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The BOOK OF INVESTING WISDOM

Classic Writings by
Great Stock-Pickers and Legends of Wall Street

Edited by Peter Krass

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Introduction

Wall Street. The phrase alone conjures up a spectrum of words and images, from wise investing to reckless gambling, from power deals to pots of gold, from venerable legends like Warren Buffett to infamous traders like Michael Milken. But legends and allure aside, most of us, in some way, are connected to Wall Street and the phrenetic world of investing. Whether we be professional money managers, do-it-yourself investors, or simply are vested in a 401(k) plan, a chunk of our personal money is in securities. That's why even amateurs must be not only Wall Street literate, but savvy as to what they have invested in and why. The need to be a superb student extends to the pros, too—just ask Warren Buffett, who studied religiously under Benjamin Graham.

But why do we need such an edge? Because, ever since the day the French aristocracy first started trading forward contracts for commodities in the twelfth century, every broker, trader, and investor has looked for that advantage to buy cheap and sell dear—and sometimes that means blindsiding the sucker. As the notorious stock manipulator Daniel Drew allegedly said, "To speckilate as an outsider is like trying to drive black pigs in the dark." Not that insiders are guaranteed success, according to Peter Lynch, who wrote in *One Up* *on Wall Street* that "professional investing" is an oxymoron on a par with "military intelligence." So where does that leave the pro as well as the amateur? In need of recruiting a panel of the greatest stock-pickers and market gurus, past and present, to instruct on the art of investing. Where can we find such a panel? Here in *The Book of Investing Wisdom.*

Wall Street. From its historical beginnings, it has been an epicenter for epic battles, financial and otherwise. One large step backward in time is necessary to give full meaning to Wall Street. Its roots lay in 1624, when the Dutch founded and settled New Amsterdam on the southern tip of Manhattan, reportedly buying it from the native Americans for about $24 worth of trinkets (a deal Donald Trump, who concludes this collection, must certainly admire). Unfortunately for the Dutch, the British also had their eyes on this upscale piece of property, and the residents of New Amsterdam were forced to build a 12-foot-high wooden stockade to protect themselves from repeated attacks. Not to be stymied, in 1664 the British simply sailed their cannon-laden warships into the harbor, and the Dutch surrendered. In 1685, the British built a road along the line of the stockade, which had been torn down, and named it Wall Street. Little did they know that on this same spot the financing would be raised to pay for the war that would expel them from the United States.

While the French had been trading paper since the twelfth century and the English had established securities markets by 1720, the United States did not witness any securities trading until the Revolutionary War, when a smattering of bonds were issued to raise fighting money. However, the first major issue of U.S. securities did not come until 1790, when the Federal Government issued $80 million in bonds to refinance all war debt. And so, the national debt was birthed. At that time New York City was the nation's capital, so it immediately took center stage in American finance, and public securities auctions were held there twice daily in 1791 and 1792. The first step toward a more formal stock exchange came in 1792, when 24 prominent brokers gathered under a buttonwood tree on Wall Street and signed the "Buttonwood Agreement," which established a bond of trust between them and—more important—set minimum commission rates. The New York Stock Exchange traces its roots to that historic day. Of course, as the market flourished, it wasn't long before those once-trusting brokers entered into skirmishes against each other; their fights, however, were a bit more civilized than those that took place there between the Dutch and the British.

The ensuing battles along Wall Street involved more slick financial skills than weapons, although Jim Fisk, stock manipulator extraordinaire and major player in the infamous gold corner of 1869, was shot to death by a jealous rival—both men were courting the same woman. The financial skulduggery of Fisk and his cronies, like Daniel Drew (see Part VI, "Lessons from Notorious Characters"), were important to Wall Street, as they actually served as catalysts for stock exchange reform. They were operating in the mid-1800s, when railroads ruled the country, both powering economic development and controlling the flow of goods. The first railroad stock was listed in 1830, when there were only 73 miles of track. Ten years later there would be 3,328 miles of track and 13 railroad stocks listed, providing ample opportunity for manipulating prices and stock watering. One result: In 1866, the New York Stock Exchange began requiring companies to provide financial reports to help prevent deceptive practices.

Other major reforms also followed scandal or financial disasters. As a result of the 1907 panic (see Frank Vanderlip), the Federal Reserve System was established in 1913; after the 1929 crash (see Edwin Lefèvre), the Securities Exchange Commission was established in 1934; after the 1987 crash (see George Soros), the SEC instituted measures to control the extreme price movements that resulted from the growth of computer-generated trades. Since the mid-1800s, technical innovations have helped modernize the various exchanges. In 1844 the telegraph was invented, paving the way for brokers to operate effectively in every American city—they could receive timely news for making decisions and were able to execute trades immediately. In 1867 the first practical ticker was introduced, which also aided the dissemination of information in real time. These technological innovations made the stock exchanges more accessible to the population.

By the early 1900s, the stock market was a pop phenomenon, with songs such as “Bulls and Bears March and Two Step” hitting the street circa 1901, and with Stock Market Cigars being manufactured by an Ohio company circa 1903. American culture and the stock market became intertwined forever, a subject tackled by Robert Prechter, whose essay, “Elvis, Frankenstein and Andy Warhol,” appears in Part IV. One of the results of the rising popularity of the stock market in the early 1900s was rampant speculation by the small investor. Meanwhile, a new school of thought was formulating in the mind of one Benjamin Graham, who began his Wall Street career in 1914 and quickly recognized the need to cut through all this speculative nonsense that had taken hold of America.

In his memoirs, Graham recalled that a burgeoning financial services industry, which included pioneers John Moody and Roger W. Babson, was providing huge quantities of information ripe for analysis. “But in 1914,” Graham wrote, “this mass of financial information was largely going to waste in the area of common stock analysis. The figures were not ignored, but they were studied superficially and with little interest. . . . To a large degree, therefore, I found Wall Street virgin territory for examination by a genuine, penetrating analysis of security values.” The ultimate result was his seminal 1934 book, *Security Analysis,* coauthored by David Dodd, which is now regarded as the investor’s bible. Graham sought to discover the true value of a company and return expectations through diligent analysis, not through inside information, rumors, tips, and flights of fancy.

The importance of securities analysis cannot be ignored or treated lightly, which is why *The Book of Investing Wisdom* begins with “The Nuts and Bolts of Analysis,” and who better to lead off the section than Warren Buffett, who worked and studied under Graham. As with the prior two collections in this series, *The Book of Business Wisdom* and *The Book of Leadership Wisdom,* this anthology is organized into eight thematic parts to address different aspects of investing and to provide insight into the various nuances of the exchanges. Each section is introduced with a few lines to summarize its purpose and to pull out some of the dominant themes. For example, Part II focuses on the attitude the investor needs to bring to the table, and one of the themes is skepticism—John Bogle, founder of The Vanguard Group, warns the investor about "past performance syndrome," which is a money manager's propensity to promote past successes when you should be focusing on the present. In another example, Part V provides the opportunity to look at investing from the professional's perspective. In this section, hedge-fund manager Michael Steinhardt writes that "short selling is psychologically unnerving and takes a greater degree of discipline than that needed in buying stocks." He goes on to admit that he is not sure the trading volume and portfolio turnover they generate is justified.

Not all of the authors are great stock-pickers; for example, B. C. Forbes was William Randolph Hearst's top finance columnist before founding *Forbes* magazine, and Edwin Lefèvre was a prolific financial journalist who wrote the investment classic, *Reminiscences of a Stock Operator.* Regardless, these astute observers of Wall Street have a wealth of information to share. Regrettably, for a variety of reasons a few prominent names are missing from the collection. The primary reason: The right stuff for this kind of collection wasn't available. Some prudent investment gurus are not going to share their secrets, except for the occasional sound bite. In other cases, a particular essay might be too constrained to the time when it was written or might even be too technical and dry.

The ultimate purpose of *The Book of Investing Wisdom* is to help you make money. Whether you are an amateur or a professional investor, you'll find practical advice, strategic wisdom, and intriguing history in *The Book of Investing Wisdom.* Investing doesn't have to be like a throw of the dice at the craps table or a wild roller coaster ride at the amusement park. Taking the gambling out of investing requires diligent study. Who better to learn from and be inspired by than the panel of investor laureates assembled here?

PART I

The Nuts and Bolts of Analysis

First and foremost, all investors must do their homework—only doing this homework well doesn't mean getting a gold star from the teacher. The stakes are higher—it makes the difference between winning and losing fortunes. In the opening essay, Warren Buffett declares that facts about a company and its track record rule whether to invest. Having the facts right makes you right, and what others say, whether they are company spokespeople or the media, must be ignored. In addition to studying a company's financials, reading up on economic and political issues can be crucial. As Jim Rogers, who was once George Soros' partner, warns: "The smart investor learns to listen to the popular press with an ear tuned for panic extremes." The essays in Part I make it clear that analysis goes beyond looking at P/E ratios and book values.

WARREN E. BUFFETT
1930–

As a youngster, the billionaire investor was said to have discovered money like "Mozart discovered music." Warren Buffett operated two paper routes, retrieved golf balls and resold them, and then later graduated to managing pinball machines in the local barbershops, among other endeavors. Born and raised in Omaha, he has chosen to remain there even after all the success. A colleague once pointed out the advantage: "Warren's kept his perspective clear by living in Omaha, away from it all, and looking at what's important rather than what's urgent or fashionable." His well-grounded philosophy is the result of having worked as an analyst under the conservative Benjamin Graham, the undisputed father of modern securities analysis.

After a two-year apprenticeship with Graham, Buffett returned to Omaha and set up his own investment partnership with $100,000. Some 30 years later, Omaha was reputed to have 52 "Buffett millionaires." For all his conservatism, Buffett did something radical in 1969: He simply dissolved the partnership in the midst of a bull market. He believed that the entire market was overpriced, and no stock winners could be found or held. At that time, he also admitted, "My idea quota used to be like Niagra Falls—I'd have many more than I could use. Now it's as though someone had damned up the water and was letting it flow with an eyedropper." The investor's version of writer's block.

Not to worry, Buffett went on to become one of the richest people in the United States by taking aggressive stock positions in companies like Coca-Cola, Geico, and the Washington Post Company. One firm he came to control virtually by accident was Berkshire Hathaway, Inc. It was a down-and-out textile company when he ran across it in 1962. Its stock was trading below $8, but he realized it had $16.50 per share of working capital alone. The rest is history. One of the key elements that goes into Buffett's analysis is the company's past performance and managerial competence, which he discusses in *Track Record Is Everything.* To make his point, Buffett indulges in a smattering of both serious and hilarious anecdotes that include allusions to Albert Einstein, Saint Peter, and the Kentucky Derby.

Track Record Is Everything
Warren E. Buffett

I've often felt there might be more to be gained by studying business failures than business successes. In my business, we try to study where people go astray, and why things don't work. We try to avoid mistakes. If my job was to pick a group of 10 stocks in the Dow Jones average that would outperform the average itself, I would probably not start by trying to pick the 10 best. Instead, I would try to pick the 10 or 15 worst performers and take them out of the sample, and work with the residual. It's an inversion process. Albert Einstein said, "Invert, always invert, in mathematics and physics," and it's a very good idea in busines, too. Start out with failure, and then engineer its removal.

> *Unfortunately . . . what happens in business and investments [is that] people know better, but when they hear a rumor—particularly when they hear it from a high place—they just can't resist the temptation to go along.*

In Berkshire Hathaway Inc.'s 1989 annual report, I wrote about something I called the "institutional imperative." I didn't learn about it in business school, but it tends to have an enormous impact on how businesses are actually run. One of its main tenets is a copycat mechanism that decrees that any craving of a leader, however foolish, will be quickly supported by detailed rate-of-return and strategic studies prepared by his troops.

For example, every time it becomes fashionable to expand into some new line of business, some companies will expand into it. Then they get out of it about five years later, licking their wounds. It's very human; people do the same thing with their stocks.

I've often felt there might be more to be gained by studying business failures than business successes.

To illustrate, let me tell you the story of the oil prospector who met St. Peter at the Pearly Gates. When told his occupation, St. Peter said, "Oh, I'm really sorry. You seem to meet all the tests to get into heaven. But we've got a terrible problem. See that pen over there? That's where we keep the oil prospectors waiting to get into heaven. And it's filled—we haven't got room for even one more." The oil prospector thought for a minute and said, "Would you mind if I just said four words to those folks?" "I can't see any harm in that," said St. Pete. So the old-timer cupped his hands and yelled out, "Oil discovered in hell!" Immediately, the oil prospectors wrenched the lock off the door of the pen and out they flew, flapping their wings as hard as they could for the lower regions. "You know, that's a pretty good trick," St. Pete said. "Move in. The place is yours. You've got plenty of room." The old fellow scratched his head and said, "No. If you don't mind, I think I'll go along with the rest of 'em. There may be some truth to that rumor after all."

That, unfortunately, is what happens in business and investments. People know better, but when they hear a rumor—particularly when they hear it from a high place—they just can't resist the temptation to go along.

It happens on Wall Street periodically, where you get what are, in effect, manias. Looking back no one can quite understand how everyone could have gotten so swept up in the moment. A group of lemmings looks like a pack of individualists compared with Wall Street when it gets a concept in its teeth.

When I was a graduate student at Columbia University, I got a piece of advice from Ben Graham, the founding father of security analysis, that I've never forgotten: You're neither right nor wrong because other people agree with you. You're right because your facts are right and your reasoning is right—and that's the only thing that makes you right.

A group of lemmings looks like a pack of individualists compared with Wall Street when it gets a concept in its teeth.

And if your facts and reasoning are right, you don't have to worry about anybody else. Watch that track record. The best judgment we can make about managerial competence does not depend on what people say, but simply what the record shows. At Berkshire Hathaway, when we buy a business we usually keep whoever has been running it, so we already have a batting average. Take the case of Mrs. B, who ran our Furniture Mart. Over a 50-year period, we'd seen her take $500 and turn it into a business that made $18 million pretax. So we knew she was competent. She's also 97 years old. In fact, now she's competing with us; she started a new business two years ago. Who would think you'd have to get a noncompete agreement with a 95-year-old? Clearly, the lesson here is that the past record is the best single guide.

Then you run into the problem of the 14-year-old horse. Let's say you buy The Daily Racing Form and it shows that the horse won the Kentucky Derby as a four-year-old. Based on past performance, you know this was one hell of a horse. But now he's 14 and can barely move. So you have to ask yourself, "Is there anything about the past record that makes it a poor guideline as a forecaster of the future?"

The situation may also arise in which there is no clear past record. Let's say that when you left college they gave you a little bonus: You got to pick out anybody in your class and you'd get 10 percent of his or her future earnings. All of a sudden you look at the whole group in a different way. You've seen them in class; you know their grades and their leadership capabilities. Taking these factors into account, you ask yourself, "Who do I pick?" But how good a choice do you think you could make? It would be a lot easier if you could make that decision at your tenth class reunion, after you've seen their actual business performance, wouldn't it?

These are the judgments that Berkshire Hathaway makes about management all the time. We try to find businesses that we really feel good about owning. What a company's stock sells for today, tomorrow, next week, or next year doesn't matter. What counts is how the company does over a five- or 10-year period. It has nothing to do with charts or numbers. It has to do with businesses and management.

What a company's stock sells for today, tomorrow, next week, or next year doesn't matter. What counts is how the company does over a five- or 10-year period.

Another thing I learned in business school was that it doesn't help to be smarter than even your dumbest competitor. The trick is to have no competitors. That means having a product that truly differentiates itself.

Say a customer goes into a drugstore and asks for a Hershey's bar. The clerk says, "We don't have any, but why don't you take this other chocolate bar instead; it's a nickel cheaper." And the customer says, "I'll go across the street." It's when the customer will go across the street that you've got a great business.