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High confidence + humble approach = happy investor

By FRANCOIS ROCHON, Freelance February 1, 2011

It's a known fact: Most equity investors -professional or not -can't beat the market over many years. But a few have managed to do it. So learn from these great investors. One of them is obviously Warren Buffett. And luckily for us, Buffett has written extensively on his philosophy.

From my experience and by reading the writings of great investors (it's less painful to acquire experience by reading books than by losing money), I have come up with a few investment "keys" to help open the doors to success in the world of equity investing.

- You have to consider stocks as fractional ownership in a real business. In other words, great investors behave like businessmen. When they buy a company's stock, they first and foremost are buying part of an enterprise. To them, the stock market is not a casino and they're not "playing" the market.

- To beat the market, you have to first and foremost be present in the market. One of the flaws many investors have is they try to "time" the market. If we look at a study by behavioural research firm Dalbar Inc., we see that for the 20-year period ending in December 2008, an investor would have realized an eight-per-cent annual return by investing in the S&P 500. Yet, the actual average performance of mutual-fund investors during this period was a mere annual return of two per cent. The only reason investors achieved such poor results was by trying to time their entry and exit points. They basically bought and sold at the wrong time (usually based on emotions rather than on valuation). So just being a full-time investor (always present in the market) is far better than being a part-time investor.

- You have to learn to profit from market fluctuations rather than suffer from them. Market fluctuations are a source of investment opportunities for the investor who knows how to stay rational and unemotional. A wise investor knows that stock market prices eventually will reflect the fair value of the underlying enterprise in the long term. So, from this perspective, the irrational market fluctuations are your allies, not your enemies.

- One key in being able to value a company is to stay within your circle of competence. For example, if you don't know the difference between the atomic number of titanium and the one for uranium, you should probably steer clear of this sector. To wander outside of your circle of competence significantly increases your probability of making a mistake. In the stock market, to realize better returns than others, you must have better knowledge regarding the value of the businesses in which you invest (remember: the others are the market). Also, having a margin of safety is crucial. Leaving a large margin of error helps prevent huge capital losses when unavoidable obstacles are encountered. So I try to always obtain a huge discount to intrinsic value (40 per cent or more) when I acquire shares in a public company.

- We also need some rules to help us know when to sell. I believe the reasons for selling a stock should be harmonized with the reasons for buying it. We should consider selling if the initial reasons for buying are no longer valid. In other words, once the investor becomes aware that he made an error in his analysis or the prospects of the business have deteriorated, it is time to sell. Another more pragmatic reason for selling is that the majority of investors do not have unlimited sources of capital at their disposal and they may, quite simply, sell in order to invest in another company whose potential seems brighter. The objective is simple: to optimize the use of our capital and to choose investments (both those that we buy and those that we sell) based on their relative attractiveness.

In summary, what differentiates successful investors from others is not related to intelligence, but rather to attitude. Rational investors do not let themselves be influenced by fads or crises: They let wisdom and reason guide their decisions.

Aside from a rational attitude, another important quality is the capacity to always want to learn from mistakes and strive to improve one's investment craft. To be in a constant state of learning, you must not only be passionate for your art, but also be humble. Without humility, there is no possible opening for something new.

Therefore, paradoxically, successful investors must be able to combine both a high confidence in their judgment while also remaining constantly humble. It represents quite a difficult and fragile equilibrium.

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