality.wordpress.com/quotes/charlie-munger/>

“I don’t think it’s necessary to be as dumb as we were.”  <http://bitly.com/YsZny5>

Where would Apple be if Steve Jobs did not make the mistakes he did at NeXT?  What we call “experience” is not only the successes we have, but the mistakes we make.

Charlie Munger admits he still makes mistakes even after many decades as a business person and investor.  He has also said that it is important to “rub your nose” in your mistakes.

“I like people admitting they were complete stupid horses’ asses. I know I’ll perform better if I rub my nose in my mistakes. This is a wonderful trick to learn.” <http://theinvestmentsblog.blogspot.com/2011_12_01_archive.html>

“Forgetting your mistakes is a terrible error if you are trying to improve your cognition. Reality doesn’t remind you. Why not celebrate stupidities in both categories?”  <http://news.morningstar.com/article/article.asp?id=169398>

Munger especially recommends paying attention to so-called “mistakes of omission” (mistakes you make by not doing something):

“The most extreme mistakes in Berkshire’s history have been mistakes of omission. We saw it, but didn’t act on it. They’re huge mistakes — we’ve lost billions. And we keep doing it. We’re getting better at it. We never get over it. There are two types of mistakes:  1) doing nothing; what Warren calls “sucking my thumb” and 2) buying with an eyedropper things we should be buying a lot of.”

<http://www.tilsonfunds.com/motley_berkshire_brkmtg01notes.php>

“Our biggest mistakes were things we didn’t do, companies we didn’t buy.”<http://money.cnn.com/magazines/moneymag/moneymag_archive/1998/07/01/244582/index.htm>

The list of big business mistakes is long. But for an ordinary investor the simple act of not saving or contributing to a 401(k) can be a huge mistake of omission.

For Charlie, thinking in terms of “opportunity cost” is essential when it comes to mistakes:

“We are apparently slow learners. These opportunity costs don’t show up on financial statements, but have cost us many billions.” <http://www.tilsonfunds.com/motley_berkshire_brkmtg03notes.php3>

“Since mistakes of omission don’t appear in the financial statements, most people don’t pay attention to them.”<http://www.buffettfaq.com/>

Munger and Buffett not investing in Wal-Mart is just one example of a mistake of omission. Buffett has said that just this one mistake with Wal-Mart cost them $10 billion.  In 1973 Tom Murphy offered to sell some television stations to Berkshire for $35 million and Buffett declined.  “That was a huge mistake of omission,” Buffett has admitted. .

By paying attention to your mistakes, you can learn from your errors and improve your methodology argues Charlie:

“You can learn to make fewer mistakes than other people- and how to fix your mistakes faster when you do make them.”<http://www.scribd.com/doc/86728974/3-Lesson-in-Elementary-Worldy-Wisdom-Revisited-1996>

Charlie has cited “Shell paying double for Belridge Oil” due to “a technical mistake” in a closed bid auction is an example to learn from. Berkshire paying too much for Conoco Phillips was a mistake as was Berkshire buying US Airways. The best way to become a millionaire is to start with a billion dollars and buy an airline is the old joke in business.

As for mistakes others have made, Groupon rejecting Google’s $6 billion purchase offer at one point was a wonderful mistake from Google’s standpoint but not for Groupon shareholders.  AOL buying Time Warner for $182 billion is among the very worst business mistakes ever made. Quaker Oats buying Snapple was also a monster mistake in the annals of business.

Of course, you can also learn from success, particularly if you remember that success can be a lousy teacher since what you may believe is the outcome of skill may be luck.   Charlie has said that more than once that he and Buffett have made a mistake only to be bailed out by luck:

“Banking has turned out to be better than we thought. We made a few billion [dollars] from Amex while we misappraisal it. My only prediction is that we will continue to make mistakes like that.”

<http://www.tilsonfunds.com/motley_berkshire_brkmtg03notes.php>

“Well, some of our success we predicted and some of it was fortuitous. Like most human beings, we took a bow.”

<http://www.tilsonfunds.com/wscmtg05notes.pdf>

“The amazing thing is we did so well while being so stupid. That’s why you’re all here: you think that there’s hope for you.  Go where there’s dumb competition.”

<http://www.valueplays.net/wp-content/uploads/The-Best-of-Charlie-Munger-1994-2011.pdf>

Munger has said repeatedly that he made more mistakes earlier in life than he is making now. One of his early mistakes was to own a company that made electrical transformers. He has also said that he has found himself in real estate ventures which would only be enjoyed by a masochist.  In another case, he and Warren Buffett bought department stores.  Charlie has said:

“Hochschild, Kohn the department store chain was bought at a discount to book and liquidating value. It didn’t work [as an investment.]” <http://bitly.com/RzDIys>

For Buffett, buying Berkshire Hathaway itself can arguably be put into the mistake category. The New England textile mill when bought in the 1960s was a lousy business that wasn’t worth putting an new capital into since it would never generate more return on capital investment than alternative investments available to Buffett. Berkshire was valuable in one way in that it taught Buffett and Charlie what \*not\* to do.  He has said: “It is remarkable how much long-term advantage people like us have gotten by trying to be consistently not stupid, instead of trying to be very intelligent.” <http://bit.ly/U31gzU>

Buying Dexter Shoes was definitely a multi-billion dollar mistake for Berkshire.  In doing the Dexter due diligence analysis Buffett and Munger made the mistake of not making sure the business had what they call a “moat” and being too focused on what they thought was an attractive purchase price.  Buffett said once about Dexter: “What I had assessed as durable competitive advantage vanished within a few years.” Capitalism inherently means that others will always be trying to replicate any business that is profitable and that means you are always in a battle to keep what you have. Dexter lost that battle in a very swift fashion.  If you make a mistake, capitalism’s “competitive destruction” forces will expose it swiftly and sometimes brutally.

The Chinese automaker BYD may end up being a mistake for Berkshire perhaps because Munger and Buffett drifted too far from what they call their “circle of competence.” Charlie has said that it was fun to make the investment and particularly at his age and level of success he is entitled to do so. But the jury is still out on BYD as an investment and they are having some significant problems. That is arguably to be expected since:  “It is fun to watch a business tackle the biggest problems we face in this world. Cheaper solar power and better batteries are holy grails.” But the BYD investment was really out of scope for Munger and should be viewed as an aberration like when they invested in US Airways.

Charlie’s view is that one great way to avoid mistakes is to own a business that is simple to understand given your education and experience:

“Where you have complexity, by nature you can have fraud and mistakes.” <http://www.tilsonfunds.com/brkmtg05notes.pdf>

“If you can’t understand it, don’t do it” is a simple rule of thumb.

If, after you have made a mistake, you can’t explain why you failed, the business was too complex for you to have invested in says Buffett. In other words, Munger and Buffett like to be able to understand why they made a mistake, so they can learn from the experience.  If you can’t understand the business you can’t determine what you did wrong.  In a sector like technology Munger and Buffett have both said they do not understand the business well enough to be investors. The other problem with investing in technology is that they don’t feel like they can forecast what the business will be like even if five years let alone for decades.

Not trying to be too clever with things like taxes is another way to avoid mistakes argues Munger. Complexity can be your friend or your enemy depending on the circumstances. For example,

“…in terms of business mistakes that I’ve seen over a long lifetime, I would say that trying to minimize taxes too much is one of the great standard causes of really dumb mistakes. I see terrible mistakes from people being overly motivated by tax considerations. Warren and I personally don’t drill oil wells. We pay our taxes. And we’ve done pretty well, so far. Anytime somebody offers you a tax shelter from here on in life, my advice would be don’t buy it.”  <http://ycombinator.com/munger.html>

Other investors like complexity and spend a lot of time deferring or avoiding taxes in complex ways. While someone like John Malone may like to do deal with complex tax strategies, it is not something Charlie likes to do.

Regarding the desire for simplicity in a business Charlie once talked at a Wesco meeting about a place he knows where poker is played. He then pointed out that” the more complex the game, the easier it is for the best players to beat the patsies.” And, of course, if you do not know who the patsy in the game is, it is you.

Munger likes to find areas where the competition is “dumb”:

“Don’t go where the big boys have to be. You don’t want to look at the drug pipelines of Merck and Pfizer.  Go where there are inefficiencies in which you can get an advantage and where there are fewer people looking at the stocks. Go where the competition is low.” <http://www.gurufocus.com/news/93302/2010-wesco-financial-corp-annual-meeting-notes>

Charlie once described a friend who is a chess master and said in business rather than competing with the equivalent of him, you want to find an area where you are the best and competitors are not so talented.  He likes investing in businesses which have “no or dumb competition” and the investors who want to invest in them are similar.

Another way to avoid mistakes is to have someone who you can run your decision by so you can improve your odds of success. Buffett and Munger have the ability to do that for each other. Warren Buffett calls Charlie “The Abominable No-Man” since his answer on a given investment is so often “no.” Having a diverse “posse” of experienced people that you trust look at a potential investment is wise if you want to avoid making too many mistakes. Philip Fisher, an investor who Munger learned a lot from, liked to have a “scuttlebutt” network of people who he would call for advice or expertise and Charlie is similar in his approach. Munger has said:

“Even Einstein didn’t work in isolation. But he never went to large conferences. Any human being needs conversational colleagues.” <http://www.gurufocus.com/news/93302/2010-wesco-financial-corp-annual-meeting-notes>

Buffett once, when discussing his mistakes, gave a huge compliment to Munger’s value as a collaborator when he said:

“I try to look out 10 or 20 years when making an acquisition, but sometimes my eyesight has been poor. Charlie’s has been better; he voted ‘no’ more than ‘present’ on several of my errant purchases.” <http://articles.businessinsider.com/2012-02-25/wall_street/31098427_1_charlie-munger-warren-buffett-berkshire-hathaway>

Another important source of mistakes is overconfidence.

“[GEICO] got to thinking that, because they were making a lot of money, they knew everything. And they suffered huge losses. All they had to do was to cut out all the folly and go back to the perfectly wonderful business that was lying there.” <http://ycombinator.com/munger.html>

Smart people are not exempt from making mistakes. A person with a high IQ can actually make more mistakes that someone who’s IQ is 30 points lower due to overconfidence. It is the person with the high IQ who falsely thinks that is 30 points higher than it really is that gets you in serious trouble. People who are genuinely humble about their IQ can sometimes make far fewer mistakes if they do the necessary work, have a sound investment process and think in rational ways. Munger has said on this: “Terribly smart people make totally bonkers mistakes.” <http://ycombinator.com/munger.html>

On numerous occasions Charlie has warned people that “the easiest person to fool is yourself” as Richard Feynman once said. Charlie puts it this way:

“The ethos of not fooling yourself is one of the best you could possibly have. It’s powerful because it’s so rare.”<http://www.fool.com/news/foth/2002/foth020515.htm>

People have a tendency to make assumptions that enable a desired result even if that assumption is obviously false.  This tendency for people to “goal seek” the result they want is a fundamental flaw in human nature in Charlie’s opinion.   “As a man wants, so shall he believe” says Charlie quoting a Greek philosopher from long ago. For this reason Charlie spends a lot of time examine anything from first principles from the ground up. Assume nothing and” think for yourself” is his mantra. Optimism is the enemy of the rational investor. Rationality comes from a combination of clear thinking and relatively unemotional temperament when it comes to investing.

Charlie over the years has repeatedly said that the most important quality that makes him a good investor is that he is rational. That rationality helps Charlie not follow others over the edge of a cliff. If you think things through from the simplest building blocks in a step-by step process you can avoid making so many mistakes or at least make more new mistakes.

“Rationality is not just something you do so that you can make more money, it is a binding principle. Rationality is a really good idea. You must avoid the nonsense that is conventional in one’s own time. It requires developing systems of thought that improve your batting average over time.”   <http://news.morningstar.com/article/article.asp?id=169398>

“[An] increase in rationality is not just something you choose or don’t choose, it’s a moral duty to keep up as much as you reasonable can. It worked so well at Berkshire , not because we were so darned smart to start with…we were massively ignorant…many of the great successes of Berkshire started with stupidity and failure.” <http://www.sancaptrustco.com/documents/7.19.11NotestoMunger.pdf>

Nothing seduces rational thinking and turns a person’s mind in mush like a big pile of money that was easily earned. About Berkshire, Charlie said once: “This is a very rational place.”

<http://jeffmatthewsisnotmakingthisup.blogspot.com/2007/06/pilgrimage-concluded-this-is-rational.html>

Not being patient can also be a huge source of mistakes as well says Munger:

“We don’t feel some compulsion to swing. We’re perfectly willing to wait for something decent to come along.  In certain periods, we have a hell of a time finding places to invest our money.”

<http://www.tilsonfunds.com/motley_berkshire_brkmtg01notes.php>

“Most people are too fretful, they worry too much. Success means being very patient, but aggressive when it’s time.” <http://www.grahamanddoddsville.net/wordpress/Files/Gurus/Warren%20Buffett/Berkshire%20Hathaway%20Annual%20Meeting%20Notes%202004.pdf>

Munger and Buffett believe that the passage of time is the friend of the investor or business person and impatience his or her enemy. When asked once about whether he was worried about a big drop in the value of Berkshire Munger said in a very direct way:

“Zero.  This is the third time Warren and I have seen our holdings in Berkshire Hathway go down, top tick to bottom tick, by 50%.  I think it’s in the nature of long term shareholding of the normal vicissitudes, of worldly outcomes, of markets that the long-term holder has his quoted value of his stocks go down by say 50%.  In fact you can argue that if you’re not willing to react with equanimity to a market price decline of 50% two or three times a century you’re not fit to be a common shareholder and you deserve the mediocre result you’re going to get compared to the people who do have the temperament, who can be more philosophical about these market fluctuations.”

<http://www.psyfitec.com/2009/10/buffett-and-munger-on-bbc.html>

Buffett has said about the importance of patience: “The Stock Market is designed to transfer money from the Active to the Patient.”  Both Munger and Buffett believe that so-called *chasing performance* (“buying high and selling low”) is one of the worst mistakes an investor can make. “Be greedy when others are fearful and fearful when others are greedy” they both advise.  People being greedy and fearful at the wrong times are what creates many significant investing opportunities Munger has said.

Another way to avoid making mistakes is to own businesses that even what Charlie calls your “idiot nephew” could run fairly well.

“Network TV [in its heyday,] anyone could run and do well. If Tom Murphy is running it, you’d do very well, but even your idiot nephew could do well.”

<http://www.designs.valueinvestorinsight.com/bonus/bonuscontent/docs/Tilson_2006_BRK_Meeting_Notes.pdf>

Having to make one hard financial decision after another in running a company can be damaging to your financial health even if you or your mangers are very talented. Munger is emphatic on this topic:

“We’re partial to putting out large amounts of money where we won’t have to make another decision.” <http://www.tilsonfunds.com/motley_berkshire_brkmtg01notes.php>

ESPN is an example of a company that could probably be run by your “idiot nephew” since its moat is so strong (moats will be the subject of the next post in this series).  Coca-Cola, Snickers and Wrigley’s are strong businesses that pass this test.

It is worth emphasizing that Munger is not saying management does not matter (another subject this series of posts will get to later).  Instead what Charlie is saying that he would prefer to have a business that passes the “idiot nephew” test \*and \* for the business to have talented management.  Owning a business with lousy underlying economics of the business facing one hard problem after another may not have a good financial outcome even with a top-notch management team according to Charlie.  In that sense, having a moat and talented management such as the team that runs the Berkshire portfolio company Iscar gives Warren and Charlie an extra margin of safety when making an investment.

Finally, after achieving some level of financial success mistakes can actually make the investing process more fun. If there was not at least some chance that your investment would end up in the business equivalent of a sand trap in golf once in a while the process that is investing would be boring, even if it was lucrative.

**Postscript and what is still to come:**

What I wrote above is the first post in a series about “methods” used by Charlie Munger to do things such as invest capital.  This series of posts is not about topics like whether he likes to fish, his unusual personality or his political views.  The focus will be on the investment methodology of Charlie Munger.  Other methods he uses in life are also discussed.  Regardless of your political persuasion, personality or hobbies, Munger’s methods are uniquely valuable. Even if you disagree with any or all of his methods it is very hard to argue that they are not interesting.

Much of the task here is to organize what Charlie has said or written into something that is easier to understand since he has never explained his investment thesis in a well-organized way. The raw material for this book consists of snippets from interviews and a few articles and papers he has written over the years.  Writing these posts is a bit like assembling a jigsaw puzzle.  Sometimes the quoted passages may seem a bit too long, but nothing says more about what Munger thinks than what he has actually said.

I will try to make the posts more interesting and current by applying Munger’s methods to companies that are in the news today and companies that are outside their circle of competence.

P.s., I decided to begin this series with a discussion of Charlie’s view on “mistakes” since it introduces some humility in the process at an early stage.  Janet Lowe in her Charlie Munger biography “Damn Right” <http://www.amazon.com/Damn-Right-Berkshire-Hathaway-Billionaire/dp/0471446912> , quotes Charlie Munger as admitting that he “was behind the door when humility was handed out.”   As I said above, my next post will be about the value of economic “moats” in business.