Avoiding Mistakes by Studying Mistakes

Most investing books—and there are many—try to impart investment wisdom by enumerating the past successes of great investors. A refreshing new book by Michael Batnick, *Big Mistakes: The Best Investors and Their Worst Investments*, takes a different approach. In sixteen brief chapters, the book examines the mistakes of a number of famous investors throughout history. The author chronicles the mistakes of Benjamin Graham, Jesse Livermore, Mark Twain, John Meriwether, Jack Bogle, Michael Steinhardt, Jerry Tsai, Warren Buffett, Bill Ackman, Stanley Druckenmiller, Sequoia Fund, John Maynard Keynes, John Paulson, Charlie Munger, Chris Sacca, and himself.

While the book is not a how-to-book per se, the stories serve as a great learning tool for any investor or any student of stock market history. The mistakes discussed in the book revolve around a number of themes, most of which are behavioral biases that we are all prone to fall prey to.

Let’s explore a few of the most interesting.

Overconfidence

Warren Buffett is arguably the greatest investor of all time, but that hasn’t prevented him from committing some rather large investing mistakes. In 1993, Buffett bought Dexter Shoe, a manufacturer of reasonably priced men’s and women’s shoes. At the time he said that Dexter Shoe “had a long, profitable history, enduring franchise and super management.” He was very wrong about the “enduring franchise” part.

Buffett had acquired a couple of years earlier another shoe company that, with hindsight, clouded is judgment. H.H. Brown, the leading North American manufacturer of work shoes and boots had performed well since he bought it, and that gave him the (over)confidence to go ahead with another acquisition in the same industry. What Buffett didn’t see was that competition from abroad, with its extremely low-cost labor, would make the domestic production of shoes basically obsolete. The year after acquiring Dexter Shoe the company’s shoe profits and revenues started to decline and by the year 2000 Buffett charged off all the remaining accounting goodwill that was attributable to the transaction.

Buffett paid $433 million for a business that would eventually be worth zero. But what made the mistake even costlier was that Buffett paid not in cash, but in Berkshire Hathaway stock for a dying business. The 25,200 Berkshire shares that Buffett exchanged for Dexter Shoe are now worth approximately $7.5 billion. Buffett has joked that the more Berkshire stock rises the more the acquisition of Dexter Shoe hurts. It is truly the mistake that keeps on giving.

Fear of Missing Out

Stanley Druckenmiller is one of the best global macro investors of all time. He is best known for partnering with George Soros at the Quantum Fund and eventually taking the reins of the fund. He convinced Soros to make his famous bet against the British pound in 1992, a bet that would make them a billion dollars.

Druckenmiller has one of the best investing records of all time, reportedly compounding at around 30% for 30 years, but that didn't stop him from succumbing to that one horrible deadly sin: envy. During the late 90s Druckenmiller watched as a number of small, inexperienced hedge fund managers were making incredible returns betting on Internet stocks. He couldn't bear watching these upstarts rack 50% returns, while his fund was stuck in the single digits. So he did what everyone was doing and went deep into Internet stocks, even though deep inside he knew that was not the right thing to do.

When the crash inevitably came, Druckenmiller lost a fortune. As he relates it: "I bought $6 billion worth of tech stocks, and in six weeks I had lost $3 billion in that one play. You asked me what I learned. I didn't learn anything. I already knew that I wasn't supposed to do that. I was just an emotional basketcase and couldn't help myself."

Envy, or the fear of missing out, is a powerful force in investing. Why should we care if somebody is else is getting richer faster than us? Yes, it is irrational to care. But we all do it.

Stepping Outside a Circle of Competence

John Paulson started his hedge fund with $2 million of his own money in 1994. He built a decent track record in the next few years, specializing in merger arbitrage. Prior to the mid-2000s Paulson was known as a solid hedge fund manager, but nothing to get too excited about. That changed in 2007, after the housing bubble burst.

In 2006, Paulson got convinced that the housing market was about to collapse and he bet against it in a huge way. His firm bought a massive amount of credit default swaps on everything housing-related, and when his prediction became a reality he became the highest earning hedge fund manager ever. In 2007 his two funds gained 590% and 350%, and his firm earned $15 billion.

After that huge score, he had to find another big trade. This time he stepped into something that would turn to be a disaster: gold. Convinced that the actions of the Fed would bring inflation, Paulson plowed $5 billion into gold-related investments in 2010, becoming the largest owner of gold in the world. Since its high in 2011, gold has lost 30% and his fund lost more than a third of its value that year. The following year the fund lost another 14% and it still hasn't recovered.

Conclusion

Charlie Munger has said that "All I want to know is where I'm going to die so I'll never go there." Studying the mistakes of great investors might not preclude us completely from making the same mistakes, but at least it gives us a sense of what to watch out for. *Big Mistakes* is a good book that should help in that endeavor.

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