# A Dozen Things I’ve learned from Stanley Druckenmiller About Investing

[*7*](http://25iq.com/2015/04/11/a-dozen-things-ive-learned-from-stanley-druckenmiller-about-investing/#comments)

“Stan may be the greatest moneymaking machine in history. He has Jim Roger’s analytical ability, George Soros’s trading ability, and the stomach of a riverboat gambler when it comes to placing his bets. His lack of volatility is unbelievable. I think he’s had something like five down quarters in 25 years and never a down year. The Quantum record from 1989 to 2000 is really his. The assets grew from $1 billion to $20 billion over that time and the performance never suffered. Soros’s record was made on a smaller amount of money at a time when there were fewer hedge funds to compete against.”  – [*Inside the House of Money*](http://www.amazon.com/dp/0471794473/?tag=25iq-20)

**1. “I think David Tepper is awesome and if he’d take my money, I’d give him some but I think his fund is closed**.”

I included this quote to make the point that even though a very small number of great investors do beat the market, it is very unlikely that they are going to be willing to invest your money. Even Stanley Druckenmiller does not believe he can get into David Tepper’s fund. In other words, you won’t be a limited partner in David Tepper’s fund anytime soon. It is also unlikely that you will be able to replicate the market outperformance of these great investors on your own. It would be much easier for me to write on this blog and elsewhere that *no one* ever beats the market even though I know it is not true. Some people might find the fib justifiable by the fact that it will encourage people to invest in a diversified portfolio of low fee index funds/ETFs. But that would not be truthful, so I just can’t do it.

But this truth has a cost since overconfidence will cause a significant number of people to think that they can do what [David Tepper](http://25iq.com/2015/03/07/a-dozen-things-ive-learned-from-david-tepper-about-investing/) and Stanley Druckenmiller have achieved as investors.  And these overconfident investors will go out and inevitably underperform the market. For me, honesty trumps paternalism. Dishonesty, even if only a fib in one area with arguably benevolent intent, is a slippery slope and has other costs. As George Washington said: ‘I cannot tell a lie.” But I will say that it is \***highly**\* unlikely that you can be as successful as David Tepper and Stanley Druckenmiller. The sooner you realize that, the better off you will be.  Having said that, everyone can benefit from learning to make better decisions in life including decisions about how to allocate assets.

**2. “George Soros has a philosophy that I have also adopted: The way to build long-term returns is through preservation of capital..“**

If you look at other posts I have written in this series on my blog you will see a consistent view expressed: not losing money is a critical part of the investing process. The great investors say it in different ways, but the point is always the same. For example, Warren Buffett says: “Rule No. 1: never lose money; rule No. 2: don’t forget rule No. 1.″ Paul Tudor Jones puts it this way: “I think I am the single most conservative investor on earth in the sense that I absolutely hate losing money.”  Seth Klarman provides the fuller explanation his book[*Margin of Safety*](http://www.amazon.com/dp/0887305105/?tag=25iq-20)*:*

“Avoiding loss should be the primary goal of every investor. This does not mean that investors should never incur the risk of any loss at all. Rather “don’t lose money” means that over several years an investment portfolio should not be exposed to appreciable loss of capital. While no one wishes to incur losses, you couldn’t prove it from an examination of the behavior of most investors and speculators. The speculative urge that lies within most of us is strong; the prospect of free lunch can be compelling, especially when others have already seemingly partaken. It can be hard to concentrate on losses when others are greedily reaching for gains and your broker is on the phone offering shares in the latest “hot” initial public offering. Yet the avoidance of loss is the surest way to ensure a profitable outcome.”

**3.** **“Soros has taught me that when you have tremendous conviction on a trade, you have to go for the jugular.”**

**“I’ve learned many things from [George Soros]  but perhaps the most significant is that it’s not whether you’re right or wrong that’s important, but how much money you make when you’re right and how much you lose when you’re wrong.”**

As I noted in my blog [post on Nassim Taleb](http://25iq.com/2013/10/13/a-dozen-things-ive-learned-from-nassim-taleb-about-optionalityinvesting/), investing “home runs” come from finding mispriced optionality. “Optionality is the property of asymmetric upside (preferably unlimited) with correspondingly limited downside (preferably tiny).” Occasionally you can find a situation with a big upside and a small downside if you are patient and work hard to find it. When that happens if you can be brave and aggressive in your bet, you can hit a home run. Charlie Munger argues that hitting a few financial home runs in a lifetime is all you need for financial success. Unfortunately, being patient, brave and aggressive is not a typical combination of character traits for most people.

**4. “My job for 30 years was to anticipate changes in the economic trends that were not expected by others, and, therefore not yet reflected in security prices.”**

Fundamentally, the job of an investor is to find assets which are available for purchase that are mispriced by the markets. If a given trend is expected by others they will be reflected in security prices and there is not opportunity for the investor. In my [post about George Soros](http://25iq.com/2013/07/30/a-dozen-things-about-investing-ive-learned-from-george-soros/)I note that he once said: “Money is made by discounting the obvious and betting on the unexpected.” Like all great investors, Stanley Druckenmiller trained himself to be an intelligent contrarian when making a bet and only to do that when there was a big upside and a small downside. Phil Fisher put it this way: “Doing what everyone else is doing at the moment, and therefore what you have an almost irresistible urge to do, is often the wrong thing to do at all.”

Richard Thaler and Cass Sunstein do a fine job of relaying a [Warren Buffett story here](http://nudges.org/2011/04/14/warren-buffetts-joke-about-herd-behavior/#sthash.E1IEM1gz.dpuf):  “Warren Buffett retells the story of the dead oil prospector who gets stopped at the pearly gates and is told by St Peter that Heaven’s allocation of miners is full up. The speculator leans through the gates and yells ‘Hey, boys! Oil discovered in Hell.’ A stampede of men with picks and shovels duly streams out of Heaven and an impressed St Peter waves the speculator through. ‘No thanks,’ says the sage. ‘I’m going to check out that Hell rumor. Maybe there is some truth in it after all.’”

**5.  “I have always made big concentrated investments. I don’t believe in diversification. I don’t believe that’s the way to make money.”**

**“You are not going to make money talking about risk adjusted returns and diversification. You’ve got identify the big opportunities and go for them.”**

**“As far as Soros is concerned, when you’re right on something, you can’t own enough.”**

As Warren Buffett has pointed out many times: “diversification is protection against ignorance. It makes little sense if you know what you are doing.” Of course is that most people have no idea what they are doing when it comes to investing.  Most people don’t even understand the difference between speculating and investing. For this reason and others almost everyone should buy a diversified portfolio of low fee index funds/ETFs. Warren Buffett points out that by acknowledging that you are not smart money by putting a strategy in place that harnesses diversification you become the smart money.

Unfortunately any investor must still choose how to diversify, so they still must learn to make sound investing decisions (portfolio asset allocation requires that an investor actively make certain choices even if it is to buy low fee index funds/ETfs).

**6. “Soros is the best loss taker I’ve ever seen. He doesn’t care whether he wins or loses on a trade. If a trade doesn’t work, he’s confident enough about his ability to win on other trades that he can easily walk away from the position. There are a lot of shoes on the shelf; wear only the ones that fit. If you’re extremely confident, taking a loss doesn’t bother you.”**

Michael Mauboussin has no peer in explaining why great investors focus on creating sound investing processes rather than outcomes. Because investing is a probabilistic process, results in the short term do not always distinguish between good and lousy processes. David Sklanskywrote in[*The Theory of Poker*](http://www.amazon.com/dp/1880685000/?tag=25iq-20): ‘Any time you make a bet with the best of it, where the odds are in your favor, you have earned something on that bet, whether you actually win or lose the bet. By the same token, when you make a bet with the worst of it, where the odds are not in your favor, you have lost something, whether you actually win or lose the bet.” If your process is sound taking a loss in the short term shouldn’t bother you, as Druckermiller learned from George Soros.

**7.** **“I particularly remember the time I gave (the research director) my paper on the banking industry. I felt very proud of my work. However, he read through it and said, ‘This is useless. What makes the stock go up and down?’ That comment acted as a spur. Thereafter, I focused my analysis on seeking to identify the factors that were strongly correlated to a stock’s price movement as opposed to looking at all the fundamentals. Frankly, even today, many analysts still don’t know what makes their particular stocks go up and down.”**

**“Valuation only tells me how far the market can go once a catalyst enters the picture to change the market direction.”**

Stanley Druckermiller is referring here to the importance of identifying what Mario Gabelli calls a catalyst. Gabelli writes: “A catalyst may take many forms and can be an industry or company specific event. Catalysts can be a regulatory change, industry consolidation, a repurchase of shares, a sale or spin-off of a division, or a change in management.” Valuation is most, ahem, valuable when it can be combined with a catalyst. Buying at an attractive valuation gives you a margin of safety against mistakes and the catalyst can provide you will a turbocharged result on that basic foundation.

**8. “I learned you could be right on a market and still end up losing if you use excessive leverage.”**

**“It takes courage to ride a profit with huge leverage.”**

Leverage magnifies mistakes as much as any successes. But because wrong decisions when leveraged can take the investor or speculator completely out of the investing process, leverage is particularly destructive of financial returns. Howard Marks point out that “Leverage magnifies outcomes, but doesn’t add value.” Having said this it is clear that George Soros uses leverage and so has Stanley Druckenmiller. So the key word for Stanley Druckenmiller must be “excessive” when it comes to leverage. How much exactly is “excessive”? The answer it seems, from what I have read, is that it depends on the strength of your confidence in the bet. Druckenmiller did says once in [The Wall Street Journal](http://www.wsj.com/articles/SB906935088416967000)that “leverage at Soros’s Quantum rarely exceeds 3-to-1 or 4-to-1.” Needless to say I don’t think anyone playing along at home should think that investing in this way is applicable or appropriate for them.

**9. “I only focus on what is black or white and kind of sift out the gray area in my investing style.”**

Why invest in anything which you are unsure about when there are other options that you are more sure about? This is simple “opportunity cost” thinking. Michael Mauboussin puts it this way:  “We don’t have odds on the tote board [like in a horse race], but we have something called the stock price. So we reverse engineer the expectations built into that price. We say, ‘What has to happen for that to make sense?’ And then we look at how the fundamentals are likely to unfold.  It’s a probabilistic exercise. That would be the first piece. The second piece, analytically, is bet size, which is once you have an edge, how much do you bet in your portfolio? That’s a second key component which is often overlooked.”

Charlie Munger finishes the thought: “And then all that is required is a willingness to bet heavily when the odds are extremely favorable, using resources available as a result of prudence and patience in the past. We look for a horse with one chance in two of winning and which pays you three to one. And 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.”

**10. “Many managers, once they’re up 30 or 40 percent, will book their year [i.e., trade very cautiously for the remainder of the year so as not to jeopardize the very good return that has already been realized]. The way to attain truly superior long-term returns is to grind it out until you’re up 30 or 40 percent, and then if you have the convictions, go for a 100 percent year. If you can put together a few near-100 percent years and avoid down years, then you can achieve really outstanding long-term returns.”**

Stanley Druckenmiller is talking about loss aversion here. Most people get conservative when they are winning. The best analogy for this bias happens in golf: “even the best golfers systematically miss the opportunity to score a “birdie” — when a player sinks a ball in one stroke less than the number of expected strokes for a given hole — out of fear of having a “bogey” — or taking one stroke more than what is expected. According to [the researchers](http://knowledge.wharton.upenn.edu/article/avoiding-the-agony-of-a-bogey-loss-aversion-in-golf-and-business/), for many, the agony of a bogey seems to outweigh the thrill of a birdie.”

Loss aversion can be found everywhere if you look. Venture capitalists investing “good money after bad” in the hope of saving a loss is just one example. Similarly, too much energy can be put into saving a business instead of devoting that energy to building one with greater potential. Daniel Kahneman describes loss aversion with a helpful example:  “In my classes, I say: ‘I’m going to toss a coin, and if it’s tails, you lose $10. How much would you have to gain on winning in order for this gamble to be acceptable to you?…People want more than $20 before it is acceptable. And now I’ve been doing the same thing with executives or very rich people, asking about tossing a coin and losing $10,000 if it’s tails. And they want $20,000 before they’ll take the gamble.”

**11. “I certainly made my share of mistakes over the years, but I was fortunate enough to make outside gains a number of times when we had different views and various central banks. Since most investors like betting with the central bank, these occasions provided our most outside returns and the subsequent price adjustments were quite extreme. I don’t know whether we’re going to end with a malinvestment bust, due to misallocation of resources. Whether its inflation, or whether the outcome will actually be benign. I really don’t. But neither does the Fed.”**

Many people believe that the Fed has extraordinary ability to predict the economy. Stanley Druckenmiller is saying that the people at the Fed put their underwear on one leg at a time like everyone else. They are reacting to events like everyone else. I think Janet Yellen is a great choice as a Federal Reserve Chairperson.  But it makes me nervous when I see people write about how she predicted this or that. I remember when people thought Alan Greenspan was great too. I believe that Janet Yellen is smart enough to know what she can’t predict.

As for how Druckenmiller made his bets against central banks, my hat is off to him. I don’t know how he did it. He has talked about the importance of understanding how [central banks impact liquidity](http://images.businessweek.com/bloomberg/pdfs/BN_0850499D_041015_19334.pdf). The story he tells about the decision to short the British Pound is incredible. My hat is particularly off to him when he admitted that in today’s environment the tools he developed probably wouldn’t work. Humility is essential in a money manager he says, as is a focus on mistakes. In my view, we are in a “new abnormal.” Charlie Munger commented about this recently: “I think it’s highly likely that the people who confidently think they know the consequences – none of whom predicted this – now they know what’s going to happen next? Again, the witch doctors. You ask me what’s going to happen? Hell, I don’t know what’s going to happen. I regard it all as very weird. Anybody who is intelligent who is not confused doesn’t understand the situation very well. If you find it puzzling, your brain is working correctly.”

**12. “This is insane. I’ve never owned a stock that goes from $40 to $250 in a few months.”**

The Internet bubble was literally insane. I’ve never been involved in anything in my life that was more surreal. Fear of missing out (FOMO) caused the bubble to reach unprecedented levels. FOMO is driven by an innate human desire to avoid regret. Daniel Kahneman has[counseled financial advisors](https://www.imca.org/sites/default/files/current-issues/JIC%20MastersInterviews/JIC131_MastersSeriesKahneman.pdf) to“try to prevent people from acting out of regret.” Investors and speculators who are prone to regret are more prone to change their mind at precisely the wrong time. Primarily you want to protect them from regret, you want to protect them from the emotions associated with very big losses.

They key takeaway from the Internet bubble, for me, is that when it happens is not predictable. If it is a bubble and it does bust, the day before is like any other day. One key “tell” that can give you a sense that something is up is looking around and seeing lots of companies that are unprofitable paying far too much to acquire customers. What is too much? If the customer over their lifetime is producing a return that is significantly net present value negative the business is paying too much. How much is too much? It depends. If this pattern of acquiring net present value negative customers is persistent and widespread hairs should be standing up on the back of your neck. The bigger the net present value deficit the bigger the risk. Can you predict when it will end? No. “You can’t predict, but you can prepare” says Howard Marks, and I agree. And for the hundredth time: risk is not the same thing as valuation.

**Notes:**

[*Inside the House of Money* (Amazon)](http://www.amazon.com/dp/0471794473/?tag=25iq-20)

[*The New Market Wizards: Conversations with America’s Top Traders* (Amazon)](http://www.amazon.com/dp/1592803377/?tag=25iq-20)

[*Soros: The Life and Times of a Messianic Billionaire (*Amazon)](http://www.amazon.com/dp/037570549X/?tag=25iq-20)

[Bloomberg Interview on Strategy, Shorting IBM](http://www.bloomberg.com/news/videos/b/cb28145f-0bb5-4cfc-9c69-0b78cb43bba9)

[Finance Trends – Stan Druckenmiller Talks Trading](http://financetrends.blogspot.com/2013/11/stan-druckenmiller-talks-trading.html)

[Speech Transcript at Alpha](http://yragharris.com/2014/07/31/druckenmiller/)

[The Wall Street Journal – May 22, 2000](http://www.colorado.edu/economics/courses/econ2020/4111/articles/soros-fund.html)

[CNBC – Delivering Alpha Speech](http://video.cnbc.com/gallery/?video=3000296912)

[Bloomberg – Druckenmiller calls it quits after 30 years](http://www.bloomberg.com/news/articles/2010-08-18/druckenmiller-calls-it-quits-after-30-years-as-hedge-fund-job-gets-tougher)

[ZeroHedge – Druckenmiller on China’s Future & Investing’s New Normal](http://www.zerohedge.com/news/2013-06-14/stanley-druckenmiller-chinas-future-and-investing-new-normal)

[CNBC Interview (video)](http://video.cnbc.com/gallery/?video=3000358500)& [article](http://www.cnbc.com/id/101842285)

### *Share this:*