Chapter Eight: *Super-Signals*

by Nathan Polackwich

Judgment, like most everything, is a skill you can develop. How? To some degree it just takes time. Judgment improves as experience grows.

One benefit of experience is that it helps to more quickly identify critical information. Consider the reactions of experienced and novice drivers in a busy city, which Dietrich Dorner contrasted in *The Logic of Failure*. The novice, naturally, finds it incredibly stressful. Not knowing where danger may lurk, he must pay close attention to *everything*. But the experienced driver, having learned what to watch out for, can overlook the irrelevant and react solely to what Dorner calls "super-signals." As Dorner wrote, for the experienced driver, "a traffic situation is not made up of a multitude of elements that must be interpreted individually. It is a 'gestalt', just as the face of an acquaintance instead of being a multitude of contours, surfaces, and color variations, is a 'face'."

Warren Buffett reportedly spends little time analyzing potential investments. Long experience has taught him to quickly recognize the "face" of a great opportunity. What does he see that others don't? Buffett's investment in packaged food company General Foods in the late 1970s is instructive.[1] This was the age (the first one, anyway) of oil and oil stocks due to the 1973-1974 OPEC oil embargo and then the 1979 Iranian Revolution. At that time, most investors weren't interested in a boring company like General Foods. If anything, they had an aversion to it because they feared that sky-high oil and other commodity prices would increase its costs and hurt profits.

Buffett looked past these concerns. He recognized that General Foods had something extremely valuable – its "shelf space" in supermarkets, which came from the powerful brands it owned. Supermarkets had to sell (and prominently display) General Foods' market-leading products like Maxwell House, Kool-Aid, and Post. Thus, despite higher costs, General Foods continued to earn a reasonably good return on investment simply by raising prices.

Then something unexpected happened. Persistently high oil prices changed people's behavior and significantly dampened their demand for gasoline. After peaking in 1980 at around $40, the price of a barrel of oil plummeted, eventually hitting $10 in 1986. Suddenly, rather than facing a stiff headwind, General Foods had the wind at its back. Not only were its costs dropping faster than its prices, but consumers had more money in their pockets. Profits exploded. In 1985 General Foods was acquired by Phillip Morris, and Warren Buffett made a killing.

Did Buffett foresee the oil price collapse? Did he predict the take-over by Phillip Morris? Nope. He simply concluded that General Foods had a tremendously valuable asset – its shelf space – which other investors, due to their infatuation with all things oil, were under-appreciating.

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[1] The story of Buffett's investment in General Foods was detailed by stock market commentator Jeff Matthews on his popular investment blog, jeffmatthewsisnotmakingthisup.com

Experience usually has another benefit, particularly when confronting chaotic systems like the stock market. It humbles you. The longer you play the Winner's Game, the less confidence you'll have in your opinions. As discussed earlier, this is a good thing because overconfidence often leads to excessive risk-taking and exposure to huge losses when things go wrong, which they inevitably do. The overconfident then make a final error in judgment: Because they lack humility, they don't acknowledge when they're wrong, and therefore struggle to sell their losing stocks and move on. Often, they even add to them, throwing good money after bad and compounding the mistake. Occasionally, the overconfident completely self destruct and permanently knock themselves out of the game.

I actually find the experience of taking losses cathartic and a relief. There are few problems and worries in life you can eliminate so easily. And not only do you get a tax benefit on the loss, but you can also add the left over money to stocks you own whose underlying businesses have proved their mettle. These companies may even benefit from the problems of weaker competitors – perhaps like the company you just sold. One of the most liberating realizations an investor can make when confronted with a losing stock is that *you don't have to make it back the same way you lost it*.