Quarterly Newsletter
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Left Brain Thinking

"Probably the greatest agreement among scholars, though, is that the failing civilizations suffered from growing hubris and overconfidence: the belief that their capabilities after many earlier tests would always rise to the occasion and that growing signs of weakness could be ignored as pessimistic"

~Jeremy Grantham

In this quarter's letter we discuss some critical "left brain" thinking processes to counter our emotional reactionary tendencies.

1. **Rationality**
2. **Margin of Safety**
3. **Passion First?**

1. Rationality

I recently listened to an interview with well-known behavioral psychologist Dan Ariely of Duke University (www.danarielly.com) conducted by Michael Covel (www.covel.com) he brought up some excellent points in relating human behavior and the world of finances. here are some of his observations:

If he had to explain the recent market run-up to either people being smarter, companies doing better or to the fact that perhaps money has no where else to go - "current constraints" - he would attribute it behaviorally that money has no where else to go. One can trade up the trend and experience the "joy" but it's not because it's rational. A lot can be contributed to what is known as recency bias. He explains further.

Lets say people think there is 1% chance that going through a red light will kill you. someone does it, survives, he will then for no other reason than recent experience, think his chances of getting hurt are lower, perhaps 0.5% not 1%. and then more likely to continue that behavior (recency bias). In other words, there is a "vicious cycle" that the more people do something without a bad outcome, without knowing the real probabilities and the real risk - because "we don't understand risk really well" - the more chance there is of an explosive blow up - because the chances are actually higher than we think and the risk is bigger than we think.

Not knowing the real probabilities also cripples political/legal action (quelle surprise) - "We know something in principle but acting on it every time is really really tough." The world is designed to tempt people to make things worse. An example - no texting and driving laws. Accidents related to texting in states with tough no texting and driving laws **increased** as people tended to text below the steering wheel rather than above so as not to be seen. The politicians in these states don't know the probabilities.

Another observation - We can't simply break people down into good and bad people - lots of people can *"bend reality"* a bit to a degree - most obvious with sports fans and their subjective view of refereeing. In finance, if someone was given lots of money to do mortgage backed securities, they would see it as a good product and likely to be blinded to the dangers to consumers of having too much of this product in the market. Were the players "bad" or could they bend what they were doing to something they thought was good - i.e. "hey we're making money and helping people get into cheap mortgages!" (my quote)

The average person is blinded by market rising. As his interviewer Covel pointed out: "don't ask about derivatives abuses on Wall Street, don't worry that you earn zero in the bank, don't worry that the government bailed out Goldman and Morgan but let Bear Sterns and Lehman fail. don't worry about all of that - the kind of things that a rational person would question— the market s going up, all is good." Ariely responded that it is a bit sad that banking is so important to the economy now. But it is - and in most

markets, more competitors should mean lower costs to the consumer - but because of regulations, competition is dropping in the banking industry and it's hard to start a new bank.

My Bottom line takeaway - it's ok to do anything in the markets, but understand the probabilities and risks involved in each decision. As many of you know, Al and I invest/trade on good fundamental reasoning coupled with a risk management plan. We quantify our risks with an analysis of the probabilities based on our fundamental valuation (the financials) and how the market is treating the stock (the behavior analysis). It's our multi pronged approach to following a risk reduction first mentality.

2. Margin of Safety - by in house "value guru" Alfred Angelici

What is 'Margin of Safety'?
It is the difference between the Intrinsic Value* and the current Market Price

*NOTE: 'Intrinsic Value' is a company's value as appraised by the investor. This valuation process is every investor's responsibility.

Why is Margin of Safety Important?

Theoretically, the further a stock's market price lies below its intrinsic value, the greater its resilience in down markets should be. A margin of safety should provide an investor some reasonable protection – in terms of preserving one's invested capital – when things get rough.
According to Ben Graham, protection of one's investment principal is paramount to any objective of achieving a profit. As a prudent investor, a margin of safety is therefore, both a desirable and necessary component to any sound investment program.

Ben Graham and Margin of Safety:

One should understand that Ben Graham was investing during and after the "Stock Market Crash of 1929" and the "Great Depression" of the 1930's. And it was in this severe financial and economic environment that necessity drove Graham to invent a way to achieve some added safety for the capital he risked in the stock market.

Graham used diversification and his new concept of margin of safety and bought dozens of "bargain" stocks selling below the internal asset values he calculated. Graham was not buying "wonderful" companies. Graham was simply trying to obtain a fair return on the difference between his derived internal asset value and the discounted stock price available in the marketplace.
Graham knew there was a fair probability that the market price might never fully reflect the entire value gap he found, or the business might continue to degrade and eat up all or more of his profit potential. This is why Graham required a very large margin of safety – one that would give him sufficient investment protection and enable him an opportunity for a fair return; or at least his original investment back.
Note: Graham was not buying many growth companies. Therefore, Graham faced the "Realization of Value" problem – namely, the longer it took the market to close the 'value gap', the lower his ultimate rate of return. And that rate of return dropped quickly!

Example:
Graham finds a company selling 50% (Margin of Safety) and buys the common stock. Then he sits back and waits for the market to pick up on the 'value gap' and raise the price. If the price goes up all the way up to close the 50% gap in:

- 3 mos. his annualized rate of return is 200%
- 6 mos. his annualized rate of return is 100%
- 1 yr. his annualized rate of return is 50%
- 2 yr. his annualized rate of return is 25%
- 3 yr. his annualized rate of return is 12.5%
- 4 yr. his annualized rate of return is 6.25%

If After 1 year the marketplace only returns 40% of Graham's calculated margin of safety, his final rate of return would be 20%! (0.5 x 0.4 = 0.2)

Warren Buffett, Charlie Munger and Margin of Safety:

Warren Buffett and Charlie Munger do not buy companies like Ben Graham. Buffett and Munger typically buy GARP (Growth At A Reasonable Price) companies. Buffett loves to wait and load up on 'wonderful' companies that Mr. Market has irrationally oversold or overlooked.

Buffett says his approach in choosing a great company stock is "very much profiting from lack of change. That's the business (Charlie and I) like. I put weight on certainty. If you do that the whole idea of a 'risk-factor' doesn't make sense to me. The definition of a great company is one that will be great for 25-30 years."

The point of bringing in Buffett and Munger into this discussion is to demonstrate how Buffett and Munger overcame the 'Realization of Value' problem incurred by Graham's style of investing. They did this by bringing growth into their investment selection process. Growth allowed Buffett and Munger to not only purchase a company stock at a smaller margin of safety, but it also provided a long-term upside possibility beyond the realization of value return; namely – future value creation from growth of an ongoing business = stock price appreciation.

3. Passion Comes After Action

I heard an amazing interview recently on the idea of finding passion in your life for what you do. Cal Newport, author of "*So Good They Can't Ignore You, Why Skills Trump Passion in the Quest for Work You Love,*" makes the point of his book that according to his research, passion is not the leader in developing a compelling career. Passion follows.

"The idea of following the goal - (and finding your) passion - is a powerful idea. The question is, how do they end up…with that passion." In our popular culture, we think the process is this: we identify the passion first…direct this unbridled passion toward your work…and love what you do." However, Newport's point is that "passion develops over time." It's a "side effect" of running your career the right way. By taking this approach, you will approach work and life differently.

Non-specific traits, impact, autonomy, recognition - often lead to more passion in work, according to Cal than having a "passion" for something before even doing it. And since passion about work is rare and valued, it must follow some kind of rare and value offer (and something that is likely difficult to master). Cal started studying this while a grad student because he wondered himself about passion. He learned to embrace something that was difficult and hard because that means you're moving in the right direction.

His bottom line advice and interesting feedback in life can be summed up from this quote on his website -

"'be useful so that you can find your passion'…is a big flip, but it's more honest, and that is why I am giving each of my three young adult children a copy of this unorthodox guide."

For those of you at home waiting for your passion to hit you, perhaps you are going at things backwards.

Find out more about Cal and his work at www.calnewport.com

4. Random…

Excellent time at the client social - so glad to see all of you that came from 3 different states just to be there (just kidding, they were in town to visit family but I can embellish no?). it was also awesome to get out to St Louis and visit clients and meet their amazing children. I write this from San Francisco bay area where I am successfully avoiding the arctic conditions back in Boston to Al and Lauren.

Thank you all again for your confidence. As always, call me with any questions. Happy new year!

Warmly,

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