Lecture 1 for Lesson 1, Readings: *Margin of Safety* and *Mr. Market* from *The Intelligent Investor*, Preface from **the book, *Deep Value*** by Tobias Carlisle, and *Behavioral Portfolio Management.*

Supplementary readings: *Quantitative Value, Margin of Safety* (Klarman) *Value Investing* (Montier) and for special projects.

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A rambling, REPETITIVE lecture, but stay with me.

Thanks for those who sent their answers. Your replies help me assess who is in the class. We have almost 500 students enrolled and many seem knowledgeable and astute. I will collate and then post some of the "student" answers. I place student in quotation marks because we are all students here. If you request something or ask a question and I don't respond**, please place in block letters in an email to aldridge56@aol.com, SECOND REQUEST**. Typically, I respond within 24 hours, but I receive hundreds of emails, so don't take it personally if I am slow to respond or your email request is lost.

Let's sit down and discuss why I sent you these readings.

All intelligent investing is value investing—acquiring more than you are paying for. You must value the business in order to value the stock. –Charlie Munger.

I think of investing as trying to buy bargains typically when other investors feel, need, or must sell urgently. If **we are correct** in our assessment of intrinsic value, ("IV")**--**defined through future discounted cash flows or private market value between two cogent investors**--**then **Regression to the Mean** should work over a reasonable time to close the gap between the price we paid and IV. Note that Graham NEVER discussed how to calculate intrinsic value.

Valuation is subject to judgment and it is often a range of values depending upon our assumptions and cost of capital. Often we can't value a company because of our lack of expertise. The market provides a place where prices are offered or bid on securities (bonds/stocks) of underlying businesses. Since we are prone to error as are all other investors we build in a **Margin of Safety** by waiting for a large enough discount in the price paid to IV, by using conservative assumptions, diversification, and by staying within our circle of competence. **Margin of safety is central to the attitude of a deep value investor.** *Margin of Safety* by Seth Klarman is an excellent book along with *The Intelligent Investor* (to be emailed later) to learn of the **ATTITUDE** of the true value investor. We also should be aware of who is on the other side of the trade from us. If the price of a company's stock is dropping while insiders are selling heavily, we had best reconsider our assumptions.

We are the enemy!

So here is our dilemma. We as Deep Value Investors ("DVIs") seek to identify measurable and persistent behavioral price distortions and then capitalize on those distortions. In other words, when people go crazy, we seek to take advantage. But people over-react, go crazy, fear loss, seek out certainty, and herd together because they are **human**, but so are we. What makes us special? Won't we fall prey to those same biases? We will explore this further in the course.

What is Value Investing?

If you asked John Neff, Peter Lynch, Ben Graham, Seth Klarman, and Charlie Munger they might say basically the same thing, buying a business for less than its worth, but their portfolios might all be different. We will be focusing on Deep Value stocks. These are losing stocks that become asymmetric opportunities with limited downside and enormous upside. Yes, but aren't we trading off big upside with big risk? If we factor in the risk of loss then are we really obtaining a bargain? What about value traps where value erodes as fast as price? **The key for us to focus on in this course will this second dilemma**. Deep value stocks may have a higher risk of bankruptcy *individually*, but as a *group*, the risk is OVERCOMPENSATED. In other words, we are highly compensated for taking the other side of the distressed selling. **Is that statement true?** If investors over-react due to various biases like recency-bias, loss aversion, myopia, etc. AND the process of Mean Reversion works, then can we profit on a risk-adjusted basis? At the end of this course, we should be able to answer that question. Any one of our investments may go to $0.00 (What did Buffett say, "Rule 1: Don't lose money and never forget rule 1." Out of 20 mispriced opportunities, we may have three go to zero, two or three drop 50% and stay there, but 14 rise and provide us with an adequate return.

Investment	Result	
$1.00	$0.00	OUCH!
$1.00	$0.00	OUCH!
$1.00	$0.00	OUCH!
$1.00	$0.50	Help!
$1.00	$0.50	Help!
$1.00	$1.20	
$1.00	$1.20	
$1.00	$1.20	
$1.00	$1.50	
$1.00	$1.50	
$1.00	$1.50	
$1.00	$1.00	
$1.00	$1.75	
$1.00	$2.00	

$1.00	$2.00
$1.00	$2.00
$1.00	$2.50
$1.00	$1.30
$1.00	$1.30
$1.00	$1.50
$20.00	$24.45
	22.50%
20 invs.	**return**

My goals for students are:

You (and I) are the enemy thus we need to build protections against our flaws. Investing often goes against the grain of how our brains evolved. See the grass rustle, a tiger lurks. Don't think about it—RUN! See the plunging price of my stock, sell! We are hardwired to react QUICKLY to danger or else we wouldn't be here (our ancestors wouldn't have passed on their genes). Recognized that we are as flawed, fearful, hopeful, and subject to emotion as others. We must figure out a way to work around our natural instincts. Buffett and Graham spoke of temperament and character being more important than IQ. So how will we develop such character? We will try in this course.

Practice thinking independently (Be skeptical/prove it to yourself). This will take courage and solitude. If you are not comfortable sitting alone in a room reading and thinking, then investing alone may not be the best use of your time. That's OK; you must find a path for yourself. Don't waste time seeking out gurus for advice. Mr. Market is there to serve you not guide you. Can you imagine walking into a grocery store/food market and asking the vendor how much you should buy and at what price? No. Good. Wall Street or the "Market" can't tell you what you should do. Wall Street is there to generate fees and commissions while raising capital for businesses and transacting trades. Two timeless books on Wall Street are ***Where Are the Customers' Yachts or A Good Hard Look at Wall Street*** by Fred Schwed, Jr. and the ***Money Game*** by "Adam Smith" (Jerry Goodman). Finally, ***Reminiscences of a Stock Operator*** by Edwin Lefevre is a classic on the psychology of traders, investors, and brokers. I suggest an annual rereading of these classics to calm the nerves. Since human nature hasn't changed, people tend to react similarly. Or, as a Wall Street veteran remarked, "The music never changes, just the players."

Try to **read original source documents** rather than a second-hand source. Read a company's 10-K rather than a brokerage report's buy recommendation. We will be reading several of the research reports that the author of DEEP VALUE read to write his book.

Investing is **most successful when most <u>businesslike</u>**. Students need to treat their investing like a business. You should know your philosophy, methodology, and strengths/weaknesses of your approach while being meticulous in recording/tracking your investments/progress. Be rational. How will you learn from your successes and mistakes? For example, since deep value investing may be highly counter-cyclical to the general market, you may widely "underperform" a benchmark index for a long period of time. The patience required is difficult and uncertainty is often confused with risk.

Risk is meaningless without a preceding adjective. Risk is not volatility but permanent loss of capital. (Unless you are heavily leveraged). Risk could be: operational, political, management, or financial risk. Or the risk could be YOU—your emotional state, your hubris, and/or undisciplined actions.

Students should realize that **investing is simple but not easy**. Prof. Joel Greenblatt in his MBA class and his book, *The Little Book that Beats the Market* (to be emailed later) says that all he does is figure out what a business is worth and then pay a whole lot less for it. Seems simple but how to go from here to there? Prof. Greenblatt also says he is not better at analyzing companies than many Wall Street analysts but he knows what he knows (his circle of competence) and he weights mispriced bets. When he often can't value a company, he moves on. Investing is something you *do* (or not do until you do decide to act). As an investor always consider **who is on the other side of the trade from you** so you don't become the patsy or fool at the poker table. A fool ceases to be a fool when he or she quits/corrects the mistake. The deep value investor is seeking out mispriced securities however that is determined.

Many readers say their goal is to **become better at determining intrinsic value ("IV")** because then they would have the knowledge and confidence to buy and sell when prices move away from IV. HOWEVER….

My bias is that it is NOT difficult to find price below value when there is **extreme panic** or distress on the part of sellers, but the difficulty lies in **ACTING to seize the opportunity**. Even DEEP VALUE investors are human with all the same biases as others. When the company's stock is plummeting, analysts are downgrading their earnings estimates, the news for the industry's future is terrible, and then perhaps, we fear, the value we see isn't there. Our fears overcome us. "Don't you read the papers, your friends and colleagues scream! We will wait until we gain more certainty—we practice REARVIEW investing. We become part of the same herd that will act emotionally to provide us with mispricing. Walking across a plank isn't hard, but when that plank is perched between two cliffs 1,000 feet above the ground, then the difficulty increases. Noise overwhelms the signal; our fears stop us from acting. Are we trapped in our humanness?

If **knowledge was all we needed**, then why are there so many fat (obese) Americans when 100s of diet books are published each year? How can we close the yawning gap between knowing and doing?

The video of the crash landing in the Hudson should teach you the importance of remaining rational/calm while following a process. The pilot went through his checklist of seeking an alternative airport, and he remained focused in **flying the plane** to the water. He wasn't focused on being killed if he made a mistake; he remained focused in the moment because that was all he could control. Was he lucky? He had tremendous flying skill, but the weather was clear so he was fortunate in that respect. Never forget the importance of randomness/luck. I think with practice one can train oneself to be calm/rational in stressful situations. Studying past market cycles/financial history and understanding the industries and the financial characteristics of businesses should help you in developing ***realistic*** assumptions. Also, developing confidence in **regression to the mean** will steady you. Always allow for being in error. Only Ben Bernanke is 100% confident that the Fed has EVERYTHING under control.

Behavioral Portfolio Management (The Next Paradigm) shows how one money manager, C. Thomas Howard built a method to protect himself from behavioral errors. We will dig deeper into this article with the help of a "volunteer."

PS: A reader mentions:

I have a splinter in my mind.

In regards to the **poker video**, a better scene would have been if Teddy made a bet not getting the right pot odds implied or otherwise.

For example, if the board was 6-7-k and Matt had 8-9 he would have an open end straight draw. He would make straight with one of four 10s or four 5s. 8 outs total. With two cards to come he has about 32% chance of making a straight or about 1:3. If he is getting 10:1 on his $ he's got to go for it. 1:1 he has to fold.

Teddy, on the other hand, has to create a situation that would put Matt in a position for him to choose to make a bad bet. Like making it so expensive for him to draw; putting 70% of his chips to gain only 30% in the pot.

When people either don't know the odds or know the odds and don't follow them due to emotion, both lead to poor long term results.

Let's continue on our journey.