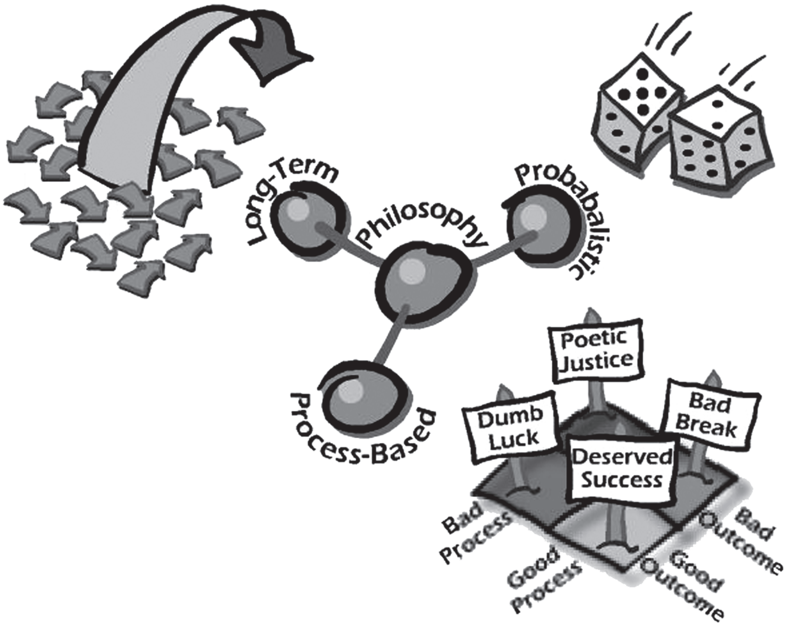
Part 1

Investment Philosophy



INTRODUCTION

Out of the blue one day, I received a complimentary e-mail from a guy who had read one of my essays. I was appreciative but didn't think much of it until I noticed he had found the piece on a Web site dedicated to *traders*. Given that my focus is almost exclusively on long-term investing, I found it odd that a trader would find use for these ideas.

So I looked to see what else was out there and found something that surprised me even more: one of the essays was highlighted on a gambling Web site. While I study and appreciate gambling methods, I felt—as most self-righteous investors do—that long-term investing is nearly the *opposite* of most forms of gambling. After thinking about it, though, I realized there is a tie that binds all of these worlds: investment philosophy.

Investment philosophy is important because it dictates how you should make decisions. A sloppy philosophy inevitably leads to poor long-term results. But even a good investment philosophy will not help you unless you combine it with discipline and patience. A quality investment philosophy is like a good diet: it only works if it is sensible over the long haul and you stick with it.

Investment philosophy is really about temperament, not raw intelligence. In fact, a proper temperament will beat a high IQ all day. Once you've established a solid philosophical foundation, the rest is learning, hard work, focus, patience, and experience.

Quality investment philosophies tend to have a number of common themes, which the essays in this part reveal. First, in any probabilistic field—investing, handicapping, or gambling—you're better off focusing on the decision-making *process* than on the short-term *outcome*. This emphasis is much easier announced than achieved because outcomes are objective while processes are more subjective. But a quality process, which often includes a large dose of theory, is the surest path to long-term success.

That leads to the second theme, the importance of taking a long-term perspective. You simply cannot judge results in a probabilistic system over the short term because there is way too much randomness. This creates a problem, of course; by the time you can tell an investment process is poor, it is often too late to salvage decent results. So a good process has to rest on solid building blocks.

The final theme is the importance of internalizing a probabilistic approach. Psychology teaches us there are a lot of glitches in the probability module of our mental hardwiring. We see patterns where none exist. We fail to consider the range of possible outcomes. Our probability assessments shift based on how others present information to us. Proper investment philosophy helps patch up some of those glitches, improving the chances of long-term success.

A closing thought: The sad truth is that incentives have diluted the importance of investment philosophy in recent decades. While well intentioned and hard working, corporate executives and money managers too frequently prioritize growing the business over delivering superior results for shareholders. Increasingly, hired managers get paid to play, not to win.

So ask the tough question: Does an intelligent investment philosophy truly guide you or the people running your money? If the answer is yes, great. If not, figure out a thoughtful philosophy and stick with it.