The most important lessons learned

By Oddbjørn Dybvad

If we were evaluating a fund manager, the first and most important question we would ask him or her is this: "What are your biggest mistakes and what have you learned from them?" The fund manager's answer to that question would be paramount to our evaluation of whether we should put money behind that manager.

Learning from your mistakes is an important part of investing. We all make mistakes and investors who learn from their mistakes will ultimately be successful. If you are not able to see a pattern in the mistakes you have made as an investor, just keep looking. Below we discuss some of the mistakes we have made over the years, which have shaped the way we invest today.

> *"If you are extremely confident in yourself, taking a loss does not bother you"*
>
> (Stanley Druckenmiller)

Confidence and humility

One of the great challenges of investing is balancing confidence and humility. You need confidence to make an investment. At the same time, you need to be aware that you could be wrong. If you are overconfident, you will never be able to admit a mistake, and your results will suffer as a result. If you constantly think you are wrong, you will not be able to make an investment. The stock market is a fantastic tool to make you humble. This is the reason why some of the very best long term investors are often of the humble kind. They have made many mistakes, but have become better investors in the process.

Learn from losses

To grow and develop as an investor, you should try to learn as much as you can from your mistakes. Over time, the mistakes you make will come to form a set of principles that will guide you through your investing career. You will learn the hard way where your strengths and weaknesses lie. Keep learning and refining your principles. Try to write your mistakes down and keep them in a journal. Over time, you will notice that some of your mistakes have something in common, situations that you should avoid in the future, because your diary and experience show that these situations are not your strengths. The best tool is to learn from your own mistakes.

> *"It is remarkable how much long term advantage people like us have gotten by trying to be consistently not stupid, instead of trying to be very intelligent"*
>
> (Charlie Munger)

Not willing to sell losers

One costly mistake we have made time and time again is not being able or willing to sell companies that have not performed according to expectations. If your investment thesis changes, you should re-evaluate the investment. Weaker than expected fundamental performance is always accompanied by a falling share price and seemingly more attractive pricing of the stock. It is better to admit you were wrong and sell the stock than to try to find a new reason to own the stock at a lower price point. We

would rather average up and buy more shares at a higher price point in companies where the underlying fundamental performance is better than expected.

Selling too early

A common mistake we have made is selling stocks far too early, simply because the price has risen sharply in the short term. Unfortunately, these exits have involved companies that have been performing well over the long term and continues to perform well. To buy the stock back at a higher price point is a tough mental exercise.

We have become very hesitant to sell shares of companies that are performing perfectly. Sometimes the shares of these companies run ahead of the underlying performance of the companies. The lesson for us is not to let a temporarily high price of a stock scare us out of the company. To quote the legendary investor Charlie Munger: “The first rule of compounding: Never interrupt it unnecessarily.”

We have come to three reasons to sell a stock:

The first is when we identify that our decision to invest in a company was flawed. The company may not be as strong as we originally thought, or we may have underestimated the cyclicality of the industry or company. In such circumstances we take the consequences and sell.

We also sell if we no longer trust management. Maybe management is starting to convey a message that we do not understand, or are using language we do not like, or we have lost confidence that they are good stewards of our capital. We have made several misjudgments when assessing management teams in the past. Through these mistakes we have developed a set of principles, which we apply when forming an opinion about management's abilities (covered in detail in an article called "Extraordinary CEOs").

The final reason we sell a stock is when it is priced far beyond what we think is rational. We believe this is the most difficult reason to sell, and we are very cautious about selling a stock based on price considerations alone. There are often very good reasons why a stock trades at a high multiple.

Buying too much too early

A mistake we have made several times is buying a large position too soon. It takes time to learn about a company and the best way to deepen your understanding is by becoming a shareholder. Sometimes owning the stock causes you to see the company through different eyes.

Based on prior experience, we now start with a smaller position when first investing in a company. After some time following the company as a shareholder, our conviction usually grows, and we buy more. Sometimes this means that the average cost of our position increases, but we are happy to pay a higher price for the stock of a company where management is executing according to plan. If the stock price has gone up after we bought the first position, the company is usually doing something right.

> *“A big part of being a successful investor is your ability to admit when you are wrong and not let it crush your self-confidence”*
>
> (Ian Cassel)

Over analysis

Some of our worst investments have been in companies where we spent way too much time analyzing complex opportunities. That experience has led us to be much less interested in complicated business models. We like simplicity. We like to read quarterly or annual reports and quickly decide whether the company is moving in the right direction or not. Too much information about a company often leads to decision fatigue. With complex business models, you are unable to form an opinion about the direction of the company because there are too many conflicting signals about the way forward. Simplicity often wins out over complexity when investing.

Charmed by management

Some investors avoid any interaction with management. Others find conversations with management very helpful. It is easy to be charmed by charismatic management. Our experience is that it is best to avoid too charismatic leaders. It's helpful to consider how the company's employees feel about the CEO sitting in front of you. Is the company a "one-man show" or is the CEO able to see and acknowledge the company's employees? What kind of culture does the CEO bring to the company? Company culture starts at the top. It is the CEO's values that are transmitted down through the organization. It has been our experience that CEOs who spend too much time talking about themselves and not the company they run are a big red flag. It takes a few management meetings to understand that you should not necessarily invest in the most charismatic and outgoing CEO in town. We like CEOs who are down-to-earth, pragmatic, and able to delegate a lot of responsibility to employees. You want to invest in companies that are run by CEOs who you think are very good role models in the organization. If you doubt that the CEO is a good role model, you should not invest.

Too much focus on numbers

At the beginning of our investment journey, we focused mostly on the quantitative aspects of potential investments. We are still very interested in the financial history of companies. Our biggest investment mistakes have resulted from investing in the wrong kind of management, wrong type of ownership structures, and dysfunctional corporate cultures. In contrast, our most successful investments have been characterized by excellent management teams and ownership structures that increase the odds of creating shareholder value. As a result, we pay more and more attention to how management communicates and interacts with investors. We are becoming more interested in the art of evaluating management, which is no easy task. We are becoming more interested in "owner operators" and companies that are run by management rather than run by the board and wholly owned by institutions. Management, being part owners, treat the business as their own. When you rent a car, you rarely, if ever, spend time and money cleaning and maintaining the car.

We try to find management teams that are down to earth, pragmatic and understand value creation. We have also concluded that management teams that do not give short term financial guidance to investors and stand by their mistakes in conference calls tend to be more interesting investment opportunities than the opposite. All of these are non-financial aspects that are more difficult to evaluate than financial numbers. But these qualitative assessments increase the chances of good shareholder returns.

To sum up

Learning from our mistakes, and avoiding doing those same mistakes in the future, is an important success factor for future performance. We have had our fair share of mistakes and think we have become better investors in the process.