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THINKING OUR WAY TO INVESTMENT SUCCESS

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The exceptional results stocks have provided investors throughout history are beyond dispute. Over the past 120 years the Dow Jones Industrial Average (DJIA), consisting of 30 large U.S. industrials, has returned 9.97% per year. Here in Canada, the benchmark for domestic stocks (the S&P/TSX index) has averaged 9.0% per year over the past thirty-eight years.

Despite these exceptional long-term results, studies routinely show that most stock market investors fail to generate anywhere close to the same results. For example, according to Dalbar Inc., over the twenty year period from 1994 to 2014 the S&P500 index grew by 9.8% per year, while the average stock market investor achieved returns of just 2.8% per year. As such, the typical investor barely outpaced inflation which averaged 2.3% over the same period.

How can this be? The Dalbar study goes on to identify a number of common investor behaviours and tendencies that help explain the wide performance gap between investment returns and actual *investor* returns. Through Dalbar's annual study (and others like it), it has become apparent that investors routinely make the same mistakes, and perhaps more remarkably, don't seem to learn from them. Indeed, among most market participants memories appear to be very short. For my part, I've been amazed throughout my own career at the propensity among investors - both novice AND professional alike - to make the same mistakes again and again.

According to Albert Einstein,

"The definition of insanity is doing the same thing over and over again, but expecting different results".

One of the key causes of the wide performance gap comes down to "first-level thinking". Howard Marks of Oaktree Capital discusses this concept in his book, *The Most Important Thing: Uncommon Sense for the Thoughtful Investor.* Before we go any further on the subject of first-level thinking, please allow me to briefly digress. There are countless books available on investing; most of which, in my perhaps not so humble opinion, are of very little use! However, this particular investing book received a rare endorsement from the world's greatest investor himself. According to Warren Buffett, *"This is that rarity, a useful book."* Need I say more? Back to the topic at hand…

In *“The Most Important Thing”,* Marks describes first-level thinking as follows:

- *“First-level thinking is simplistic and superficial, and just about everyone can do it.”*
- *“First-level thinkers look for simple formulas and easy answers.”*
- *“First-level thinkers think the same way other first-level thinkers do about the same things, and they generally reach the same conclusions.”*

It should go without saying that in order to be better than average we have to think, act - and perhaps most important – ***react,*** different than the average investor. Let us never forget Einstein’s definition of insanity. Successful investing requires a different approach; what Howard Marks refers to as “second-level thinking”.

The book lists examples of how first-level thinking is applied to everyday investing. I’ll provide a couple of those examples below as quoted directly from the book. In order to differentiate from what actually works in investing, I’ll explain the fallacy of the first-level thinking approach. Finally, I’ll describe how we use second-level thinking in order to gain an advantage, as based upon my own experience as your portfolio manager.

Example #1: First-level thinking says, *“It’s a good company; let’s buy the stock.”*

This approach oversimplifies what it takes to invest successfully. If simply investing in the shares of easily identifiable “good” companies is all it takes, everyone would be rich. Further, there most definitely would not be such a wide performance gap if such a simplistic approach actually worked.

This is also akin to taking somewhat of a *rear-view* mirror approach. A company that is widely deemed to be ‘good’ today is likely described as such because of what the business has done already, i.e. *in the past.* This may, *or may not,* be indicative of its *future* success – which is the only thing that should matter to the intelligent, *forward*-looking investor. You can’t buy last year’s performance today!

Canadian businesses like Nortel (which eventually went bankrupt) and Research In Motion (now better known as BlackBerry) come to mind. Both, at one point, were widely considered to be good if not great companies. As such, first-level thinkers flocked to buy their shares. This bid up prices significantly – AND well beyond any semblance of ‘fair’ value, as many investors would come to realize.

Here is yet another reason why first-level thinking in this scenario doesn’t work; there is no proprietary information or independent thinking here. What the investor in this example fails to recognize is that, if he or she knows this to be a good company, so does everyone else.

In this scenario, as second-level thinkers, we might say the following; “It’s a good company, but everyone knows it’s a good company. As such, the current share price already well reflects all the positive sentiment surrounding the business. Buying what is already popular is not how we’re going to win with stocks. We know that even a ‘good’ business can be a bad investment if purchased at too high a price. I’m looking for stocks trading at ‘bargain basement’ prices. No bargains to be found here. Let’s sell.”

Example #2: First-level thinking says, *"The outlook calls for low growth and rising inflation. Let's dump our stocks."*

Again, this seems to be an attempt to oversimplify what it really takes to succeed in the markets. If the future were knowable, investing should – *in theory* – be easy. Clearly the future is very unknowable. Therefore accurately AND consistently forecasting it is anything but easy. According to economist John Kenneth Galbraith, ***"We have two classes of forecasters: Those who don't know – and those who don't know they don't know."***

Furthermore, what the first-level thinker fails to recognize is that any outlook is really nothing more than a best guess. Whose outlook is it anyway, and what does their previous record say about their past ability to forecast the future? The fact is that most of the so-called experts have an abysmal track record when it comes to predicting the near-term direction of the stock market or the economy. As stated above, this simply comes down to the obvious fact that no-one has a crystal ball.

Perhaps most important, consensus forecasts don't make money anyway. Why? If it's the consensus, it is inevitably already baked in to current prices. (Finally, any second-level thinker would further conclude that if anyone actually did somehow possess the uncanny ability to see into the future, they wouldn't share their foresight with anyone. Doing so would only serve to eliminate their advantage, AND the infinite fortune to be had).

In this case, a second-level thinker says; "Attempting to predict the unpredictable is clearly not a path to success. Besides, when the outlook is negative share prices generally already reflect the prevailing bearish sentiment. As such, it's too late to sell. In fact, history has shown that a negative consensus typically coincides with attractively priced stocks. Therefore, let's buy."

In conclusion, the key is that the successful investor cannot think on the same level as the typical or average investor. If you do, your results will also be typical, and just average. Successful investors don't want average – they want to do better, and doing so requires second-level thinking.