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# 10 Ways to Improve Your Investment Process

... and make more money.

Greg Speicher

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IDEAS FOR INTELLIGENT INVESTING

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# Introduction

You would not be reading this if you did not want to improve your investing results. Provided that you already have a rational investing philosophy, the key to improving your results lies in improving your investment process.

I have been investing for over twenty years. Like you, I want results. If over time I can't beat the market averages, what's the point? I'd rather buy an index fund and forget about it.

The good news is that there is plenty of evidence that this goal is achievable – not easy, but achievable.

One thing I have learned in studying the great investors is that they all have a great investment process that drives everything they do.

There's no secret formula. No valuation algorithms hidden away in Omaha. No short cuts. You need to create a solid investment process based on a rational investing philosophy that has been proven to generate market-beating results.

The outcome of some activities is entirely a function of skill. Examples include chess and the 100-meter dash. Other

activities, such as rock-paper-scissors or roulette, are based entirely on luck.

Investing is somewhere in the middle. Its outcome is a function of both skill and luck. That is why it is difficult to identify if an investor has skill. A know-nothing investor can be lucky and a skilled investor can have periods of under-performance.

Serious investors recognize this reality and focus on what they can control. They focus on their investment process knowing that – over time – real skill will reveal itself in superior long-term performance.

This leads us to a definition of process.

A process is an organized group of activities designed to constantly improve skill and increase its role in an outcome, thereby minimizing – to the degree possible – the role of luck.

### **An Example from Sports**

You can learn about the power of process by studying football coach Nick Saban. He won college BCS National Championships at LSU in 2003 and at Alabama in 2010.

Saban's success comes down to an almost maniacal focus on getting better in all aspects of the game – an effort he simply calls The Process.

Saban's process includes recruiting, conditioning, practicing, work ethic, strategy, and organizational structure. His recruiting process alone has five distinct steps. The process begins as soon as the season ends and it continues year round.

Saban's process is an effort to squeeze chance from the equation and increase the odds of winning.

Saban talks about how you can't skip steps. You can't get from point A to point Z without passing through point B and that if you skip a step, you won't achieve your desired outcome. Saban talks about finishing.

Saban's process is not about genius, better information, or even better athletes. It's about sweating the details. It's about working harder and smarter and looking to exploit the weaknesses of your opponents.

In this series of blog posts, I'd like to share ten ideas to improve your investment process. I've learned these ideas

from my own experience and from studying the great investors.

## **Passion**

Before laying out the ten ways to improve your investment process, I want to say a word about passion. Passion is essential if you want to be a great investor. You need to love what you're doing.

If you choose to pursue becoming a great investor, you will spend a great deal of your time reading and thinking. Many days your work will not appear to be fruitful. Only occasionally will you find a truly worthwhile idea. Then, if the idea checks out and you make a purchase, you will need to patiently wait for your thesis to play out. This may take several years.

Unless you love what you're doing and can derive pleasure from the process of learning and mastering your craft, it's unlikely that you will persevere. This requires passion.

# #1. Define Your Outcome

The first idea to improve your investment process is to define your outcome. You must have a crystal clear idea of what you're trying to accomplish.

If your target is clear, it helps you define a good process. For example, whether your goal is to beat the S&P 500 or achieve an absolute return of 15%, it forces you to think carefully about the type of strategy you'll need to actually do it. What type of securities will you need to buy? What are their characteristics? How will you find them? What about taxes and transaction costs?

Equally important, it will give you a yardstick to say no to the majority of securities that won't help you meet your goal.

If your target isn't clear, you may be tempted to rationalize poor results. Buffett warns about shooting an arrow into a blank canvas and then drawing the bull's-eye around the implanted arrow.

If you don't have a yardstick, you can't measure your performance and see if you're making progress. Without a yardstick, you can't see if you're actually adding value.

Isn't the purpose of an actively managed fund to add value?

Finally, a word of caution. You can't define success as achieving your outcome each and every year. External factors and chance have too much impact on short-term performance.

However, if you can't reach your outcome over a five-year period, you may be kidding yourself. Your investment process may not be adding any value.



## #2. Define Your Process

The second idea to improve your investment process – if you have not already done so – is to carefully define it in writing. As investors, by default we all have some type of investment process. Some are good and some are not so good. Some are thoughtfully constructed, some are not.

All of them can be improved through focused effort.

If you haven't done so already, you should commit your process to writing – not just your general philosophy – but all aspects of your process: your search strategy, research and valuation methods, portfolio management, sell strategy, everything – and then work like crazy to improve it. If you don't write it down, you can't study it, tweak it, improve it, and develop it.

### **What's Your Edge?**

To have a good investment process, you need to answer the question, "What's my edge?" Investing is highly competitive, and you have to assume that the person on the other side of the trade is intelligent and well-informed.

Michael Mauboussin talks about three types of edge: analytical, psychological and institutional.

## **Analytical Edge**

First, let's consider an analytical edge. Mauboussin explains that you can think of it as the ability to recognize a gap between the fundamentals and expectations. For example, consider horse track betting. The fundamentals are the speed of the horses or the records of the jockeys. The expectations are the odds and the payouts. Having an analytical edge means being able to skillfully handicap the race and see valuation gaps between the fundamentals and expectations.

How do you get an analytical edge? You could focus on one industry or sector, perhaps where you have specialized knowledge or experience. Or, you could focus on complex situations that are hard to understand. Perhaps you could gain an edge by focusing on micro or nano-cap stocks with little or no analyst coverage.

You might want to focus on securities that have shown persistent outperformance, such as special situations. You could look for time arbitrage opportunities where the market

is overreacting to recent events and undervaluing a business's long term prospects.

Don't underestimate the knowledge and expertise it takes to gain an analytical edge in today's highly competitive market. The required skill is similar to that of a medical specialist or skilled attorney.

Charlie Munger tells the story of Max Plank traveling around Europe lecturing after he won the Nobel Prize. Apparently he gave the same speech so many times that his chauffer memorized it. To amuse themselves, so the story goes, Plank would have the chauffer occasionally give the speech. During the Q&A that followed, if someone asked a question that the chauffer couldn't answer, he would retort, "My good man, I'm surprised you would ask such a simple question in a sophisticated European city. I'm going to have my chauffer answer that one."

We need to avoid chauffer knowledge like the plague when pursuing an analytical edge. Simply regurgitating someone else's thesis is not having an edge.

## **Psychological Edge**

Another type of edge is a psychological edge. One form of having a psychological edge is having the emotional discipline to exploit fear – to step up when others are in a state of panic. Another form of psychological edge is having the patience to wait for obviously attractive opportunities. Also, you might seek an edge in how you run your portfolio by placing large bets on your high-conviction ideas. This is how some of the most successful investors run their portfolios.

Professional poker players only bet in size when the odds are favorable. If you don't know your edge, you can't assess when the odds are in your favor. If you invest anyway, you'll make yourself the patsy and the outcome is much less likely to be positive.

## **Institutional Edge**

Finally, a word about having an institutional edge.

If your money is managed by a professional money management firm, you will have an edge if they truly put your interests first. How do you know? Do they eat their own cooking? That is, is a substantial part of their net worth in the

fund? Are their fees fair? Will they close the fund if it gets too large or are they more interested in harvesting assets? Do they look like a closet index fund or do they have a process that adds real value? Pay close attention and focus your investments with managers who adhere to these principles.

## #3. Don't Focus on the Outcome

The third idea to improve your investment process is to not focus on the outcome. One of the interesting ironies of most activities is that if you focus on the outcome, you're less likely to achieve it.

A few years ago, Michael Lewis wrote a book called *Moneyball*. The book tells the story of how Billy Beane built the Oakland A's into a winning baseball team in spite of having an undersized payroll. Beane worked side by side with a wizkid from Harvard named Paul DePodesta. Together they used creative thinking and statistical analysis to find undervalued players for the A's to draft.

For a few years, DePodesta maintained a blog on baseball called "It Might Be Dangerous... You Go First". In one memorable post, he wrote about the relationship between process and outcome. He tells the story of an evening in Las Vegas where he observed a game of black jack. He saw a player draw a seventeen and then, to the surprise of the dealer, ask for a hit, which is a sub-optimal choice. The player drew a four and won the hand. The dealer responded, "Nice Hit!"

DePodesta spent the rest of the evening thinking about what he had observed and the relationship between process and outcome.

He concluded that the blackjack player had had a good outcome, but a bad process.

### **Outcome Bias**

It's easy to fall into the trap of overemphasizing the outcome. After all, results are what matter and people mistakenly believe that a good outcome implies a good process. That's a false assumption.

The best hope for a good outcome is a good process. You should focus on what you can control. The odds are stacked in favor of the casino, but it doesn't win every hand. The casino is profoundly interested in a good outcome, but to achieve it, it maniacally focuses on the PROCESS.

A bad process can also lead to a good outcome, as we saw in the blackjack story. This is, according to DePodesta, the "wolf in sheep's clothing" that "allows for one-time success but almost always cripples any chance of sustained success."

## **Focus on Having a Good Process**

What you should be after is “deserved success” which is a good outcome that results from a good process. This is where championship sports franchises like the Patriots or the Steelers live, or great investors such as Warren Buffett or Seth Klarman.

Even great achievers experience failure and make mistakes. Having a good process and getting a bad outcome is a tough reality of operating in areas that involve uncertainty and luck, such as investing. Nevertheless, focusing on a good process is the best path to sustained success.

It's tough to admit that you're lucky when you undeservedly get a good outcome, but it's critical in order to improve. According to Paul DePodesta, Billy Beane was successful because he was quick to notice the role of luck “embedded” in a good outcome. Beane refused to congratulate himself when this happened.

This is what Buffett is getting at when he says that you don't know who's swimming naked until the tide goes out. When everything's going up, there are a lot of folks running around who confuse luck and skill.



You need to guard against this tendency to judge a decision based on the outcome rather than the process of what went into it.

In his 2010 letter to shareholders, Buffett commented on his process for selecting a new chief investment officer. He wants someone with a good track record, but he's even more focused on HOW the record was achieved.

Here's Buffett:

"It's easy to identify many investment managers with great recent records. But past results, though important, do not suffice when prospective performance is being judged. *How the record has been achieved is crucial...*" [emphasis added]

Focus on the process, not the outcome, and you'll improve your chance of sustained success.

## #4. Use Checklists

The fourth idea to improve your investment process is to use checklists. Charlie Munger has been talking about checklists for years and they recently got a big plug from Atul Gawande's book *The Checklist Manifesto*.

Checklists are still massively underutilized, in spite of being one the best performance levers out there.

You should use checklists because they work. Consider the following.

In 1935, Boeing nearly lost a major contract for the B-17 when it crashed during a demo to the Army. Boeing determined that the crash was the result of human error. The B-17 was much more complicated than prior planes. To fix the problem, Boeing came up with a simple checklist. The B-17 went on to fly almost 2 million miles without an accident and the Army bought almost 13,000 planes.

Checklists played a role in the successful landing of US Airways flight 1549 on the Hudson River in 2009. Captain Sully Sullenberger and his co-pilot Jeffrey Skiles followed a series of checklists to try to restart the engines and then ditching procedures to land the plane on the icy river.

They used checklists to stay on task in a moment of massive stress. The checklists didn't substitute for judgment, but greatly lessened the chance of making a dumb and potentially lethal mistake.

Checklists have also had an unexpected impact in medicine. A simple 4-point checklist was rolled out to Michigan Intensive Care Units to reduce infections from line insertions. Line infections continue to kill thousands of people each year.

The results were dramatic. The typical I.C.U. cut its quarterly infection rate to zero. Fifteen hundred lives were saved and costs were reduced by a hundred and seventy-five million dollars.

Checklists also work in finance. One study looked at the use of checklists by 51 venture capitalists – a group that's both intelligent and highly motivated to succeed. The VCs said one of their biggest challenges was deciding which entrepreneurs to fund. They found that the jockey was often more important than the idea itself.

The study identified a half-a-dozen different ways that the VCs used to decide who to back. Some went by gut feel. Another relied on extensive interviews. One group used a

checklist. This group ended up firing only 10% of entrepreneurs vs. 50% for the other groups. The average return in the checklist group was 80% vs. 35% for the others.

Hedge fund manager Guy Spier talks about how checklists counter what he calls “cocaine brain” which is the feeling of euphoria that can cloud your judgment when you get excited about a stock. A checklist brings you back to earth and prevents stupid mistakes.

Another hedge fund manager in *The Checklist Manifesto* uses checklists to both drive performance and reduce the time it takes to evaluate a security. This was a surprise because his analysts thought checklists would slow them down.

We can summarize some of the things checklists do.

They are not a substitute for judgment, but they do aid our memory and help us to manage complexity. They help us to manage our emotions and misjudgments. They also help reduce the effects of complacency. Instead of thinking – “Why bother reading the proxy and footnotes? Most of the time there’s not much in them.” – you go through them because it’s on your list and part of your discipline.

In short, checklists help us to prevent mistakes.

So why aren't they used more often? I think the answer lies in human nature. We all know that diet and exercise are good for us. The problem is often not with knowing what to do, but actually doing it.

I also believe there is some resistance to checklists on the basis of pride. It can be difficult for a highly trained expert to acknowledge that a simple checklist can improve his or her performance.

Checklists are also a useful way to store wisdom and make it accessible. When you come across a good idea to improve your investment process, where do you put it? If you've recorded your process in checklists, you can simply add it to the appropriate one. You can even have a "someday" checklist for ideas you want to think about before making them part of your process.

The use of checklists will improve your investing process and in turn improve your results.

## #5. Improve Your Search Strategy

The fifth idea to improve your investment process is to improve your search strategy. First, you want to increase the number of ideas you're looking at. The more rocks you turn over, the greater your chances of finding a great investment.

Second, you don't want to miss an obvious investment because you weren't paying attention. That's Buffett's famous sin of omission.

I maintain four checklists to help me do this.

First, I have a checklist of great investors whom I track for new ideas. I limit the list to investors whose process and philosophy is similar to my own. I track their 13F disclosures and their investor letters, if available. Caution: any idea you find this way is only a starting point. You still need to do your own work, otherwise you won't have the necessary conviction to buy a meaningful position and hold the stock through periods of volatility for big gains.

Second, I have a checklist of publications, forums and blogs that I follow for new ideas.

Third, I keep a checklist of my daily routine that includes basic screens I look at – like the 52-week low list – to make sure I don't miss something.

Finally, I keep a growing watchlist of stocks I follow which includes a valuation estimate and a target price to buy the stock.

It's easy to get away from this discipline because most days there's nothing there. This is a common error with checklists. You get complacent and skip steps even when you remember them. For example, think of an airline pilot who always finds that a given gauge gives the correct reading. He may be tempted to skip the step of checking it. With investments, that might be the day an elephant decides to tiptoe by.

You can also improve if you focus your time on ideas that are obvious. If it's too close to call, the investment may not be worth it. You'll get better returns over time if you do this. You'll also save yourself a lot of time.

Improve your search strategy and you will improve your results.

## #6. Improve Your Risk Management

The sixth idea to improve your investment process is to improve your risk management. The recent financial crisis was another reminder that smart people are capable of doing very foolish things with their money. We all need to re-double our efforts to improve how we manage risk. You are the chief risk officer of your portfolio, and you should never completely delegate that to someone else.

In the book *The Warren Buffett's Next Door*, investor Bob Krebs tells a story about risk management. Krebs was impacted by an article about fifty career carpenters. It told how ten of the fifty went thirty years with their fingers intact even though they worked daily with saws and cutting tools.

The forty who lost a finger said they knew just before an accident that they were at high risk, but failed to yield to a primal scream inside that was yelling STOP. The other ten, in contrast, always listened to this inner voice. They never operated equipment when tired, rushed or after drinking.

One old-timer, who had gone 70 years without an accident, would carefully inspect his hands for three or four minutes



before working. He'd take careful stock of his fingers and imagine how awful it would be to lose them.

I have adapted this simple approach and resolved to regularly review my investments with the use of a risk checklist. I look for flaws in my thinking and risks I'm taking that aren't worth it.

Here are some of the questions I consider regarding each investment:

1. What is the competitive risk the business is facing?
2. Does the investment expose me to life-changing economic risk?
3. What is my ignorance risk? In other words, am I holding an investment I don't understand?
4. Is the stock materially overvalued thereby exposing me to overvaluation risk?
5. Am I exposed to macro risk? For example, am I continuing to hold a large percentage of my portfolio in equities when the market is clearly overvalued?

6. What about leverage risk? Is the business overleveraged and vulnerable to a shock if it can't access the capital markets to roll over its debt?

7. What other risk to the business am I ignoring because it doesn't fit in neatly with my thesis? Remember, your brain works hard to ignore information that runs counter to a deeply held belief.

Simply thinking through a series of questions like these will help you avoid costly mistakes and permanent loss of capital, provided like the carpenters who kept their fingers intact, you heed the warning of your inner voice.

## #7. Manage Yourself

The seventh idea to improve your investment process is to manage yourself. I want to focus on three components of self-management: management of cognitive biases, management of your time and management of your work ethic.

### **Cognitive Biases**

We all have certain quirks in our mental wiring that impair our judgment. Behavioral scientists call these cognitive biases.

They include being overly confident in our abilities, giving too much importance to recent events, and discounting information that runs counter to our beliefs. They influence us on a subconscious level and geniuses are not excluded.

The problem is that they lead to irrational and costly decisions.

If you want to avoid these errors, you need to understand these quirks and take precautions. Following Munger, I recommend making a checklist of these misjudgments and

studying it. You can then run it down when you're making an important decision.

You could also collect the best books and articles on the subject and make their study a serious part of your professional development.

## **Time Management**

The second element of self-management is time management.

Time is arguably an investor's scarcest resource. There is always something to do, along with unlimited distractions and interruptions.

A successful investor must become a master of his or her time. Having a well defined process is half the battle because it gives you a tool to say NO to things that don't serve your objectives.

Fortunately, there are a number of good tools available to help you manage your time. Two I like are *Getting Things Done* by David Allen and *The Pomodoro Technique* by Francesco Cirillo.

*Getting Things Done* gives you a robust process for managing your tasks and projects. It uses checklists to manage everything from what to do now to thinking about your career over the next five years.

*The Pomodoro Technique* gives you a simple approach to remain focused by doing your work in pre-planned 25-minute chunks, where you work hard at managing interruptions.

*The Pomodoro Technique* also allows you to track your time so you'll know how it's really used. Self delusion is not a useful component of a winning investment process.

## **Work Ethic**

The third element of self-management is managing your work ethic.

Woody Hayes said, "I've had smarter people around me all my life, but I haven't run into one yet that can outwork me. And if they can't outwork you, then smarts aren't going to do them much good. That's just way it is."

Alice Schroder credits much of Warren Buffett's success to his work ethic. When digging into Buffett's life, Schroder found no holy grail; rather, she found an intelligent man who worked very hard.

Improve your management of your cognitive biases, your time and your work ethic, and you'll improve your investment results.

## #8. Pay Attention to the Details

The eighth idea to improve your investment process is to pay attention to the details.

The book *The Extra 2%* tells the story of how former Goldman Sachs colleagues Stuart Sternberg and Matthew Silverman took over operations of the Tampa Bay Rays baseball team in 2005. Prior to that, the team had been a disaster and a perennial bottom feeder.

The turnaround was dramatic. In 2008, the Rays became the first team in modern Major League history to hold the best record through Memorial Day after having the worst record the year before. They went on that year to play in the World Series where they lost to the Phillies.

How did they do it?

They relentlessly sought to improve all aspects of their baseball process, no matter how small – from parking, to concessions, to how they looked for new players. To identify undervalued ball players, they carefully analyzed statistical data – a method known as sabermetrics – to rebuild the team around lesser-known young stars.

The lesson here is fairly obvious, yet nonetheless powerful: to be successful, you need to look at all aspects of your process and look for small incremental ways to make them better. If you plug away at it, these little things – the extra 2% – can make a huge difference.

In an earlier section, I mentioned how casinos achieve a good outcome by focusing on their process, namely only playing games where the mathematical expectancy is in their favor. But they don't stop there. They maniacally focus on little things to keep folks playing, knowing the longer people play, the more the house earns: free drinks, comps, table limits, shoes vs. single decks, "help" from the dealer, minimum bet sizes, classes on how to play, an exciting ambiance, comfortable seats, attractive servers, cameras to prevent cheating, and chips instead of cash to foster mental accounting. Nothing is overlooked.



## #9. Be Patient

The ninth idea to improve your investment process is to be (more) patient.

The great investor Peter Cundill, who died earlier this year and whose fund achieved 15% returns for over thirty years, stated that the most important attribute for success as an investor is being patient and that most investors don't have it. The importance of patience is frequently cited by other great investors.

No investment process – even the best – outperforms in every period. This is asking too much given the amount of external factors that affect performance.

Patience is not only required of long-term investors. Even frequent traders must have conviction in their investment process and have the patience to trade through the inevitable draw-downs.

In short, investors cannot escape the requirement of patience or they condemn themselves to mediocrity or failure. Without patience, you'll abandon your current approach only to chase the next investment fad, only to see it take an inevitable downturn.

Can patience be learned? I think it is one of the fruits of a good investment process. The better your process, the greater your conviction to stay with it long enough to bear fruit. This is the only sensible approach to building a consistent record of good performance.

## #10. Continuously Improve

The tenth idea I'll leave you with is to seek to continuously improve your process.

The best coaches, the best CEOs, the best investors all religiously do this.

One of Nick Saban's assistant coaches, who was with him at LSU in 2000, re-joined him after ten years apart. The assistant coach was asked how Saban's process had changed. He responded, "It's been polished. Coach knows what he wants to do. That's why he's been so successful."

In an interview with ESPN, Paul DePodesta, distanced himself from the notion that his baseball process as described in Moneyball was limited to using statistics to identify and draft undervalued ball players. Rather, he defined his process in much broader terms which could be applied whether you're running a sports club or a hedge fund.

According to DePodesta, "It's a constant investigation of stagnant systems, to see if you can find value where it isn't readily apparent. It can be anything. At the time, it happened to be using statistics to make us better decisions. That's not

always the case. There are new frontiers we need to conquer.”

One final example of continuous improvement is that of value investor Mohnish Pabrai – a disciple of Warren Buffett and Charlie Munger. Pabrai uses a checklist to capture investment mistakes that have been made by great investors. Pabrai scoured their past investment letters and holdings looking for mistakes. In some cases, it was easy because the investors acknowledged the mistake and explained why it happened. In other cases, he had to find the mistakes on his own and deduce why they happened.

Pabrai currently has more than seventy items on his checklist which he credits for improving his performance and avoiding mistakes.

I think this is a powerful way to improve – and to keep improving. Create a checklist of all your investing mistakes and then add to it as you come across mistakes made by other investors.

In the words made famous by Nike, “Just Do It!”