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The Most Important Thing Is . . .
Second-Level Thinking

The art of investment has one characteristic that is not generally appreciated. A creditable, if unspectacular, result can be achieved by the lay investor with a minimum of effort and capability; but to improve this easily attainable standard requires much application and more than a trace of wisdom.

BEN GRAHAM, THE INTELLIGENT INVESTOR

Everything should be made as simple as possible, but not simpler.

ALBERT EINSTEIN

It’s not supposed to be easy. Anyone who finds it easy is stupid.

CHARLIE MUNGER

Few people have what it takes to be great investors. Some can be taught, but not everyone . . . and those who can be taught can’t be taught everything. Valid approaches work some of the time but not all. And investing can’t be reduced to an algorithm and turned over to a computer. Even the best investors don’t get it right every time.

The reasons are simple. No rule always works. The environment isn’t controllable, and circumstances rarely repeat exactly. Psychology plays a major role in markets, and because it’s highly variable, cause-and-effect relationships aren’t reliable. An investment approach may work for a while,
but eventually the actions it calls for will change the environment, meaning a new approach is needed. And if others emulate an approach, that will blunt its effectiveness.

Investing, like economics, is more art than science. And that means it can get a little messy.

One of the most important things to bear in mind today is that economics isn’t an exact science. It may not even be much of a science at all, in the sense that in science, controlled experiments can be conducted, past results can be replicated with confidence, and cause-and-effect relationships can be depended on to hold.

“WILL IT WORK?” MARCH 5, 2009

Because investing is at least as much art as it is science, it’s never my goal—in this book or elsewhere—to suggest it can be routinized. In fact, one of the things I most want to emphasize is how essential it is that one’s investment approach be intuitive and adaptive rather than be fixed and mechanistic.

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At bottom, it’s a matter of what you’re trying to accomplish. Anyone can achieve average investment performance—just invest in an index fund that buys a little of everything. That will give you what is known as “market returns”—merely matching whatever the market does. But successful investors want more. They want to beat the market.

In my view, that’s the definition of successful investing: doing better than the market and other investors. To accomplish that, you need either good luck or superior insight. Counting on luck isn’t much of a plan, so you’d better concentrate on insight. In basketball they say, “You can’t coach height,” meaning all the coaching in the world won’t make a player taller. It’s almost as hard to teach insight. As with any other art form, some people just understand investing better than others. They have—or manage to acquire—that necessary “trace of wisdom” that Ben Graham so eloquently calls for.

Everyone wants to make money. All of economics is based on belief in the universality of the profit motive. So is capitalism; the profit motive
makes people work harder and risk their capital. The pursuit of profit has produced much of the material progress the world has enjoyed.

But that universality also makes beating the market a difficult task. Millions of people are competing for each available dollar of investment gain. Who’ll get it? The person who’s a step ahead. In some pursuits, getting to the front of the pack means more schooling, more time in the gym or the library, better nutrition, more perspiration, greater stamina or better equipment. But in investing, where these things count for less, it calls for more perceptive thinking . . . at what I call the second level.

Would-be investors can take courses in finance and accounting, read widely and, if they are fortunate, receive mentoring from someone with a deep understanding of the investment process. But only a few of them will achieve the superior insight, intuition, sense of value and awareness of psychology that are required for consistently above-average results. Doing so requires second-level thinking.

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Remember, your goal in investing isn’t to earn average returns; you want to do better than average. Thus, your thinking has to be better than that of others—both more powerful and at a higher level. Since other investors may be smart, well-informed and highly computerized, you must find an edge they don’t have. You must think of something they haven’t thought of, see things they miss or bring insight they don’t possess. You have to react differently and behave differently. In short, being right may be a necessary condition for investment success, but it won’t be sufficient. You must be more right than others . . . which by definition means your thinking has to be different.

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!”

• First-level thinking says, “I think the company’s earnings will fall; sell.” Second-level thinking says, “I think the company’s earnings will
fall less than people expect, and the pleasant surprise will lift the stock; buy.”

First-level thinking is simplistic and superficial, and just about everyone can do it (a bad sign for anything involving an attempt at superiority). All the first-level thinker needs is an opinion about the future, as in “The outlook for the company is favorable, meaning the stock will go up.”

Second-level thinking is deep, complex and convoluted. The second-level thinker takes a great many things into account:

- What is the range of likely future outcomes?
- Which outcome do I think will occur?
- What’s the probability I’m right?
- What does the consensus think?
- How does my expectation differ from the consensus?
- How does the current price for the asset comport with the consensus view of the future, and with mine?
- Is the consensus psychology that’s incorporated in the price too bullish or bearish?
- What will happen to the asset’s price if the consensus turns out to be right, and what if I’m right?

The difference in workload between first-level and second-level thinking is clearly massive, and the number of people capable of the latter is tiny compared to the number capable of the former.

First-level thinkers look for simple formulas and easy answers. Second-level thinkers know that success in investing is the antithesis of simple. That’s not to say you won’t run into plenty of people who try their darnedest to make it sound simple. Some of them I might characterize as “mercenaries.” Brokerage firms want you to think everyone’s capable of investing—at $10 per trade. Mutual fund companies don’t want you to think you can do it; they want you to think they can do it. In that case, you’ll put your money into actively managed funds and pay the associated high fees.

Others who simplify are what I think of as “proselytizers.” Some are academics who teach investing. Others are well-intentioned practitioners who overestimate the extent to which they’re in control; I think most of them fail to tote up their records, or they overlook their bad years or attribute losses to bad luck. Finally, there are those who simply fail to under-
stand the complexity of the subject. A guest commentator on my drive-
time radio station says, “If you have had good experience with a product,
buy the stock.” There’s so much more than that to being a successful
investor.

First-level thinkers think the same way other first-level thinkers do
about the same things, and they generally reach the same conclusions.
By definition, this can’t be the route to superior results. All investors can’t
beat the market since, collectively, they are the market.

Before trying to compete in the zero-sum world of investing, you must
ask yourself whether you have good reason to expect to be in the top half.
To outperform the average investor, you have to be able to outthink the
consensus. Are you capable of doing so? What makes you think so?

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The problem is that extraordinary performance comes only from correct
nonconsensus forecasts, but nonconsensus forecasts are hard to make,
hard to make correctly and hard to act on. Over the years, many people
have told me that the matrix shown below had an impact on them:

<table>
<thead>
<tr>
<th>Conventional Behavior</th>
<th>Unconventional Behavior</th>
</tr>
</thead>
<tbody>
<tr>
<td>Favorable Outcomes</td>
<td>Average good results</td>
</tr>
<tr>
<td>Unfavorable Outcomes</td>
<td>Average bad results</td>
</tr>
</tbody>
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You can’t do the same things others do and expect to outperform. . . .
Unconventionality shouldn’t be a goal in itself, but rather a way of
thinking. In order to distinguish yourself from others, it helps to
have ideas that are different and to process those ideas differently.
I conceptualize the situation as a simple 2-by-2 matrix:

Of course it’s not that easy and clear-cut, but I think that’s the
general situation. If your behavior is conventional, you’re likely to
get conventional results—either good or bad. Only if your behavior
is unconventional is your performance likely to be unconventional,
and only if your judgments are superior is your performance likely to be above average.

“DARE TO BE GREAT,” SEPTEMBER 7, 2006

The upshot is simple: to achieve superior investment results, you have to hold nonconsensus views regarding value, and they have to be accurate. That’s not easy.

The attractiveness of buying something for less than it’s worth makes eminent sense. So how is one to find bargains in efficient markets? You must bring exceptional analytical ability, insight or foresight. But because it’s exceptional, few people have it.

“RETURNS AND HOW THEY GET THAT WAY,” NOVEMBER 11, 2002

For your performance to diverge from the norm, your expectations—and thus your portfolio—have to diverge from the norm, and you have to be more right than the consensus. Different and better: that’s a pretty good description of second-level thinking.

Those who consider the investment process simple generally aren’t aware of the need for—or even the existence of—second-level thinking. Thus, many people are misled into believing that everyone can be a successful investor. Not everyone can. But the good news is that the prevalence of first-level thinkers increases the returns available to second-level thinkers. To consistently achieve superior investment returns, you must be one of them.