The Most Important Thing

1. Second Level Thinking
    - First level thinking is simplistic and superficial and just about everyone can do it. All the first level thinker needs is an opinion about the future as in “the outlook for the company is favorable, meaning the stock will go up.”
    - Second level thinking is deep, complex and convoluted. The second level thinker takes great many things into account:
        1. What is the range of likely future outcomes?
        2. Which outcome do I think will occur?
        3. What’s the probability I am right?
        4. What does the consensus think?
        5. How does my expectation differ from the consensus?
        6. How does the current price for the asset comport with the consensus view of the future, and with mine?
        7. Is the consensus psychology that’s incorporated in the price too bullish or bearish?
        8. What will happen to the asset’s price if the consensus turns out the to be right and what if I am right?
    - The difference in workload between first level and second level thinking is clearly massive and the number of people capable of the latter is tiny. First level thinkers look for simple formulas and easy answers. Second level thinkers know that success in investing is the antithesis of simple.
    - To outperform the average investor, you have to be able to outthink the consensus. Are you capable of doing so? What makes you think so?
    - To achieve superior results you have to hold nonconsensus views regarding value and they have to be accurate.

	Conventional Behavior	**Unconventional Behavior**
Favorable Outcomes	Average good results	Above average results
Unfavorable Outcomes	Average bad results	Below average results

2. Understanding Market Efficiency and its Limitations
    - No market is completely efficient or inefficient. It is just a matter of degree. The mainstream securities markets can be so efficient that its largely a waste of time to work at finding winners there.
    - Respect for efficiency says that before we embark on a course of action we should ask some questions:
        1. Why should a bargain exist despite the presence of thousands of investors who stand ready and willing to bid up the price of anything that is too cheap?
        2. If returns appear so generous in proportion to risk, might you be overlooking some hidden risk?
        3. Why would the seller be willing to part with it at a price which it will give you an excessive return?
        4. Do you really know more about the asset than the seller does?
        5. If it is such a great proposition why hasn’t someone else snapped it up?
    - Inefficiency is a necessary condition for superior investing but it is not a sufficient condition. All that means is that prices aren’t always fair and mistakes are occurring: some assets are priced too low and some too high. You still have to be more insightful than others in order to regularly buy more of the former than the latter.
    - If you entirely ignore theory, you can make big mistakes. But swallowing theory whole can make us give up on finding bargains.
3. 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.

- If you have settled on the value approach to investing and come up with an intrinsic value for a security the next important thing is to hold it firmly. This is because you will not be proved correct right away and it may continue to decline in value. A firmly held view on value can help you cope with this disconnect.
- An accurate opinion on valuation loosely held will be of limited help. An incorrect opinion on valuation, strongly held is far worse. Thus this is very hard to get it right.
- Value investors score their biggest gains when they buy an underpriced asset, average down unfailingly and have their analysis proved out. Thus, there are two essential ingredients for profit in a declining market: you have to have a view on IV, and you have to hold that view strongly enough to be able to hang in and buy even as price declines suggest that you are wrong. There is a third: you have to be right.
- The emphasis in value investing is current value i.e. on tangible factors like hard assets and cash flows. Growth investing goal is to identify companies with bright futures. That means there is less emphasis on the company's current attributes and more on its potential. Value investors buy stocks (even those whose IV may show little growth in the future) out of conviction that the current value is high relative to the current price. Growth investors buy stocks (even those whose current value is low relative to their current price) because they believe the value will grow fast enough in the future to produce substantial appreciation. The choice is really between value today and value tomorrow. Growth investing represents a bet on the company's performance that may or may not materialize in the future.
- It would be convenient to say that value investing permits investors to avoid conjecture about the future and that growth investing consists only of conjecture about the future, but that would be a considerable exaggeration. After all, establishing the current value of a business requires an opinion regarding its future and that in turn must take into account likely macro-economic environment, competitive developments and technological advances. Compared to value investing, growth investing centers around trying to find big winners. Upside potential for being right about growth is more dramatic, and the upside potential for being right about value is more consistent. Consistency trumps drama.

4. Relationship between Price and Value
    - No asset class or investment has the birthright of a high return. It is only attractive if its priced right. We don't spend a lot of time thinking about what price we are going to be able to sell a holding for, or when, or to whom, or through what mechanism. If you have bought it cheap, eventually those questions will answer themselves.
    - How are prices set? Underlying fundamental value in the long run. In the short term price is set primarily by psychology and technical's.
    - Best buys occur due to forced selling but you cannot make a career out of buying and selling to forced sellers and buyers. They are not around all the time, just on rare occasions at the extremes of crisis and bubbles.
    - The safest and most potentially profitable thing is to buy something when no one likes it. Given time, its popularity and thus its price, can only go one way: up. This is extremely difficult to master as the psychological factors that weigh on other investors minds and influence their actions will weight on yours as well. For self-protection, then, you must invest the time and energy to understand market psychology. 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 technical's on your side as well.
    - Possible routes to investment profit
        1) Benefiting from a rise in the asset's intrinsic value. The problem is that increases in value are hard to predict accurately. Further, the conventional view of the potential for increase in baked into the price. You might try to actively increase the value of the asset via activist role but it is time consuming.
        2) Applying leverage. It merely magnifies whatever gains or losses may materialize.
        3) Selling for more than your asset's worth. Not dependable.

4) Buying something for less than its value. Most dependable way to make money. Buying at a discount from IV and having asset price move towards its value doesn’t require serendipity, it just requires that market participants wake up to reality.

- Even buying cheap isn’t sure to work. You can be wrong about the current value. Or events can come along that reduce value. Or deterioration in attitudes or markets can make something sell even further below its value. Or the convergence of price and intrinsic value can take more time than you have.

5. Understanding Risk
    - Investing consists of exactly one thing: dealing with the future. You are unlikely to succeed for long if you have not dealt explicitly with risk. Consists of three steps
        1. Understanding Risk
        2. Recognizing when its High
        3. Controlling Risk
    - Riskier investments are those for which the outcome is less certain. That is, the probability distribution of returns is wider.
    - Pragmatic value investors feel that high return and low risk can be achieved simultaneously by buying things for less than they are worth.
    - How do measure risk
        1. It is nothing but a matter of opinion an estimate.
        2. Standard for quantification is nonexistent.
        3. Risk is deceptive as improbable events can occur.
    - Skillful investors can get sense for the risk present in a given situation. They make that judgment primarily based on (a) the stability and dependability of value (b) the relationship between price and value.

6. Recognizing Risk
    - The received wisdom is that risk increases in the recessions and falls in booms. In contrast, it may be more helpful to think of risk as increasing during upswings, as financial imbalances build up, and materializing in recessions.
    - High risk comes primarily with high prices. There are few things as risky as the widespread belief that there is no risk. Contributing underlying factors can include low prospective returns on safer investments, recent good performance by risky ones, strong capital inflows, and easy availability of credit. The key lies in understanding what impact things like these are having.
    - When worry and risk aversion are present as they should be investors will question, investigate and act prudently. But only when investors are sufficiently risk averse will markets offer adequate risk premiums.
    - The capital market line shows increasing returns as risk increases. The problem is that current artificially low return on the low risk asset (T-Bills) reduces prospective return all along the line.
    - The herd is wrong about risk at least as often as it is about return. A broad consensus that something is too hot to handle is almost always wrong.
7. Controlling Risk
    - Risk control only show up in bad years and since bad years occur less than good years, risk control costs might seem excessive and reduce returns.
    - The intelligent acceptance of recognized risk for profit underlies some of the wisest and most profitable investments – even though most investors dismiss them as dangerous speculations. It is the investors job to intelligently bear risk for profit. Doing it well is what separates the best from the rest.
    - In most cases you cant prepare for the worst case. It should suffice to be prepared for once-in-a generation events.
    - There is a distinction between risk control and risk avoidance. Risk control is the best route to loss avoidance. Risk avoidance, on the other hand, is likely to lead to return avoidance as well.
    - The road to long term investment success runs through risk control more than through aggressiveness.

8. Being Attentive to Cycles
    - There are very few sure things in investing, but there are two concepts we can hold with confidence
        1. Most things will prove cyclical
        2. Some of the greatest opportunities for gain and loss come when other people forget the above.
    - Economies, markets and companies wax and wane. The basic reason for this cyclicality is the involvement of humans. When people are involved, the results are variable and cyclical. Yet, every decade or so, people decide cyclicality is over.
9. Awareness of the Pendulum
    - Investment markets follow a pendulum like swing: between euphoria and depression; between celebrating positive developments and obsessing over negatives; and thus between overpriced and underpriced.
    - The attitudes toward risk is a common thread that runs through many of the market's fluctuations.
    - Two main risks of investing: risk of losing money and risk of missing opportunity. In ideal world investors would balance between these two concerns. But from time to time, one or the other predominates.
    - The occurrence of this pendulum like pattern is in most markets is extremely dependable. But we never know: how far the pendulum will swing; what might cause the swing to stop and turn back; when this reversal will occur; how far it will then swing in the opposite direction.
10. Combating Negative Influences
    - Capitulation is a regular feature of investor behavior late in cycles. Investors hold to their conviction as long as they can, but when the economic and psychological pressures become irresistible, they surrender and jump on the bandwagon.
    - Ego – it is enormously challenging to remain objective in face of facts like: investment results are evaluated and compared in the short run; incorrect and even imprudent decisions to bear risk generally lead to better returns in good times and most times are good times. Greatest formula for long term wealth creation is to follow a path that emphasizes humility, prudence and risk control.
    - A through understanding of the insidious effect of psychology on the investing process at market extremes is very helpful in overcoming these negative influences.
11. Contrarianism
    - Once in a lifetime market extremes seem to occur once every decade or so – not enough to build a career on but capitalizing on them is an important component of any investor's approach.
    - Potentially profitable recognition of divergences from consensus thinking must be based on reason and analysis. You must do things not just because they are the opposite of what the crowd is doing, but because you know why the crowd is wrong. Only then will you be able to hold firmly to your views and perhaps buy more as your positions take on the appearance of mistakes and as losses accrue instead of gains.
    - Contrarianism itself can appear to have become too popular, and thus contrarianism can be mistaken for herd behavior.
    - What is clear to the broad consensus of investors is almost always wrong.
    - When dealing with future we must think about two things (a) what might happen (b) the probability that it will happen.
    - Skepticism calls for pessimism when optimism is excessive ("no, that's too good to be true"). But it also calls for optimism when pessimism is excessive ("no, that's too bad to be true").
    - When the dust has settled and uncertainty has been resolved, there will be no great bargains left. When buying something that has become comfortable again, its price will no longer be so low that its a great bargain. Its out job as contrarians to catch falling knives, hopefully with care and skill.
12. Finding Bargains
    - An investor might narrow down the list of possible investments to those who riskiness falls within acceptable limits, since there can be risks with which certain investors are not comfortable – risk of obsolescence in fast moving segment of the technology world, risk of hot consumer product will lose its popularity, outside of their expertise. In other words, there can reasonably be some places investors wont go regardless of price.

- Good places to start looking for bargains
    1. Little known and not fully understood
    2. Fundamentally questionable on the surface
    3. Controversial, unseemly or scary
    4. Deemed inappropriate for respectable portfolios
    5. Unappreciated, unpopular and unloved
    6. Trailing record of poor returns
    7. Recently subject of disinvestment not accumulation

13. Patient Opportunism
    - There aren't always great things to do and waiting for bargains is often the best strategy. You will do better for investments to come to you rather than go chasing after them.
    - It is essential to recognize the condition of the market (overpriced, fairly valued, underpriced) and decide on our actions accordingly.
    - One way to be selective is by making every effort to ascertain whether we are in a low return environment or a high return environment. You simply cannot create investment opportunities when they are not there.
    - How might one cope in a market that seems to be offering low returns?
        1. Invest anyway – trying for acceptable relative returns, even if they are not attractive in the absolute.
        2. Invest anyway – ignoring short run risk and focusing on the long run.
        3. Hold cash
        4. Concentrate your investments in special niches and special people. This might be the best bet. There are no easy answers for investors faced with low returns. The one course of action that must be avoided is: reaching for return. This is a classic mistake.

14. Knowing What You Don't Know
    - It is hard to know what the macro future holds and few people posses superior knowledge of these matters that can be regularly turned into an investing advantage.
    - The more we concentrate on the smaller picture things, the more its possible to gain a knowledge advantage. With hard work and skill, we can consistently know more than the next person about individual companies and securities, but that's much less likely with regard to markets and economies. Thus people should try to "know the knowable". An exception to this, is that investors should make an effort to figure out where they stand at a moment in time in terms of cycles and pendulums. That wont render the future twists and turns knowable, but it can help one prepare for likely developments.
    - Predictions are most useful when they correctly anticipate change. If you predict something wont change and it doesn't change, that prediction is unlikely to earn you much money. Forecasts that correctly extrapolate past experience (continuation of recent history) are of little value.
    - Ask yourself how many correctly predicted the subprime crisis, global credit crisis and meltdown of 2007-2008. There might be a few. Then ask yourself how many of those few went on to correctly foresee the economic recovery that started in 2009. Those who got 2007-2008 right probably did so at least in part because of a tendency towards negative views. As such, they probably stayed negative for 2009. The overall usefulness of these forecasts was not great, even though they are right about some of the most momentous financial events in the last 80 years.

15. Having a Sense for Where We Stand
    - In the world of investing, nothing is as dependable as cycles. It is essential that we strive to ascertain where we stand in cyclical terms and act accordingly.
    - It is reasonable to try to (a) stay alert for occasions when the market has reached an extreme (b) adjust our behavior in response, and (c) most important, refuse to fall into line with the herd behavior.
    - Understanding where we are in the cycle will give us valuable insight into future events and what we might do about them. When I say the present position (unlike the future) is knowable, I don't mean to imply that the understanding comes automatically. It takes work, but it can be done. A few concepts that are essential in that

effort: We must be alert to what's going on. What we need to do is "take the market temperature". If we are alert and perceptive, we can gauge the behavior of those around us and from that judge what we should do. The essential ingredient here is inference about the psyches of market participants and the investment climate. We must strive to understand the implications of what's going on around us.

Economy	Vibrant	Sluggish
Outlook	Positive	Negative
Lenders	Eagar	Reticent
Capital Markets	Loose	Tight
Capital	Plentiful	Tight
Terms	Easy	Scarce
Interest Rates	Low	High
Spreads	Narrow	Wide
Investors	Optimistic, Eagar to buy	Pessimistic, Distressed, Uninterested in buying
Asset Owners	Happy to hold	Rushing for the exits
Sellers	Few	Many
Markets	Crowded	Started for attention
Funds	Hard to gain entry, new ones daily, general partners hold all cards	Open to anyone, only the best can raise money, Limited partners have bargaining power
Recent Performance	Strong	Weak
Asset Prices	High	Low
Prospective Returns	Low	High
Risk	High	Low
Popular qualities	Aggressiveness, Broad Reach	Caution and discipline, Selectivity

- If most of your checkmarks are on the left hand column, hold on to you wallet.

16. Appreciating the Role of Luck
    - In the short run, a great deal of investment success can result from just being in the right place at the right time. The key to profit are aggressiveness, timing and skill, and someone who has enough aggressiveness at the right time doesn't need much skill. At a given time in the markets, the most profitable traders are likely to be those that are best fit to the latest cycle.
    - A good decisions is that that a logical, intelligent and informed person would have made under the circumstances as they appeared at the time, before the outcome was known.
    - Investors of the "I Know" school feel it is possible to know the future, they decide what it will look like, build portfolios designed to maximize returns under that one scenario, and largely disregard the other possibilities. The suboptimizers of the "I Dont Know" school, on the other hand, put their emphasis on constructing portfolios that will do well in the scenarios they consider likely and not too poorly in the rest. This school things of future events in terms of a probability distribution. We may have one idea of which outcome is most likely to occur, but we also know there are many other possibilities, and those other outcomes may have a collective likelihood much higher that the one we consider most likely.
    - It is more important to ensure survival under negative outcomes than it is to guarantee maximum returns under favorable ones.
    - Given the highly indeterminate nature of outcomes, we must view strategies and their results – both good and bad – with suspicion until proved over a large number of trails.
17. Investing Defensively
    - Asking for investment advice without specifying their attitude towards risk and reward is like asking a doctor for a good medicine without telling him what ails you.
    - Even if you do everything right, other investors can ignore your favorite stock; management can squander the company's opportunities; government can change the rules or nature can serve up a catastrophe. Investment results are only partly within the investor's control.

- Few people have the ability to switch tactics to match market conditions on a timely basis. So investors should commit to an approach – hopefully one that will serve them through a variety of scenarios.
- Two principal elements in investment defense.
    1. First is elimination of losers from portfolios. This is best accomplished by conducting extensive due diligence, applying high standards, demanding a low price and generous margin for error and being less willing to bet on continued prosperity, rosy forecasts and developments that may be uncertain.
    2. The second element is the avoidance of poor years and especially exposure to meltdowns in crashes. This requires thoughtful portfolio diversification, limits on the overall riskiness borne, and a general tilt towards safety. Concentration and leverage are two examples of offense.
- It is not hard to make investments that will be successful if the future unfolds as expected.
- Low price is the ultimate source of margin for error.
- Investing scared, requiring good value and a substantial margin for error, and being conscious of what you don't know and cant control are the hallmarks of the best investors I know.

18. Avoiding Pitfalls
    - Relying to excess on the fact that something "should happen" can kill you when it doesn't. Even if you properly understand the underlying probability distribution, you cant count on things happening as they are supposed to. And the success of your investment actions shouldn't be highly dependent on normal outcomes prevailing, instead, you must allow for outliers. Investors make investments only because they expect them to work out, and their analysis will center on the likely scenarios. But they should not fixate on what is supposed to happen and load up on risk and leverage to the point where negative outcomes will do them in.
    - It can make great sense to use leverage to increase your investment in assets at bargain prices offering high promised returns or generous premiums. It makes little sense to use leverage to try to turn inadequate returns into adequate returns.
    - Human nature causes defensive investors to derive comfort in down markets when they lose less than others. This has two very important benefits. First, it enables them to maintain their equanimity and resist the psychological pressures that often make people sell at lows. Second, being in a better frame of mind and better financial condition, they are more able to profit from the carnage by buying at lows. Thus they generally do better in recoveries.
    - One way to improve investment results is to think about what "today's mistake" might be and try to avoid it. There are times in investing when the likely mistake consists of: not buying, not buying enough, holding too much cash, not using enough leverage or not taking enough risk.

19. Adding Value

	Aggressive Investor	**Defensive Investor**
Without Skill	Gains a lot when market goes up and loses a lot when market goes down.	Doesn't lose much when the market goes down, but doesn't gain much when market goes up.
With Skill	Gains a lot when the market goes up, but doesn't lose the same degree when the market goes down.	Doesn't lose much when the market goes down, but captures a fair bit of the gain when the market goes up.

20. 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.
    - Your view of value has to be based on solid factual and analytical foundation and it has to be held firmly. Only then will you know when to buy or sell. Only a strong sense of value will give you the discipline needed to take profits on a highly appreciated asset that everyone things will rise nonstop, or the guts to hold and average down in a crisis even as prices go lower every day. Of course, for your efforts in these regards to be profitable, you estimate of value has to be on target.