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Book Review – The Four Filters Invention

Behavioral finance and its role in investment policy is a fascinating topic, primarily because it is still so early in its evolution. The committee that awards the Nobel Prize advanced its cause a few years ago when it awarded its prestigious prize to Kahneman and Tversky, providing much needed exposure to ideas that had not reached many in the investment community. Bud Labitan has attempted to take a step forward by combining behavioral finance with the investment style of Warren Buffett and Charlie Munger, who have a strong track record of returns while running Berkshire Hathaway. His book is called *The Four Filters Invention of Warren Buffett and Charlie Munger: Two Friends Transformed Behavioral Finance*. While it is not a groundbreaking book as it relies too much on previously published material, the book makes you think. Behavioral finance has spent 2 decades telling us why we don't make good decisions and aren't good investors. Labitan tells us that behavioral finance can move beyond this to help develop investment strategies, and uses value investing as practiced by Warren Buffett as his example.

When writing to shareholders in his famous annual letters, Buffett has often described his investment philosophy in simple terms. Labitan has taken one of these descriptions and calls it the Four Filters Invention. An investment must be 1) understandable, 2) have competitive advantages into the future, 3) managed by competent and honest people, and 4) be available at a reasonable price. It sounds pretty simple, but it's not.

Is this a methodology that can provide excess returns for investors, or does it rely on Buffett's skills? It is proactive, but perhaps not in the way that Labitan expects. It proactively filters out companies that don't meet the criteria, not in. Buffett and Munger start with all companies. Then they draw a circle of competence around their knowledge. Which companies and industries do they understand? Eliminate those where you can't picture their industry into the future. This is step one. Step 2 extends this to say you need to recognize if a company has a competitive advantage into the future, often referred to by Buffett as a moat. This eliminates even more companies. For the personal investor step 3 is the toughest, as most never actually meet or are exposed to management. You have to rely on articles and impressions, but can often get a good feel for the CEO's style by reading their annual report. Make sure to find out how their incentive compensation works. And don't forget Mr. Market. He knocks on the door every day, sometimes offering more and sometimes less than the intrinsic value you have calculated in advance. Insist on a large margin of safety. It is a combination of these 4 characteristics that provide candidates for a portfolio. Few can afford to say it doesn't matter what they already own and the marginal impact on a portfolio. This often ultimately determines what company and stock is purchased.



With the first biography of Warren Buffett recently published, it is likely that efforts to define and explain his investment style mathematically will “Snowball”. Labitan has beaten the crowd, but the best part of the book is the title. It does not stand up to the Robert Hagstrom books or Poor Charlie’s Almanack.

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