

AUTHOR INTERVIEW:

Michael Mauboussin

By Anne Maggisano, CIM

Michael J. Mauboussin is chief investment strategist at Legg Mason Capital Management. He has been an adjunct professor of finance at Columbia Business School since 1993. *BusinessWeek's Guide to the Best Business Schools* highlighted him as one of the school's "Outstanding Faculty" – a distinction received by only seven professors. Michael is also a 2009 recipient of the Dean's Award for Teaching Excellence, based on Columbia Business School student and faculty input.

What do you think are the common skills and attributes that make a great investor? What made all the legendary investors in history great?

MM: There are three specific attributes but at the end of the day what distinguishes good investors from great investors is their temperament: Making good decisions in the face of difficult circumstances.

The question then becomes, how much of temperament is genetic and how much is learned? For most people it's a combination. You are both naturally inclined and you also work hard at doing it properly.

When you look across the spectrum of probabilistic fields (i.e. sports teams, investing), the most successful people have three attributes:

1. Focus on process vs. outcome:

In any probabilistic field, if you make a good decision you can have a bad outcome, and if you make a poor decision you can have a good outcome. If you make the right decision over time you will be rewarded. In the investment world, we are too focused on the short term. All the great investors are process focused.

2. Making sure the odds are in your favour:

This idea is encapsulated in Ben Graham's margin of safety. A clear metaphor is also the example

of the racetrack. Here you have expectations (i.e. odds) versus fundamentals (i.e. how fast the horse can run). What makes you money is a mispricing between expectations and fundamentals. Great investors are always distinguished by finding situations in which the odds are in their favour.

3. Understanding the role of time:

In a probabilistic field, you need to have a long-term perspective on things. In the investment world, there is too much noise in the short term.

In *Think Twice*, you refer to the idea of "deliberate practice" – the notion that to get better at something you need to not only work consistently at your craft, but also structure that work to incorporate goals and feedback, among other things. What specific things do you think that investors should be "deliberately practicing"?

MM: You need to make sure that your process is economically sound. For example, looking at the cash flows of the business, making sure it has a sustainable competitive advantage. You also need to make sure that the process is repeatable in various fields. You need to identify things that are repeatable. What does this entail? Taking a step back and thinking a lot. Great investors are voracious readers – they spend a lot of time reading and thinking.

How can an investment firm ensure they have a diversity of opinion and encourage the ability to think critically and independently, when they are all working within the constraints of a specific style, for example value?

MM: There are three different types of diversity. There is social/identity diversity, which is diversity based on gender, age, race, etc. This may be helpful but not always. There is also cognitive diversity, which comes from varied experiences, backgrounds, training, and points of views. Finally, there is values diversity: Do we share the same values?

In an investment firm, I believe the most important thing is to have high cognitive diversity and low values diversity. Therefore, even with different points of view, everyone will be working toward the same mission.

Too much diversity can also be a problem. If people are too different from one another, then they won't be able to connect and socialize.

How can we ensure that there is a diversity of thought? When there is a large controversial position, assign a team to be the devil's advocate. Sit everyone in a room and have a discussion.

There are two facets to being contrarian. First, you are doing something that everyone else is not doing. Second, you don't want to be contrarian for the sake of being contrarian. This is where the difference between fundamentals and expectations comes into play. The greatest error is a failure to distinguish between fundamentals and expectations. You can buy when you have good fundamentals, and sell when you have bad fundamentals. But disciplined value investors build in price and fundamentals. In that sense it is a relative game.

Your book gives readers some suggestions for how to apply the lessons of behavioural psychology to their own decision-making – the idea of the decision-journal for example. What do you think are some of the barriers investors will face in actually implementing your advice?

MM: There are four challenges for readers to overcome. The first is inertia. We don't want to change what we are doing and what has worked in the past.

The second is that it takes effort and discipline to implement the ideas. If you get into the habit it is not difficult, but it is something at which you have to work.

Feedback is the third challenge. It is difficult to get feedback, therefore you have to orient ourselves around process versus outcome. In reviewing performance, ideally you should

only focus on those aspects that are under your control. In the investment business that would be the quality of your reasoning, for example.

The final challenge is consistency. We like consistency, but this prevents us from thinking and acting.

When you think about what is being taught in business schools today, what do you think is being taught that shouldn't be taught? What do you think should be taught?

MM: Today, the standard financial models/approaches are still being taught even though they have several limitations. We talk in mean-variance language and the trade-off between risk and reward, even though we know that the assumptions are invalid and the statistical evidence is poor. I'm not sure we should stop teaching these, however, because I don't know what we would teach in its place.

I talk about market efficiency in my course at Columbia Business School, but I talk about markets as Complex Adaptive Systems. This allows

you to understand why markets are largely efficient but why you can also get periods of diversity breakdown.

The tools of standard finance – for example, how do I do DCF modeling? How do I analyze the competitive position of a company? – these are prerequisites for the game. You have to do these well just to get into the game.

I think you need to be better at making decisions. We don't teach enough of this. How do you develop the tools and techniques to be aware of your mistakes? What can we do in a concrete fashion to improve ourselves? We can all improve. We can all get better.

When I ask MBAs about what they do in their day job that they did not learn about in business school, they all talk about the psychological aspects of dealing with other people. Managing them, understanding their motives and incentives. Business school is like trade school but when you get into the real world the softer issues like psychology become more important.

Anne Maggisano, CIM is a Level III CFA candidate. She works for Burgundy Asset Management in Toronto.

BOOK REVIEW



THINK TWICE: Harnessing the Power of Counterintuition

By Michael Mauboussin

Leaders in all fields make crucial decisions every day. The harsh truth is that they may be likely to mismanage many of those choices, even though they have the right intentions. These blunders take a huge toll on leaders, their organizations, and the people they serve. Why is it so hard to make sound decisions? We fall victim to simplified mental routines that prevent us from coping with the complex realities inherent in important judgment calls. Yet these cognitive errors are preventable. In *Think Twice*, Michael Mauboussin shares vivid stories from business and beyond, giving the reader powerful rules for avoiding each error, and showing you how to recognize-and avoid-common mental missteps, including:

- Misunderstanding cause-and-effect linkages
- Aggregating micro-level behaviour to predict macro-level behaviour
- Not considering alternative possibilities when making a decision
- Relying too much on experts

By understanding how to know when it's time to think twice—to question your reasoning and instead adopt decision-making strategies that are far more effective—even if they seem counterintuitive.

Master the art of thinking twice, Mauboussin asserts, and you'll start spotting dangerous mental errors – in your own decisions and in those of others. Equipped with this awareness, you'll soon begin making sounder judgment calls that benefit (rather than hurt) your organization.

Source: Harvard Business Review Press (www.hbr.org). Used with permission.