

The Jedi Knight's Guide to Real-Life Investing

By Mariko Gordon

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There are many benefits to locating Daruma World Headquarters on the 9th floor of a building built in 1902 to house artists.

For one thing, there's a wrap-around balcony you can actually walk out on, provided you're not scared of heights. For another, the entire space is bathed in northern light, streaming in through a wall of glass. There are windows you can actually open, vestigial fireplaces and even bits of carved marble.

The downside, though, is a pair of shoebox-sized elevators that have a knack for going on the fritz at the most inopportune time - such as when you're expecting 26 guests.

In this case, the guests happened to be young and fit - students in the prestigious [applied finance program at Marquette University](#) - so we didn't need to call 911 after they climbed the 202 steps. **They were in town on their annual visit to the hallowed temples of Wall Street**, and at the behest of two Midwestern clients, we ended up on their dance card (despite being too irreverent to be hallowed and too lacking in gold leaf to qualify as a temple).

Once they'd loosened their ties, kicked off their heels and recovered from the hike up, we got down to business. **The students manage a 75 stock, small-cap portfolio and produce a thoughtful, detailed analysis for each holding.** We had fun arm-wrestling over the stocks we held in common, and after a brief overview of how Daruma invests, we broke up into small groups to answer questions.

The questions were a mix of investment-related ("How do you find new ideas?") and career-related ("What are the pros and cons of the buy-side versus the sell-side?"). **There was also a fair amount of unsolicited advice from me and my veteran Daruma colleagues**, mostly in the form of triumphant investing tales, stories of psychopaths we've met along the way, and the obligatory bragging about how, when we first got into the business, we "walked two miles to work, barefoot, in the snow."



I have to say that the brains, energy and enthusiasm in the group were astounding (I was so clueless at that age). **And yet hanging out with so much raw talent did bring to mind what Darth Vader famously said to Luke Skywalker** (use your best James Earl Jones voice for the full effect): "Impressive. Most impressive. But you are not a Jedi yet."

The plain truth is that no matter how good the program, there is much about investing in real life that no one teaches you at school. Here are just a few things that came up as we chatted with the apprentice knights:

1. **The future is imprecise.** The value of a security today cannot be precisely known. Your neat mathematical formula which totes up the sum of all future tomorrows' cash flows discounted back to the present, is based on many assumptions. Who knows what the future will bring?

Someone might **invent a better mousetrap**; someone might **legislate mousetraps out of existence**; the sole plant of the sole manufacturer of better mousetrap springs **might blow up**; all rodents on the planet might be **wiped out by spontaneous combustion**. Oh yeah, and who knows where interest rates will be in the future anyway?

Your precise formula is a function of imprecise inputs.

2. **School won't turn you into a world-class cynic - markets can.** Oh sure, study Watergate in American History and you'll learn to "follow the money." European History will teach you that "absolute power corrupts absolutely," to paraphrase Lord Acton.

But only the markets will challenge your humanity. Watch a leveraged buy-out rape and pillage public shareholders, only to return to the public markets six months later at a higher price. The enterprise is now debt-laden, a bunch of employees lost their jobs in the name of cost-cutting, and not much good has been created for the commonweal.

As an investor, every bit of news is parsed with "**cherchez le buck**" in mind, and every utterance is run through the "**What's a possible hidden motive?**" filter. So watch out - don't let the markets wring every last drop of faith in human nature out of you.

3. **You are a blind man groping an elephant.** Businesses are complex. They have heaps and heaps of employees, customers, end markets, geographies, regulators, competitors, processes, raw materials, factories, etc. **Investors don't really know what's happening inside the elephant** - the *elephant* doesn't always know what's happening inside the elephant.



So while investors will always grope as hard as they can to make rational sense of it all, psychology, groupthink and fickleness play a critical role in the conclusions reached. **Complexity will often drive investors to obsess over a single data point or facet of a business** until, suddenly and inexplicitly, they focus elsewhere. Today the elephant is a paintbrush; tomorrow it's a snake.

It's the investing equivalent of fads that end abruptly. Knowing where the crowd is headed - whether for logical reasons or not - is an important component in investment decisions.

4. **Business models - not industries - are what really matter.** Endless industry data is less important than an understanding of where the levers are in the business model. **Where does stepping on a log send the rock (profits) flying?** Where does the operating leverage exist?

Two companies in the same industry, for example, - one with 80% of its cost of goods sold in materials and the other with 80% in labor - may fare quite differently under the same external conditions.

Yes, understanding the industry matters. But **understanding how a particular company makes money is a more important question** in determining its future value.

5. **Simplicity rules.** When you're in school, mastering complex stuff is cool. The more complicated it is, the smarter you feel.

In investing, it's the opposite: **If you don't understand it, it will lose you money.** (Even if you do understand it, it can lose you money. But if you don't understand it, it will *definitely* lose you money).

Most investment cases rest on one or two simple premises. There's a misvaluation opportunity caused by investors - a misunderstanding, a temporary absence of demand, a different time horizon, a superficial, misleading analysis.

If it's incomprehensible, it's uninvestable. **The way to make money is to question the Emperor's new clothes** - to be the kid who trusted his eyes and didn't assume that everyone else had it right.

And that, a couple of hours later, is how we left our young friends ... brains churning, academic "truths" shaken, curiosity piqued. Not to mention nine flights of stairs to descend - a story for them to share one day, with the next generation.



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