

The Most Important Thing

If you were asked to boil down the secret of investment success to its one key ingredient, what would you say? Intelligence? Rationality? Luck? Insider information?

Last year Columbia University published a book whose title purports to answer that very question. But before we get to that, let's back up a bit and introduce you to the book's author. The tale begins, as so many great investing stories do, in Omaha, Nebraska.

It All Goes Back to Omaha

Long ago, when we were fresh-faced young MBA students at the Wharton School, we made our annual pilgrimage to Omaha for the Berkshire Hathaway shareholders' meeting. There, Chairman and CEO Warren Buffett showed a slide presenting outlandish returns that were recently made in the junk-bond market. While Buffett had made similar investments, he mentioned that these specific junk bond investments belonged to a friend of his, a guy named Howard Marks.

What? Who? Warren Buffett was touting the record of some investor we had never heard of?

Needless to say, when we returned to Philadelphia, we immediately searched for more information about this mysterious Mr. Marks. We learned that he had more than four decades of investment experience and was the chairman and co-founder of Oaktree Capital Management, a highly successful, Los Angeles-based investment firm. Oaktree manages investments in a number of strategies, but it specializes in distressed debt. It currently manages about \$80 billion.

For the last twenty years, Marks has been writing occasional client memos, commenting on the state of the markets and setting forth his investment philosophy. In 2003, attempting to pull together all the essential elements an investor needs for success, he wrote a memo trying to convey what was “the most important thing” in investing. But there was a catch. There was no one “most important thing.” Instead, there are a great number of “most important things.”

Marks has taken the original idea of that memo and expanded it into a book, appropriately named *The Most Important Thing*. This is not a how-to book. Marks clearly states that he did not set out to write a manual, but a statement of his investment philosophy. The book is divided into twenty chapters, each explaining in detail a different “most important thing.” Below, we delve into the most interesting aspects of the book by grouping the chapters into similar themes.

The Most Important Thing Is ... Thinking Correctly

In the first chapter, Marks introduces us to a concept he calls ‘second-level thinking.’ In Marks’ own words:



What is second-level thinking?

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

Second-level thinking says, “It’s a good company, but everyone thinks it’s a great company, and it’s not. So the stock’s overrated and overpriced; let’s sell.”

First-level thinking says, “The outlook calls for low growth and rising inflation. Let’s dump our stocks.”

Second-level thinking says, “The outlook stinks, but everyone else is selling in panic. Buy!”

Marks explains that, to be an above-average investor, you must think one step beyond what everyone else is thinking. You must first know what the consensus is, and then understand how and why your thinking differs from the consensus.

The Most Important Thing Is ... Value

Intrinsic value is at the heart of value investing, and Marks spends some time explaining its importance. Success in investing is difficult to achieve without having an accurate estimate of the intrinsic value of an investment. If you don’t know the value of an asset, how can you know whether the price offered is the right one?

Marks also has harsh words for day traders:

The way I see it, day traders considered themselves successful if they bought a stock at \$10 and sold at \$11, bought it back the next week at \$24 and sold at \$25, and bought it a week later at \$39 and sold at \$40. If you can’t see the flaw in this—that the trader made \$3 in a stock that appreciated by \$30—you probably shouldn’t read the rest of this book.

The Most Important Thing Is ... Risk

Marks feels that dealing with risk is an essential element in investing, so he spends three chapters on the issue, concentrating on understanding, recognizing, and controlling risk.

Academics define risk as volatility. That is, the faster the price of an asset wobbles its way up and down a performance chart, the riskier that asset is to own. Marks, however, says that—while there are many kinds of risks—volatility is the least relevant of them all. He defines risk as the likelihood of losing money.

In recognizing and controlling risk, Marks has a point of view that flies in the face of most investors. Most investors think that quality, as opposed to price, is the main determinant of whether an asset is risky. Marks disagrees. The main determinant is not the quality of the asset, but the price paid for it. In other words, a high-quality asset can be risky if you pay dearly for it, while a low-quality asset can be safe if bought very cheaply.



The Most Important Thing Is ... The Market Environment

The investment pendulum swings wildly from exuberance to depression, so Marks recognizes the importance of understanding where in the cycle the investment climate is. Understanding the market environment will prevent savvy investors from falling prey to the prevailing herd behavior of the market. Marks offers the three stages of a bear and bull market, which we feel are spot on.

The three stages of a bull market:

1. *When a few forward-looking people begin to believe things will get better*
2. *When most investors realize improvement is actually taking place*
3. *When everyone concludes things will get better forever*

The three stages of a bear market:

1. *When just a few thoughtful investors recognize that, despite the prevailing bullishness, things won't always be rosy*
2. *When most investors recognize things are deteriorating*
3. *When everyone's convinced things can only get worse*

Marks also shares his thoughts about market efficiency. In a completely efficient market, all market participants are rational and objective. Everyone has access to all relevant information. Information is reflected fully in market prices, so no participant can consistently do better than the market. While Marks believes that some asset classes are quite efficient, he also believes that others are not so.

The Most Important Thing Is ... Not Fooling Yourself

Warren Buffett has said that temperament is a more important quality than IQ in becoming a successful investor. In other words, a person with a 120 IQ and a favorable temperament will probably out-perform a 140-IQ investor who allows himself to be unduly influenced by the short-term noise of CNBC.

Marks agrees. Psychological biases are inherent in all of us, and they can be detrimental to investment success. Marks says that investors must check at the door their greed, fear, envy, self-deceit, and ego, because such negative influences will only stand in the way of good investing.

Do you know those people who come up with their pronouncements each January of precisely where the S&P 500 will end up on the next December 31? Marks has quite a limited opinion of them or other forecasters who are confident of their ability to correctly divine the future direction of economies or interest rates.

These people belong to what Marks calls the "I know" school. Marks is not afraid to belong to the "I don't know" school, understanding that it's hard to know what the macro-economic future



holds and that few people possess superior knowledge of these matters. Marks concentrates on smaller-picture things, where it's more possible to gain a knowledge advantage.

The Most Important Thing Is ... Being a Contrarian

Most of the best investors in the world go against the herd. Marks is no exception:

... following the beliefs of the herd—and swinging with the pendulum—will give you average performance in the long run and can get you killed at the extremes...

In looking for assets to buy, Marks concentrates his efforts on finding under-priced assets. These can be found among things that are: little known and not fully understood; controversial, unseemly, or scary; unpopular and unloved; deemed inappropriate for “respectable” portfolios; or fundamentally questionable on the surface.

Conclusion

If you're looking for a how-to book offering a recipe list of simplistic investment formulas, this is not the book for you. If, on the other hand, you want to learn the proven investment principles of one of the most successful investors in the world, to see inside the mind of someone who comes with the imprimatur of Warren Buffett himself, look no further. This is a book that belongs on the bookshelf of any serious investor.



Felipe Garcia, CFA
Chief Investment Officer
INKWELL CAPITAL LLC



Aaron Byrd, CFA
President
INKWELL CAPITAL LLC

