



Investment Philosophies: Introduction

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What is an investment philosophy?

- An investment philosophy is a coherent way of thinking about markets, how they work (and sometimes do not) and the types of mistakes that you believe consistently underlie investor behavior.
- An investment strategy is much narrower. It is a way of putting into practice an investment philosophy.
- For lack of a better term, an investment philosophy is a set of core beliefs that you can go back to in order to generate new strategies when old ones do not work.

Ingredients of an Investment Philosophy

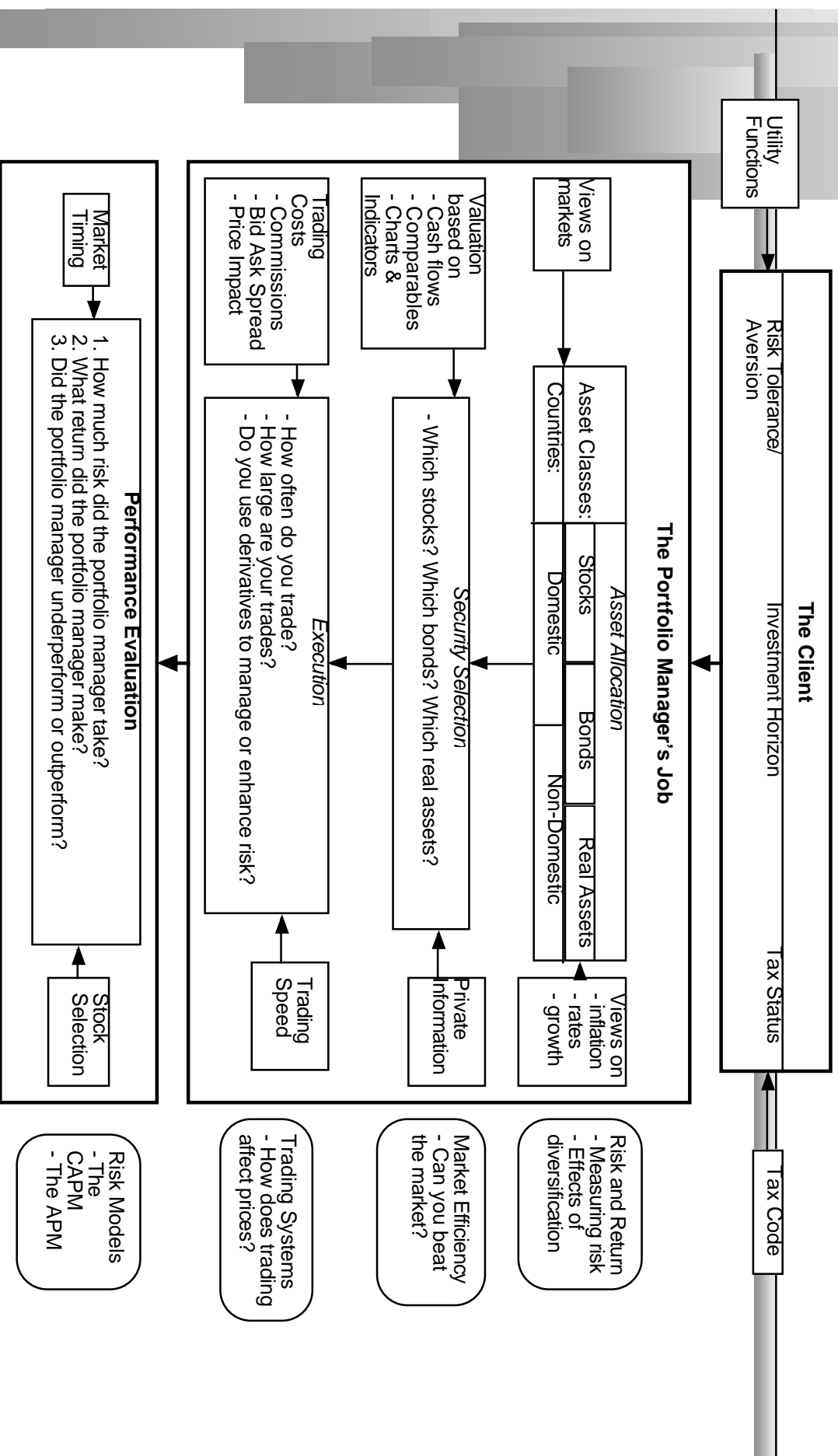
- Step 1: All investment philosophies begin with a view about how human beings learn (or fail to learn). Underlying every philosophy, therefore is a view of human frailty - that they learn too slowly, learn too fast, tend to crowd behavior etc....
- Step 2: From step 1, you generate a view about markets behave and perhaps where they fail.... Your views on market efficiency or inefficiency are the foundations for your investment philosophy.
- Step 3: This step is tactical. You take your views about how investors behave and markets work (or fail to work) and try to devise strategies that reflect your beliefs.

Why do you need an investment philosophy?

n If you do not have an investment philosophy, you will find yourself:

1. Lacking a rudder or a core set of beliefs, you will be easy prey for charlatans and pretenders, with each one claiming to have found the magic strategy that beats the market.
2. Switching from strategy to strategy, you will have to change your portfolio, resulting in high transactions costs and you will pay more in taxes.
3. With a strategy that may not be appropriate for you, given your objectives, risk aversion and personal characteristics. In addition to having a portfolio that under performs the market, you are likely to find yourself with an ulcer or worse.

Figure 1.1: The Investment Process

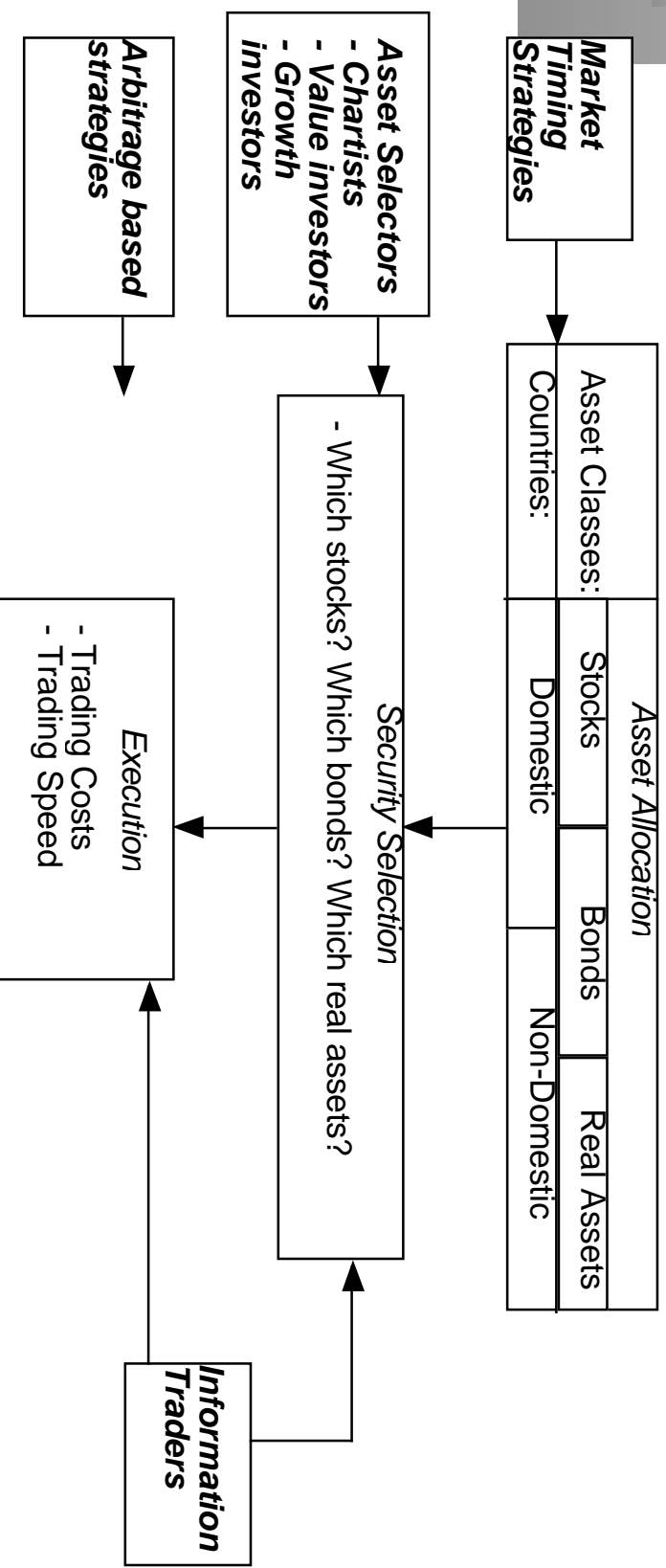


Categorizing Investment Philosophies

- *Market Timing versus Asset Selection*: With market timing, you bet on the movement of entire markets - financial as well as real assets. With asset selection, you focus on picking good investments within each market.
- *Activist Investing versus Passive Investing*: With passive investing, you take positions in companies and hope that the market corrects its mistakes. With activist investing, you play a role (or provide the catalyst) in correcting market mistakes.
- *Time Horizon*: Some philosophies require that you invest for long time periods. Others are based upon short holding periods.

Investment Philosophies in Context

Figure 1.2: Investment Philosophies



Developing an Investment Philosophy

■ Step 1: Understand the fundamentals of risk and valuation

■ Step 2: Develop a point of view about how markets work and where they might break down

■ Step 3: Find the philosophy that provides the best fit for you, given your

- Risk aversion
- Time Horizon
- Portfolio Size
- Tax Status