

>: Want to learn how to invest?

Monday, October 23, 2006 / Dylan Jovine

A new member of Fallen Angel Stocks who hails from Canada recently asked me how he could become a better investor. Although it's a question I am often asked, I found myself surprised at the answer I gave him.

The first part of my answer was standard ...

To learn how to study a business, I suggested he start by reading *Competitive Strategy* by Michael Porter. This is by far the best book ever written on how to determine the competitive position of a business.

Next, I recommended he read Warren Buffett's annual shareholder letters dating back to 1977 (www.berkshirehathaway.com) to learn how to value a business. Even today, most people don't realize just how lucky we are to have a giant such as Buffett openly share his thoughts with us.

And finally, I suggested the classic *Reminiscences of a Stock Operator* by Edwin Lefevre to learn how to study the market.

It was with the next part of my answer that I found myself in unfamiliar territory ...

For the first time in my life, I found myself discussing the importance of the qualitative "intangibles" to his investment operations. Specifically, I said to him that a respect for the facts and for history, as well as a strong emotional disposition and self-awareness were as important, if not more so, than any knowledge that can be gleaned from a textbook.

At first, I couldn't tell whether he thought I was kidding or if I actually took myself as seriously as some new-age Dr. Phil-type wannabe. But he understood where I was coming from.

And when I got off the phone with him, I decided to share with you exactly what I meant by that.

The Evolution of an Investor

The evolution of a professional investor is a curious thing.

At a young age, most investors are still captive to their "institutional" programming. Thus, the ideas they have are based largely on what they've been told by their parents or taught in school. Facts are used to fit their preconceived notions of the world and the stock market.

Investors who operate at this level are still operating "within the box." All market moves are seen through a narrow lens.

But a good investor will begin to tear down conventional wisdom one experience at a time. He learns quickly that the market doesn't suffer fools gladly. If you don't have a healthy respect for the facts, the market will take your money from you, no questions asked.

At some point in your career ? after gaining a certain amount of knowledge and experience ? you begin to "see" things differently.

Instead of reacting to what the market does or what the headlines proclaim, you begin to act independently of them. At this stage of the game, you have learned to trust your analysis of the facts to guide your decision making.

It's at this point that you realize cold-bloodedly that there actually is a "box" and 99% of all market participants operate within it. Personally, that's when I first looked in the mirror with pride and was able to call myself a professional investor.

But as you will see very soon, I was a bit early.

To the Man with the Hammer, Everything Looks Like a Nail

Several years ago, I made what was at that point of my life a large investment of time and money into an internet start-up. Looking back now, it's almost laughable ? but at the tail end of the 1990's I thought the company was actually onto something.

The fact that most of America joined me in my folly was of no comfort to me. Not only did I have a great reputation as an investor, but I had earned a reputation as a savvy businessman when I sold my brokerage firm at the ripe old age of 28. In my circle of friends, I'm known as the "wise skeptic."

I, of all people, should have known better.

That's why it didn't bother me to lose my money. From a very early age, the market trained me to study my losses objectively and move on to the

next opportunity. I never carry losses with me for too long. Far worse was the humiliation I felt. How could I do something so darn stupid, I asked myself repeatedly.

I remember one of my friends trying to console me one day over drinks. He said that it wasn't my fault. I had the "right idea at the wrong time."

But any businessperson worth his salt knows that's horses?!! Half of the job of having a good idea is knowing when.

Mistakes Made

It took me almost a full year of anger and depression before I was even able to look at my actions properly. Believe me when I tell you I almost couldn't do it. To look at my actions objectively would require brutal honesty which is hard to come by even on the best of days. But I knew that my primary goal in life was not to protect my ego ? it was to become a great investor. And to continue on that road I had to be brutally honest with myself.

That brings me back to the second part of my answer.

It was this single experience that led to my understanding of the "intangibles" needed to continue on my road to becoming a great investor. While every great investor has gone through a watershed moment like this, I don't think it's possible to learn from their mistakes. Intellectually, I had read all the case studies and studied all the greats; but you don't "know it" until you experience it and recover from it.

I often meet older businesspeople who experienced this moment of failure much later in their lives. In some ways I feel sorry for them. It's much harder on the ego, and consequently much harder to recover after you've had decades of success.

And certainly, it doesn't help having the financial responsibility that comes with an established family. Fortunately for me, I was hindered by neither. But still, my path was extremely difficult.

Here's what I learned:

I first realized that my ego had gotten the better of me. Flushed with business success early in life, it simply never occurred to me that I could be wrong. Perhaps even worse was that my oversized ego led me to dismiss lessons learned as an investor; instead of taking my loss early, the company continued to wander around as a corporate zombie, half dead and half alive.

Since I was allocating capital personally, the buck stops on my desk.

My inflated ego led me to myriad other problems that affected my decision making. However, due to the importance of each issue, each problem is worth noting on its own.

Secondly, I realized that I suffered from a tremendous lack of knowledge of both the markets and the industry I was operating in. My ignorance of both magnified the problems greatly.

With regard to the market, I should have realized that everything that was happening ? cheap money, a booming stock market, the "new, new" thing ? had happened before.

One need look no further than the 1960's boom in transistors or the 19th century boom in railroad stocks to see it.

I actually remember picking up a copy of Ben Graham's Intelligent Investor, written in 1934, and almost vomiting as he confessed to making the same mistakes earlier. The fact that he scolded himself for not picking up historical books earlier was a bit helpful ? it seems that he also missed studying the many other bubbles throughout history.

Last but not least, I was hampered by plain, old-fashioned greed.

For some reason, I believed that I would parlay what I had already made on Wall Street into a Forbes type fortune from my internet investment. Even worse, many other great investors (who were actually on the Forbes 400 list) were making the same investment mistakes. "If they're doing it, it must be smart" was my thinking.

This is the height of folly when it comes to making investment decisions. It suggests a complete lack of independent thought, which is the hallmark of a novice investor.

Looking back now, I can say that my greed actually overwhelmed me. Curiously, I have always been a student of Warren Buffett's. His investment style has always fit my natural emotional disposition. But at the height of the boom, I even mocked his decision to stay on the sidelines. I convinced myself that he was "out of touch." As I studied my mistakes, I realized I was dead wrong about Buffett. He had done his homework and knew exactly what was going on. It was I who was truly out of touch.

How You Can Benefit from This

calculations to determine where our time and money is best served.

But as I discussed what it took to become a great investor with our friend from Canada, it occurred to me that not many great investors discuss the single most important rule to becoming one:

Having an awareness of our own human nature.

You see, without an understanding of your own nature, you will be controlled by your base emotions. Instead of using history and facts to see past the financial headlines, you will follow them. The result will be that your fear and greed instincts will control your investment decisions.

If that happens, mark my words, you will never make a killing in the field of investing. I know because I never made one until I transcended them.

Instead of the patience that comes with a strong understanding of history, you will be compelled to move at all times, which is a recipe for destruction. And finally, if you are unaware of yourself, your ego will find a way to cloud the facts, which will limit your ability to evolve.

When you are at the age when you sit on the porch with your grandchildren and they ask you about investing, one of two comments will come out. If you ignore this advice, you'll end up telling your grandchildren that Wall Street is a big casino that's rigged for the richest people in the world. This will have the intended effect: your grandchildren will never take it seriously.

But, if you find yourself sitting on that porch one day, and you're asked about Wall Street, you may say something far different, indeed. You can pass on the knowledge that there is a "box," and the first order of business is to learn that it exists. Secondly, you will tell them that their ability to come back from ruin will mean far more than any success they ever have.

And finally, you will tell them that to be a master investor they have to understand and master their emotions. Then you will have truly passed on the kind of knowledge that allows our young ones to stand on our shoulders.

At least that's the way I see it at this point of my own evolution.



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