

INVESTMENT PHILOSOPHIES: FINDING YOUR INVESTING LODESTAR!

The pathway to investment serenity!

THE LEAD IN

- During **periods of uncertainty in markets**, it is natural to feel unsettled and off balance. I find that it helps to have a **core set of beliefs about markets and investing** to go back to, during these times, to get back to stable ground.
- There are **two classes that I teach at New York University's Stern School of Business every year** - a class on corporate finance to the first-year MBAs and two classes on valuation, one to the second-year MBAs and one to undergraduates. There is a **third class that I do teach in the certificate program** that I have never taught in-person at New York University, and it is a **class on investment philosophies**. It is the **least technical** of my classes, and while I find it the **most nettlesome** of the three classes I teach, it is also the one that I learn the most from, even as I am teaching it.
- I not only have a **free online version of this class** as well, but also a book that I wrote to accompany it, close to two decades ago, with a **third edition available soon** at your local bookseller.

THE ORIGINS OF THE CLASS

- In the late 1990s, I was approached by the Stern School of Business about serving as the **organizer for a class on investing**, where MBA students would hear from successful investors of all stripes in one session a week, and discuss what they learned from that talk in the second session each week.
- Over the course of the semester, the class had **fourteen speakers, and it drew from a range of investing types**. The speakers approached investing in very different ways and had **different perspectives** on financial markets and how to exploit their mistakes, but they all had been **successful in delivering investment success**.
- I noticed students in my class **develop whiplash**, as they **instinctively try to incorporate those views and practices into their thinking**. As the weeks went on, that became a problem, since other than investment success, the speakers shared very little, and their views about markets were sometimes contradictory.

MY OBSERVATIONS

- *There are very few active investors, who win consistently over time:* Since you can match the market or even investment style (value, growth etc.) by investing in index funds, **active investing has the unenviable task of trying to be better than average, and by enough to cover the costs associated with being active.**
- *Even with those successful few, it is very difficult to separate luck from skill:* Much as investment books and classes claim otherwise, investing **results are affected by so many forces that are out of your control** that disentangling how much of your final returns can be attributed to **skill and how much to luck** is very difficult to do.
- *These successful investors have widely different pathways to delivering success:* If you were to make a list of the hundred investors who have had the most success in markets in the last century, I would wager that you would be **looking at a very diverse group**, not just in terms of how they succeeded, but also in terms of personality.
- *Imitating successful investors does not seem to provide much payoff:* The practices of successful investors are probed and investigated by other investors and journalists, and some of them have dozens of books that claim to tell you the secret of their success. **Imitating those practices does not seem to deliver the same returns.**

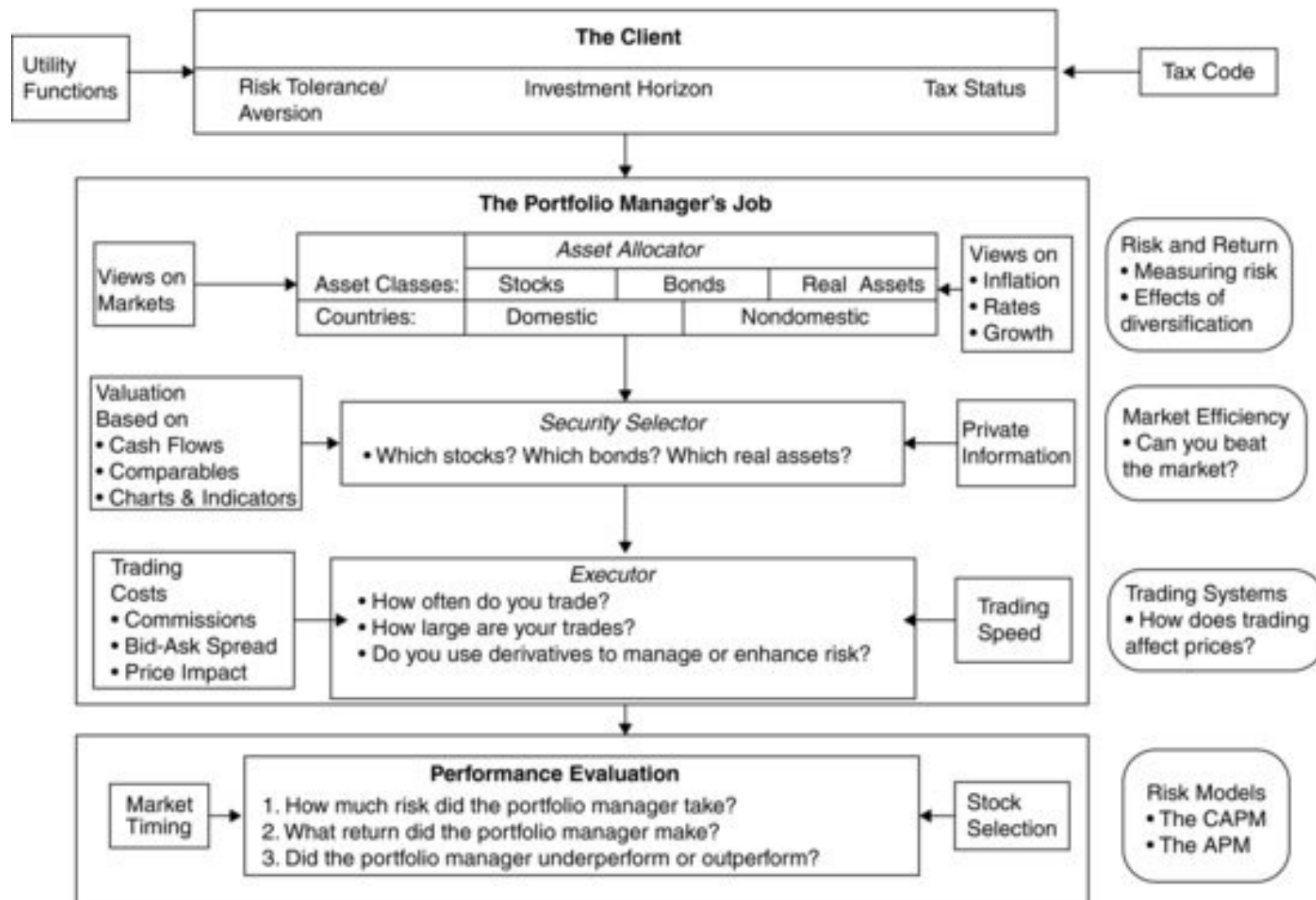
THE CORE IDEA (FOR BOOK AND CLASS): EVERYONE NEEDS AN INVESTMENT PHILOSOPHY!

- I should start with a definition of what I mean by an investment philosophy, and perhaps **the best way to do that is by describing what it is not.**
 - First, an investment philosophy is **much richer and complete than an investment strategy**, with the latter often coming out of the former.
 - Second, an **investment philosophy is not an investment slogan.** "Buy low, sell high" is an investment slogan, and a meaningless one at that, since that is the end game of almost every investment philosophy.
- **Everyone needs an investment philosophy, a set of centralized beliefs about markets and how they work.**

WHAT HAPPENS IF YOU DON'T HAVE A PHILOSOPHY?

- Chasing winners: If you don't have an investment philosophy, it is almost a given that you will find yourself drawn to whatever strategies worked best in the recent past. Your **portfolio will suffer from whiplash** as you chase last year's winners and while your **turnover and transactions costs rise**, you will have little to show for those costs in terms of returns.
- Scam target: Without an investment philosophy constraining you, **you will be an easy mark for investment scams**, where the scammers will promise you exceptional alphas (excess returns) from novel strategies.
- Empty investing cupboards: If you do find an investment strategy that works at delivering returns, it is worth remembering that the clock is ticking, and that **imitation and market corrections will cause that strategy to stop working**, sooner rather than later. If that is all you brought to the market, your investing cupboard will be empty and you will find yourself running to stay in place.

THE INVESTMENT PROCESS



CHOICES IN PHILOSOPHY: ACTIVE VERSUS PASSIVE INDEXING

- If, as we noted in the last section, doing nothing can deliver returns approximating the average, and nine out of ten investors who try to beat the average fail, **there is no shame in adopting a passive indexing philosophy**, where your allocation across asset classes is determined by your risk aversion and need for liquidity, and index funds fill out the rest of the dance card.
- It is **human nature, though, to seek to be better than average**, and it is perhaps that desire that drives many into active investing choices, and there are multiple pathways that they can adopt.

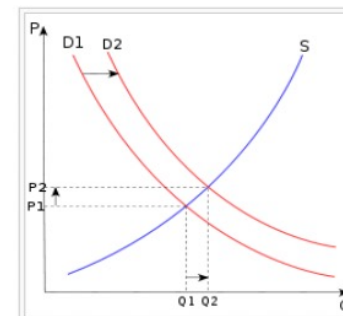
TRADING VERSUS INVESTING

The Investing Game

Estimate the intrinsic value of an asset, and buy (sell) it if the price is less than value. Make money on the convergence, if and when it happens.

The Pricing Game

Buy at a low price and sell at a higher price, riding price momentum and shifting before price reversals.



The Melded Version

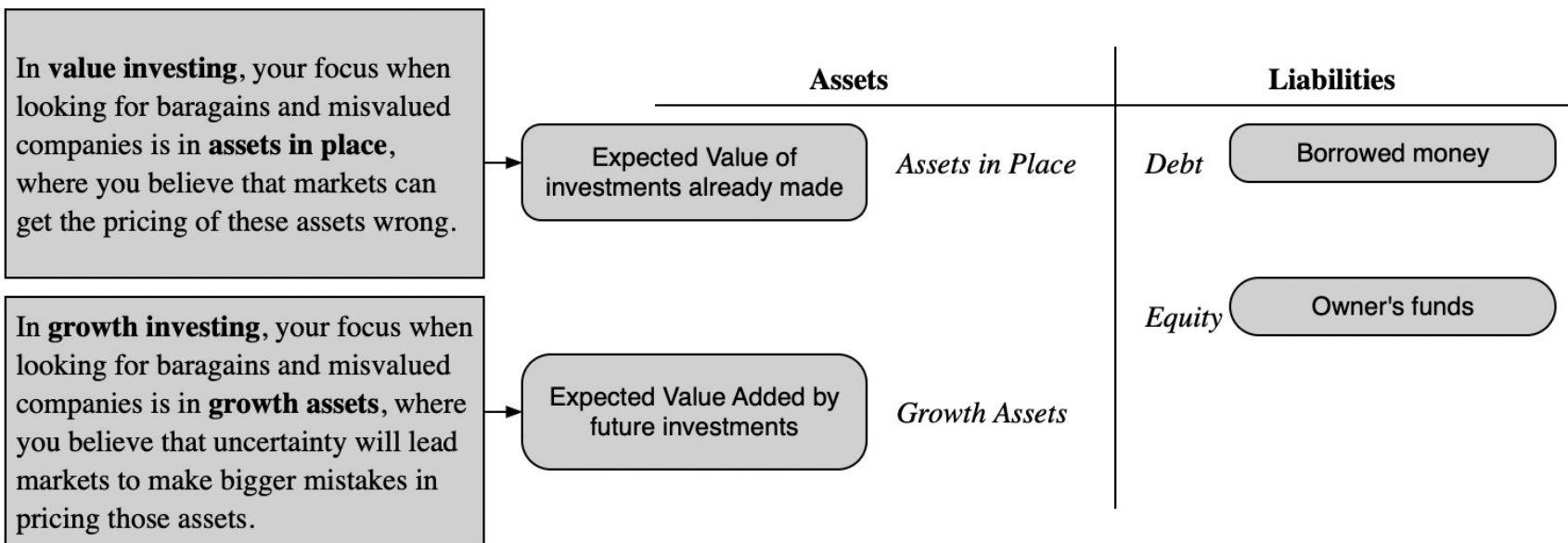
In the melded version, either the investing side or the pricing side can take the front row seat, with

- Investors using pricing tools to determine the timing of when to buy undervalued and sell overvalued assets
- Traders using investment tools to gauge shifts in momentum or imminent reversals.

TRADING SUB-CHOICES

- **Price traders**, and perhaps largest grouping, uses the information on prices and trading volume to detect shifts in mood and momentum, with charts and technical indicators as tools, to try and generate profits.
- **Information traders**, trades around information releases, in the form of earnings reports, acquisition announcements or even insider trades, with some trading ahead of the news, some at the time the news is announced and some in the aftermath, all trying to take advantage of what they see as market mistakes in reacting to that information.
- **Arbitrageurs**, focused on finding the same or related assets trading on different markets, looking for mispricing across these markets, and locking in that mispricing as excess returns.

INVESTING SUB-CHOICES: VALUE VS GROWTH



The Melded Version

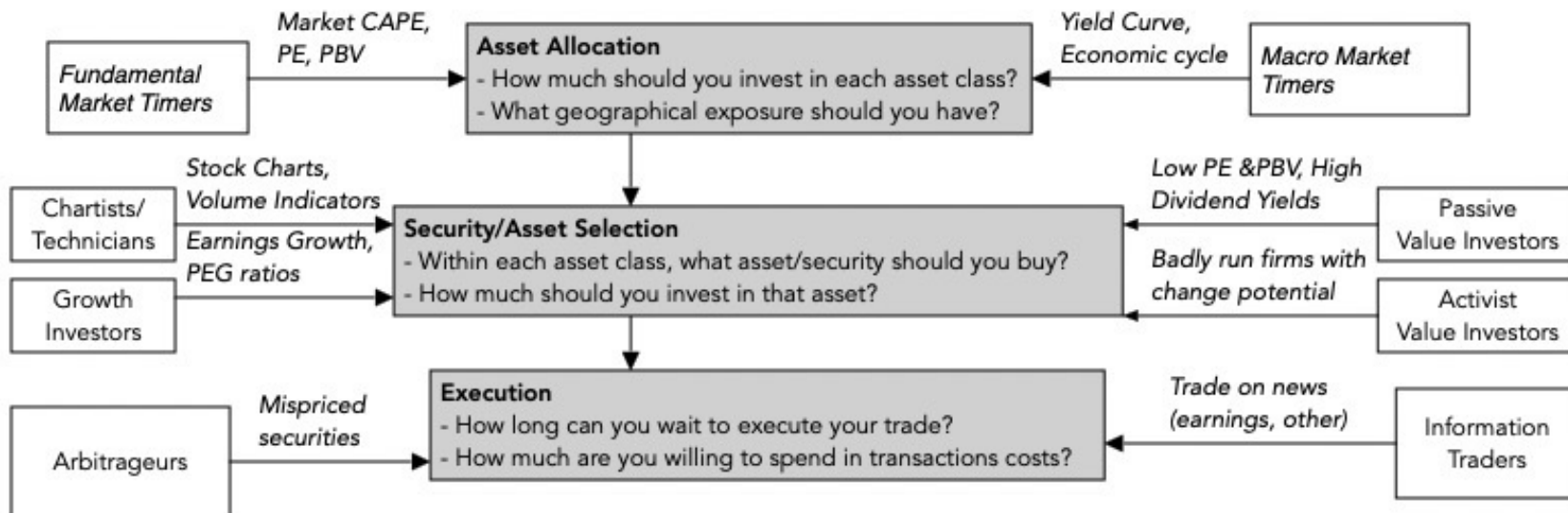
In the melded version, you focus on finding undervalued companies, and are agnostic about whether the market mistake is in assets in place or growth assets, though your philosophy may tilt towards one or the other, and vary across time.

MARKET TIMING VS ASSET SELECTION

- In market timing, **your focus is less on individual and more on deciding whether a market (equities, bonds, real estate etc.) is under or overpriced.**
 - Returning to the investment process, your focus is on allocating your portfolio across asset classes, based on your market views, underweighting "expensive" classes and overweighting "cheap" ones.
- In **stock/asset picking**, you take the market as a given and try to find the best individual investments within each investment class for you - the **cheapest stocks, bonds and real estate that you can find.**
- There is an ironic contradiction in making this choice. It is **undeniable that a successful market timer will make far more money than a good stock picker**, but it is also true that it is much **more difficult to be a successful market timer** than it is to be a good stock picker.

INVESTMENT PHILOSOPHIES IN INVESTMENT PROCESS

Investment Philosophies



1. START WITH MARKET MISTAKES AND CORRECTIONS!

- **Even the firmest believer in efficient markets will concede that markets not only make mistakes**, but they sometimes make big ones, but the divergence between them and active investors lies in what these mistakes will look like.
 - **In an efficient market, market mistakes will be random**, and since there is no systematic pattern to them, there is no pathway for active investors to find these mistakes, even with access to data and powerful tools.
 - Active investors, in contrast, believe that **there are systematic patterns that you can use to find these mistakes**, and take advantage of them, with traders believing that those patterns are in the pricing and volume data and investors hewing more to fundamentals.
- That said, active investors can and will disagree about the types of market mistakes, with some buying into the notion that markets learn slowly, whereas others believe that markets overreact. For markets to function, it is healthy for investors to disagree about market mistakes and corrections.

2. PICK A PHILOSOPHY THAT REFLECTS MARKET VIEWS!

	MARKET MISTAKE		
	LEARN SLOWLY	OVERREACT	INEFFICIENCY POCKETS
Short-term (days to a few weeks)	<ol style="list-style-type: none"> <i>Technical momentum indicators</i>: Buying stocks based on trend lines and high trading volume. <i>Information trading</i>: Buying after positive news (earnings and dividend announcements, acquisition announcements). 	<ol style="list-style-type: none"> <i>Technical contrarian indicators</i>: Mutual fund holdings, short interest. These can be for individual stocks or for the overall market. 	<ol style="list-style-type: none"> <i>Pure arbitrage in derivatives and fixed income markets</i>. <i>Technical demand indicators</i>: Patterns in prices and trading volume (charting patterns)
Medium-term (a few months to a couple of years)	<ol style="list-style-type: none"> <i>Relative strength</i>: Buying stocks that have gone up in the past few months. <i>Information trading</i>: <i>Buying small-cap stocks</i> with substantial insider buying. 	<ol style="list-style-type: none"> <i>Market timing</i>, based on normal P/E or normal range of interest rates. <i>Information trading</i>: Buying after bad news (buying a week after bad earnings reports and holding for a few months) 	<ol style="list-style-type: none"> <i>Near arbitrage opportunities</i>: Buying discounted closed-end funds. <i>Speculative arbitrage opportunities</i>: Buying paired stocks and merger arbitrage
Long-term (several years)	<ol style="list-style-type: none"> <i>Passive growth investing</i>: Buying stocks where growth trades at a reasonable price (PEG ratios). 	<ol style="list-style-type: none"> <i>Passive value investing</i>: Buying stocks with low P/E, PBV, or P/S ratios. <i>Contrarian value investing</i>: Buying losers or stocks with lots of bad news. 	<ol style="list-style-type: none"> <i>Active growth investing</i>: Taking stakes in small growth companies (private equity and venture capital investing). <i>Activist value investing</i>: Buying stocks in poorly managed companies and pushing for change.

STEP 3: CHECK FOR VIABLE STRATEGIES

- On the **transactions cost front**, the brokerage trading cost is just a small part of the overall cost, with two other costs that can often be much larger. The first is the bid-ask spread, small for large, very liquid stocks, but much larger for smaller and less liquid investments. The second is price impact, again non-existent if you are a small investor buying or selling shares in a large market-cap company, but substantial if you are a large investor trading on an obscure stock.
- On the **tax front**, some strategies will create more tax costs than others, partly because of how investment income is taxed (dividends create immediate tax consequences but capital gains require trading to incur tax liabilities) and partly because of how much trading your strategy will require of you. Trading strategies, built around momentum, can require you to trade multiple times in a day, and that turnover will have tax effects.

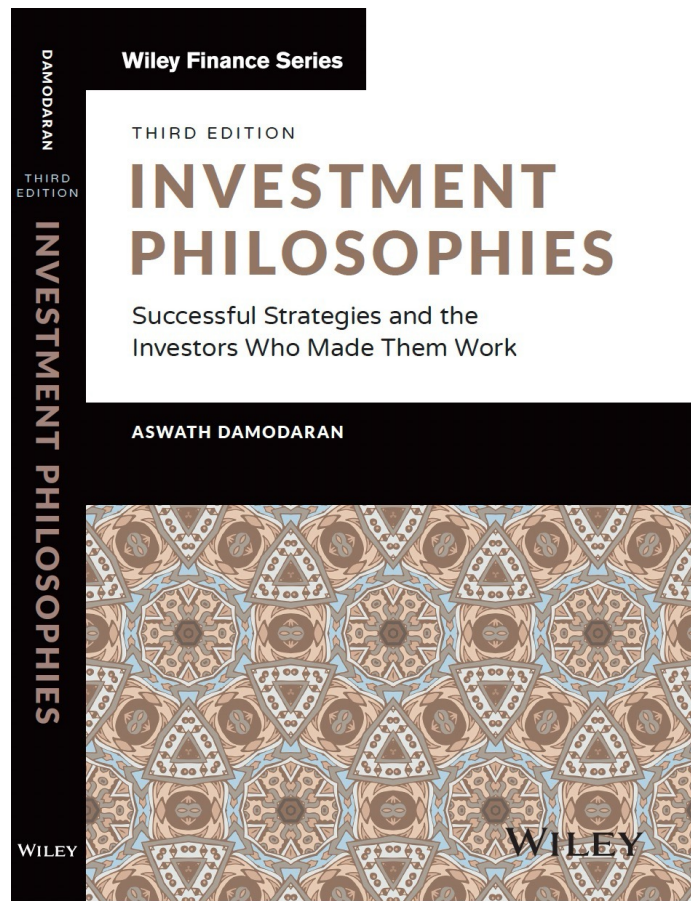
STEP 4: CHECK FOR PERSONAL FIT!

- **Capital to invest:** If you are just starting on your investment journey, and have only a small amount of capital to invest, your choices in terms of investment strategies narrow. The good news is that you continue to build up your capital, your investment choices will widen, and you can modify your portfolio accordingly. At the other end of the spectrum, and this is perhaps more the case if you are managing other people's money, you can have so much capital to invest that some investment strategies become infeasible again.
- **Time horizon:** The truth is that for most investors, time horizon is as much determined by external factors, such as age, health and liquidity needs, as it is by internal motivations. If you have to pay tuition for your children or expect to have substantial hospital bills in the near future, your time horizon just became shorter, and that has to be factored into your choice of investment strategies.
- **Risk exposure:** As with time horizon, the willingness to take risk is partly a function of your personal makeup and partly determined by your life standing.
- **Personal qualities:** Your personality and characteristics also come into play in your choice of investment philosophy and strategies. If you are, by nature, impatient, it is unlikely that you will be able to sustain a strategy of buying undervalued companies and waiting for a long time for mistakes to correct.

STEP 5: KEEP THE FEEDBACK LOOP OPEN!

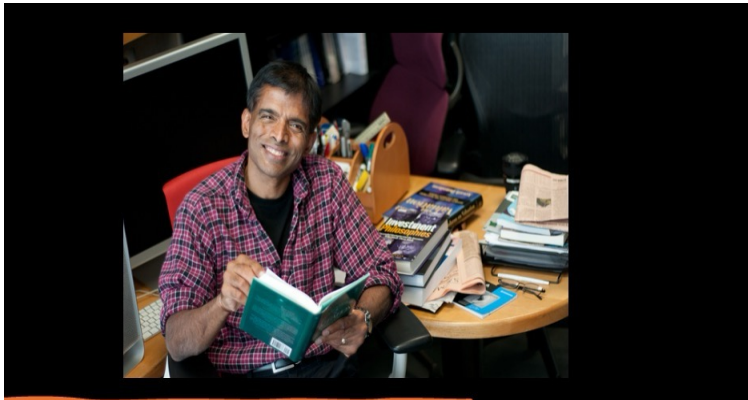
- *Economic setting:* Over time, economic settings and structures change, and investment philosophies have to adapt or even be abandoned.
- *Market lessons:* Your views on market mistakes come from looking at data and your own experiences in the market, and as a consequence, they should be revisited as markets change over time. Just in this century, it is becoming increasingly obvious that assets across classes (stocks, real estate etc) and geographies are moving far more in sync than they did in the last century. That reality has to be integrated into your market views and the investment philosophy/strategies that you use.
- *Trading microstructure:* It is undeniable that access to information and trading on most assets has become easier over the last few decades. That is good, but it does come with a cost. Investment philosophies built around the assumption that most investors, especially retail and individual, would not be able to access data or trade easily, may need tweaking, adapting or even abandonment.
- *Personal changes:* It won't come as no secret to you, but you will older, the amount of capital you have to invest will change, your health and family obligations will shift, and you may even become more or less patient or more or less susceptible to peer pressure. Those factors will all feed into your investment philosophy.

INVESTMENT PHILOSOPHIES: THE BOOK



Chapter	Coverage
1	An Investment Philosophy?
2	Risk
3-4	Accounting & Valuation
5	Transactions costs & taxes
6	Testing investment strategies
7	Technical analysis
8	Value Investing
9	Growth Investing
10	Trading on information
11	Arbitrage & Long/Short
12	Market Timing
13	Doing nothing?
14	Alternative Investments
15	Finding your philosophy

INVESTMENT PHILOSOPHIES: THE CLASS



An Online Class

YouTube:

<https://youtu.be/jBl8FXPc9tY?si=AfXOLg7vazPVákr3>

Webpage:

https://pages.stern.nyu.edu/~adamodar/New_Home_Page/webcastinvphil2025.htm

Session	Coverage
1	An Investment Philosophy?
2-4	Risk
5	Accounting & Valuation
6	Transactions costs & taxes
7-8	Testing investment strategies
9-11	Technical analysis
12-16	Value Investing
17-21	Growth Investing
22-26	Trading on information
27-29	Arbitrage & Long/Short
30-34	Market Timing
35-37	Passive Indexing
38-41	Alternative Investments
42	Finding your philosophy

INVESTMENT SUCCESS OR INVESTMENT SERENITY!

- We all share the same end game in investing, which is that we want to generate the highest returns on the capital we invest, though there are wide variations in how much risk we are willing to take and how long we will wait before cashing out.
- That is the definition of investment success but given that there are so many forces that are out of our control, you can do everything right and still fail in meeting your objectives.
- It is for that reason that a better endgame for investors is to seek out investment serenity, where you choose an investment path that you are comfortable with, and accept the results that emerge from it, good or bad.

A PERSONAL NOTE: MY INVESTMENT PHILOSOPHY!

- Intrinsic value matters: It is no secret that I believe that every asset (anything that generates cash flows) has a intrinsic value, and that with imagination and a willingness to be wrong, you can estimate that intrinsic value for any company, from start-ups to companies on the verge of default.
- Markets are for the most part right, but make mistakes during periods of uncertainty and change: In an age where we have turned over our choices on what movies to watch to Rotten Tomatoes and which restaurant to eat at to Yelp!, it is worth remembering that markets were the original fount for crowd wisdom. That said, it is also true that markets have provided us with examples of crowd madness, where the collective wisdom is hopelessly wrong, and I believe that this is the case when investors face uncommon uncertainty, as is the case when companies transition from one stage of the life cycle to another, when entire industry groups are faced with the threat of disruption and when markets are put into upheaval by crises.
- Do no harm: While I seek out investments to make that will beat the market, I am cognizant of the reality that I am not entitled to rewards, just because I put in the work, and that luck and chance still can wreak havoc on my best-laid plans. In particular, I have learned, through experience, that my biggest mistakes come from overreach and overactivity, and I build that learning into my investment philosophy by:
 - *Spreading my bets*: I must confess that I don't share the conviction that concentrated investors bring to the game, and not only spread my portfolio over three dozen stocks, but also follow rigid rules on not letting any single investment exceed 15% of my portfolio.
 - *Staying away from my weaknesses*: I steer away from active market timing and sector bets for a simple reason. I am not good at either.
 - *Being aware of my blind spots*: I try to be self-aware, though I don't always succeed. I know that I am thrown off my game plan by taxes (I don't like playing them, and that sometimes gets in the way of doing what I should be doing) and I sometimes fall in love with company narratives, because I want them to be true.