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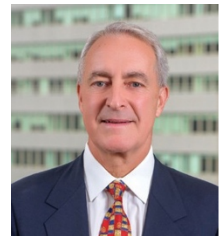
Thoughts for Investors



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Winter Newsletter to Clients

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"Reading, after a certain age, diverts the mind too much from its creative pursuits. Any man who reads too much and uses his own brain too little falls into lazy habits of thinking."

– Albert Einstein

To me, Wolfgang Amadeus Mozart's music is unique among the great composers. Albert Einstein thought so as well. In fact, he defined the uniqueness, saying that Beethoven created his music while Mozart found his. Einstein said that Mozart's music "was so pure that it seemed to have been ever present in the universe, waiting to be discovered by the master." In a recent New York Times article, Arthur Miller, professor of the history and philosophy of science at University College London, talked about how the genius of Mozart inspired the genius of Einstein, pointing out, "it was less laborious calculation, but 'pure thought' to which Einstein attributed his theories."

Can something like "pure thought" work for investors? In this newsletter I will examine why I think the answer is yes. In my opinion, investors can benefit more from "pure thought" than by strictly relying on "laborious calculation" of the kind employed by asset allocation, or the myriad of financial self-help books.

Benjamin Graham, whom I admire and respect, pioneered the use of quantitative investment analysis. The essence of his work was to calculate the value of a company using various financial data. If the stock price was less than his calculation of value he would buy the stock and wait for the value to be recognized. This approach worked wonderfully for decades and in many instances still works. Unfortunately its luster has been dimmed by overuse and over analysis. Graham did these calculations when few other investors bothered. The reasons were both the difficulty in obtaining the data and the "laborious calculation" required to make sense of the data. Furthermore, you had to repeat the process over and over with many companies in many industries to build up your knowledge of what constituted over, under, or fair value.

"Not everything that can be counted counts; and not everything that counts can be counted."

– Albert Einstein

In Graham's day, many companies owned tremendous amounts of physical assets and inventories that could be valued. Today that is much less the case. What is the "value" of Microsoft? They don't have any plants. They don't manufacture their own products. A great part of their "value" is their human capital – the software programmers. How can their value be "calculated?" Those "assets" go out the door every night and may not come back the next day.

"***"Information is not knowledge."***

– Albert Einstein

Today, access to data is unparalleled. Anyone with a web browser can visit the finance.yahoo.com website, type in a ticker symbol, and instantaneously collect massive amounts of data ranging from past and current financial metrics, to industry comparisons, news stories, insider transactions, listing of major shareholders, short interest, competitors, analyst estimates, trading volume, even blogs. One can find almost everything except whether the stock will go up (although there are plenty of sites that claim they can do that too!) With so much data to sort through, portfolio managers now program computers to do the "laborious calculation." Consequently, lots of people see the same results and this dilutes the value of those calculations. Financial planners and hedge funds have stepped in, "overlaying" their "proprietary" methodologies for analyzing the analysis. In my opinion, this amounts to repackaging - with an added cost. Furthermore, some experts suspect that some hedge funds are now just clones of each other, operating in identical manner and chasing the same investment opportunities. This is because many of today's hedge fund managers are former students of the great original hedge fund founders such as Soros or Robertson.

"Asset allocation is nonsense. The best way to minimize risk is to think."

– Warren Buffett

In the end, to get a return there is no escaping the need to think independently, uniquely, and to think about the future. And because no one knows the future, risk becomes inextricably linked to return. There is no way to get a return without risk. Mathematically, zero risk yields zero return. US Treasuries are not riskless. Their yield, meager as it is, comes not from credit risk, but from inflation risk. Wall Street has long touted ways to "maximize/maintain return while minimizing risk."

I believe that on the purest level this is nonsense. It is akin to believing that long-term weight loss (with minimum risk) is achieved by gastric bypass surgery or a pill rather than by the hard work of long-term proper nutrition and exercise. Recall the tale of the fox and the eggs. The wily fox finds a nest with multiple eggs in it. While it can easily carry off one egg in its mouth, it would rather carry off more. The story ends in frustration for the fox as it refuses to leave with just one egg. Human nature is to want more. It is human impetuousness to believe that it is possible without added cost. And, it's Wall Street's job to try to convince you that it knows how.

In summary, there is no way for an investor to get around thinking – and thinking about the future. Furthermore, there is no way to erase the risk that comes with the uncertainty of the future. No amount of financial planning, asset allocation, hedging or "laborious calculation" will uncover a "secret formula" for success in investing. Thinking leads to discipline, discipline leads to temperament, temperament leads to confidence, confidence leads to patience and as I've written time and again, patience leads to investment success. So put on some Mozart and think. If it worked for Einstein, it may work for you.

"Oh the thinks you can think up if only you try!"

– Dr. Seuss

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Hear the Other Side

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If you would like to discuss the topic of this newsletter, or our team's approach to investing, please feel free to contact us by email at al.boris@alexbrown.com.

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