The Most Important Thing
Howard Marks

Second Level Thinking

p.1 "No rule always works. The environment isn't controllable, and circumstances rarely repeat exactly."

p.3 Beating the market requires superior insight that comes through thinking differently than others (second level thinking)

p.4 "Second level thinking is deep, complex and convoluted."

p.5 Ref. to Peter Lynch mantra "Buy what you know" (an example of first level thinking)

p.7 "to achieve superior investment results, you have to hold nonconsensus views regarding value, and they have to be accurate. That's not easy."
prevalence of first-level thinkers increases returns available for second-level thinkers

Understanding Market Efficiency (and Its Limitations)

p.9 efficient = quick to incorporate information
Markets may quickly digest information and make a consensus view, but that view may be incorrect--(the mispricing argument)
NOTE: argument for existence of value premium is: 1) risk or 2) mispricing

p.10 "The bottom line for me is that, although the more efficient markets often misvalue assets, it's not easy for any one person--working with the same information as everyone else and subject to the same psychological influences--to consistently hold views that are different from the consensus and closer to being correct."

p.11 Index funds are an outcome from the Chicago theory (markets are efficient)
EMH says alpha doesn't exist, and higher returns are a form of compensation for bearing some form of risk--Marks disagrees with the relationship between risk and return

p.12 "... if riskier investments could be counted on to produce higher returns, they wouldn't be riskier."

p.13 "To me, describing a market as inefficient is a high-flown way of saying the market is prone to mistakes that can be taken advantage of."

p.14 "Human beings are not clinical computing machines. Rather, most people are driven by greed, fear, envy and other emotions that render objectivity impossible and open the door for significant mistakes."

p.15 Inefficient markets provide the raw material to produce high returns, but it still takes skill to realize those returns

p.16 Inefficiency is a necessary condition to produce superior returns, but on its own is insufficient, skill and second-level thinking are still required

Value

p.19 Intrinsic value as an objective measure of fair price--helps determine what a high price and low price are

p.22 "The emphasis in value investing is on tangible factors like hard assets and cash flows. Intangibles like talent, popular fashions and long-term growth potential are given less weight."

p.23 Value vs. growth: choice is between value today (growth) or value tomorrow (value)

p.26 "Being too far ahead of your time is indistinguishable from being wrong."
THOUGHT: there is probably a reason a company is mispriced or under-priced, but it may not be known broadly, what you don't know can hurt in value investing, particularly what company managers are actually doing behind the scenes

p.27 "We learn in Microeconomics 101 that the demand curve slopes downward to the right; as the price of something goes up, the quantity demanded goes down... It works that may in most places, but far from always, it seems, 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."

The Relationship Between Price and Value

p.30 "No asset class or investment has the birthright of a high return. It's only attractive if it's priced right."
p.32 technicals are nonfundamental factors that affect the supply and demand for securities
p.33 "The safest and most potentially profitable thing is to buy something when no one likes it."
p.34 fundamentals are only one factor that affect price
p.35 Reference to Minsky's mania, which goes back to the perversion that as price increases demand should decrease, but does not (see quote on p. 27)
p.36 "Eventually, though, valuation has to matter."
Possible paths to profit:
1) Benefitting from a rise in the intrinsic value of the asset
2) Applying leverage
3) Selling for more than the asset is worth
4) Buying something for less than its value
p.38 "Of all the possible routes to investment profit, buying cheap is clearly the most reliable."

Understanding Risk

p.39 "Investing consists of exactly one thing: dealing with the future."
p.41 Capital market line: upward slope that relates risk and return
Taking more risk to get higher return sis the wrong thought. Riskier investments offer the potential for higher returns, but there's no guarantee that those returns will occur
p.43 When priced fairly, riskier investments should entail: higher expected returns, the possibility of lower returns, and the possibility of losses
p.44 Volatility became a proxy for risk out of convenience
"To me, "I need more upside potential because I'm afraid I could lose money" makes an awful lot more sense than "I need more upside potential because I'm afraid the price may fluctuate.""
p.45 Different forms of risk
p.47 "Mostly it comes down to psychology that's too positive and thus prices that are too high. Investors tend to associate exciting stories and pizzazz with high potential returns."
Overpaying implies low expected return and high risk (see p. 30)
p.49 "The bottom line is that, looked at prospectively, much of risk is subjective, hidden and unquantifiable."
p.50 Ref. to Taleb's "alternative histories"
p.51 Difficult to tell how much risk was involved with an investment, even if it was profitable
p.54 "Here's the key to understanding risk: it's largely a matter of opinion. It's hard to be definitive about risk, even after the fact."

Recognizing Risk

p.57 "Risk means uncertainty about which outcome will occur and about the possibility of loss when the unfavorable ones do."

General theme is that of mean reversion, highest risk is what is expensive and has done well recently

p.58 High risk and low prospective return are two sides of the same coin: both come from high prices
"High risk, in other words, comes primarily with high prices."

p.59 "There are few things as risky as the widespread belief that there's no risk; because it's only when investors are suitably risk-averse that prospective returns will incorporate appropriate risk premiums."

p.61 "Risk cannot be eliminated; it just gets transferred and spread."

p.64 Explanation of the security market line

p.68 "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... The ultimate irony lies in the fact that the reward for taking incremental risk shrinks as more people move to take it."
THOUGHT: AQR paper on Betting Against Beta makes a similar remark, that low beta assets outperform because investors chase returns and pile into high volatility assets with higher expected returns

Controlling Risk

p.71 Difficult to tell how risky an investment actually is, even after the fact

p.72 Distinguish between risk and loss, risk may be present even though loss did not occur
Risk control is invisible during "good times"
-Present but not required
-Lacking all together

p.75 "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."

p.78 Need to be conservative, but how conservative? Running a business based on the worst case scenario would prevent anything from getting done

Being Attentive to Cycles

p.81 Rule 1: Most things are cyclical
Rule 2: The greatest opportunities for profit and loss occur when others forget rule 1

p.82 Humans are the cause of cyclicality
"Objective factors do play a large part in cycles, of course--factors such as quantitative relationships, world events, environmental changes, technological developments, and corporate decisions. But it's the application of psychology to these things that causes investors to overreact to underreact, and thus determines the amplitude of the cyclical fluctuations."

p.83 Capital destruction: when the cost of capital exceeds the return on capital (providers fund borrowers and projects that aren't worthy of financing)

p.84 "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."

p.87 "Ignoring cycles and extrapolating trends is one of the most dangerous things and investor can do"

Awareness of the Pendulum

p.89 Market attitudes swing like a pendulum
-euphoria and depression
-optimism and pessimism
-credulousness and skepticism

p.91 "Reaping dependably high returns from risky investments is an oxymoron."
p.93 "Stocks are cheapest when everything looks grim."

Combating Negative Influences

p.97 "Why do mistakes occur? Because investing is an action undertaken by human beings, most of whom are at the mercy of their psyches and emotions."
p.99 Psychological factors that undermine the efforts of investors: greed, fear and the willing suspension of disbelief (i.e. self deceit), tendency to conform to the herd mentality, envy and ego
p.102 "People who might be perfectly happy with their lot in isolation become miserable when they see others do better."
p.104 Capitulation: investors hold on to their convictions, but jump on the bandwagon late in the cycle when psychological pressures become irresistible
p.105 "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."
p.108 "To avoid losing money in bubbles, the key lies in refusing to join in when greed and human error cause positives to be wildly overrated and negatives to be ignored."

Contrarianism

p.111 "There's only one way to describe most investors: trend followers. Superior investors are the exact opposite."
p.115 Comments on Swensen and his views about contrarianism
p.116 "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)."
"The very coalescing of popular opinion behind an investment tends to eliminate its profit potential."
p.119 "Only a skeptic can separate the things that sound good and are from the things that sound good and aren't. The best investors I know exemplify this trait. It's an absolute necessity."
p.120 skepticism applied not only to something too good to be true, but also something too bad to be true
p.121 "Thus, a hugely profitable investment that doesn't begin with discomfort is usually an oxymoron."

Finding Bargains

p.123 "Securities that the market deems ultra safe may offer uninteresting returns, while securities at the other extreme may exceed investors risk tolerance. In other words, there can reasonably be some places investors won't go, regardless of price."
1. Identify a feasible set of investments
2. Select those offering the best value (risk-to-return), this depends on price
3.

p.125 "... the failure to distinguish between good assets and bad buys gets most investors into trouble."
p.127 Value investor "shopping list"
p.130 "Since bargains provide value at unreasonably low prices--and thus unusual ratios of return to risk--they represent the Holy Grail for investors."

Patient Opportunism

p.131 Wait for great investments to come to you, rather than go searching for them (requires incredible patience)
p.134 "One of the great things about investing is that the only real penalty is for making losing investments."
p.135 Reaching for yield--an example of trying to create higher returns where they don't exist (or require more risk)

p.138 Problem with investment requirements is that they won't always be achievable, but taking on more risk may make the problem worse

p.140 Forced sellers and the need for liquidity

Knowing What You Don't Know

p.144 "... the important thing in forecasting isn't getting it right once. The important thing is getting it right consistently."

p.146 The shortcomings of forecasting (9 point list)

p.150 Mark Twain: "It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so."
THOUGHT: Buffett has similar thought with his circle of competence idea

Having a Sense for Where We Stand

p.151 Three ways to deal with cycles
1) Increase efforts to predict the future direction of markets, continue making investments based on conclusions (really bad idea)
2) Accept that the future is unknowable and ignore cycles, make good investments and hold throughout (not a bad idea, has worked historically)
3) Figure out where we stand in each cycle and what it means for our future actions (best idea)

p.153 Strive to understand the implications of what's going on around us
"When others are recklessly confident and buying aggressively, we should be highly cautious; when others are frightened into inaction or panic selling, we should become aggressive."

p.156 Money as a commodity

p.158 Checklist for taking the market's temperature

Appreciating the Role of Luck

THOUGHT: To determine skill vs. luck a skillful person can fail "at will"--not sure where this is from

p.163 "In the short run, a great deal of investment success can result from just being in the right place at the right time."
Keys to profit: aggressiveness, timing and skill (enough of the first two requires little of the latter)

p.167 "Short-term gains and short-term losses are potential impostors, as neither is necessarily indicative of real investment ability (or the lack thereof)."
"I know" school
"I don't know" school

p.168 "The actions of the "I know" school are based on a view of a single future that is knowable and conquerable. My "I don't know" school thinks of future events in terms of a probability distribution. That's a big difference."

p.165 Taleb's alternative histories: the other things that reasonably could have happened.

Investing Defensively

p.172 Charley Ellis' "The Loser's Game"

p.173 "...defense--significant emphasis on keeping things from going wrong--is an important part of every great investor's game."
Odds of an up year in the market

p.174 "So investors should commit to an approach--hopefully one that will serve them through a variety of scenarios."

Analogy to soccer players having to play offense and defense

p.176 concentration and leverage are two examples of offense

p.177 Margin of safety or margin for error makes outcomes tolerable when the future doesn't live up to expectations

p.178 Klarman reference to Charles Prince: "as long as the music is playing, you've got to get up and dance" and the need to produce short-term profits

p.179 Bond investments: upside is fixed, avoiding losses is key

THOUGHT: William Bernstein's comment that expense ratio matters hugely when considering bond fund options

p.181 Careers of managers end prematurely not because they don't have enough winners, but because they have too many losers

P.184 "Invest scared!"

Avoiding Pitfalls

p.186 Analytical error called "failure of imagination": "either being unable to conceive of the full range of possible outcomes or not fully understanding the consequences of the more extreme occurrences."

p.187 Reasons for extrapolating the recent past into the future

-Those who experience extreme events retire or die before a similar event occurs (long-cycles)

-Short-term financial memory

-change of remembering is erased by the prospect of easy money that comes with a new investment fad

"Relying to excess on the fact that something "should happen" can kill you when it doesn't."

"Investors make investments only because they expect them to work out, and their analysis will center on the likely scenarios."

p.188 "... it's worth noting that the assumption that something can't happen has the potential to make it happen, since people who believe it can't happen will engage in risky behavior and thus alter the environment."

p.190 Error of not noticing: investing in an index fund regardless of market condition

p.192 What we learn from a crisis

p.196 Why volatility does not equal risk

Adding Value

p.203 Beta as a measure of systematic risk

p.204 CAPM provides insight as to how much return comes from market conditions and how much from investor skill

Reasonable Expectations

p.212 Voltaire: "The perfect is the enemy of the good."

p.213 Expected returns may be so high that they aren't worth pursuing (too much risk)

Putting It All Together

p.216 "The relationship between price and value holds the ultimate key to investment success. Buying below value is the most dependable route to profit. Paying above value rarely works out well."