Timeless Wisdom from the Life of Charlie Munger

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Introduction

While widely recognized as Warren Buffett's trusted confidant, Charlie Munger was more than just a right-hand man; he was an accomplished investor in his own right. Initially a real estate attorney, Munger transitioned into real estate investment and development early in his career. He later became Chairman of Wesco Financial Corporation, which began as a savings and loan association, but eventually controlled Precision Steel Corp., CORT Furniture Leasing, Kansas Bankers Surety Company, and other ventures.

Most recently, Munger served as Vice Chairman at Berkshire Hathaway. Describing Munger as one of his "superinvestors" in "The Superinvestors of Graham Doddsville," Buffett acknowledged Munger's pivotal role in bouncing ideas and preventing unsound investments from infiltrating Berkshire Hathaway's portfolio.

The recent passing of Munger is a profound loss to the investment community. Munger's candid realism, sharp wit, and profound insights endeared him to countless Berkshire shareholders and investors over the years. Immersed in his myriad thoughts and musings, one cannot help but be struck by his intelligence, distinctive personality, and profound wisdom.

This week, we are presenting a condensed transcript from a lecture Munger delivered to students at the University of Southern California Marshall School of Business almost three decades ago. Despite the passage of time, Munger's insights remain as pertinent today as they were then, underscoring the timeless nature of his business and investment wisdom.

"A Lesson on Elementary, Worldly Wisdom as it Relates to Investment Management & Business"

Edited from a lecture to the students of Professor Guilford Babcock at the University of Southern California Marshall School of Business that was later published in the Outstanding Investor Digest on May 5, 1995.

ALL TOO LITTLE WORLDLY WISDOM IS DELIVERED BY MODERN EDUCATION.

I'm going to play a minor trick on you today - because the subject of my talk is the art of stock picking as a subdivision of the art of worldly wisdom. That enables me to start talking about worldly wisdom - a much broader topic that interests me because I think all too little of it is delivered by modern educational systems, at least in an effective way.

And therefore, the talk is sort of along the lines that some behaviorist psychologists call Grandma's rule - after the wisdom of Grandma when she said that you have to eat the carrots before you get the dessert.

The carrot part of this talk is about the general subject of worldly wisdom which is a pretty good way to start. After all, the theory of modern education is that you need a general education before you specialize. And I think to some extent, before you're going to be a great stock picker, you need some general education.

So, emphasizing what I sometimes waggishly call remedial worldly wisdom, I'm going to start by waltzing you through a few basic notions.

WITHOUT MODELS FROM MULTIPLE DISCIPLINES, YOU'LL FAIL IN BUSINESS AND IN LIFE.

What is elementary, worldly wisdom? Well, the first rule is that you can't really know anything if you just remember isolated facts and try and bang 'em back. If the facts don't hang together on a latticework of theory, you don't have them in a usable form.

You've got to have models in your head. And you've got to array your experience – both vicarious and direct - on this latticework of models. You may have noticed students who just try to remember and pound back what is remembered. Well, they fail in school and fail in life.

You've got to hang experience on a latticework of models in your head. Absent enough models, your brain will torture reality.

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YOU'RE GIVING A HUGE ADVANTAGE TO OTHERS IF YOU DON'T LEARN THIS SIMPLE TECHNIQUE.

First there's mathematics. Obviously, you've got to be able to handle numbers and quantities - basic arithmetic. And the great useful model, after compound interest, is the elementary math of permutations and combinations. And that was taught in my day in the sophomore year in high school. I suppose by now in great private schools, it's probably down to the eighth grade or so.

It's very simple algebra. And it was all worked out in the course of about one year in correspondence between Pascal and Fermat. They worked it out casually in a series of letters.

It's not that hard to learn. What is hard is to get so you use it routinely almost everyday of your life. The Fermat/Pascal system is dramatically consonant with the way that the world works. And it's fundamental truth.

So, you simply have to have the technique. Many educational institutions - although not nearly enough - have realized this. At Harvard Business School, the great quantitative thing that bonds the first-year class together is what they call decision tree theory. All they do is take high school algebra and apply it to real life problems. And the students love it. They're amazed to find that high school algebra works in life....

By and large, as it works out, people can't naturally and automatically do this. If you understand elementary psychology, the reason they can't is really quite simple: The basic neural network of the brain is there through broad genetic and cultural evolution. And it's not Fermat/Pascal. It uses a very crude, shortcut-type of approximation. It's got elements of Fermat/Pascal in it. However, it's not good.

So you have to learn in a very usable way this very elementary math and use it routinely in life - just the way if you want to become a golfer, you can't use the natural swing that broad evolution gave you. You have to learn to have a certain grip and swing in a different way to realize your full potential as a golfer.

If you don't get this elementary, but mildly unnatural, mathematics of elementary probability into your repertoire, then you go through a long life like a one-legged man in an ass-kicking contest. You're giving a huge advantage to everybody else.

One of the advantages of a fellow like Buffett, whom I've worked with all these years, is that he automatically thinks in terms of decision trees and the elementary math of permutations and combinations....

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THE HUMAN MIND HAS ENORMOUS POWER, BUT IT ALSO HAS STANDARD MISFUNCTIONS.

I suppose the next most reliable models are from biology/physiology because, after all, all of us are programmed by our genetic makeup to be much the same. And then when you get into psychology, of course, it gets very much more complicated. But it's an ungodly important subject if you're going to have any worldly wisdom.

And you can demonstrate that point quite simply: There's not a person in this room viewing the work of a very ordinary professional magician who doesn't see a lot of things happening that aren't happening and not see a lot of things happening that are happening. And the reason why is that the perceptual apparatus of man has shortcuts in it. The brain cannot have unlimited circuitry. So, someone who knows how to take advantage of those shortcuts and cause the brain to miscalculate in certain ways can cause you to see things that aren't there.

Now you get into the cognitive function as distinguished from the perceptual function. And there, you are equally - more than equally in fact - likely to be misled. Again, your brain has a shortage of circuitry and so forth - and it's taking all kinds of little automatic shortcuts.

So when circumstances combine in certain ways - or more commonly, your fellow man starts acting like the magician and manipulates you on purpose by causing your cognitive dysfunction - you're a patsy.

And so just as a man working with a tool has to know its limitations, a man working with his cognitive apparatus has to know its limitations. And this knowledge, by the way, can be used to control and motivate other people....

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ORGANISMS, PEOPLE & COMPANIES WHO SPECIALIZE CAN GET TERRIBLY GOOD IN THEIR LITTLE NICHE.

Now we come to another somewhat less reliable form of human wisdom - microeconomics. And here, I find it quite useful to think of a free market economy - or partly free market economy - as sort of the equivalent of an ecosystem....

This is a very unfashionable way of thinking because early in the days after Darwin came along, people like the robber barons assumed that the doctrine of the survival of the fittest authenticated them as deserving power - you know, "I'm the richest. Therefore, I'm the best. God is in his heaven, etc."

And that reaction of the robber barons was so irritating to people that it made it unfashionable to think of an economy as an ecosystem. But the truth is that it is a lot like an ecosystem. And you get many of the same results.

Just as in an ecosystem, people who narrowly specialize can get terribly good at occupying some little niche. Just as animals flourish in niches, similarly, people who specialize in the business world - and get very good because they specialize - frequently find good economics that they wouldn't get any other way.

And once we get into microeconomics, we get into the concept of advantages of scale. Now we're getting closer to investment analysis - because in terms of which businesses succeed and which businesses fail, advantages of scale are ungodly important.

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AND THERE ARE OTHER ECONOMIES: GEOMETRIC, ADVERTISING, INFORMATION, EVEN PSYCHOLOGICAL.

Let's go through a list - albeit an incomplete one of possible advantages of scale. Some come from simple geometry. If you're building a great circular tank, obviously as you build it bigger, the amount of steel you use in the surface goes up with the square and the cubic volume goes up with the cube. So, as you increase the dimensions, you can hold a lot more volume per unit area of steel.

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Another advantage of scale comes from psychology. The psychologists use the term "social proof". We are all influenced - subconsciously and to some extent consciously - by what we see others do and approve. Therefore, if everybody's buying something, we think it's better.

We don't like to be the one guy who's out of step. Again, some of this is at a subconscious level and some of it isn't. Sometimes, we consciously and rationally think, "Gee, I don't know much about this. They know more than I do. Therefore, why shouldn't I follow them?"

The social proof phenomenon which comes right out of psychology gives huge advantages to scale - for example, with very wide distribution, which of course is hard to get. One advantage of Coca-Cola is that it's available almost everywhere in the world.

Well, suppose you have a little soft drink. Exactly how do you make it available all over the Earth? The worldwide distribution setup - which is slowly won by a big enterprise - gets to be a huge advantage.... And if you think about it, once you get enough advantages of that type, it can become very hard for anybody to dislodge you.

HOWEVER, BIGGER ISN'T ALWAYS BETTER - THERE ARE ALSO DISADVANTAGES OF SCALE.

And there are also disadvantages of scale. For example, we - by which I mean Berkshire Hathaway - are the largest shareholder in Capital Cities/ABC. And we had trade publications there that got murdered - where our competitors beat us. And the way they beat us was by going to a narrower specialization.

We'd have a travel magazine for business travel. So, somebody would create one which was addressed solely to corporate travel departments. Like an ecosystem, you're getting a narrower and narrower specialization. Well, they got much more efficient. They could tell more to the guys who ran corporate travel departments. Plus, they didn't have to waste the ink and paper mailing out stuff that corporate travel departments weren't interested in reading. It was a more efficient system. And they beat our brains out as we relied on our broader magazine.

That's what happened to The Saturday Evening Post and all those things. They're gone. What we have now is Motorcross - which is read by a bunch of nuts who like to participate in tournaments where they turn somersaults on their motorcycles. But they care about it. For them, it's the principal purpose of life. A magazine called Motorcross is a total necessity to those people. And its profit margins would make you salivate.

Just think of how narrowcast that kind of publishing is. So occasionally, scaling down and intensifying gives you the big advantage. Bigger is not always better.

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A BASIC LESSON OFTEN FORGOTTEN: NEW TECHNOLOGY CAN KILL YOU.

The great lesson in microeconomics is to discriminate between when technology is going to help you and when it's going to kill you. And most people do not get this straight in their heads. But a fellow like Buffett does.

For example, when we were in the textile business, which is a terrible commodity business, we were making low-end textiles - which are a real commodity product. And one day, the people came to Warren and said, "They've invented a new loom that we think will do twice as much work as our old ones."

And Warren said, "Gee, I hope this doesn't work - because if it does, I'm going to close the mill." And he meant it.

What was he thinking? He was thinking, "It's a lousy business. We're earning substandard returns and keeping it open just to be nice to the elderly workers. But we're not going to put huge amounts of new capital into a lousy business."

And he knew that the huge productivity increases that would come from a better machine introduced into the production of a commodity product would all go to the benefit of the buyers of the textiles. Nothing was going to stick to our ribs as owners.

That's such an obvious concept - that there are all kinds of wonderful new inventions that give you nothing as owners except the opportunity to spend a lot more money in a business that's still going to be lousy. The money still won't come to you. All of the advantages from great improvements are going to flow through to the customers.

Conversely, if you own the only newspaper in Oshkosh and they were to invent more efficient ways of composing the whole newspaper, then when you got rid of the old technology and got new fancy computers and so forth, all of the savings would come right through to the bottom line.

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THE NATIONAL CASH REGISTER MODEL IS EXACTLY WHAT YOU'RE LOOKING FOR.

Then there's another model from microeconomics which I find very interesting. When technology moves as fast as it does in a civilization like ours, you get a phenomenon which I call competitive destruction. You know, you have the finest buggy whip factory and all of a sudden in comes this little horseless carriage. And before too many years go by, your buggy whip business is dead. You either get into a different business or you're dead - you're destroyed. It happens again and again and again.

And when these new businesses come in, there are huge advantages for the early birds. And when you're an early bird, there's a model that I call "surfing" - when a surfer gets up and catches the wave and just stays there, he can go a long, long time. But if he gets off the wave, he becomes mired in shallows....

But people get long runs when they're right on the edge of the wave whether it's Microsoft or Intel or all kinds of people, including National Cash Register in the early days.

The cash register was one of the great contributions to civilization. It's a wonderful story. Patterson was a small retail merchant who didn't make any money. One day, somebody sold him a crude cash register which he put into his retail operation. And it instantly changed from losing money to earning a profit because it made it so much harder for the employees to steal....

But Patterson, having the kind of mind that he did, didn't think, "Oh, good for my retail business." He thought, "I'm going into the cash register business." And, of course, he created National Cash Register.

And he "surfed". He got the best distribution system, the biggest collection of patents and the best of everything. He was a fanatic about everything important as the technology developed.

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And, of course, that's exactly what an investor should be looking for. In a long life, you can expect to profit heavily from at least a few of those opportunities if you develop the wisdom and will to seize them. At any rate, "surfing" is a very powerful model.

FIGURE OUT WHERE YOU HAVE AN EDGE THEN, PLAY THERE AND ONLY THERE.

However, Berkshire Hathaway, by and large, does not invest in these people that are "surfing" on complicated technology. After all, we're cranky and idiosyncratic - as you may have noticed.

And Warren and I don't feel like we have any great advantage in the high-tech sector. In fact, we feel like we're at a big disadvantage in trying to understand the nature of technical developments in software, computer chips or what have you. So, we tend to avoid that stuff, based on our personal inadequacies.

Again, that is a very, very powerful idea. Every person is going to have a circle of competence. And it's going to be very hard to advance that circle. If I had to make my living as a musician.... I can't even think of a level low enough to describe where I would be sorted out to if music were the measuring standard of the civilization.

So you have to figure out what your own aptitudes are. If you play games where other people

have the aptitudes and you don't, you're going to lose. And that's as close to certain as any prediction that you can make. You have to figure out where you've got an edge. And you've got to play within your own circle of competence.

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BETTING ON HORSES AND PICKING STOCKS HAVE MORE THAN A LITTLE IN COMMON.

The model I like - to sort of simplify the notion of what goes on in a market for common stocks - is the pari-mutuel system at the race track. If you stop to think about it, a parimutuel system is a market. Everybody goes there and bets and the odds change based on what's bet. That's what happens in the stock market.

Any damn fool can see that a horse carrying a light weight with a wonderful win rate and a good post position etc., etc. is way more likely to win than a horse with a terrible record and extra weight and so on and so on. But if you look at the damn odds, the bad horse pays 100 to 1, whereas the good horse pays 3 to 2. Then it's not clear which is statistically the best bet using the mathematics of Fermat and Pascal. The prices have changed in such a way that it's very hard to beat the system.

And then the track is taking 17% off the top. So not only do you have to outwit all the other betters, but you've got to outwit them by such a big margin that on average, you can afford to take 17% of your gross bets off the top and give it to the house before the rest of your money can be put to work.

Given those mathematics, is it possible to beat the horses only using one's intelligence? Intelligence should give some edge, because lots of people who don't know anything go out and bet lucky numbers and so forth. Therefore, somebody who really thinks about nothing but horse performance and is shrewd and mathematical could have a very considerable edge, in the absence of the frictional cost caused by the house take.

Unfortunately, what a shrewd horseplayer's edge does in most cases is to reduce his average loss over a season of betting from the 17% that he would lose if he got the average result to maybe 10%. However, there are actually a few people who can beat the game after paying the full 17%.

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The stock market is the same way - except that the house handle is so much lower. If you take transaction costs - the spread between the bid and the ask plus the commissions - and if you don't trade too actively, you're talking about fairly low transaction costs. So that with enough fanaticism and enough discipline, some of the shrewd people are going to get way better results than average in the nature of things.

It is not a bit easy. And, of course, 50% will end up in the bottom half and 70% will end up in the bottom 70%. But some people will have an advantage. And in a fairly low transaction cost operation, they will get better than average results in stock picking.

How do you get to be one of those who is a winner - in a relative sense - instead of a loser?

Here again, look at the pari-mutuel system. I had dinner last night by absolute accident with the

president of Santa Anita. He says that there are two or three betters who have a credit arrangement with them, now that they have off-track betting, who are actually beating the house.

They're sending money out net after the full handle - a lot of it to Las Vegas, by the way – to people who are actually winning slightly, net, after paying the full handle. They're that shrewd about something with as much unpredictability as horse racing.

And the one thing that all those winning betters in the whole history of people who've beaten the pari-mutuel system have is quite simple. They bet very seldom.

It's not given to human beings to have such talent that they can just know everything about everything all the time. But it is given to human beings who work hard at it - who look and sift the world for a mispriced bet - that they can occasionally find one. And the wise ones bet heavily when the world offers them that opportunity. They bet big when they have the odds. And the rest of the time, they don't. It's just that simple.

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