Raw Notes on Adam Smith's *The Money Game*

0. PREFACE TO THE VINTAGE EDITION

- The money which can preoccupy so much of our consciousness is an abstraction and a symbol
- The game we create with it is an irrational one, and we play it better when we realize that, even as we try to bring rationality to it.
- Another day it would come back, but not until the unscarred generation, so bold without memories, had become scarred like its predecessor.
- The small investor is a lovable fool, and the professional manager is a worldly riverboat dealer; find smart people, the small investor is told.
- But how do you find smart people? Those who have just finished being smart are sometimes the dumb ones in the next part of the cycle
  - They are not smarter, they merely have more information
- The market motion is more violent, not really conducive to serenity
- The first thing you have to know is yourself. A man who knows himself can step outside himself and watch his own reactions like an observer.
- The stock doesn't know you own it.
- Prices have no memory, and yesterday has nothing to do with tomorrow.
- The how-to-do-it, if there is such, is all about behavior

Conclusion: The game we create with it is an irrational one, and we play it better when we realize that, even as we try to bring rationality to it.

1. WHY DID THE MASTER SAY "GAME"?

- The game of professional investment is intolerably boring and over exacting to anyone who is entirely exempt from the gambling instinct; whilst he who has it must pay to this propensity the appropriate toll.
- Active investors do not pursue bonds (except convertibles) and preferreds (except convertibles).
  - It isn't that one can't make money with these instruments, it's that they lack romance enough to be part of the game; they are boring
- Most of what has been written about the market tells you the way it ought to be, and the successful investors I know do not hold to the way it ought to be, they simply go with what is.
- But the real object of the Game is not money, it is the playing of the Game itself

Conclusion: The word game was deliberately chosen to describe the stock market and the sooner that all of us small investors understand that this is a game, the better off we may be.

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2. MISTER JOHNSON'S READING LIST

- The dominant note of our time is unreality
- Market values are fixed only in part by balance sheets and income statements; much more by the hopes and fears of humanity; by greed, ambition, acts of God, invention, financial stress and strain, weather, discovery, fashion, and numberless other causes impossible to be listed without omission.
- The market, says Mister Johnson, is like a beautiful woman --- endlessly fascinating, endlessly complex, always changing, always mystifying.
- There are fundamentals in the marketplace, but the unexplored area is the emotional area. All charts and breadth indicators and technical palaver are the statistician's attempts to describe an emotional state.
- What is it that a good manager has?
    - It's a kind of locked-in concentration, an intuition, a feel, nothing that can be schooled.
    - The first thing you have to know is yourself
- But if you stop to think about it, here is one authority saying there are no formulas that can be automatically applied
- You are – face it – a bunch of emotions, prejudices, and twitches, and this is all very well as long as you know it
- **Irregular Rule #1: If you don't know who you are, this is an expensive place to find out**
- If the emotional area is the unexplored area, and the statistical area is being so thoroughly explored, why not explore the unexplored area?
- The one man who really knew both the stock market and the human mind → I know mass psychology and the marketplace as an area for study

Conclusion: Do not forget the Irregular Rule: If you don't know who you are, this is an expensive place to find out!

3. CAN INK BLOTS TELL YOU WHETHER YOU ARE THE TYPE WHO WILL MAKE A LOT OF MONEY IN THE MARKET?

- Portfolio managers have usually been trusted officers, safe, sound Prudent Men
- The analyst really wants to be right; his ego needs the pleasure of being right, and he would almost rather be right than making money
- The aggressive portfolio manager doesn't care about being right on each judgment, as long as he wins when you tot up the score.

- Performance-orientated investing, where one reacts quickly to information is distinguished from that of small investors who hear a tip and rush out to buy
    - The small investor has the reaction without the knowledge
    - The small investor has no "apperceptive mass" behind the reaction
    - The performance-oriented portfolio manager, quite simply, can remember the profit margins of a hundred companies
    - If you really know what's going on, you don't even have to know what's going on to know what's going on
- All you need is a hell of an apperceptive mass, an IQ of 150, and a dollop of ESP, and you can ignore the headlines because you anticipated them months ago
- There is one requirement that is absolute in money managing, and you have already learned it with the first Irregular Rule: *If you don't know who you are, this is an expensive place to find that out*. The requirement is emotional maturity.
- The real test is how you behave when the crowd is roaring the other way.

Conclusion: It all comes back to the Irregular Rule that you must know yourself for the stock market is an expensive place to find that out. The requirement to win this game is emotional maturity.

4. IS THE MARKET REALLY A CROWD?

- The first thing we know, says good Dr. Le Bon, is that an individual in a crowd acquires – just from being in a crowd – "a sentiment of invincible power which allows him to yield to instincts which, had he been alone, he would perforce have kept under restraint … the sentiment of responsibility which always controls individuals disappears entirely."
- The second element in Le Bon's crowd was contagion
- The third element in Le Bon's crowd was suggestibility.
- Once we have dissolved responsibility, we are ripe for contagion and suggestibility and acts of irresistible impetuosity
- Le Bon did not like crowds: an individual upon becoming a member of a crowd descends several rungs in the order of civilization because the mind of the crowd is not an average but a new common denominator, mindless in the sense that it has surrendered to its unconscious impulses
- Because of the crowd tendency there is no substitute for good information in the market
    - Good research and good ideas are the one absolute necessity in the marketplace and they will be the best tools until otherwise stated.
- The crowd does not reason it only thinks it reasons
- Wall Street unconsciously accepts all of this and this is not news to the players of the Game

  - The image that a company or a stock present helps its price, and can keep it up long after the rational factors of earnings and return on invested capital has begun to deteriorate
- 80% of the market is psychology

Conclusion: Since 80% of the market is psychology or deeper still human emotionality, the market can really be seen as a crowd. Because of this tendency, there is no substitute for good information, good research, and good ideas.

5. YOU MEAN THAT'S WHAT MONEY REALLY IS?

- The investors who follow the market, the ones who call up all the time, ninety percent of them don't care whether they make money or not
- Adam Smith the First economic man was a rational man, and much of economics assumes that men will always go in the direction of the maximization of profit or production.
- At the root of the impulse to pile up this useless money is "the compulsion to work"
- Norman Brown believed that the apparent accumulation of wealth is the impoverishment of human nature.
- It is true that you have to work long enough to acquire a surplus enough to buy some chips for the Game, but the money you make playing the Game isn't work, it's play – or are you making it seem like work?
- Norman Brown believed that the dynamics of capitalism is the postponement of enjoyment to the constantly postponed future

Conclusion: On one hand you have Adam Smith the father of modern economics stating definitely that money is about the maximation of profit and in some sense the accumulation of wealth (i,e. The Wealth of Nations). On the other hand, you have Norman Brown who sees money as a noose around our necks that ultimately makes our human nature impoverished. You must decide for yourself!

6. WHAT ARE THEY IN IT FOR?

- Some people go to all the trouble of actually losing money just to have the sheer wallowing job of losing
- Some own stock forever and never reap the benefits of their ownership
  - Owning IBM forever is like a parable of pure capitalism; never jam today and a case of jam tomorrow
- Some just want to own good long-term stocks

Conclusion: There are countless reasons people get into the Game. Some people love to gamble and lose. Others just want to make money over the long-term by owning stocks forever. Regardless of your reason, you need to know yourself and stick to your plans.

7. IDENTITY AND ANXIETY

- If the occupation is money-making in its pure raw white form, then anxiety is always a threat that the money which represents the achievement can melt away.
- The strongest emotions in the marketplace are greed and fear. In rising markets, you can almost feel the greed tide begin.
    - Usually it takes from six months to a year after the last market bottom even to get started.
    - The greed itch begins when you see stocks move that you don't own.
    - Then friends of yours have a stock that has doubled; or if you have one that has doubled, they have one that has tripled.
- No matter what role the investor has started with, in a climax on one side or the other the role melts into a crowd role of greed and fear.
- The end object of investment is serenity, and serenity can only be achieved by the avoidance of anxiety, and to avoid anxiety you have to know who you are and what you're doing.
- **Irregular Rule #2: The identity of the investor and that of the investing action must be coldly separated.**
- A stock for all practical purposes is a piece of paper that sits in a bank vault and most likely you will never see it.
- The most important thing to realize is simplistic: The stock doesn't know you own it
- If you know that the stock doesn't know you own it, you are ahead of the game. You are ahead because you can change your mind and your actions without regard for what you did or thought yesterday.
- If your course is successful, you will realize that you do not want a million dollars but something else that the million dollars represent to you.
    - What do you do if the million dollars arrives and serenity does not?
- It's a kind of virus in the whole country when the cards of identity say not how well the shoe is cobbled or the song is sung, but are a set of numbers from an adding machine.
- **You are either a wage slave or you are not**

Conclusion: The only real protection against all the ups and downs of the market (the anxiety) is to have an identity so firm it is not influenced by all the brouhaha in the marketplace. And remember, the stock doesn't know you own it!

8. WHERE THE MONEY IS

- Really big money is not made in the stock market by outside investors.
- It is certainly possible to make ten or twenty times your money as an outside investor in the stock market given enough time, enough intelligence, enough emotional detachment, enough luck, and somebody smart on the other end of the phone
  - It is possible because a lot of people have done it
- Who makes the really big money?
  - The inside stockholders of a company do, when the market capitalizes the earnings of that company
- One of our learned economists has described our economic system as "state socialism for the rich."
  - If socialism is the public ownership of the major institutions and industries of the nation, maybe we are just taking a unique way of getting there.

Conclusion: So if we are talking about real big money, forget the stock market. Build a company and have the market capitalize on your earnings.

9. MR SMITH ADMITS HIS BIASES

- Nothing works all the time and in all kinds of markets.
- This is what is wrong with systems and books that tell you *You Can Make a Million Dollars.*
- If a decision is made not to make a decision, that is just as much a decision as a decision that initiates action
- What you should do with General Motors is inherit it. That $9 billion of additional wealth benefits the existing holders
- Solitron's earnings increased more than tenfold, but the market's opinion of that earnings increase made the stock appreciate 250-fold → That is the way the market creates wealth
- What you want is the company which is about to do that over the next couple of years. And to do that, you not only have to know that the company is doing something right, but what it is doing right, and why these earnings are compounding.
- Any company whose earnings are growing consistently – or more importantly, are likely to grow consistently – has something unique about it.
- What is unique is always the same thing: it is people, the brains and talents of people.
  - Sometimes these people produce patents, sometimes they produce a reputation for service
  - But always they produce something that cannot be easily duplicated by anyone else.
- Even if, by some magic, you knew the future growth rate of the little darling you just discovered, you do not know how the market will capitalize on that growth.
  - Sometimes the market will pay twenty times earnings for a company growing at an annual compound rate of 30%

    - Sometimes the market goes on a growth binge, especially when bonds and the more traditional securities do not seem to offer intriguing alternatives
- There will always be something to make your little darling seem expensive
- **However marvelous the product is, no company is immune to mistakes by its management.**
- Chemicals, for example, sold at growth premiums to the market in the 1950s
    - Currently not only has their premium vanished but they sell at a discount to the Dow-Jones average
- So it gets hard to collect more than 200 shares without attracting a crowd and remember the nature of crowds.
- There is depth to its management so that the absence of one or two key people does not harm the company.
- I always try to find the time to listen once to any investment man …
    - In other words, he found some smart people.
    - That is one of the most important of the Irregular Rules, *find smart people*, because if you can do that, you can forget a lot of the other rules.
- But the good ideas? Well, the good ideas came from smart people.
- But no one can cover everything, and no one can know everything
    - So most professionals depend on the people – their analysts, other people's analysts, other managers, their friends – whom they have come to respect as acute intelligence and as talents at whatever course they happen to be talented at.

Conclusion: The "simple equation of wealth": To get rich, you find a stock whose ______ has been compounding at a very fat _____ and then the stock zooms and there you are.

10.CAN FOOTPRINTS PREDICT THE FUTURE?

- Unfortunately, as we have seen, the playing of the Game is not entirely a rational affair.
- Charts are a tangible, visible way of finding out if not *What is everybody else doing?*, at least *What has everybody else doing?*
- You can see that in our vast, myriad, and changing world, some things are constant.
- A chart can be a handy way of looking at what has happened.
- If once could depend on these charts, it would be a very neat world indeed.
    - But if things were this cut and dried, all the twenty-two million active investors would simply load up with charts and the Game would be over
- It is the idea that charts can indicate some *future* course that is so controversial
- You can see that there is an underlying assumption in charting, and that is that what was true yesterday will also be true tomorrow.
- That phrase "long-term" is the key phrase. It is used probably for 80% of all stocks that are not headed for bankruptcy at any given moment.

    - Never mind that the long term is a series of short terms, or that in the long run, we are all dead
- Can the footprints of price movements predict the future?
    - When everyone knows something, then no one knows anything.
    - The market would soon become too "efficient" that is, the gap between present and future value would quickly be closed by the predicting devices.
- Past patterns help determine future patterns; momentum can be shown on the charts.

Conclusion: Charting assumes that what was true yesterday will also be true tomorrow. But you and I know that past patterns/performance are not predictive of future patterns/performance.

11. WHAT THE HELL IS A RANDOM WALK?

- Charting seeks to find some order in what has happened
- The random-walk thesis maintains there is no order
- **Prices have no memory, and yesterday has nothing to do with tomorrow**
    - Every day starts 50-50
    - Yesterday's price discounted everything yesterday
    - To quote Professor Fama, "the history of the series of stock price changes cannot be used to predict the future in any meaningful way. The future path of the price level of security is no more predictable than the path of a series of cumulated random numbers
- If the random walk is indeed Truth, then all charts and most investment advice have the value of zero, and that is going to affect the rules of the Game
- "If the random-walk model is a valid description of reality," says Professor Fama, "the work of the chartist, like that of the astrologer, is of no real value."
- There are discrepancies between the actual price and the true intrinsic value of a stock
- An "efficient" market closely conforms to the random-walk model, in which the price reflects the true discount of intrinsic value.
- The investor in the random-walk model is suspiciously *Homoeconomicus*.
    - There is nothing so disastrous, said Lord Keynes as a rational investment policy in an irrational world
- There are few rich random walkers, and few rich Chartists. But there are some quite successful investors around who have no particular system
- Perhaps they are the lucky holders of serial runs, perhaps they are more rational or have better access to information, and perhaps – something not taken into account in the austere statistical worlds – they are better students of psychology.
- Intuition is still with us, even though it cannot be programmed into a computer.

Conclusion: To quote Professor Fama, "the history of the series of stock price changes cannot be used to predict the future in any meaningful way. The future path of the price level of security is no more predictable than the path of a series of cumulated random numbers. If the random walk is indeed Truth, then all charts and most investment advice have the value of zero, and that is going to affect the rules of the Game.

12.<u>COMPUTERS AND COMPUTERS</u>

- "Irwin," I said, "tell the truth now. If all these computers go on the air, as you say, does an individual investor have any chance?"
- "There is always luck", Irwin said. "Luck – which is to say a serial run of random numbers – can happen any time.
- And the computer is out for really aggressive performance
- An individual with a longer time horizon might be able to do passably. But on the whole, and over any given period, the computer will always win.

Conclusion: The Game is such that computers take away any long-term advantages individuals find. Our only chance is to rely on luck (random walk thesis).

13.<u>BUT WHAT DO THE NUMBERS MEAN?</u>

- Numbers imply precision, so it is a bit hard to get used to the idea that a company's net profit could vary by 100% depending on which bunch of accountants you call in.
- Accountants are not some kind of super-authority, they are professionals, employed by clients.
- In short, there is not a company anywhere whose income statement and profits cannot be changed, by the management and the accountants, by counting things one way instead of another.
- Most accountants are honorable men, trying to do a job. But they are hired by corporations, not by investors.
    - Not only are they professionals hired by the corporations, but they are frequently further involved in company affairs as tax and management consultants.
- "It's not important what our company makes," Sidney said. "What is important is the image, the management, and the concepts. Wall Street loves all three."
- But let us just say that accounting is supposed to be uniform and consistent and it isn't.

Conclusion: The numbers created by "independent auditors" should be looked at with a grain of salt given that the accountants are paid and hired by the companies themselves.

14. <u>WHY ARE THE LITTLE PEOPLE ALWAYS WRONG?</u>

- When the sophisticates are Accumulating, they have to be Accumulating from someone, and when they are Distributing, somebody has to be there to buy.

Conclusion: Someone has to be on the losing end of the transaction and that is usually the little investor.

15. <u>THE CULT OF PERFORMANCE</u>

- Who are They? Well, They are the people who move stocks.
- They get information first, maybe They even create the information, and They are about to put the stock up or down
- They are mysterious, anonymous, and powerful, and They know everything because They are the powers of the marketplace.
- They do get information first, They do have the ability to move stocks, and it helps a lot if you know what They are doing.
- To the elder generation, The Depression of the 1930s was a profound traumatic experience.
    - Stocks crashed in 1929, but that was not the worst
    - They rallied in 1930 and then started a steady erosion that scarred for life anyone who experienced it.
- The fall in the market was very largely due to the psychology by which it went down because it went down.
- Now, as we have seen previously, the great mature American companies do not consistently offer the greatest possibilities for capital gains
- **So the "performance" fund managers moved out of the two hundred biggest companies into, quite simply, stocks that would go up.**
    - They bought the growth stocks, the senior sisters like IBM, Polaroid, and Xerox, though they were not too senior in those days because they had not yet gone up the last 1000%.
- Not only did the "performance" fund managers buy the growth stocks – they traded them.
    - Trading was not for the Prudent Man; the short-term fluctuations in the market were not for him
    - The "performance" fund managers figured the safest way to preserve capital was to double it.
- A lot of the customers weren't interested in nice, balanced, diversified funds anymore. They wanted the funds that had gone up the most on the idea that those were the funds that would keep going up the most.
- Thus was performance born, out of distrust for fixed income, out of suspicion of the erosion of the dollar, out of the capital gains available from the companies that had some sort of lock on something, technological or otherwise.

- **Joe Namath may not have been the best quarterback in a decade, but the idea that Sonny Werblen had paid $400,000 for a quarterback gave a new dimension to a pro football league because nobody had ever paid that much for a quarterback.**
- Once the tide of "performance" started, there was no stopping. More fund management started aggressive, capital-gains-oriented funds.
- The characteristics of performance are concentration and turnover.
    - By concentration, as I said before, I mean limiting the number of issues.
    - Limiting the number of issues means that attention is focused sharply on them, and the ones that do not perform well virtually beg to be dropped off
    - If you have two hundred stocks, no one of them can make a real difference to you, but if you have only six stocks, you are going to be watching all six.
    - Turnover means how long you hold the stocks
        - If you buy stocks and put them away, your turnover is 0
        - If on December 31 you have replaced all the stocks you had the previous January with other stocks, your turnover is 100%.
- So there derives a great hunger for short-term information.
- They are concerned, not with what an investment is worth to a man who buys it "for keeps," but with what the market will value it at, under the influence of mass psychology, three months or a year hence.
- Thus the professional investor has been forced to concern himself with the anticipation of impending changes, in the news or the atmosphere, of the kind by which experience shows that the mass psychology of the market is most influenced.
- Nothing, for the foreseeable future, is going to hinder the impulse to volatility.
- At the moment "performance" seems like the logical reaction to worldwide inflation, inflation that reflects the aspirations of much of society running ahead of society's ability to pay for these aspirations on a current basis or at least the discipline of paying for aspirations traditionally.

Conclusion: Professional investors are "performance" managers who are focused on driving results in the short term. Very few "performance" managers think in the long term. It's all about driving big capital gains!

16. LUNCH AT SCARSDALE FATS'

- You get two phone calls, and lunch invitations, one from the old firm with Wedgwood plates in the private dining room and one from Scarsdale. You already know what stocks the Wedgwood-plates-dining-room people are selling. At Scarsdale's, you can find out – maybe, because there is a certain poker-game aspect – what some of your compatriots are up to, and nobody will try to sell you. Certainly not Scarsdale; he prides himself on not knowing anything, even though his corned-beef sandwiches are buying the best research in the country. All you have to do is stay friends.

Conclusion: Like everything in life, those that are really in the know!

17. LOSERS AND WINNERS: POOR GRENVILLE, CHARLEY, AND THE KIDS

- We live in an age of charts and computers, and the thing about charts and computer studies is that they show what is moving, and if everybody plays this game, then what moves is what is already moving.
- Maybe he doesn't have any of the money; maybe it's all tied up in trusts and he needs this job.
- Grenville should have all $100 million fully invested if the market is coming off the floor; his fund is "performance-oriented," trying for big capital gains.
- **But the market does not follow logic, it follows some mysterious tides of mass psychology.**
- This is what the French sociologist Emile Durkheim called anomie. In market terms, it means anxiety builds up as the market drops, and then as you get all the noise about "resistance levels" and so on, and the market goes plunging through them, and you get anomie.
- But when prices go up enough, everybody believes something, even if it is only that everybody else is just about to believe.
- **"The kids are taking everything over. It has gone from a garbage market to a kids' garbage market. Only the kids would buy this kind of garbage."**
- Everybody has some sort of infallible market indicator they use to help them in the difficult business of piling up a fortune, and I am in the process of devising one myself.
- Billy the Kid smiled tolerantly, well aware that the older generation has trouble figuring out the New Math, the New Economics, and the New Market.
- The strength of my kids is that they are too young to remember anything bad, and they are making so much money they feel invincible.

Conclusion: The market does not follow logic, it follows some mysterious tide of mass psychology.

18. TIMING, AND A DIVERSION: THE COCOA GAME

- The most brilliant and perceptive analysis you can do may sit there until someone else believes it too, for the object of the game is not to own some stock, like a faithful dog, which you have chosen, but to get to the piece of paper ahead of the crowd.
- Some markets want cyclical stock; some do a fugal counterpoint to interest rates; some become as stricken for romance as the plain girl behind the counter at Woolworth's; there

are some that become obsessed with the future of technology, and there are some that don't believe at all

Conclusion: If you are in the right thing at the wrong time, you may be right but have a long wait; at least you are better off than coming late to the party.

19. MY FRIEND THE GNOME OF ZURICH SAYS A MAJOR MONEY CRISIS IS ON ITS WAY

- The world, as T.S. Elliot said, cannot bear too much reality, and the Gnome counts himself a realist.
- Thus the Gnomes of Zurich came to stand for International Speculators or skeptics.
- We are cynical about the ability of men to manage their affairs rationally for very long.
- Particularly politicians. They promise things to the people for which they cannot pay. So we Gnomes stand for Reality or discipline.
- It's very difficult to reconcile your posture of saving the world with your balance of payments deficit.

Conclusion: Sooner or later you have to come to reality, and stop being a father to the world. Lead it, yes. Buy it. No.

20. IF ALL THE HALF DOLLARS HAVE DISAPPEARED, IS SOMETHING SINISTER GAINING ON US?

- The government is committed to full employment, and if it must pump money into the economy to achieve this, and if there isn't enough money, it creates the money.
- But it does seem easy to produce jobs with currency rather than productivity.
- Markets are only a tiny facet of society, but being made by mass psychology, they are a good litmus paper for what is going on.
- Markets only work when they believe, and this confidence is based on the idea that men can manage their affairs rationally.
- In the longer run, the actions of all the investors, individual and institutional, professional and nonprofessional, have to be based on the belief that leadership knows what it is doing and that rational men are handling the nation's business rationally.
    - If belief fades, then so do the markets.
    - They don't merely dive, they dive and then they disappear
- **Can it all come tumbling down? In a paper market based on belief, this fear is universal, no matter how deep it is buried.**

Conclusion: Sure, it can all come tumbling down. All it takes is for belief to go away!

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21.<u>THE PURPOSIVE INVESTOR</u>

- Do You Really Want to Be Rich?
- It is part of the ethos of this country that you out to be rich.
- You ought to be unless you have taken some specific vow of poverty such as the priesthood, scholarship, teaching, or civil service because money is the way we keep score.
- For our purposes Keynes is not the Master because he changed the course of economic history.
    - **He is the Master because he started with nothing, set out to become rich, did so part-time, from his bed, as a player of the Game, and having become rich, had some thoughts that must be integral to any study of the Game.**
- All purposeful money-making impulses come from the thousands of years of economic scarcity.
- But wealth is not pursued solely as an answer to scarcity.
- The compounding of wealth, like the building of the City, is part of the much older game of life against death.
    - Immortality is spurious because that particular wheel is fixed
    - You do have to lose in the end.
    - That is the way the senior game is set up: You can't take it with you.

Conclusion: You need to create your own money philosophy to answer the question do you really want to be rich.

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