What Makes Great Value Investors Admirable?

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> There are no dependable ways of making money easily and quickly, either in Wall Street or anywhere else.
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> —Ben Graham[a]

[a] *Security Analysis, 2nd (1940) Edition, Chapter LII.*

In his famous published speech *Superinvestors*,[1] Warren Buffett talked about a group of value investors with great results. What makes those value investors successful? Could it be due to some secret techniques? It doesn't appear to be so because their specific approaches differ from each other.[2] What do those great value investors have in common? Can we find any pattern?

[1] *The Superinvestors of Graham-and-Doddsville.* Warren Buffett.

[2] Buffett explained their technical difference in *Superinvestors*.

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What they share is a *philosophical framework*: value investment. What's value investment? Ben Graham, the father of it, (wisely) never precisely defined it.[3] But if we look at what it does essentially, it's this: buying a stock[4] with a price below its *intrinsic value* with a wide *margin of safety*.

[3] Perhaps Graham knew, in investment, people would turn any precise ideas into dogmas (although Graham occasionally slipped away by giving mathematically precise criteria). He would agree that the specific methods need to be flexible to deal with the forever-changing market. (He wasn't dogmatic at all.) But value investors still need to stick to the principles. This *golden mean* between sticking to the principles and allowing flexibility is the subtle art of value investment (and doing any great work in general).

[4] More precisely, securities i.e. bonds, preferred stocks, and common stocks.

The idea of intrinsic value and how to estimate it is, of course, the hardest part of value investment. But roughly speaking, the intrinsic value of X is just what X is worth. So value investment simply means this: buying a stock with a price much lower than what it's worth.

But you might ask: Wait, isn't it just the definition of *investment in general*, regardless of whether it's value investment or not? When you invest in X, don't you simply want the money you pay for X now to be less than the value you'll get from it in the future? Or more generally, isn't it what you want when you buy *anything*?

This simple idea might *seem* obvious by common sense. In reality, however, this is often not what we do. For example, when we buy luxuries, we usually don't ask if the price justifies the value.[5] Nor is it what speculators "think" when they buy stocks. When speculators buy a stock, they don't look at its *value*, i.e. what the *company* behind the

[5] Graham had a great analogy: buying stocks should be like buying groceries, not perfume.

ticker symbol and its *business* are worth. Instead, they look at its *price*, and *wish* the price would go up (regardless of the underlying value) so that they could profit by taking money from other speculators (instead of by generating economic values from the company's business, which is the value investor's view).[6]

[6] Graham insisted a clear-cut distinction between speculating and investing, and between *speculators* and *investors*.

So value investment is just going back to the original definition of investment, after clearing up the muddy head confused by speculation. And it's the same for another important view in value investment: What's a stock? Value investment regards a stock as a piece of business. But again, isn't it just what the stock was designed for originally? Stock, by definition, is a certificate that you can claim as *business ownership*. Similarly, this simple and obvious view is easy to be carried away by what speculators believe a stock to be, i.e. a lottery ticket with a price that fluctuates constantly.

In a way, the phrase "value investment" is a tautology.[7] No wonder people regard Graham as conservative – if conservative means sticking to the original definition of investment.[8]

[7] Buffett and Charlie Munger often said all good investments are value investments.

[8] Graham wrote about the change of investment view after WWI. And many of his ideas were to come back to the pre-WWI investment philosophy. He wrote that before WWI, people bought stocks like buying private businesses, i.e. they valued the company before they bought. After WWI, people only looked at earning trends, and stock analysis was reduced to something a "$30-a-week clerk" could do. (*Security Analysis*, 2nd (1940) Edition, Chapter XXVII.)

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Now we've known the "secret" of value investment, we can ask again: What makes those great value investors successful? But we get more confused: if the idea of value investment – just sticking to what investment *is* – is so simple and obvious, why don't more people do it?

Buffett summed it up: "It doesn't sound like it can promise much." By insisting on a wide margin of safety, you would miss speculators' favorite stocks that look exciting and sexy (but likely overpriced).[9] It doesn't let you make quick profits by gambling on short-term stock movements. It doesn't make you *feel* that what you're buying now will make you rich in a few days or months, as some people want to sell you on. In short, it doesn't say what you *wish* to hear: how to make money *easily* and *quickly*. So value investment requires you to be *not greedy*.

[9] And instead choose undervalued but "boring" ones. It might be an understatement to call those value stocks boring – someone once wrote an article about Walter Schloss (one of Graham's followers) titled "Making Money Out of Junk."

Not greedy? In the investment world where the goal is to make money, you ask the practitioners to be not greedy? It's like asking people in a monastery to not believe in God. But if we look at the facts about those great value investors, it's hard to say they're greedy. Starting with Graham, they don't go after quick profits; they have high ethical standards;[10] they rarely spend (on themselves) the money they've compounded. They don't make money for the sake of what money can buy.

[10] When people asked Walter Schloss what Graham's followers had in common, he joked none of them smoked. Later he said they were all rational.

Instead, they *love the game itself*. Their reward is the mental pleasure of playing the game of investment, not spending the money coming out of it. Therefore, when the market goes crazy, they wouldn't join the crowd at the risk of destroying their beloved games, just to make some quick money that they have no use for in life. In other words, they overcome their *gambling instincts*.

Being not greedy alone isn't enough to make great value investors successful; otherwise, monks would be the richest. They also need *rationality*. Rationality is a suitcase word, so we need to unpack it. In investment, it means (1) emotional discipline and (2) looking at facts, not what you wish to believe.

(1) Emotional discipline means *not trusting your emotions*. The market is dominated by greed and fear, and it'll forever be because human nature doesn't change. Often quoted for both good and bad reasons, Buffett's point that being greedy when others are fearful and being fearful when others are greedy is right – *if you know what you're doing*.

(2) Since investment deals with the real world, you need to look at what things are, *not what you wish to believe*. The human brain is *very, very* good at fooling itself into believing what *feels good*,[11] so you need to be *very, very* cautious about it. Great value investors don't believe something *merely* because it feels good to do so. Instead, they look at what the facts are and what the facts tell them. It can be, of course, unpleasant when facts confront existing beliefs.[12] But great value investors can endure the mental pain from challenging, modifying, and destroying their cherished beliefs to improve the mind,[13] like enduring the physical pain from exercise to improve the body.

After great value investors detach themselves from the market's emotions and look at facts objectively, they naturally become *independent-minded*. In investment, if you just do what everyone else is doing, you can't make money.[14] Graham often said thinking correctly isn't enough in investment; you also need to think independently. His famous Mr. Market analogy[15] showed the essence: you shouldn't follow a man with bipolar disorder (i.e. the market and the crowd) who often overreacts with violent emotions, but only view him as chances to buy low and sell high.[16] Another Graham quote: "You're neither right nor wrong because the crowd disagrees with you; you're right because your facts and reasoning are right."

Great value investors must be *patient* because time, in investment (and

[11] That's what religions and ideologies are largely based on.

[12] That's why a belief, once formed, is almost impossible to change.

[13] Absolute certainty is dangerous in investment (and in life). Everything is a degree of belief, and needs to be re-examined constantly with new facts, as Keynes demanded, "When new facts come in, I change my mind. What do *you* do?"

[14] Graham's argument is that otherwise, it would imply the market, as a whole, beats itself – a logical impossibility.

[15] *The Intelligent Investor*, Chapter 8.

[16] Munger and (non-early) Buffett might disagree with the "sell high" part. They want to hold forever.

in life), can be either your best friend or worst enemy. Value investment focuses more on *downward protections* than *upward potentials*. So great value investors don't count on getting rich quickly by gambling on hot stocks. But they're unlikely to become poor either by paying a price that is too high and then losing the principal hugely. As long as you can keep not losing money,[17] the *magic of compounding* will work *in the long run*. The long run is key because it'll take time for the market to correct its misjudgments. After you buy an undervalued stock, its price is unlikely to skyrocket immediately. In fact, the price is most likely to continue to go down (here the emotional discipline comes in) until the market corrects itself.[18]

[17] Buffett used to say investment only has two rules: (1) Don't lose money and (2) Don't forget about the first rule.

[18] We don't know exactly why undervalued stocks will eventually bounce back to their intrinsic value. Graham admitted in a Congress hearing that "That is one of the mysteries of our business...we know from experience that eventually the market catches up with value." Munger's explanation is that other smart people would also realize they're cheap and start buying.

Patience also means *doing nothing* when you should, which, in investment, is the *overwhelmingly* vast majority of the time.[19] Great opportunities are rare, and they often come together *in clusters* at the same time. Therefore, the optimal strategy is doing nothing most of the time patiently; but acting decisively and aggressively when great opportunities come together. The hardest part is doing nothing because it's against our human nature – we crave for actions, as Keynes called *animal spirits*.[20] But great value investors can overcome their animal spirits, showing almost inhuman patience, because doing nothing is better than doing something wrong.

[19] It's really most of the time. In fact, almost all the time. The most extreme example is Buffett who, on average, makes only one decision every *5 years*!

[20] *General Theory*, Chapter 12.

Great value investors *know their limits*. They know that to invest well, they need to learn a lot about what they do, but they can't be good at everything, so they stick to what they're best at. They also know that sticking to their own games means they would miss other people's trendy games, and they're fine with it. The emotional discipline makes them *content* with what they do and the results they get. More importantly, it suppresses their *envy* of speculators' quick profits and their *fear* of missing out on trendy things preached by the market.

When people ask them to predict the future of something outside their *circle of competence*, they're cautious about not turning themselves into prophets.[21] The standard reply is "I don't know." And they focus a lot more on individual companies than macroeconomics[22] because it's more predictable. If they can't confidently predict an external force, then how it would impact them is something they *can't* control; and they'd better switch to things they *can* control. In short, they *accept what's not up to them*; and instead *focus on what's up to them*. Like great card players, they concentrate on how to *play their hands well*, not the results.

[21] It's in our human nature that we always want to predict the future. In the past, every civilization had its prophets, astrologers, and fortune-tellers. And they had enormous influence and power. Today, they're downgraded to mere chartists, stock recommenders, and economic forecasters.

[22] Buffett: you need to focus on what's important *and* knowable. Big external forces like future macroeconomic factors are important but unknowable. (Too many things are knowable but unimportant.)

Nobody can do great work without *hard work*. Great value investors

need to know their facts, and they need to know a lot of them. It takes effort to absorb lots of facts (mostly by reading), and then think. In addition, you have to do lots of futile work. After learning a lot about a stock and thinking of it intensely, you might (rightly) end up doing nothing about it.[23] The analysis often *seems* useless.[24] You need to accept the inevitability of futile work, but still work hard while knowing hard work alone doesn't guarantee great results. And hard work means doing hard things. In today's investment game, it's easy to compute numbers and build models, but it's hard to *think*, as always, at any age.

[23] You need patience to suppress animal spirits and wait for truly great opportunities.

[24] It might not be completely useless. You need to be prepared when opportunities come. And *seemingly* futile work might turn out to be useful later.

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We can see the pattern. What attracted those superinvestors around Graham was a set of shared *temperaments*:[25] (1) not greedy, (2) rational, (3) independent-minded, (4) patient, (5) knowing-your-limits, and (6) hard-working.[26] [27] Buffett said if you aren't interested in value investment after hearing about it for 5 minutes, then you wouldn't in your life. It's because (value) investors and speculators have fundamentally different temperaments, and they can tell immediately, by instinctive like or dislike, if the idea fits them or not.

And those temperaments are nothing but just *old-fashioned virtues*. They *work*, as Buffett and Munger often said, "If it's trite, it's right." What makes those great value investors successful in their careers is also a list of personal virtues that make them admirable in character. Investment philosophy isn't different from life philosophy.

[25] They support it. Graham believed that character is the most important in investment. Buffett and Munger often said, in investment, temperament is more important than IQ.

[26] Those adjectives are more or less overlapped with each other. When we describe people, we're limited by our words.

[27] If those traits sound like Stoicism, it probably isn't a coincidence. Graham wrote in his memoir that Stoicism was a gospel sent to him from Heaven when he was a teenager. People around Buffett and Munger also occasionally commented about their stoicism.

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Value investment is like losing weight: it's simple but not easy. Everyone knows how to lose weight, i.e. eating less and exercising more, but few can stick to it. The crowd and speculators often overlook or mock value investment because it doesn't promise what sounds easy, but is demanding in many ways: (1) overcoming gambling instincts, (2) being painstakingly rational, (3) being comfortable with disagreeing with the crowd, (4) waiting patiently while suppressing animal spirits, (5) focusing on playing your hands well and not envying other people's games, and (6) working hard. Even only one of them would make value investment sound unattractive in the (investment) world.

But Graham pointed out the truth sharply: "There are no dependable ways of making money easily and quickly, either in Wall Street or anywhere else." Easy and quick speculation obviously doesn't work[28] –

[28] It normally ends up with short-term profits but long-term disasters.

doing great things is neither easy nor quick; value investment obviously works – those virtues and demands are necessary for doing anything great.

Value investment is the *hard* but *right* thing. It works because it isn't so easy that everyone can follow. It has worked before, it works now, and it'll work in the future. It's timeless because it's just common sense, and human nature doesn't change.

Sticking to value investment is, of course, hard. But I think Graham wouldn't mind borrowing the epilogue of Spinoza's *Ethics* as the final words on his (investment) philosophy:

> If the way I have shown to lead to these things now seems very hard, still, it can be found. And of course, what is found so rarely must be hard. For if salvation were at hand, and could be found without great effort, how could nearly everyone neglect it? But all things excellent are as difficult as they are rare.