

On Saturday April 30th, investors flocked to Omaha Nebraska for Berkshire Hathaway's annual shareholder meeting, otherwise known as the Woodstock of Capitalism. The meeting drew over 40,000 attendees all hoping to hear pearls of wisdom from Warren Buffett and his investing partner Charlie Munger. Fortunately, for those of us that didn't make the trek to Omaha this year, the meeting was broadcast live on the internet for the first time ever. Allowing Berkshire devotees like us to cuddle up with our laptops and listen in live. As usual, the meeting was full of insights on a wide array of topics ranging from politics to negative interest rates, stock buybacks, Valeant, bashing the hedge fund industry and more.

Although our favorite pearl of wisdom from Warren and Charlie is the importance of **developing a multi-disciplined mental framework** (or model) to broadly understand, collect and organize the factors that affect an investment. In fact, the key to their long-term investing success is derived from this approach and not, as they often joke, from a superior intellect. In the book *Poor Charlie's Almanack*, Munger describes the approach as **"Quickly eliminate the big universe of what not to do, follow up with a fluent, multidisciplinary attack on what remains, then act decisively when, and only when, the right circumstances appear."** As he once said, "it's kind of fun to sit there and outthink people who are way smarter than you are because you've trained yourself to be more objective and more multidisciplinary. Furthermore, there is a lot of money in it, as I can testify from my own personal experience."

We couldn't agree more and have worked hard to develop our own mental models built on the advice of great investors like Warren, Charlie and others. As we approach our two year anniversary we thought it would be interesting to highlight our investing framework, which is a summary of the lessons we have learned over the past 25 years. Below is a summary of "Steve's Investment Rules" which is also available on our website.

Steve's 12 Investment Rules:

1. Focus on executing your process, not short-term results

Our investing process is based on sound principles and lessons we've learned from studying some of the most successful investors over the past 25 years. Our experience and results have taught us that consistently executing our investment process is the key to long-term success. To avoid being swayed by short-term noise in the markets we constantly remind ourselves of the Ben Graham quote "in the short-run, the market is a voting machine, but in the long-run it's a weighing machine." **Our investment processes are disciplined and time-tested, and keep us focused in the following areas: asset allocation, manager and stock selection,** for more information on these processes visit our website or give us a call.

2. Asset allocation is the most important decision

Our asset allocation approach begins with a strategic allocation to four core asset classes that we only deviate from if we have a high level of confidence we can significantly improve returns. We refer to this as a "Fat-pitch" investing, meaning **we only look to "swing" at other asset classes when valuations are low and the odds of us outperforming our strategic allocation are high.** One of the biggest mistakes investors repeatedly make is chasing the latest fad or hot asset class, buying them at the top of the market and selling them at the bottom. A strategy guaranteed to lead to poor results. **Our Fat-pitch approach keeps us disciplined and helps us to avoid the common mistakes other investors make.**

3. Markets tend to mean revert over time

Which simply means that when stocks go far too far in one direction, they tend to come back, often overshooting in the other direction. The examples are numerous: tech stocks in the '90's, financial stocks in '07, energy stocks the past year and a half, etc. Examples go the other way as well, where groups of stocks are ignored and trade at exceptionally low valuations for extended periods. Think small-cap, value stocks and REITs in the early 2000's. Our best returns are often generated from taking advantage of the opportunities created when other investors become too euphoric or pessimistic. **We try to never lose perspective of the *future* return potential of an investment.**

4. Volatility is a friend to the long-term investor

Periods of high volatility (corrections) tend to take all stocks lower, the good and the bad. **As investors in quality stocks we welcome periods of volatility as they present wonderful opportunities to buy great investments at reasonable valuations.** The volatility this past January/February is a great example of how investors sell everything when they panic; it provided a great opportunity for us to buy quality investments. In fact, this period of volatility was by far the most active we have been buying new positions since we founded the firm two years ago. Needless to say, as long-term investors we look forward to more volatility!

5. Contrarianism works when markets are at extremes

There is a tendency on the part of investors to always want to be a contrarian, in other words to do the opposite of what other investors are doing. **The reality is that the investing crowd isn't always wrong and that contrarianism usually only works when the crowd goes to extremes.** However, when extremes do occur it's time to take decisive action in the other direction.

6. Don't be emotional, know your strengths & weaknesses, have a plan

Most investors fail because of emotional mistakes, tending to invest when it's comfortable and everything is working well (market tops) and sell when it's uncomfortable and stocks are going down (market bottoms). Numerous studies have shown that the average investor widely lags the popular indices. The best way to combat the emotional traps investors fall into is to be a student of financial history (it repeats) and behavioral finance (investor mistakes), and to have a plan in place ahead of time. **Investing with emotional intelligence, having a disciplined investment process and a well thought out strategy gives you a big edge over the average investor.**

7. Admit mistakes- sell your losers and let the winners grow

All investors make mistakes, the key is to admit them quickly and limit your losses. On the flipside, some of the biggest mistakes we have made over the years is selling an investment too early. The temptation to book a profit can be high, however when a great idea is made the biggest returns are made by letting it compound value over the long-term.

8. Valuation wins in the long-run

In the short-run valuation is a poor predictor of performance, however longer-term valuation is one the best predictors of future performance. We find lots of potential investments that have many of the attributes we like to invest in, however it is a very small subset of that group that also meets our valuation criteria. Staying patient and waiting for good value has significantly increased our long-term investing success.

9. Costs matter

One of the top predictors of investment success is how much you pay in costs, with lower obviously being better. **When we founded our business two years ago we purposefully decided to keep costs as low as possible by not accepting any commissions, revenue sharing or soft dollar agreements. These are costs we wouldn't want to pay as investors and don't think our clients should either.** As we've talked to prospects in the community the past couple of years one of our biggest surprises has been that most investors don't know how much they pay in fees. Many have been shocked to learn that their old brokers had been charging as much as 2-4% or more; levels that we find unacceptable and in some cases unethical.

10. Risk cannot be avoided, be decisive when opportunities arise

Investors are compensated for accepting uncertainty and taking risk; if there is no risk there is typically very little or no return. **Returns are often greatest when risks appear highest, investors that can filter out the noise and identify the real risks will receive the greatest rewards.** Knowing that we can't avoid risks, we want to be decisive when opportunities arise.

11. Wall Street is not your friend- avoid hype and complexity

We are regularly pitched exotic new products and strategies, most of which are simply convoluted attempts by financial engineers on Wall Street to sell us something we don't need, and make a commission. **Our experience has taught us that fancy presentations and complexity don't equal great investments, our preference is always for simplicity and strong fundamentals.**

12. Avoid intellectual arrogance, it is the enemy of good decision making

We have seen many managers over the years fall in love with their own thought process and analysis, often becoming blinded to the big picture due to their "intellectual arrogance." **When we see managers and investors display intellectual arrogance we tend to run the other direction. Charlie Munger summed it up well when he said "investing is not easy and anybody who thinks it is, is stupid."**

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