February 24, 2016 ~ Guy Spier, Founder and Managing Partner, Aquamarine Capital

Ben Graham Centre (BG): What are your thoughts on the intermingling of ratings agencies with big banks? What is your opinion on the reinstatement for the Glass-Steagall Act?

Guy Spier (GS): Here's the problem that we have: anybody who goes into a period of market turbulence wishes that they had more cash, because with cash you can put it to work and it gives you strength and flexibility. But you go into the period of market turbulence with the cash that you have, not the cash that you wish that you had. So if you were fully invested, you'd just have to ride it out. If you were not fully invested, then you could put the cash to work that you had which, even though it's not as much as you wanted, you put it to work. But you can't say "oh now the market is turbulent, so now I'm going to raise cash" because that's' the opposite of what you want to do. And I see the same pattern in bank capital ratios, so the period leading up to the financial crisis had banks and investment banks too leveraged, but then immediately as you go into the crisis that is exactly the wrong time to increase their capital ratios. Yes you want to do it, but you want to wait until the crisis is over so the conversations with banks a year or two ago, they were saying "yeah, on the one hand the central banks us to lend all this money out and stimulate the economy, on the other hand, we're dealing with Basel III ratios and credit agencies have become a lot more conservative". It's kind of like slamming the barn door shut after the animals have fled. It's just not easy because I think that the policy makers would think "yes it is the wrong time to be closing the barn door, but we have to close it now because we'll never be able to close it any other time." So yes, we just have to put those capital ratios in now and it will be painful for five years, but we'll never do it if we wait five years, which would be the ideal but that's a whole political lifetime away. It's interesting, the Glass-Steagall act was put in place just after 1929, and now they're talking about bringing it back, and the last vestiges of the Glass-Steagall act I think were removed in the five or six years before the crisis of 2008, so again that was counter-cyclical, and I would argue that we're on the verge of a thirty-year long expansion of credit from the banking system that will start any time in the next year or two with Basel III and the reform of the banking system and making the banking system safe when it has run its course. And then in thirty years' time, when all of us are retired, we will probably have another financial crisis again.

BG: You've mentioned that the subconscious can influence and cause irrational behaviour, and you've mentioned you have a checklist to help keep you in place. How would you go about controlling those subconscious influences when you don't know they're seeping into you?

GS: I mentioned in my book that I am not like Warren Buffett, and while that is true, why did I set up so many aspects of my life to be like Warren Buffett? It's really important, when we model somebody, to model the right parts of them. For example (and forgive me for the salacious example), Madonna slept around a lot when she was active as a pop star, but she also worked damn hard. Now this is a very cartoonish cut out distinction, but I could choose to model her sexual behaviour, or I can choose to model how hard she worked, and one will lead me to good results and one won't. So I need to model Warren Buffett in a way that is consistent that Warren Buffett is very different in terms of ability and personality to me. I can easily draw the wrong lessons by modelling the wrong thing, so I think that by his makeup, like his ability to sell Fannie Mae and Freddie Mac years before the proverbial you-know-what hit the fan, it's just something that I won't know I will ever be capable of. But the checklist is a great idea. Here is some really important things that are missing, and it blows me away that Mohnish and I missed it. In flying, you don't just have a pre-take-off checklist, you have an in-flight checklist as well! But I didn't apply an "in-flight" checklist during the investment. So if we talk about my disaster in Horsehead Holding Corp., I did not monitor the buildup of leverage. If I'd have looked at that investment as a new position in my portfolio, it wouldn't have made it past the leverage screening and the checklist. Because it was already in the portfolio, I wasn't really asking myself that question seriously. I now have a member of my team whose role is risk manager, and his role is to run an in-flight checklist on a regular basis across all the positions to ask what is going on, what changes have taken place, and if changes have taken place, I need to write up the reason why it's still ok to be in the portfolio. I think in some way, the question you asked contains within it the seeds of the answer, which is once you identify the subconscious ways in which things seep in, you can start figuring out how to handle it.

BG: Many would say that the first half of 2009 was the best time to buy in terms of low valuations. What went through your mind during the first half of 2009? Did you buy stocks at that time? If you did buy, what gave you the courage to buy?

GS: I was throwing up over every stock that I bought in 2009. It was very hard for me, but there were a number of stocks that were very cheap, and it was easy to see that they were cheap. Did I buy as much as I would have liked? No. And I sold some business which I wish I hadn't sold. In the run-up to the crisis, I sold CRISIL, the Indian credit rating company, and after the financial crisis I sold Moody's which I really wish I hadn't sold. I was worried they'd get litigated and their balance sheet would be destroyed by the litigation, though that turned out not to be the case at all. One of the stocks that I bought was London Mining. They had about $300 million in cash, and was trading at a $200 million market capitalization, and it had these projects in Saudi Arabia and Greenland, etc. They had great projects going on, and there was a strong price of iron ore, which did not decline by that much then. I did buy some things, but how did I feel? I was throwing up all over with every purchase that I made. I knew I had to be buying, and it was really hard for me to do it. If I can improve as an investor, it's not going to be because I buy better, it's because I become less exuberant, and identify the ways in which I can become exuberant, and I can prevent myself from doing that. When we go through market turmoil like we're going through right now, I've coached my wife to say "did you buy a good stock today" when I come home from work. And I've also coached her to tell me when there's exuberance to say "wow, people are making money fast, maybe it's time to pull in our haunches a little bit".

BG: Even in the present times, if your portfolio did fall by 20%, do you have a group of friends that will support you through the bad times?

GS: Well my portfolio has dropped by more than 20% in the last year and a half. 20% is nothing! In 2008 my portfolio dropped by 46%. Certainly, a group of friends is good. Misery loves company, and it is miserable. Maybe Warren Buffett doesn't feel miserable, and even if I have cash to invest, it's just not a nice feeling to know that the liquidating value of your portfolio is lower. I think even more important than that is to have your lifestyle set up in such a way that it really doesn't matter. Speaking to which, I have a one-track mind, and my one-track mind right now is thinking of cyclical, pro-cyclical, and counter cyclical. One of the aspects of setting up a fund where you have outside investors is that it is incredible pro-cyclical, because the only times that you can raise money is when your fund is going up. That's not entirely true but it's largely true. When the fund is going down is when people want to redeem which is exactly when you need funds bad. So in that way, it is structurally not ideal. Even within different kinds of funds, for example if you have redemption terms with one week's notice, that makes it much more likely that people will take money out at the bad times exactly when you need that cash to invest. In my fund you have annual redemptions. That's a lot less pro-cyclical than if my fund allowed weekly or daily redemptions which would be far more pro-cyclical. Once a year redemption is still, I would argue, slightly pro-cyclical. It's those kinds of structural aspects that would really help. Friends is nice, but friends is dangerous because they can come and go, and they may not think the same as you, and they may lose heart themselves, so I think that you have to go to a far more lonely personal place. Good investing is just not a social activity. Having said that, I had a nice conversation with our compatriot Mohnish Pabrai today and it felt good to talk to somebody else who is taking a beating!

BG: In 2007, there was a lot of talk among the general public to invest, and as you know, this is a tell-tale sign that the market is going to go bust very soon. From your experience, are there any other tell-tale signs that one should watch out for?

GS: [During these periods], I feel like some really good investors in my generation are really uncomfortable, and rattled, and don't understand what's going on. One of the hard things that I've had to do is try and calibrate my peer group. I have a bunch of really smart friends, so they are not necessarily the vast majority of investors. Do I want to be in sync with them, or out of sync with them? If my friends are really bullish, does that mean I should be fearful because they represent the average stock market investor, or should I be bullish along with them because the reset of the market participants are fearful. So when the barber is talking about what stocks he's buying, that's probably a good bearish signal, showing that the exuberance has reached that far. As for a bullish signal example, there was a point in my life when people said "you buy stocks? You never buy stocks, those things never go up." When the Washington Post was trading at a discount to everything you could measure, and people said "well you don't buy the stock, that's just never going to go up." We're never going to get back to that period. Calibrating the overall state of whether the average market participant is fearful or greedy is a fantastic thing to think about. It's just really hard to measure. I would argue now that you don't have to talk to people, you just have to look at the market action of many of the stocks out there to know that there's more fear than greed.

BG: You talked about how your investors are naturally very pro-cyclical. Do you do anything to pre-qualify these investors or to prime them to your philosophy? Do you sometimes turn away investors who are not right for you?

GS: Here's what I've learned: In 2008, somebody who had always professed to be a long term investor suddenly needed to put their hands on cash instantly. Suddenly all the long term-ism disappeared, and there was a short-term need for cash. There are all sorts of reasons for that. Part of it was psychology, but part of it is that she was probably over extended. She either had debts that were coming due, or had a big mortgage, etc. I think that interviewing somebody, or talking to them or communicating with them is not the most effective way of picking an investor base that is as counter-cyclical as possible. I think you need to set up shop in such a way that counter-cyclical investors are more likely to show up. For me, the transition to the 0% management fee, 1 year lockup, compensation structure from the slightly more standard 1 and 20 where people are allowed to take their money out once per quarter -- it's not a guarantee --but the people who show up for those kind of investment terms tend to be more long-term. It's not in the interviewing of people, because people will say something and genuinely believe it, but then the crisis hits and all they want to do is get out of your fund. I don't think interviewing them is the right way to do it. I think that structuring it so that only the right people show up is. So what I would likely do in the future with Aquamarine Fund, is to bake in the existing investors, but say any new money is only going to be invested with me if you invest five years at a time. This effectively says that unless you want to put your money with me for five years, and after five years you can either take it out or re-up for another five years, you kind of say I only want long term money, and it's baked into the terms of the contract.

BG: There's also a lot of pro-cyclicality in the public. Do you see any public policies out there that are genuinely counter cyclical that one could support?

GS: In a time of economic decline or of low growth in the economy, or a contraction, the taxation base goes down. The amount of taxation revenues that the government takes in becomes lower, but much of the government spending remains fixed because there are commitments to unemployment benefits, and transfer payments of all sorts. That is a natural stabilizer. The government takes less money out of the economy through taxation, and borrows more in order to fund spending that continues no matter what. That is counter-cyclical, and very good. In spite of the political debate with people on the right talking about the government spending is ridiculous, at the end of the day it happened, and even if a lot of it was misspent, it happened. So I would argue that there are some natural stabilizers there. The independence of the central bank is another one. When there was political interference with central banks, central banks' policy was far more pro-cyclical. Every developed economy has understood that you need an independent central bank where the person studying monetary policy has got some clear targets which are not related to the political side, and that's a really good thing.

BG: You've spoken about how you wanted to get away from the noise of Wall Street, and have since based your firm in Zurich, could you tell us some of the disadvantages of not being on Wall Street?

GS: In a certain way, for the first year it was all quiet, and then Wall Street came and found me in Zurich! It's a part of my personality that attracted that in. Moving to Zurich helped me for a short time, but it just masked what the real issue was. The real issue was not where I lived, but rather what parts of my personality attract that stuff into my life. I'd attract them into my life wherever I lived. If I had that knowledge now and had chosen to stay in New York City – look I think New York City is a hard place to develop a calm, equanimeous attitude to the world, but it's an inner struggle. There's a mis-projection that it's assuming it's all the environment when it's not. Much more of it is internal. There are some great investors in New York, but they have a different set of relationships and they've managed themselves in a different way than I have. I think that, similar to how I've mentioned that my book is stuck with my way of thinking in one particular point in time. Perhaps a better way of describing that move is where am I the most grounded? Where is the place where I have the biggest number of people who know how I used to be, where I can really feel like I am the truest version of myself. It's not about moving to some place designed to bring out some aspects of our personalities. I think I travel a lot to the US, and I learn a lot in the US, and I'd actually prefer not to travel as much, and I think that maybe if I was not in Zurich and I was somewhere in the US, I would travel less. When I moved to Zurich, that was when the first iPad had come out. I get on my desk every day, and I have up to date news, a voice over IP telephone that puts me in touch with anyone who I want to be in touch with on a local line, so I don't think there are that many disadvantages really on a practical level! I look at the same Capital IQ Bloomberg that everyone else looks at. I look at the same filings as everyone else does, participate in conference calls the same way that everybody else can. I don't think that's important. I think the bit that's really important is where am I most grounded? Go to the place where you're grounded, and everything else will flow from there. Having said that, feel free to go to New York for a few years. It's really a lot of fun! It doesn't hurt to go to New York for a few years; even Warren Buffett did it for a few years. There's a sort of change that happens in one's mind that can happen while in New York that can be really valuable to experience.

BG: You've stated that you're Indian at heart, and follow the teachings of Gandhi, and contribute to the Dakshana Foundation. How do you feel about investing in Indian equities?

GS: I just read in the newspaper today that Ikea was having great trouble. Can you believe that? It just shows the problems that people like Narenda Modi [current prime minister of India] have to deal with. There's one of the lowest cost economies on the planet, and Ikea, who required to source I think about 1/3 of their product locally, and they can't find product to fill their stores with locally because they're having real problems complying with the regulations. The article talks about a flat-packed furniture sourced in India has a certain kind of formaldehyde which are too high-level for their corporate standards, and is potentially dangerous. Obviously it will not be like that in twenty years, but it's just an enormously different economy to one like the United States or Western Europe. If I were *really* Indian (not just pretend!), and I spoke Hindi, I think that is a market where it is good to be on the ground, and to do really aggressive scuttlebutt to go and meet with companies. It's a market where being very close on the ground would probably yield enormous rewards that is just very hard to figure out from just reading the documents at a great distance, which is what I'd be forced to do. That said, I really regret selling my investment in CRISIL. I am now set up so that I don't have to take too many steps to reinvest in them, and probably would at the right moment, but the great thing about finding an investment like CRISIL is that it's almost not like an Indian investment. You're investing alongside S&P and get S&P's management and all those good things. I think once you've lived in a developed economy like the US, Canada or Western Europe, it's very hard to want to live in an undeveloped economy because it's just so many things. But I think the opportunity is great if you're willing to live there.

BG: Regarding the circle of competence which Warren Buffett talks about. Value investors are really independent, so how do you take advice from other people's circle of competence?

GS: When markets go down, it's when investors realize their circle of competence is narrower than they really thought it was. When markets go up, our circles of competence expand and expand! Trying to work out what is your circle of competence, asking yourself "what do I really know? Do I really have an edge or do I not have an edge?" is just not an easy question to answer. It's so easy to say "invest in your circle of competence", but defining what one's circle of competence is, and really knowing what it is and developing it is something that I would give a lot of thought to. You could imagine business schools ten years out will have a whole module or maybe even a whole course just on defining your circle of competence! For example, I invested in this company called Alaskan Milk in the Philippines. Was that in or out of my circle of competence? The investment worked out really well, so I think I could make a claim it was inside, but maybe it was outside and it was just blind luck! I thought I could have a clear analysis and understanding that the family that was controlling this company was not corrupt and wanted to make money for everyone, but maybe that was just dumb luck.

BG: Could you share with us some of your methods or ideologies when you have a big investment in order to give yourself the confidence to make your next big investment, especially when your money is yours and other people's as well.

GS: It's very hard. My father is one of my most important investors, and just a few weeks ago he said "I don't envy you, Guy. You have a really difficult job!" I have to accept and understand, and my investors have to accept and understand that I will make mistakes, and it's kind of inevitable. It's easier to write about than to actually live through it. It's easy to write about Sir Earnest Shackleton's mistakes that he made. He was trying to save the lives of his men, and he made mistakes that resulted in his ship sinking in the middle of the Antarctic ice. I don't think there's any answer other than to say yes it is hard! I did force myself to buy some stocks a couple weeks ago. I think they're really good stocks that will do really well, but I think it's hard. The worst was when I wrote this letter to my investors telling them that "this is not an easy time, this may be a bullish signal, and I had suffered some tremendous losses, and I'm learning some lessons." A lot of investors were like "Guy, we're with you." And then there's one guy who sent me a flame piece of hate mail, which is shocking to me. I just got up from my desk and walked away. It was quite upsetting to me to see that. At that moment I thought to myself "if only I had shut down the fund six months ago", then I wouldn't have had to deal with this! I don't know what the answers are. It was not easy for me in 2008, and I don't think it's easy for me now either, but who said life was supposed to be easy? This is not an easy moment for me that's for sure. I'd like to pretend that it's all just fine, and it's not easy to see investors rattled. It's not easy to see losses on the stocks that I own. I have my analysis to see as to why they're wrong, but right now the market agrees with the people who want to sell the stocks that I own! And those are the guys that rule the day. I think they're wrong and eventually I'll be proven right, but right now it's not an easy place to be. Part of why I was talking about the cyclicality is that during an exuberant period, people like Guy Spier become more and more confident about what they're doing, and so I became more concentrated than I would have like to be. If my position sizing had been more conservative, I'd be dealing with what's going on in my portfolio, it certainly would have been a little less hard to deal with.

BG: Do you have any other advice?

GS: Somebody must have said it before me, and I'm going to pass this on to you. Your success in life will be directly proportionate to the amount of uncertainty that you're willing to tolerate. In a certain way, I will have greater rewards than someone who is not willing to tolerate the kind of thing that I am going through right now, and I will have lesser rewards than people who are willing to tolerate a lot more. If you agree with that statement, which I think is just a true statement, the worst thing to be would be to pick a safe path when you're actually capable of a lot more uncertainty. You need to realize that uncertainty is not a bad thing, and anguish is not a bad thing. It's a part of life and if you're willing to put yourself in a place where you have that, there are enormous rewards because many humans are just not willing to do that. So I wouldn't necessarily shy away from it. What I would tell you which is certainly true, and I feel very strongly about this, is that the biggest asset that every single person has is that you have your careers ahead of you, and there is a big difference with how rationally you should behave when you have a lot of years ahead of you to recover from mistakes and setbacks than when you have a short number of years. When you come out of business school, you should go for high beta, high uncertainty outcomes in the choices you make. As long as you don't lose much, as long as you don't get injured or get any diseases, or do permanent damage to yourself, you want to get into situations where there is enormous uncertainty and there is enormous upside and leave the safer bets for later on in life when you don't have as much time to recover from them.

BG: What is the most important thing in life and investing that you learned in the last twenty years?

GS: Outside of investing and life, the most important lessons I've learned are from my wife. It's in the relationship with my wife. I think that we have a good marriage – I think! Think of the enormous amount of humility that you could muster up, and the biggest amount of forgiveness that you could possibly muster up, and the biggest amount of acceptance of the things that you'd think that you'd never want to accept, and multiply by infinite, and that's what you learn in marriage! Learning how to accept how the marriage shapes me and learning how to be the person that could make the marriage successful I think is in a certain way, humiliating because I had to give up so much of who I thought I was. But of course what I gained is a place in the world, a very real place in the world because I am a husband and a father and all of those things. It took me ten years out of business school, I graduated at 27 and got married at 37. If I had that time over, I would've wanted to get married sooner. I think that in a certain way, maturity only happens once you're married, and it's a good to get going on that sooner rather than later. I also know people who got married at 21, and there's drawbacks to that but I think I got married too late!

In investing, I think that I have continuously underestimated the need to manage my own psychology and the realization that it's not just managing my own psychology, it's managing my own psychology through a changing landscape. My own psychology twenty years ago when nobody knows who the hell I am and I can quietly operate out of the bedroom of my apartment is one thing, and managing my psychology when I've got professors of business like George inviting me to speak is another thing! People think that I'm nuts. I pray at the church of Warren Buffett. I really think that Warren Buffett is a kind of prophet in the same way that if we had lived in Old Testament times, people like Ezekiel would have been a prophet! I think that Warren Buffett is not just somebody who just happens to be a successful businessman. He is a guy who's fundamentally changed our own perception of what it means to be a capitalist. He has taken it many steps further and I think that the world is a better place, and capitalism is something better because Warren Buffett has lived the life that he's led. So the lesson that I've learned is that there's nothing that I learn that I don't realize after I've learned it that Warren Buffett already knew. I think that he deserves enormous and intense study. There is just so much in that life that can instruct us. In a certain way we're all seeking the same thing. We're all seeking the wisdom of Warren Buffet and Charlie Munger, so maybe that's the lesson! As you can see, I'm a work in progress and there's a lot more improving that I can do!