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There's only one right way©

Three ways of Investing: [1]

There are three ways in which an investor can invest and try to achieve superior results. One is intellectually difficult, one is physically difficult and one is emotionally difficult.

The Intellectually Difficult Path

Investors like Warren Buffet, Charlie Munger, John Templeton, and a very few others have taken the intellectually difficult part of beating the markets. Intellectually difficult path of investing is pursued by those who have a deep and profound understanding of the true nature of investing, see the future trends clearly and have a good ability to understand business and the environment. They understand that patience is a virtue and thus take long-term positions. We admire them but usually in retrospect. At the time of doing their best work we see them as misguided. We do not want to do what they are doing because it sounds so unpromising. I would say that it is more due to our intellectual inability to grasp their point of view.

This way of Investing is all about the cash flow approach. It is the most difficult path, as it requires an intellectual mind to study the different concepts of investing. Moreover hard work is required to understand how different businesses work, how economic policies and market forces affect the business environment. A good grasp of the various fields of management is required to understand organizations and their ability to capitalize on various business opportunities. A good knowledge in the field of liberal arts forms the basis to understand mental models and thus derive various investment concepts. Here the name of the game is patience. Such investors are always looking for good opportunities available at bargain prices. They are willing to wait for them, as they are long-term investors. They never entertain short-term ideas. They are not perturbed by events, news, rumours and gossips, which create short-term volatilities. They have a strong belief in their abilities and since their goal is investing for the long term for cash flows as against capital gains, they are in no hurry to invest. They strongly believe that opportunities are always there but when they come one must have the money. So such investors are very careful when they allocate resources. They never buy on impulses. They can be out of markets for months, even years. They have the patience to wait till the right opportunities come. They eagerly wait for opportunities when bad things happen to a good company. Brokers usually do not like such investors, as they do not churn their portfolios regularly. The intellectual investors are also the ones who are also emotionally very strong. That is the reason they are able to exercise restraint.

We all want to be such investors but we cant, as we believe that we are not intellectually blessed as they are. It is a wrong notion. The fact that they are intellectually capable is because they have put in hard work and efforts to reach that stage. They are constantly exploring by talking to managements, reading different subjects on business, trying to understand economic policies and its effect of business environment, etc. Their intellectual ability is derived by doing the hard work and their strong belief in the long-term approach to investments. Moreover they use common sense in their judgements and do not get swayed away by noise and action.

The Physical Difficult Path

Most people are deeply involved in the physically difficult way of beating the markets. How do they follow this physical way? They come to the office early and stay late. They do not know what their children are doing as they don't have time for them. They choose work over the family. They read a large number of reports very rapidly. They carry all the newspapers with them so that they can read them whenever time permits them. They are always busy with breakfast meetings, more luncheon meetings and even more dinner meetings. Their talk revolves on finding the next best investment opportunity to make money. They go for company visits and plant visits. They talk to the management to know more about their companies. They are always travelling to different places. They are in touch with a number of brokers as they believe that the more brokers they talk to, the more efficient they will be in making money in the stock markets. They love to have more and more information as it gives them a feeling of being well connected and better informed. They love to be in an information overload mode. They thrive on confusion. They are on the telephone making calls and receiving more calls though most of the times they are in meetings and on calling them one can merely hear the answering machine. They are continuously monitoring stock price movements. At office they are in front of the terminals and watching the stock price movements. At office they try to catch the CNBC news and at home they are again excited about the NASDAQ movements. They carry huge reports home at night determined to read them before the next day. When they are mobile they are busy on the mobile phones. They love to hear market gossip and are always excited on hearing rumours. They tend to make decisions based on gossips, rumours, news etc. News regarding political development, monsoon forecasts, inflation figures, and change in minister's portfolios, GDP growth figures plays an important role in their lives. They tend to always look at opportunities to time the markets on such news. In every way they put tremendous amount of physical energy and effort to try to beat the market by outworking the competition. But they don't realize that this is the most mediocre thing to do, since everyone is also doing the same thing.

My experience in the stock markets dealing with money managers has been really amusing. They strongly believe that keeping themselves busy this way increases their ability to pick up the winners in the stock markets. Moreover they make the outside world feel that they are very important as they are so busy. Once I was in the office of a money manager and we were just chatting. There was no business talk per se. The telephone rang and he did not answer it. After a couple of rings, it went to the answering machine. The calling person would imagine the fund manager to be very busy. It was some news regarding an inside information on a company. This is how most of them behave. Show the world they are busy. The day traders are also doing the physical difficult part of investing. They try to be very busy the entire day collecting information and on the basis of that information, they try to make money in the markets. All the fund managers are doing the same thing, all the day traders are doing the same thing and they all feel that they are differentiating. How can one achieve a superior performance this way?

Most of us are not blessed with the intellectual competence to take on the intellectually difficult way nor are we inclined to take the physically difficult way. In that case one could choose the emotionally difficult way. This is a very straightforward and an untiring approach. Simply work out a long-term investment policy, which is right for you, and be committed to it.

The Emotionally Difficult Path

Here is the emotionally difficult part: When your friends tell you about a great investment opportunity, which could be a ten bagger, and they feel that it is a great time to buy or an opportunity will be lost; don't buy. When your favourite TV channel everyday has analysts talking about great investment opportunities don't buy. When you broker calls you up and asks you to buy a great ten-bagger don take the bait. When the newspapers talk about the stock markets offering great investment opportunities please be wary of such news. When your neighbours talk to you about how the stock markets have made them rich in the last couple of months, avoid the temptation of buying. When you hear stories of how people have created great wealth in the stock markets in a short span don't make the mistake of following them. When your banker starts offering you credit facility against your shares to buy more shares do not jump on such deals to buy more shares. Be absolutely uninterested.

When they tell you that the market is going to crash and the stock prices will nose dive; don't sell. When the analysts on the TV show talk about selling stocks don't sell. When newspaper start reporting the setting of a bear phase and ask you to liquidate your portfolio don't sell. When your neighbours are busy exiting the stock markets don't follow them. When your broker asks you to sell as he sees bad times ahead do not listen to his advice and sell. When you hear only gloomy news around you and find that people are exiting the stock markets, don't exit.

Be absolutely disinterested. Here you do not require any intellectual effort or any physical effort but for most emotional discipline is the most difficult. Do not get carried away by market sentiments. They only help you to make blunders. Try to control your emotions. Try not to follow the herd. Believe in yourself and the investment policy you have committed yourself to .On the contrary it would pay to go against the popular opinion. When others are greedy be fearful and when others are fearful be greedy.

The intellectually difficult path as well as the emotionally difficult path lay stress on the virtue of patience as they consider the long-term approach to investments as the only strategy, which can enrich investors and increase their wealth. Stress is on the cash flow approach to investments. Patience focuses an investor's attention on the goal of compounding money over a long period. Compounding can be magic even when the compounding rate is modest. To give an example: if one were to compound money at a modest rate of 7% the money would double at the end of 10 years and it would be 16 times at the end of 40 years. Patience also helps one to control the transaction costs. The more you churn your portfolio the more you pay the broker in terms of brokerage and of course the government has its share of the revenue on the capital gains you make. Then you also have costs like depositary charges, transaction tax and service tax. All these costs could be avoided if one has patience.

The physically difficult way is more about trying to time the markets, finding the direction of the markets and getting as much of information as possible to make investment decisions. Trying to do so many things only results in information overload. This clouds the mind and distorts thinking. Good opportunities come once in a while and you spot them only when you are cool and thus have the time to think. The physically difficult way assumes that there are a lot of opportunities there and you have to be digging hard to be successful at investing. The current volatility in the markets is the result of too many people trying to invest following the physically difficult way. Life is simple. We make it complicated.

The emotionally difficult path requires an understanding of how our emotions guide our decision-making especially when we are dealing with money. The effect is directly felt on our investing and spending decisions. We are human beings and hence emotional. What is emotion? It is energy in motion. In the next four chapters we will learn how to use this energy in motion to our benefit. We have to learn how to think with our emotions rather than have our emotions do the thinking. Not only understanding our own anomalies but also that of others will help us become better investors.

Why is Investing so Difficult?

The most difficult part is understanding the behavior of the stock markets. Why is that so? Because markets are made on the basis of varied opinions expressed by its participants. These opinions are subject to change with the changes in the sentiments of these emotional people. It's the crowd behavior that dominates the decision-making and is responsible for the sudden changes in the sentiments. Take for instance the black Monday in May 2004 when the markets lost around 700 points as the election results brought the Congress to power. What precipitated this huge fall? Had any thing gone drastically wrong with the performance of the companies whose stock prices crashed? Definitely no. But the sentiment changed. BJP going out of power was a big change and normally we do not like changes. Hence there was a gloom all around and people started dumping stocks as though there was going to be no future. The markets started crashing on reflexivity as each one wanted to get out faster than his neighbour. This is known as the madness of the crowds. Herd Mentality was at work and no rational thinking would work. Imagine yourself being emotionally strong and you bought when the others were panicky. You would end up making a huge fortune. But this seems easy only in hindsight. At that point of time to go against the crowd is the most difficult but the most sensible thing to do. Understanding Behavioural Science is the key to success in the financial markets. Its application not only helps you be in control of your emotions but also helps you to understand other's emotions and benefit from their mistakes.

1.Investor's Anthology by Charles D. Ellis. 1998 address to the Empire Club in Toronto.