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LAUREN FOSTER: Hello, everyone. Welcome to the *Take 15 Podcast* from CFA Institute. I'm Lauren Foster and this is the show where we bring you an unbiased lens on investing and capital markets through short conversations with some of the world's most interesting and accomplished people.

Today on the show, a very special guest, Robert Hagstrom, author of the New York Times best seller,*The Warren Buffett Way,* which considers how the Oracle of Omaha analyzes stocks and makes investment decisions. Robert has written a number of other books, including *The Warren Buffett Portfolio* and *Investing, the Last Liberal Art.* He's a CFA charter holder and a senior portfolio manager at equity compass, where he launched the global leaders portfolio.

Robert also serves as chairman of the investment management committee for Stifel Asset Management. Robert and I talked about what motivated him to write his first book, his writing process, the challenges of managing high active share portfolios, hiring and firing managers, and how to live up to Charlie Munger's maxim-- "go to bed smarter than when you woke up."

We packed a lot into our brief time together and I hope you enjoy the conversation. As we start the new year, I want to say thank you for listening and subscribing to the show. I wish you and your loved ones peace and good health in 2021.

Robert Hagstrom, welcome.

ROBERT HAGSTROM: Hi, Lauren.

LAUREN FOSTER: It's so great to see you. The last time we were together it was beautiful, sunny Chicago. And we found ourselves as deskmates in the auditorium for a seminar for global investors. So it was great to meet you then.

ROBERT HAGSTROM: Yes, I had a good time. That was a great conference in July, 2019. I remember it well.

LAUREN FOSTER: And you delivered a really interesting presentation on liberal arts investing. And I would tell listeners they should Google enterprising investor, Robert Hagstrom, liberal arts investing and they could find both a summary there and your actual presentation. So that's a good place to start.

ROBERT HAGSTROM: Great, great.

LAUREN FOSTER: So I thought a fun place for us to start would be your investment origin story. You didn't exactly intend going into the money management world. Tell us how you landed up there?

ROBERT HAGSTROM: Yeah, I wasn't one of those people that the hand came down between the clouds and the finger said, you're going to be a money manager. I was a political science major in college. And I wanted to go to Washington and write. I always enjoyed writing. I wrote for the school newspaper, and local newspapers in Philadelphia.

I got to Washington and found out I didn't much care for that environment and came back to Philadelphia. A local newspaper that I had written for, I wanted to write for them. And they couldn't afford to pay me. But they said if I sold advertising, quarter page ads in the newspaper, once a month they'd let me write a column.

So this was the early '80s, around '83. And I would go up and down Lancaster Avenue, Route 30 and bang on doors. And one day I came across something called Legg Mason Wood Walker, members of the New York Stock Exchange. I thought it was a law firm, I had no idea what it was.

And walked in and said, hey, would you like to buy a quarter page ad in the newspaper? And the manager said, no, would you like to be a stockbroker? So that's how I fell into it. I became a stockbroker advertising.

LAUREN FOSTER: And the rest is history. OK, so you've made a very successful sort of dual career, both as an investor and a money manager as well as an author. And your, I believe, it's 10th book is coming out in February.

But it was really your first book, *The Warren Buffett Way* that sort of launched your career as a writer. And just so listeners know, that instantly became a New York Times bestseller. I read that it spent a staggering 21 weeks on the New York Times hardcover non-fiction best seller list and sold over a million copies. So, wow, congratulations on that one.

So take us back in time, did you always know that you would one day have a book in you? And there were lots of books I'm sure even then on the Oracle of Omaha. What made you write this book?

ROBERT HAGSTROM: Well, you know, first of all, a New York Times bestseller is always made possible when you've got the right topic. So Warren Buffett was the right topic to write about. I think actually it was the very first book, there was a smaller book that John Train wrote.

John Train wrote a very great book called *The Money Masters* in 1980. And profiled Warren Buffett and Phil Fisher, Ben Graham. Shortly thereafter he wrote a very small book called *The Midas Touch* in the early '80s, didn't do very well. But when I did the book in 1993, going in 1994 it had a lot to do with the CFA Institute, believe it or not.

At that time you might remember, 1992, we would call the Association of Investment Management and Research, came out with performance presentation standards. And that if you were going to publish your performance, it needed to be discretionary.

I was, at the time, working for a small investment counseling firm which was very much like a trust company. We interacted with our clients. We would do tax loss selling. We would buy stocks that they wanted to have particular. So you could look at that track record and see that it was 100% discretionary.

So I said to my colleagues, I said, if we're ever going to have a published track record, we need to make it discretionary. We need to figure out what to do. And they said, well, what do you think? And I said, well, I'd love to do a Warren Buffet type portfolio.

I said, let me write up a marketing plan on it and kind of a white paper on it. And they said, go ahead. And that white paper actually turned into kind of like a book proposal that was picked up in New York.

And someone said, a great guy named Miles Thompson, who at the time was at John Wiley, thought it would be a good book. And I took off and started writing it, took about a year. And in the blink of an eye, the book was published and two months later, we were on the New York Times bestseller list. It was a whirlwind.

LAUREN FOSTER: That's amazing. So I guess over about a 25 year period, 10 books. That's about a book every two or so years.

ROBERT HAGSTROM: Yeah.

LAUREN FOSTER: I'm curious about the writing process. Sort of how do you juggle it and how do you do it?

ROBERT HAGSTROM: Well, the important thing is that being an investor, I write investment books. So I'm not doing anything that takes me off my craft, whether it is writing or investing for my clients. One enhances the other, so to speak. And I do think writing makes you smarter about the material. I mean, you get really good about what you're studying when you actually start to write it down on paper.

But when I write a book, I never think about writing a book. I really do think about writing a series of term papers. A non-fiction book, which is different from a fiction book, but a non-fiction book is nothing more than a series of term papers that you're walking the reader through what you want to explain, what you're trying to describe.

And so when I write a book, and I try to write a book within a year's period of time, I think about eight, nine, 10 term papers, 25, 30 page term papers that I'm going to write. I try to knock out one a month. And in 10 months, the book is pretty much done. It leaves you a few months to edit and clean it up.

So I really take it slowly on a month by month basis. And it doesn't seem to be overwhelming when you approach writing in that way.

LAUREN FOSTER: So just getting back to *The Warren Buffet Way,* just briefly, just give us sort of a cliff notes version without giving away the whole book. Just tell us sort of one or two key things in that book that might entice them to read some more.

ROBERT HAGSTROM: Well, what we did was everything that was written in *The Warren Buffett Way* was loosely noted in all of the Berkshire Hathaway annual reports that had been written since 1965 into the 1970s. And there were magazine articles and things of that nature. And so I divided them into four categories.

When Warren thinks about buying a stock, or a business, and they're synonymous in his mind. There's no difference between him buying a private business for Berkshire and buying a common stock. He thinks about the business, what we call the business tenants, how to think about a business. The description of the business, simple and understandable, long term favorable prospects.

We go through the management tenants, how to think about management. We then go through the financial tenants, what are the economics that he's looking for in and his companies? And then lastly we do the valuation work called the market tenants, where we do the discounted present value.

So the trick in the book was to organize all of these tenants individually. But then the trick was, what worked out well, we took all the major stock positions that Warren had bought over the years from Washington Post, Capital Cities, ABC, American Express, Coca-Cola was the big one. And we lined up each of those purchases along the tenants and they worked out beautifully. And so it really became a method book, a learning book about how to think about stock investing the way Warren does.

LAUREN FOSTER: So one of your titles that really sort of piqued my interest, partly because one of my former colleagues, Jason Voss, who's a charter hold, one of the smartest guys I know, had talked about some books that shaped his career as an investor. And one of them was, *How to Solve a Murder, the Forensic Handbook.* Another one was *Crime Scene from Fingerprints to DNA Testing,* which got me thinking about your book *The Detective and The Investor, Uncovering Investment Techniques from the Legendary Sleuths.* So tell us, what can investors learn from these great literary detectives.

ROBERT HAGSTROM: Well, actually it was my dad. My dad turned me on to reading mystery books. And so the book was really kind of a testament to him.

But if you go through what are called the great detectives. If you think about the great detectives, there really are three of them. Auguste Dupin, who was the very first one, who Edgar Allan Poe invented the very first detective. And then obviously Sherlock Holmes was the second. And then the third was from Gilbert Keith Chest, *The Father Brown.* And what was common about all three of these, they solved mysteries by their mental acumen, their mental capabilities.

They didn't pistol whip out a confession. They didn't break into something. I mean, they did it by their mental abilities. And so what I did was go through each of the short stories and tease out what I thought were the methods each of these detectives used. And then lined it up how an analyst or a portfolio manager ought to think about a stock as if they were a detective trying to solve a mystery. That was the outline of the book.

LAUREN FOSTER: That sounds great. So something that we talked about on the phone a little bit earlier that you've been thinking about a lot is the challenges of managing high active share portfolios. And you mentioned to me that there's sound evidence for holding a concentrated portfolio. But there are also some challenges associated with that. Can you just walk us through your thinking on that?

ROBERT HAGSTROM: Yeah, well, this also came out of *The Warren Buffett Way.* In *The Warren Buffet Way* we didn't talk about portfolio management. We were just so focused on stock selection we didn't get into portfolio management. But I did realize I left out the very important part, which is now that you've got a stock, how do you think about putting it together a portfolio.

So the second book I wrote was called *The Warren Buffett Portfolio.* And it was called *Mastering the Focus Investment Strategy.* Well, focus investing came from Warren. Warren said, Robert, we're just focused investors. We focus our portfolios. And so I called it focus investing. And there were some focus funds back in those days.

But the real academic leap that occurred in doing really solid academic evidence of why, what they called high active share portfolios outperform, goes back to 2009 was Martijn Cremers and Petajisto-- and it was in the *Financial Analyst Journal*-- that to the degree that you reduce the number of stocks in your portfolio you increase the odds of being able to beat the market. And to the degree that you have too many stocks in your portfolio, you really become more like the index itself.

And by the time you reduce the returns by your management fees, and trading expenses, and things of that nature, we began to discover why big, widely diversified, high turnover portfolios rarely beat the market. It was a matter of composition. And so when you begin to understand the way to beat the market is to concentrate on fewer names, not more, hold them longer term, not trade them, then you have the pathway in which to think about how to beat the market. So it really seemed to be kind of rational and commonsensical.

LAUREN FOSTER: What are some of the challenges though, and we talked about this--

ROBERT HAGSTROM: Yeah, there are immense challenges. And most of them have to do not with the complexity of running a high active share portfolio. It is the challenges of running a high active share portfolio in an industry, our money management industry, that struggles with variance, tracking error, periodic underperformance. The data's very clear, over time these high active share portfolios, if you have the skill, one, skill of picking stocks, two, the conviction to hold the stocks despite the market not being in favor of them any one month or quarter whatever the case may be.

And then ultimately as Cremers pointed out in a follow up article in 2016, it's the opportunity. You have to have the opportunity to manage that portfolio. You have to have clients that are willing to give you that opportunity to manage a high active share portfolio. And there are very few clients that actually have the emotional whereforall to be able to think about a high active share low turnover portfolio that's going to underperform the market maybe 30% of the time, 40% of the time. And that's very hard emotionally for a lot of clients to do.

LAUREN FOSTER: So maybe that's a good segue to talking about sort of hiring and firing managers. We we're having this conversation. So the tail end of 2020 which seemed like it would never end. But 2021 is here and will be here.

And I guess as the year rolls around, many people are looking at performance and thinking, do I retain this manager, do I fire this manager? How can investors who are selecting active equity managers maximize their odds for success? And how should they be thinking about their managers, not just focusing on performance?

ROBERT HAGSTROM: Well, the way in which hiring and firing managers typically occurs is they look at their roster of managers at year end. And those that underperform are given the exit door and those that outperform are asked to join the party. And so it is based upon outcomes, right? You fire those that underperform and you hire those that outperform.

The problem is that the work was done, and it was two great professors, one guy named Amit Goyal down at Emory University, another one, Sunil Wahal at Arizona State University. They did this terrific study. I think they looked at 6,200 institutional portfolios of about 1,500 investment managers.

And they did it over a 15 year period of time. And they went back and looked and found, in fact, to the degree that you fired managers in your portfolio that underperform, lo and behold, a year or two later they were outperforming the managers that you'd then subsequently hired when you fired them.

So you had a manager that underperformed, you fired him, gave him the exit. Then they looked at the returns of those that were fired and found out that a year later, two years later, they were actually outperforming the manager that you just hired because you bought a manager that had just the most recent best performance.

So the selection of portfolio managers based upon outcome can be a very dangerous thing. It's a very slippery slope unless you understand the process. And so if high active share portfolios, academically, will tell you that's the way in which you should manage money, you have a high active share portfolio manager that just happened to underperform because they are going to underperform, one out of three years, and you fired them, well, that's probably not a good way to think about it because you didn't understand the process.

And so the key is understanding the process of your manager is the process, a good process, is it a successful process? Is it demonstratively successful? And then understand that it has ebb and flow of performance issues. And understand that as opposed to relying solely on outcomes. And that's the challenge.

LAUREN FOSTER: So I should just mention to listeners that you actually wrote a blog about this for an enterprising investor. And they can go back and find that if they'd like to read about it, was January 2019. And was called *Hiring and Firing Portfolio Managers, Process and Outcome.* So they can dig a little bit deeper into that if they want to.

I know that you like to live by Charlie Munger's sort of maxim-- "go to bed smarter than when you woke up." So how do you ensure that each day you become smarter? And I'm also curious about what role creativity plays in your process, how you kind of keep creativity flowing.

ROBERT HAGSTROM: Well, it is creativity, Lauren, I think it's also curiosity. Being a liberal arts major, I was a political science major in college, but really it's a liberal arts background. And Charlie's great speech that he gave at USC in the early '90s was the art of achieving worldly wisdom. And we wrote a book on it called *Investing, the Last Liberal Art,* which is if you went through all the major studies physics, biology, math, philosophy, psychology, history, sociology, on down the line, like you're a liberal arts major.

And you teased out the major mental models of each of those disciplines, what could you take to the table as an investor? And in fact, as Charlie pointed out, there's a lot of information there, a lot of insights that you can get in these liberal arts courses that will make you a better investor. And so it began a curiosity addiction, so to speak.

When I finished the book in the first edition I went, gosh, I can't believe all this that I've learned. So I continued to read and different disciplines. So we all read the newspapers. And we read the magazines, and the financial analysts journal. We have to read our profession's go-to work. But I probably spent half my time or if not more on reading about different things and different-- philosophy, psychology, biology, physics.

I spend a lot of time in different disciplines and I seem to come up with a little insight that you didn't necessarily get from the Wall Street Journal or Barron's that week. It's almost addictive, you're always looking for another way in which to explain something.

LAUREN FOSTER: So you're obviously very widely read. And you've contributed soon to be 10 books to the library that's out there. Are there one or two books that you find yourself often returning to or recommending, whether it be to students or young investors? Anyone out there?

ROBERT HAGSTROM: Well, that's a great question. I'm looking off at my library now. And there's, gosh, you know, hundreds of books up and down the thing. I do go back to the classics in philosophy. Anything that William James wrote about pragmatism, anything about the study of pragmatism I will read and reread over and over. Because our whole business, I think the success of investment management is a practice of pragmatism. You're trying to figure out what works, right?

Pragmatism is trying to figure out the cash value of an idea, and does it work? As opposed to hanging on to absolute ideas and stubbornly hanging on to them when that's long been recognized that they don't work anymore. So pragmatism is a huge, huge philosophical additive to investment management. Wittgenstein, Ludwig Wittgenstein, tremendous philosopher did a lot of work on the philosophy of language.

And it's well known that the descriptions that we come up with are meant to form an explanation, right? So let's put it this way, any time you go back in your life, and you look at your failures. And it's usually a failure of explanation, you explained it wrong, whatever it was. And it was all based upon the fact that your original description of what was going on was wrong. So you failed to describe something which then formed the incorrect explanation.

Wittgenstein teaches you that the world is very compatible with many various different descriptions at any one point in time. Your trick as an analyst, as a portfolio manager is to make sure you've got the right description of what's going on. And so that's a lot of fun. I think any time I'm looking at a stock, I'm coming up with how many different descriptions I can come up with of that company. How many different ways can you think about it, or the industry? And Wittgenstein is terrific in that area.

LAUREN FOSTER: Yeah, so one thing we often think about a lot in investing is sort of luck versus skill. And when we had our conversation ahead of this, you had mentioned there were some, I guess, fortuitous events with your first book in terms of who wrote the foreword, a fortuitous review. So there was maybe a little bit of element of luck in addition to the skill. When we think of investing and luck versus skill, how do you think about those two elements?

ROBERT HAGSTROM: Well, first of all, when you say luck and skill, I always remember my good friend Michael Mauboussin, who I know you know. And Michael's an adjunct professor at Columbia, he's now at Counterpoint Global at Morgan Stanley. And he does a lot of writing in this area of luck and skill and trying to disentangle what is luck and what his skill. But undoubtedly, it's good to be lucky too. But you've got to have the right skill set at the time when luck shows up.

And so we talked about publishing *The Warren Buffett Way.* It was just so lucky for me. I mean, the skill was there. We wrote the book, we did the methods. But it was luck that the book was published at that time. Because when it came out in '93 and '94, the market had been suffering. We'd come out of recession, stock returns weren't doing very well. So there was demand to try to figure out what worked.

I mentioned to you that we used a lot of quotes from the Berkshire Hathaway Annual Report. I had to write Warren a letter and said, you know, Warren, you don't know me. But I'm going to write a book about you. May I have your permission to use your copyright material? And I had to go through that. And eventually he gave me permission.

Peter Lynch wrote the foreword. How I got Peter Lynch wrote the foreword was total luck, because I happened to know John Rothchild who ghost wrote many of Peter's books. And we asked John, John, can you check and see if Peter wants to do the foreword?

And so he contacted Peter. Peter contacted Warren. And Warren said, well listen, the kid's OK. He did a good job. It's up to you whether you want to do the foreward or not. So Peter Lynch did the foreword.

And then the real one was that I mentioned Phil Fisher, a great investor, in the book. And I said, Phil Fisher had a huge impact on Warren. Of course Ben Graham, huge impact. But we underestimate how much Phil Fisher influenced him. Well, his son is Ken Fisher, who at the time was a columnist at *Forbes* magazine. And he was so touched with the way I treated his father in the book that he wrote a very nice review about it.

So I mentioned to you, it was during the Thanksgiving weekend. I was in New York walking down Fifth Avenue at the Barnes and Noble. And there's a big picture of the book, huge picture of Warren Buffett, the great picture of *The Warren Buffett Way.* And at the top in blue was, foreward by Peter Lynch, one of the great money managers of all time. And off to the side was a quote from *Forbes* magazine saying, best book of the 1990s. Buy it and read it.

And at the very, very bottom, at the bottom right, less than a half an inch tall was, by Robert Hagstrom. Well, when all of these confluences came together at that time, it was a lot of luck that that book received the treatment that it did. The planets aligned very nicely. But luck works when opportunity meets luck. And I had a great opportunity. And so I never underestimate how lucky I've been in my life.

LAUREN FOSTER: So just one more extension of that sort of luck versus skill. When you think of some great investors, what do you think separates the best from the average investor?

ROBERT HAGSTROM: They understand process. I mean if you really get down to it, they don't get hung up on outcomes. Yeah, they want to win. There's no doubt. I mean, all great investors are competitors. They're athletes, if you will. They want to win. They want to score well. But if you look at all the great investors, they were more beholden to their process than they were their outcomes.

They understood the process. And they worked to improve the process and recognized that outcomes are variant. Sometimes you win, sometimes you don't. But if you've got the right process, their willingness to that process is what made them great over time.

LAUREN FOSTER: So the way we wrap up our conversations, I always ask is the same two questions. And the first question, and the idea was from a NASA education model for students, asking students to think about they're about to go on a long duration space flight, and they have to take one object with them. And what does that object and why? So putting you on the space flight. You're about to go into space.

ROBERT HAGSTROM: Oh, gosh.

LAUREN FOSTER: What object would you take with you?

ROBERT HAGSTROM: If I was going to be in a long space flight, I guess I would have a Kindle with the greatest amount of memory with all of the greatest books that I could ever come up with. I'm looking at a book that I just got, it has 52 of Harold Bloom's greatest novels. And to go through those. So I would just stock it full of everything that I haven't read that I want to read. And I would enjoy the ride. I assure you, I would enjoy the ride.

LAUREN FOSTER: And then the last question is what we call the ray of sunshine question. And this is something I borrowed from Trevor Noah way early in the pandemic. He would always end his session with this little clip at the end called the ray of sunshine. And so I ask people to think or to say what they hope will be one long-lasting positive outcome of the global pandemic?

ROBERT HAGSTROM: My personal hope of the outcome of the pandemic will be a re-engagement of globalization again, that we can't do this alone. That we have to work together. We have to support each other. We have to be allies with each other. We have differences, yes, we do. We have different systems, yes we do.

But I think going it alone causes us more problems. And I think we've learned that going alone was not necessarily the right way here, that we need to be integrated as a global community. And if we can get back to some type of integration of our global relationships, that will be my ray of sunshine going forward.

LAUREN FOSTER: Well, my ray of sunshine today was having you on the show. So thank you so much for joining me. It a pleasure speaking with you.

ROBERT HAGSTROM: Always great to be with you, Lauren, best of luck.

LAUREN FOSTER: Take care.

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