

IF YOU DON'T LIKE MONEY

This is a two-part letter. The first section concerns patterns of thought. Good investment decisions are made by a mix of common sense, being well informed about the world around us, and adhering to rational models of decision making that make judgments about business platforms, price, comparative advantage, opportunity/risk, etc. Investing requires an understanding of behavioral science and the ability to channel financial emotions intelligently. Investors need to understand what is knowable and what is inherently uncertain. This always imperfect, multi-factor decision model is what makes investing endlessly interesting, challenging, humiliating, and pure intellectual fun. The other great part of the investment management profession is getting to be friends with clients and doing a good job for them.

Charles Munger, Warren Buffett's partner and advisor, is someone we should all study, admire, and despite his advantage in pure brights, try to emulate. At some point most of our parents told us that there was much to learn from anyone who was really good (like Munger) at whatever they did—trash collectors on up. Munger's main lessons are persistence in learning, honesty, integrity, adherence to reason, virtue, goodness, discipline, patience, responsibility, curiosity, flexibility, and a sense of fun. He has a long history of challenging himself and others in seeking better and different patterns of thought and using a multi-disciplinary approach. Most of us think problems forward. If we **do** this, this, and this, the result will be X. Munger at times recommends an inverse approach: if you **do not** want X, do this, this, and this.

He gave a wonderful speech that is an example of his inverse approach to the 1986 graduating class at what is now Harvard-Westlake School in Los Angeles. Most graduation speakers lay out their prescriptions on how to lead a happy life. Munger inverted, and told students how to reach a state of misery. His negative inverted approach was forceful, memorable, and helpful to the student audience and probably to the parents. His guarantee of a miserable life included ingesting chemicals in an effort to alter mood or perception; envy; resentment; unreliability; learning life's lessons from experience, not from others' mistakes (i.e., put your own hand on the hot stove); giving up after one of life's inevitable defeats. Kids and grandkids entering high school should all get a copy of this speech.

The following uses Munger's inversion principal with the hope that it drives home some of the important prescriptions for being a successful investor. *If You Want To Lose Money*, try these tactics:

- Embrace offensive investing with your mother lode. Risk orientation is for worry warts. Success comes from hitting home runs, not singles.
- Concentrate your holdings in as few individual names as possible. Load up and put all your eggs in a small number of baskets.
- Diversification, both by asset class and by holdings, limits opportunity in your best ideas. If you believe, go for it in size.
- Invest with a short-term outlook. The long term is made up of many short terms. Long-term investors are sissies.
- Be a rocket ship in stock selection and shoot for the stars. Look for popular issues in the current fad. Picking the right stock is more important than avoiding the bad ones.
- Taxes are inevitable, dismiss them in decision making.
- Have strong opinions and don't listen to opposing points of view. Enron, Countrywide, GM, and Bear Stearns are aberrations.

- Trust the wisdom of the crowd instead of relying on your own independent research. CNBC pundits, locker room tips, and cab drivers are good sources of information.
- Low-quality debt and some equity instruments often entice investors with high yields—go for it.
- Leverage magnifies return. If you have conviction, let the good times roll.
- Trust your emotions. Do what feels most comfortable. When your belly says buy—buy. If it says sell—sell.

The second section of this letter concerns the current investment background. Investors can always come up with lists of positive and negative factors on the economy and the investment markets. The current negatives have been well vetted by the media. Eugene Field wrote wonderful bedtime poems for children. You might remember “The Duel—The Gingham Dog and the Calico Cat,” “Wynken, Blynken, and Nod,” and “Seein’ Things.” The latter had a great picture of a little boy sitting up wide-eyed in bed after his mother turned off the light and left his room. In the dark background were creepy ghost figures that were barely visible. The scene is not unlike the negatives in today’s investment background. It is important not to let fears dominate your thoughts, but it is wise to pay attention to them. Similarly, a built-in bullish bias can also lead to trouble.

Peter Bernstein, who passed away in June, was one of the best authors, thinkers, and practitioners Wall Street ever produced. His take on projecting the future of markets was to be humble. He wrote that no one knows what the future holds. Warren Buffett and Charlie Munger second that belief. We do know that America and the rest of the industrial world dug themselves into a deep hole of debt, dependence on credit, and leverage, and that it is probably going to take time to dig ourselves out. The U.S. has faced problems like this before and, in time, motivated individuals and our “free market” have always righted the ship. Risk management, considering where we seem to be in the cycle, suggests it is time to err on the side of caution.

Do not forget there are positives, including the huge amount of sideline cash that could be fuel for a stock market rally, the emergence of a large middle class population outside the U.S. who want to live like Americans, and that central bankers all over the world are pumping money into their economies. It is possible to make money in weak environments, but you should not expect miracles from stocks. Economic growth will be slow and it is probable, for a time, that stock returns will be muted compared to historic averages. Giving up on stocks is not a good option, mainly because it is impossible to time a lasting upturn and some quality issues now provide competitive hard dollar returns.

Covington’s conclusions are to:

- have a moderate as opposed to full position in stocks
- have a core position in quality, dividend-paying domestic equities
- think globally and have exposure to both developed and emerging markets where growth is expected to outpace the U.S.
- maintain exposure to quality, intermediate-term corporate and municipal bonds
- participate in foreign and American government spending on infrastructure and other initiatives.

It is a time for diversification, moderation, patience, avoiding serious errors, and risk management.