'The most important thing' – Howard Marks

- Where does an investment philosophy come from? The one thing I'm sure of is that no one arrives on the doorstep of an investment career with his or her philosophy fully formed. A philosophy has to be the sum of many ideas accumulated over a long period of time from a variety of sources. One cannot develop an effective philosophy without having been exposed to life's lessons. In my life I've been quite fortunate in terms of both rich experiences and powerful lessons.

The most important thing is … value

- For investing to be reliably successful, an accurate estimate of intrinsic value is the indispensable starting point. Without it, any hope for consistent success as an investor is just that: hope
- In the world of investing. There, many people tend to fall further in love with the thing they've bought as its price rises, since they feel validated, and they like it less as the price falls, when they begin to doubt their decision to buy. This makes it very difficult to hold, and to buy more at lower prices (which investors call "averaging down"), especially if the decline proves to be extensive. If you liked it at 60, you should like it more at 50… and much more at 40 and 30. But it's not that easy. No one's comfortable with losses, and eventually any human will wonder, "Maybe it's not me who's right. Maybe it's the market." The danger is maximized when they start to think, "It's down so much, I'd better get out before it goes to zero." That's the kind of thinking that makes bottoms . . . and causes people to sell there.

The most important thing is … the relationship between Price and Value

- For a value investor, price has to be the starting point. It has been demonstrated time and time again that no asset is so good that it can't become a bad investment if bought at too high a price. And there are few assets so bad that they can't be a good investment when bought cheap enough.
- Investment success doesn't come from "buying good things," but rather from "buying things well.
- It's essential to understand that fundamental value will be only one of the factors determining a security's price on the day you buy it. Try to have psychology and technicals on your side as well.
- Selling for more than your asset's worth. Everyone hopes a buyer will come along who's willing to overpay for what they have for sale. But certainly the hoped-for arrival of this sucker can't be counted on. Unlike having an underpriced asset move to its fair value, expecting appreciation on the part of a fairly priced or overpriced asset requires irrationality on the part of buyers that absolutely cannot be considered dependable.
- Buying something for less than its value. In my opinion, this is what it's all about—the most dependable way to make money. Buying at a discount from intrinsic value and having the asset's price move toward its value doesn't require serendipity; it just requires that market participants wake up to reality. When the market's functioning properly, value exerts a magnetic pull on price.
- "The market can remain irrational longer than you can remain solvent."

The most important thing is … Understanding Risk

- Risk means more things can happen than will happen.
- Dull, ignored, possibly tarnished and beaten- down securities— often bargains exactly because they haven't been performing well—are often the ones value investors favor for high returns. Their returns in bull markets are rarely at the top of the heap, but their performance is generally excellent on average, more consistent than that of "hot" stocks and characterized by low variability, low fundamental risk and smaller losses

when markets do badly. Much of the time, the greatest risk in these low-luster bargains lies in the possibility of underperforming in heated bull markets. That's something the risk- conscious value investor is willing to live with.

- Risk exists only in the future, and it's impossible to know for sure what the future holds… No ambiguity is evident when we view the past. Only the things that happened, happened. But that definiteness doesn't mean the process that creates outcomes is clear-cut and dependable. Many things could have happened in each case in the past, and the fact that only one did happen understates the variability that existed.
- **Decisions whether or not to bear risk are made in contemplation of normal patterns recurring, and they do most of the time. But once in a while, something very different happens. . . . Occasionally, the improbable does occur.**
- Projections tend to cluster around historic norms and call for only small changes. . . . The point is, people usually expect the future to be like the past and underestimate the potential for change.
- We hear a lot about "worst- case" projections, but they often turn out not to be negative enough. I tell my father's story of the gambler who lost regularly. One day he heard about a race with only one horse in it, so he bet the rent money. Halfway around the track, the horse jumped over the fence and ran away. Invariably things can get worse than people expect. Maybe "worst- case" means "the worst we've seen in the past." But that doesn't mean things can't be worse in the future. In 2007, many people's worst- case assumptions were exceeded.
- Risk shows up lumpily. If we say "2 percent of mortgages default" each year, and even if that's true when we look at a multiyear average, an unusual spate of defaults can occur at a point in time, sinking a structured finance vehicle. It's invariably the case that some investors—especially those who employ high leverage— will fail to survive at those intervals.
- **People overestimate their ability to gauge risk and understand mechanisms they've never before seen in operation. In theory, one thing that distinguishes humans from other species is that we can figure out that something's dangerous without**

experiencing it. We don't have to burn ourselves to know we shouldn't sit on a hot stove. But in bullish times, people tend not to perform this function. Rather than recognize risk ahead, they tend to overestimate their ability to understand how new financial inventions will work.

- Finally and importantly, most people view risk taking primarily as a way to make money. Bearing higher risk generally produces higher returns. The market has to set things up to look like that'll be the case; if it didn't, people wouldn't make risky investments. But it can't always work that way, or else risky investments wouldn't be risky. And when risk bearing doesn't work, it really doesn't work, and people are reminded what risk's all about.

The most important thing is … Recognizing Risk

- Worry and its relatives, distrust, skepticism and risk aversion, are essential ingredients in a safe financial system. Worry keeps risky loans from being made, companies from taking on more debt than they can service, portfolios from becoming overly concentrated, and unproven schemes from turning into popular manias.
- The reality of risk is much less simple and straightforward than the perception. People vastly overestimate their ability to recognize risk and underestimate what it takes to avoid it; thus, they accept risk unknowingly and in so doing contribute to its creation. That's why it's essential to apply uncommon, second- level thinking to the subject.
- Risk arises as investor behavior alters the market. Investors bid up assets, accelerating into the present appreciation that otherwise would have occurred in the future, and thus lowering prospective returns. And as their psychology strengthens and they become bolder and less worried, investors cease to demand adequate risk premiums. The ultimate irony lies in the fact that the reward for taking incremental risk shrinks as more people move to take it.

  Thus, the market is not a static arena in which investors operate. It is responsive, shaped by investors' own behavior. Their increasing confidence creates more that they should worry about, just as their rising fear and risk aversion combine to widen risk premiums at the same time as they reduce risk. I call this the "perversity of risk."

> "I wouldn't buy that at any price—everyone knows it's too risky." That's something I've heard a lot in my life, and it has given rise to the best investment opportunities I've participated in. . . .
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> The truth is, the herd is wrong about risk at least as often as it is about return. A broad consensus that something's too hot to handle is almost always wrong. Usually it's the opposite that's true.
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> I'm firmly convinced that investment risk resides most where it is least perceived, and vice versa:

- When everyone believes something is risky, their unwillingness to buy usually reduces its price to the point where it's not risky at all. Broadly negative opinion can make it the least risky thing, since all optimism has been driven out of its price.
- And, of course, as demonstrated by the experience of Nifty Fifty investors, when everyone believes something embodies no risk, they usually bid it up to the point where it's enormously risky. No risk is feared, and thus no reward for risk bearing—no "risk premium"— is demanded or provided. That can make the thing that's most esteemed the riskiest.
- This paradox exists because 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.

The most important thing is … Controlling Risk

- Outstanding investors, in my opinion, are distinguished at least as much for their ability to control risk as they are for generating return.
- Since usually there are more good years in the markets than bad years, and since it takes bad years for the value of risk control to become evident in reduced losses, the

cost of risk control—in the form of return forgone— can seem excessive. In good years in the market, risk-conscious investors must content themselves with the knowledge that they benefited from its presence in the portfolio, even though it wasn't needed. They're like the prudent homeowners who carry insurance and feel good about having protection in place . . . even when there's no fire.

- Risk control is the best route to loss avoidance. Risk avoidance, on the other hand, is likely to lead to return avoidance as well. Skillful risk control is the mark of the superior investor.
- Volatility + Leverage = Dynamite

The most important thing is … Being attentive to cycles

- I think it's essential to remember that just about everything is cyclical. There's little I'm certain of, but these things are true: Cycles always prevail eventually. Nothing goes in one direction forever. Trees don't grow to the sky. Few things go to zero. And there's little that's as dangerous for investor health as insistence on extrapolating today's events into the future.
- The longer I'm involved in investing, the more impressed I am by the power of the credit cycle. It takes only a small fluctuation in the economy to produce a large fluctuation in the availability of credit, with great impact on asset prices and back on the economy itself. The process is simple:
  - The economy moves into a period of prosperity.
  - Providers of capital thrive, increasing their capital base.
  - Because bad news is scarce, the risks entailed in lending and investing seem to have shrunk.
  - Risk averseness disappears.
  - Financial institutions move to expand their businesses— that is, to provide more capital.

- They compete for market share by lowering demanded returns (e.g., cutting interest rates), lowering credit standards, providing more capital for a given transaction and easing covenants.

- "The worst loans are made at the best of times." This leads to capital destruction—t hat is, to investment of capital in projects where the cost of capital exceeds the return on capital, and eventually to cases where there is no return of capital. When this point is reached, the up-leg described above—t he rising part of the cycle— is reversed.
    - Losses cause lenders to become discouraged and shy away.
    - Risk averseness rises, and along with it, interest rates, credit restrictions and covenant requirements.
    - Less capital is made available—and at the trough of the cycle, only to the most qualified of borrowers, if anyone.
    - Companies become starved for capital. Borrowers are unable to roll over their debts, leading to defaults and bankruptcies.
    - This process contributes to and reinforces the economic con traction.
- I stated earlier that cycles are self- correcting. The credit cycle corrects itself through the processes described above, and it represents one of the factors driving the fluctuations of the economic cycle. Prosperity brings expanded lending, which leads to unwise lending, which produces large losses, which makes lenders stop lending, which ends prosperity, and on and on.

The most important thing is … Awareness of the Pendulum

- When things are going well and prices are high, investors rush to buy, forgetting all prudence. Then, when there's chaos all around and assets are on the bargain counter, they lose all willingness to bear risk and rush to sell. And it will ever be so.
- Three stages of a bull market. Now I'll share them with you.
    - The first, when a few forward- looking people begin to believe things will get better.
    - The second, when most investors realize improvement is actually taking place.

    - The third, when everyone concludes things will get better forever.
- The three stages of a bear market:
    - The first, when just a few thoughtful investors recognize that, despite the prevailing bullishness, things won't always be rosy
    - The second, when most investors recognize things are deteriorating.
    - The third, when everyone's convinced things can only get worse.
- In theory with regard to **polarities such as fear and greed**, the pendulum should reside mostly at a midpoint between the extremes. But it doesn't for long.
- Primarily because of the workings of investor psychology, it's usually swinging toward or back from one extreme or the other.
- The pendulum cannot continue to swing toward an extreme, or reside at an extreme, forever (although when it's positioned at its greatest extreme, people increasingly describe that as having become a permanent condition).
- Like a pendulum, the swing of investor psychology toward an extreme causes energy to build up that eventually will contribute to the swing back in the other direction. Sometimes, the pent-up energy is itself the cause of the swing back— that is, the pendulum's swing toward an extreme corrects of its very weight.
- The swing back from the extreme is usually more rapid—and thus takes much less time—than the swing to the extreme.

  But just like the oscillation of cycles, we never know:
    - How far the pendulum will swing in its arc,
    - What might cause the swing to stop and turn back,
    - When this reversal will occur, or
    - How far it will then swing in the opposite direction.

The most important thing is … Combating negative influences

- The desire for more, the fear of missing out, the tendency to compare against others, the influence of the crowd and the dream of the sure thing— these factors are near universal. Thus they have a profound collective impact on most investors and most markets. The result is mistakes, and those mistakes are frequent, widespread and recurring.
- Inefficiencies—mispricings, misperceptions, mistakes that other people make—provide potential opportunities for superior performance. Exploiting them is, in fact, the only road to consistent outperformance. To distinguish yourself from the others, you need to be on the right side of those mistakes.
- The biggest investing errors come not from factors that are informational or analytical, but from those that are psychological.
- What weapons might you marshal on your side to increase your odds?
    - A strongly held sense of intrinsic value,
    - Insistence on acting as you should when price diverges from value.
    - Enough conversance with past cycles— gained at first from reading and talking to veteran investors, and later through experience— to know that market excesses are ultimately punished, not rewarded.
    - A thorough understanding of the insidious effect of psychology on the investing process at market extremes.
    - A promise to remember that when things seem “too good to be true,” they usually are.
    - Willingness to look wrong while the market goes from mis-valued to more mis-valued (as it invariably will), and
    - Like-minded friends and colleagues from whom to gain support (and for you to support).

The most important thing is … Contrarianism

- To buy when others are despondently selling and to sell when others are euphorically buying takes the greatest courage, but provides the greatest profit.
- The ultimately most profitable investment actions are by definition contrarian: you're buying when everyone else is selling (and the price is thus low) or you're selling when everyone else is buying (and the price is high). These actions are lonely and, uncomfortable. How can we know it's the opposite— the consensus action— that's the comfortable one? Because most people are doing it.
- It should be clear from the first element that the process has to begin with investors who are unusually perceptive, unconventional, iconoclastic or early. That's why successful investors are said to spend a lot of their time being lonely.
- We're not going to try to catch a falling knife; it's too dangerous." They usually add, "We're going to wait until the dust settles and the uncertainty is resolved." What they mean, of course, is that they're frightened and unsure of what to do.
- The one thing I'm sure of is that by the time the knife has stopped falling, the dust has settled and the uncertainty has been resolved, there'll be no great bargains left. When buying something has become comfortable again, its price will no longer be so low that it's a great bargain. Thus, a hugely profitable investment that doesn't begin with discomfort is usually an oxymoron.
- It's our job as contrarians to catch falling knives, hopefully with care and skill. That's why the concept of intrinsic value is so important. If we hold a view of value that enables us to buy when everyone else is selling— and if our view turns out to be right— that's the route to the greatest rewards earned with the least risk.

The most important thing is … Buying Bargains

- The best opportunities are usually found among things most others won't do.

- It’s obvious that investors can be forced into mistakes by psychological weakness, analytical error or refusal to tread on uncertain ground. Those mistakes create bargains for second-level thinkers capable of seeing the errors of others.

The most important thing is … Patient Opportunism

- So here’s a tip: You’ll do better if you wait for investments to come to you rather than go chasing after them. You tend to get better buys if you select from the list of things sellers are motivated to sell rather than start with a fixed notion as to what you want to own. An opportunist buys things because they’re offered at bargain prices. There’s nothing special about buying when prices aren’t low.
- The key during a crisis is to be (a) insulated from the forces that require selling and (b) positioned to be a buyer instead. To satisfy those criteria, an investor needs the following things: staunch reliance on value, little or no use of leverage, long-term capital and a strong stomach. **Patient opportunism, buttressed by a contrarian attitude and a strong balance sheet, can yield amazing profits during meltdowns.**

The most important thing is … Knowing what you don’t know

- We have two classes of forecasters: Those who don’t know— and those who don’t know they don’t know - JOHN KENNETH GALBRAITH
- It’s frightening to think that you might not know something, but more frightening to think that, by and large, the world is run by people who have faith that they know exactly what’s going on - AMOS TVERSKY
- There are two kinds of people who lose money: those who know nothing and those who know everything -HENRY KAUFMAN

The most important thing is … Having a sense for where we stand

- In the world of investing, nothing is as dependable as cycles. Fundamentals, psychology, prices and returns will rise and fall, presenting opportunities to make mistakes or to profit from the mistakes of others. They are the givens.
- We cannot know how far a trend will go, when it will turn, what will make it turn or how far things will then go in the opposite direction. But I'm confident that every trend will stop sooner or later. Nothing goes on forever.
- So what can we do about cycles? If we can't know in advance how and when the turns will occur, how can we cope? On this, I am dogmatic: We may never know where we're going, but we'd better have a good idea where we are. That is, even if we can't predict the timing and extent of cyclical fluctuations, it's essential that we strive to ascertain where we stand in cyclical terms and act accordingly.
- It would be wonderful to be able to successfully predict the swings of the pendulum and always move in the appropriate direction, but this is certainly an unrealistic expectation. I consider it far more reasonable to try to (a) stay alert for occasions when a market has reached an extreme, (b) adjust our behavior in response and, (c) most important, refuse to fall into line with the herd behavior that renders so many investors dead wrong at tops and bottoms.
- Most people strive to adjust their portfolios based on what they think lies ahead. At the same time, however, most people would admit forward visibility just isn't that great. That's why I make the case for responding to the current realities and their implications, as opposed to expecting the future to be made clear.

The most important thing is … Appreciating the role of luck

- Every once in a while, someone makes a risky bet on an improbable or uncertain outcome and ends up looking like a genius. But we should recognize that it happened because of luck and boldness, not skill.
- The Intelligent Investor describes a contest in which each of the 225 million Americans starts with $1 and flips a coin once a day. The people who get it right on day one collect a dollar from those who were wrong and go on to flip again on day two, and so forth.

Ten days later, 220,000 people have called it right ten times in a row and won $1,000. "They may try to be modest, but at cocktail parties they will occasionally admit to attractive members of the opposite sex what their technique is, and what marvelous insights they bring to the field of flipping." After another ten days, we're down to 215 survivors who've been right 20 times in a row and have each won $1 million. They write books titled like How I Turned a Dollar into a Million in Twenty Days Working Thirty Seconds a Morning and sell tickets to seminars. Sound familiar?

- Investors are right (and wrong) all the time for the "wrong reason." Someone buys a stock because he or she expects a certain development; it doesn't occur; the market takes the stock up anyway; the investor looks good (and invariably accepts credit).
- The correctness of a decision can't be judged from the outcome. Nevertheless, that's how people assess it. A good decision is one that's optimal at the time it's made, when the future is by definition unknown. Thus, correct decisions are oft en unsuccessful, and vice versa.
- Randomness alone can produce just about any outcome in the short run. In portfolios that are allowed to reflect them fully, market movements can easily swamp the skillfulness of the manager (or lack thereof). But certainly market movements cannot be credited to the manager (unless he or she is the rare market timer who's capable of getting it right repeatedly).
- For these reasons, investors oft en receive credit they don't deserve. One good coup can be enough to build a reputation, but clearly a coup can arise out of randomness alone. Few of these "geniuses" are right more than once or twice in a row.
- Thus, it's essential to have a large number of observations— lots of years of data— before judging a given manager's ability.

- Several things go together for those who view the world as an uncertain place: healthy respect for risk; awareness that we don't know what the future holds; an understanding that the best we can do is view the future as a probability distribution and invest accordingly; insistence on defensive investing; and emphasis on avoiding pitfalls. To me that's what thoughtful investing is all about.

The most important thing is … Investing Defensively

- There are old investors, and there are bold investors, but there are no old bold investors.
- The aggressive lender will look smarter than the prudent lender (and make more money) as long as the environment remains salutary. The prudent lender's reward comes only in bad times, in the form of reduced credit losses. The lender who insists on margin for error won't enjoy the highest highs but will also avoid the lowest lows. That's what happens to those who emphasize defense.

The most important thing is … Avoiding Pitfalls

- An investor needs do very few things right as long as he avoids big mistakes.
- Too much capital availability makes money flow to the wrong places. When capital is scarce and in demand, investors are faced with allocation choices regarding the best use for their capital, and they get to make their decisions with patience and discipline. But when there's too much capital chasing too few ideas, investments will be made that do not deserve to be made.
- Bullish investors focus on what might work, not what might go wrong. Eagerness takes over from prudence, causing people to accept new investment products they don't understand. Later, they wonder what they could have been thinking.
- Psychological and technical factors can swamp fundamentals. In the long run, value creation and destruction are driven by fundamentals such as economic trends, companies' earnings, demand for products and the skillfulness of managements. But in the short run, markets are highly responsive to investor psychology and the technical factors that influence the supply and demand for assets. In fact, I think confidence matters more than anything else in the short run. Anything can happen in this regard, with results that are both unpredictable and irrational.

- Loss of confidence and resolve can cause investors to sell at the bottom, converting downward fluctuations into permanent losses and preventing them from participating fully in the subsequent recovery. This is the greatest error in investing— the most unfortunate aspect of pro- cyclical behavior— because of its permanence and because it tends to affect large portions of portfolios.

The most important thing is … Putting it all together

- To achieve superior investment results, your insight into value has to be superior. Thus you must learn things others don’t, see things differently or do a better job of analyzing them— ideally, all three.
- The relationship between price and value is influenced by psychology and technicals, forces that can dominate fundamentals in the short run. Extreme swings in price due to those two factors provide opportunities for big profits or big mistakes. To have it be the former rather than the latter, you must stick with the concept of value and cope with psychology and technicals.
- It’s impossible to know when an overheated market will turn down, or when a downturn will cease and appreciation will take its place. But while we never know where we’re going, we ought to know where we are. We can infer where markets stand in their cycle from the behavior of those around us. When other investors are unworried, we should be cautious; when investors are panicked, we should turn aggressive.
- Buying based on strong value, low price relative to value, and depressed general psychology is likely to provide the best results. Even then, however, things can go against us for a long time before turning as we think they should. Underpriced is far from synonymous with going up soon. Thus the importance of my second key adage: “Being too far ahead of your time is indistinguishable from being wrong.” It can require patience and fortitude to hold positions long enough to be proved right.
- Risk control and margin for error should be present in your portfolio at all times. But you must remember that they’re “hidden assets.” Most years in the markets are good years,

but it’s only in the bad years—w hen the tide goes out— that the value of defense becomes evident. Thus, in the good years, defensive investors have to be content with the knowledge that their gains, although perhaps less than maximal, w ere achieved with risk protection in place . . . even though it turned out not to be needed.

- One of the essential requirements for investment success—and thus part of most great investors’ psychological equipment—is the realization that we don’t know what lies ahead in terms of the macro future. Few people if any know more than the consensus about what’s going to happen to the economy, interest rates and market aggregates. Thus, the investor’s time is better spent trying to gain a knowledge advantage regarding “the knowable”: industries, companies and securities. The more micro your focus, the greater the likelihood you can learn things others don’t.
- Many more investors assume they have knowledge of the future direction of economies and markets—and act that way—than actually do. They take aggressive actions predicated on knowing what’s coming, and that rarely produces the desired results. Investing on the basis of strongly held but incorrect forecasts is a source of significant potential loss.
- Many investors—amateurs and professionals alike—assume the world runs on orderly processes that can be mastered and predicted. They ignore the randomness of things and the probability distribution that underlies future developments. Thus, they opt to base their actions on the one scenario they predict will unfold. This works sometimes—w inning kudos for the investor— but not consistently enough to produce long- term success. In both economic forecasting and investment management, it’s worth noting that there’s usually someone who gets it exactly right … but it’s rarely the same person twice. Th e most successful investors get things “about right” most of the time, and that’s much better than the rest