Mind Matters

A summer reading list

In the past I have put together reading lists of books that to my mind form the core of what every investor should know. Every so often someone will ask what I would add to the list now. This note seeks to answer that question by offering up my selection of recent reads that I think investors could benefit from reading. As ever the selections are personal and eclectic.

My top three books this year are Bill Fleckenstein’s ‘Greenspan’s Bubbles’, Howard Marks’ ‘Memo to Oaktree Clients’, and ‘The Myth of the Rational Market’ by Justin Fox.

This year’s list is split into four categories. The first group concerns the current crisis. All these authors exemplify the spirit of good analysis. They all spotted and documented the current crisis before it unfolded. My favourite book in this category is Bill Fleckenstein’s ‘Greenspan’s Bubbles’ – an excellent exposé of incompetence during Alan Greenspan’s tenure as Fed Chairman. The next choice in this group is Whitney Tilson and Glen Tongue’s ‘More Mortgage Meltdown’. This book explains clearly how we ended up in this mess (and is based on the authors’ real time experience), and an added bonus is the insight into Tilson’s investment process provided by the case studies. My final choice in this section is Jim Grant’s ‘Mr. Market Miscalculates’. I’ve mentioned this excellent book before, and I believe it deserves a place on all investors’ bookshelves.

The second group of books I labelled broadly as covering the topic of investment. First up in this selection is Howard Marks’ ‘Memo to Oaktree Clients’. To my mind, Marks’ letters are in the same category as those of Klarman – simply a must read for investors. The topics covered in this collection include investment processes, bubbles and the folly of forecasting. My next choice in this category is ‘Distressed Investing’ by Marty Whitman and Fernando Diz. Given the current situation I can’t imagine a more timely addition to an investor’s library, or indeed better authors to serve as guides. The third book in this selection is ‘Snowball’ by Alice Schroeder. Schroeder’s warts-and-all magnum opus provides a wealth of insights into Buffett both as an investor and as a person. A stop press addition to this list is Justin Fox’s ‘The Myth of the Rational Market’.

The third category comprises books covering psychology. This year, three books have made it onto my list. The first is Akerlof and Shiller’s ‘Animal Spirits’. This book attempts to flesh out some of the psychology behind Keynes’ infamous animal spirits, and provides examples of how they can improve our understanding of economic problems. Second is Michael Mauboussin’s ‘Think Twice’, which provides a tour de force of behavioural decision errors and some clever suggestions as to how we might be able to protect ourselves against mental pitfalls. Finally in this field I recommend Makridakis et al’s ‘Dance with Chance’. This offers an in-depth exploration of the illusion of control, and highlights the paradox of control – when we stop seeking to control the things we can’t, we free up time to concentrate to the things we can influence.

Finally, we have the hidden gems. ‘Ghost Map’ by Steven Johnson, ‘The Tao of Pooh’ by Benjamin Hoff and ‘A Gift to my Children’ by Jim Rogers. Each of these books provides investment insight from an unexpected source.
A summer reading list

As long-term (or should that be long-suffering) readers will know, every so often I attempt to put together a reading list for investors. Oddly enough these lists have become some of my most read notes (beaten only by my essays on happiness and my paper of the tenets of investing). The first two lists contained books that I think should be required reading for every investor. A summary of those two lists can be found below.

**Investment 101**

**The classics**

‘Security Analysis’ by Ben Graham and David Dodd (The sixth edition)

Chapter 12 of ‘The General Theory of Employment, Interest and Money’ by John Maynard Keynes

‘Theory of Investment Value’ by John Burr Williams

‘Manias, Panics and Crashes’ by Charles Kindelbeger

‘Reminiscences of a Stock Operator’ by Edwin Lefevre

**Modern wonders**

‘The Little Book That Beats the Market’ by Joel Greenblatt

‘The Little Book of Value Investing’ by Chris Browne

‘Fooled by Randomness’ by Nassim Taleb

‘Contrarian Investment Strategies’ by David Dreman

‘Speculative Contagion’ by Frank Martin

**Psychological musts**

‘Robot’s Rebellion’ by Keith Stanovich

‘Strangers to Ourselves’ by Tim Wilson

How We Know What Isn’t So’ by Tom Gilovich

‘Stumbling upon Happiness’ by Daniel Gilbert

‘The Psychology of Intelligence Analysis’ by Richard Heuer Jnr

**Hidden gems**

‘Halo Effect’ by Phil Rosenzweig

‘Mindless Eating’ by Brian Wansink

‘The Inefficient Stock Market’ by Robert Haugen

‘The Margin of Safety’ by Seth Klarman

‘Your Money and Your Brain’ by Jason Zweig
This year I once again have some recommendations. I have tried to group my picks into four topics this year covering 12 books (enough I hope to fill the summer months). The four categories are: the current crisis, investment, psychology and hidden gems.

Summer list 2009

Current crisis
Even before we know the outcome of the current crisis, there has been an outpouring of books covering what went wrong and why. I’ve chosen three books to cover this genre, all by authors who can legitimately claim to have seen the crisis coming.

First up is ‘Greenspan’s Bubbles’ by Bill Fleckenstein. Now normally I leave the Greenspan bashing to Albert, but I love this short book. It is a perfect antidote to the fawning ‘Maestro’ by Bob Woodward and the appalling ‘Age of Turbulence’ by Greenspan himself. Fleckenstein and his co-author, Frederick Sheehan, go back and expose exactly what Greenspan was saying at the time. They lay bare not only the former Fed chairman’s complicity in the creation of bubbles (as if that wasn’t bad enough), but also his cheerleading activities in bubble promotion. This is a short book that offers a damning indictment of the incompetence of the oft hallowed Greenspan Fed. (Also keep an eye out for Fred’s own book ‘Panderer to Power’ due out later this year.)

Second on my list is ‘More Mortgage Meltdown’ by Whitney Tilson and Glenn Tongue. This book splits nicely into two sections. The first provides an in-depth analysis of the problems in the US housing market. The authors succeed in making the dry technicalities of mortgage malpractices lively and engaging. The crisis has left more than enough blame to go around. Tilson and Tongue do a good job of ensuring that the guilty parties are named and shamed – from the Fed to Wall Street and the ratings agencies, all the way to the government and homeowners themselves. They also provide a good analysis of why the housing market
isn't out of the woods just yet. The Alt-A crisis has yet to unfold. The peak of these resets is forecast to be somewhere in 2012!

The second part of the book walks readers through the analysis of six investment opportunities that are created by the crisis. Whether you agree with the authors’ analysis or not (and generally I do) the real benefit of this section is the way it lays out the investment process that Tilson and Tongue follow, and shows how to follow this process using worked examples. The book reads easily, as those who know Whitney have come to expect. This is a great addition to any investor’s library.

My final choice in this trilogy for understanding how we got into this mess is Jim Grant's ‘Mr. Market Miscalculates’. I first recommended this book at the end of last year and it is a great example of a master wordsmith at work. Grant’s writing style is poetic and flows seamlessly as he moves from the insights of Thomson Hankey (sparring partner to Walter Bagehot) to documenting the disasters of the Mortgage Science Project (CDOs). His insights lay bare the fallacy of Greenspan’s view that bubbles can’t be analysed ex ante.

**Investment**

So on to the second topic – investment. These books aren’t related to the current crisis but all provide deep insights into the nature of investing. Top of the list is Howard Marks' ‘Memo to Oaktree Clients’. Regular readers of my notes will have come across references to Howard Marks and his letters before. To my mind they are in the same class as Seth Klarman’s comments – indispensable reading for those engaged in investing. Indeed Marks wrote one of the introductory essays in the 6th Edition of ‘Security Analysis’ which Klarman edited.

This book isn’t the easiest to track down (or indeed the cheapest at $200, available from Wave Publishing). However, the publishers did an excellent job of sending me a copy and an invoice which I was able to pay in sterling (at a time of sterling strength which brought the cost of the book down significantly). The book collects together some of the best of Marks’ writings from 1990 to 2005. The letters focus on Oaktree’s investment philosophy and its application to the current investment juncture. Given that Oaktree is a fixed income outfit, the letters show how useful a value perspective can be in that market. The topics covered come close to my own heart such as the folly of forecasting, bubbles, the nature of risk and investment vs speculation. This is a collection that will have you returning on a regular basis to refresh your memory of Marks’ words of wisdom.

My next choice is ‘Distressed Investing’ by Marty Whitman and Fernando Diz. As I have regularly observed in the last six months, generally a backdrop of poor profits and massive leverage is the perfect breeding ground for distressed investing (both equity and debt). Who better to provide a guide through such a world than Marty Whitman (of Third Avenue fame).

The authors walk the reader through the tricky pathways of reorganisation and bankruptcy. En route they chart the perils and pitfalls that can easily consume the unwary. They also elucidate on the nature of valuation and risk as it applies to distress investing.

The book is written for US investors, so much of the focus is on ‘going concern valuation’ (Chapter 7 style), rather than liquidation. Despite the US focus, I think the book contains enough perspective to be worthy of an international audience.
My third choice in the investment section is ‘Snowball’ by Alice Schroeder. This is without a doubt the longest book on this year’s list, weighing in with an impressive (and slightly daunting) 966 pages! Of course, technically Snowball isn’t an investment book. It is a biography of Warren Buffett, but to me the two are intimately linked.

Schroeder does an admirable job of portraying Buffett ‘warts and all’. She documents the way in which Buffett built upon Ben Graham’s ideas and extended (often in ways that Graham himself would probably have disapproved). But she goes further and provides us with a psychological profile which yields intriguing insights. For instance, Schroeder writes “he tended to extrapolate mathematical probabilities over time to the inevitable (and often correct) conclusion that if something can go wrong it eventually will.”

Schroeder often leaves me wondering if I would actually like Buffett as a person (I can’t help but admire him as an investor, of course). My wife often tells me that I am enormously change resistant (I prefer to follow the ‘if it ain’t broke, don’t fix it’ school of thinking). However, Buffett seems even to me to be stuck in his ways, particularly with respect to his dietary habits. The tale of Buffett’s dinner with the chairman of Sony left me shaking my head. Regardless of such issues, Snowball is a delight to read, and somewhat surprisingly for such a magnum opus, flies past.

A stop press addition to this list is Justin Fox’s ‘The Myth of the Rational Market’. This book arrived at the weekend, and I decided to start reading it. Having read around one-third of the book I have decided that it deserves a place on this year’s list. It charts the history (or rise and fall) of the efficient markets hypothesis (EMH). My favourite quotation in the book is from Robert Shiller (during his angry young man phase in the early 1980s) when he describes the EMH as “one of the most remarkable errors in the history of economic thought. It is remarkable in the immediacy of its logical error and in the sweep and implications for its conclusion.” Amen to that!

Psychology

The third category of books concerns my own favourite subject area – Psychology. As Ben Graham long ago opined “The investor’s chief problem and even his worse enemy is likely to be himself.” The books in this section try to bring to life Graham’s observation and in some cases explain how we might try to defend ourselves against ourselves.

First up in this category is ‘Animal Spirits’ by Robert Shiller and George Akerlof. Strangely enough I like this book (confirmatory bias at work no doubt!). Akerlof and Shiller set out to provide us with some of the psychology that underlies Keynes’ rightly famous notion of animal spirits. They choose five psychological elements found at the heart of various economic conundrums – confidence, fairness, corruption and bad faith, money illusion and stories.

They then go on to explain how these five factors interact to help us understand some of the mysteries of economics, such as why do economies fall into depression, why does involuntary unemployment exist, and why are financial markets excessively volatile. In essence this book is a brave attempt to undo the separation of economics and psychology that occurred during the formalization of the former. Some chapters hold together better than others, but ultimately the book serves as a powerful reminder that “left to their own devices, capitalist economies will pursue excess...There will be manias. The manias will be followed by panics”.

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My second choice in the realm of psychology is Michael Mauboussin’s forthcoming ‘Think Twice’. Michael is something of a pioneer in my field; it was he who first tried to reach outside the standard approach to finance to gain insights into markets, a furrow that I have since endeavoured to plough. In his excellent new book, Michael takes the reader on a tour de force of behavioural decision errors. But he doesn’t stop there. Mauboussin also provides readers with concrete advice on how to avoid stumbling into some of the most common mental pitfalls.

As one would expect from any book written by Michael, it reads exceptionally well, the pages almost turning themselves. As ever, I often measure a book by the number of pages I’ve marked or turned down. ‘Think Twice’ has more than its fair share. Of course, I don’t agree with everything – that would be dull. Michael places far more importance on the “wisdom of crowds” than I do. But for anyone willing to seek wider insights into the nature of decision-making and how we can avoid stumbling into mental pitfalls, this book is a must read.

My third choice in this field is ‘Dance with Chance’ by Spyros Makridakis, Robin Hogarth and Anil Gaba. What happens when a statistician, a cognitive psychologist and a decision scientist decide to write a book together? The answer is a book all about the ‘illusion of control’, which the authors define as trying to control what cannot be controlled, or to predict what cannot be predicted. In essence this is a book about the folly of forecasting – need I say more as to why I enjoyed it?

The authors highlight the paradox of control. That is by giving up the pursuit of things we cannot control, we actually gain more control. This is similar to the point I have made before on the need to focus on the process rather than on the outcome. Freeing ourselves from endless worrying about things we can’t control provides us with the ability to focus on the things we can. However, sometimes the book appears to offer poor advice. For instance, the authors seem to subscribe to the ‘stocks for the long run’ philosophy (buying stocks and holding them forever, regardless of valuation), which is anathema to me. However, if one can skip over these weaknesses, the book ultimately reminds me of Reinhold Neibuhr’s serenity prayer: “God grant me the serenity to accept the things I cannot change, the courage to change the things I can, and the wisdom to know the difference.”

**Hidden gems**

The final group of books are what I call hidden gems. These are books from outside the mainstream (by and large). My first choice in this category is ‘Ghost Map’ by Steven Johnson. Part medical thriller, part detective story, part history lesson, this book tells the story of the cholera epidemic in C19th London. Not a topic for fun or frivolity for sure. However, this is the tale of Doctor John Snow and how he set out to track down the root causes and transmission mechanism of the terrifying disease.

The ruling belief in Snow’s time was that cholera was spread by bad air and bad smells. The book recounts the way in which John Snow and Henry Whitehead eventually traced the spread of disease to the water supply. The tale holds some powerful lessons for the way in which we should approach investment. Snow and Whitehead did their own work, they refused to be swayed by the popular beliefs of their time, and they continued to pursue the facts they uncovered until they reached the logical conclusion. Contrarians rejoice.

The final two choices are more personal to me than any other on my lists. In the past I have occasionally referred to Winnie the Pooh as a source of much underestimated investment
advice. My Bloomberg header is a quotation from Pooh, “Never underestimate the value of doing nothing.” I’m also a fan of eastern philosophy. These may seem like non-sequiturs, but both are brought together in one of this year’s hidden gems, ‘The Tao of Pooh and the Te of Piglet’ by Benjamin Hoff. Hoff uses the medium of the much-loved Pooh bear to expound and explain the essence of Taoism. I have long felt that investors could learn much from such an approach.

Every so often a book appears that just coincides with events in your own life, and my final choice for this year is one such book. The birth of my first child occurred last week and my thoughts of late have turned to my new role as a father, thus my final choice is Jim Rogers’ ‘A Gift to My Children’.

The wisdom packed into this little book’s 85 pages is wonderful. Much of it relates to investing, such as “If anyone laughs at your idea, view it as a sign of potential success” and “people are easily carried away by mob psychology”. Rogers also stresses the importance of history in understanding (both life and markets). Indeed understanding history was one of the ten tenets of investing I published earlier this year (see Mind Matters, 24 February 2009).

However, my favourite advice is this: “The basic principle to remember is this: They need you more than you need them… Don’t follow a boy to a different school, city, or job. Make the boys follow you”. Funnily enough, Rogers has two daughters, and my new arrival is a girl.

I hope that this list of books will provide you with some fuel for thought. If you have any good recommendations please don’t hesitate to drop me a line – although everyone tells me that my days of being able to sit quietly and read a book are about to come to an end!
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