The VIEW from BURGUNDY

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PERFORMANCE KILLERS

The following issue of The View from Burgundy *was initially written as a consequence of the times, but the information contained remains applicable and is considered "timeless." The value philosophy described remains useful today and into the future.*

THE 1990S HAVE BEEN AMONG THE BEST YEARS in history for investors in the capital markets. Yet we know many intelligent people with money to invest who have done much worse than they should have, in a period when great returns were there for the taking. There are many reasons for poor investment results. We believe that some basic behavioural traits cause the most common mistakes. In this issue of *The View from Burgundy,* we will share experiences and observations on this subject, so that perhaps we can help some people become more successful investors. Here are some of the "performance killers" we have witnessed:

Fear of Opportunity and Misjudgment of Risk

Traditional economics teaches us that when prices for goods are low, demand is stimulated, but that as prices rise, demand declines. This is the concept of demand elasticity and every former economics student knows how to graph the relevant curves. If you offer a "bargain," be it for winter coats or sirloin steaks, the lower prices will normally attract more buyers.

Oddly, it seems that in the investment world the opposite is true. High prices attract more investors. As prices of individual securities or mutual funds rise in a bull market, more people become buyers, which bids up prices even further. And as stock prices rise, the executives of public companies, and their handmaidens, the large securities firms, create new issues for the investor to buy. Eventually supply exceeds demand and prices decline.

Benjamin Graham, the father of value investing, wrote a classic article for *Ladies Home Journal* in the 1940s in which he (having despaired of inculcating sensible investment habits in the nation's men) addressed the following brilliant exhortation to America's women: "Ladies, buy stocks the way you buy your groceries, not the way you buy your perfume."[1] There exists no better quick summation of the value investor's approach. Hard-headed calculation and a focus on price and that elusive thing called value is the basis of this method. Most of us can recognize value when we see it at a supermarket or at a hardware store. We have a little more trouble in a jewelry store or in a perfume boutique, where considerations of status, emotion and perception come into play. Value investors believe that any sensible person can behave the same in the stock market as in a supermarket. If a good stock is "on sale" in the stock market, it should be bought, period.

But, just as high prices seem to attract investors, so too do low prices seem to scare them off. We believe that the best way to make money is to own outstanding companies run by capable management, which can be trusted to act in the interests of shareholders. But everything in the market has its price, and the long-term returns from even the best investments are heavily influenced by the price you pay for them. Someone recently calculated that if you had bought the "Nifty Fifty" stocks of 1972 at their very highest prices

(and they were VERY overpriced) and held them until today, you would have outperformed the S&P 500 Index. That person's point was that you should be able to buy good stocks anytime and that you will eventually do well; this is, theoretically, a good point. In practice, however, waiting 20 years for your investments to come onside is something few investors have the patience or the resources to do. On the other side of the ledger, if you had bought the "Nifty Fifty" stocks in 1975, when they were bombed out and deeply unpopular, you would have returns like Warren Buffett. That's basically what he did. So, the difference between the patient investor and a Hall-of-Famer like Buffett is in large part the price at which stocks are bought.

Market Timing, Pessimism and Bearishness

In the last three years, probably the largest single performance killer has been market timing. Some people confuse opportunism with market timing, but they are entirely different things. Opportunism is focused on individual businesses and stocks, while market timing is based on general sentiments about "the market." Opportunism is based on optimism – it looks for a break in a company's stock price but maintains a belief in the attractive nature of the company's business. Market timing is based on a pessimistic assessment of market valuations, economic forecasts or political risks. Not surprisingly, specific optimism beats generalized pessimism most of the time. After all, if someone doesn't want to invest in good markets, what are the chances they will act in bad ones?

Bearishness has its attractions. There is something in human nature that finds it deeply rewarding to look on the dark side, and certainly the stock market – with its extravagant tales of cupidity, sleaze and stupidity – is a fine theatre of the absurd for the cynical and the skeptical. And, of course, while bulls make most of the money, bears have most of the good lines.

At Burgundy, we think that Jim Grant – publisher of *Grant's Interest Rate Observer* – offers the best and most consistent financial writing. Grant's general bearishness is expressed in a writing style so fluent and shot with humour that he has kept the honest esteem of investment professionals, despite being consistently far too early in his projections of loss and gloom. Indeed, one of the small, but meaningful consolations of the next bear market will be to attend the Grant's conference in New York City and to applaud Jim for his acutely perceptive foresight. Nonetheless, we are reminded of what Warren Buffett calls the Noah principle: "Predicting rain doesn't count, building arks does."[2] Everybody knows markets will go down; the problem is to do something sensible about it with your money.

The great investors and moneymakers throughout history have been optimists. Warren Buffett's ease and grace are based on a fundamentally happy view of the world. Listening to John Templeton enthuse about the excitement and opportunities of our times is a good antidote to depression. Even Ben Graham, who is often taken as a patron saint by the bears, was an optimist who found a way to make money in the toughest equity markets in history. Phil Fisher, Peter Lynch, all these great investors were – despite their very different approaches – fundamentally people who felt they were surrounded with opportunities to be seized, not risks to be avoided.

Just as you study Bach to learn music and Einstein to learn physics, we feel that you should look to these great investors to learn about investing. An optimistic attitude, desire for a margin of safety and a focus on specific opportunities is what we believe must be fostered by would-be investors. As Buffett says: "The most common cause of low prices is pessimism... we want to do business in such an environment, not because we like pessimism but because we like the prices it produces."[3] Too many market timers simply like pessimism.

Not Doing Enough Homework

It is amazing how little work and thought most people put into their investments. For some reason, the stock market induces a type of behaviour in people that is seen nowhere else in their economic lives. They act largely on impulse and rely to a large extent on specific advice from so-called "experts" in stock market matters.

Think about the big-ticket purchases most people make in their lives. There are certain minimum levels of investigation undertaken by almost everyone, which guarantee a degree of satisfaction with those purchases. In the case of a house purchase, people have an idea of the type of house they want, the neighbourhood, access to transit, good local schools, and so on. They would hire a lawyer to inspect the title to the property, ensure that there were no liens against it, and handle the closing. An engineer would probably be hired to perform a house inspection. The price paid would be compared to other recent transactions in the neighbourhood.

In other words, a house buyer expects to give the purchase serious thought, and spend both time and money to avoid obvious problems. Now, contrast that behaviour to the type of thing we see intelligent people doing in the stock market every day. Stocks are bought because of tips from relatives, friends, brokers – even from total strangers. Mutual funds are bought solely on past performance, without even looking at the kind of investments the fund makes or the level of risk the manager takes. Investment managers or brokers are given, without much insight into their competence, total discretion over someone's entire life savings.

We have a modest proposal. If you do your own direct investing, approach a stock purchase the way you would approach a car purchase. Kick the tires! Look for a few good companies at attractive prices. Find out about the business: its economics, management, track record and barriers to competition. Good investing is just common sense. For example, two of our favourite stocks, Johnson & Johnson and Rubbermaid, were purchased in part because our partners' families had personal experience with the excellence of the companies' products. If you have kids, you've probably bought a lot of J&J products and when you take out the garbage or do the dishes, chances are you've used Rubbermaid goods. This isn't exactly rocket science, just common sense. The famous Peter Lynch, star fund manager, wrote a good book about common-sense investing in 1989 called *One Up On Wall Street*.

If you lack the time or interest to do your own investing, make sure you do your homework about the investment manager you hire. Interview several different managers, check their investment philosophies, look at their track record and, most important, carefully check their references. Establish a high level of comfort before acting. Remember, the investment business is primarily about people, not just numbers.

Hyperactivity and Frictional Costs

The secret to successfully compounding capital is to hold investments for the long term. If you buy stock in a good company and hold it for a very long time, it will compound in value, and you won't have to pay tax on the accrued capital gain until you sell it. It sounds simple, doesn't it? But like most simple things, it is not easy to do.

For one thing, the whole structure of the financial industry works against it. Stockbrokers, financial planners and underwriters only make money when there is a transaction. For them, a client using a buy and hold strategy is a nightmare. They exert all their considerable persuasive abilities to get clients to do something – to do anything, in fact. Yet buying and holding is the best strategy to use in the stock market.

There is another market participant that just loves hyperactivity and profit taking: Revenue Canada.

Generally, the taxman only collects when a transaction is made. We mentioned earlier the great value of buying and holding as a tax deferral strategy. Warren Buffett, in the 1993 Berkshire Hathaway Annual Report, had a valuable story on this subject of postponing taxes:

"Through my favourite comic strip, Li'l Abner, I got a chance during my youth to see the benefits of delayed taxes, though I missed the lesson at the time. Making his readers feel superior, Li'l Abner bungled happily, but moronically, through life in Dogpatch. At one point he became infatuated with a New York temptress, Appassionatta Van Climax, but despaired of marrying her because he had only a single silver dollar and she was interested solely in millionaires. Dejected, Abner took his problem to Old Man Mose, the font of all knowledge in Dogpatch. Said the sage: Double your money 20 times and Appassionatta will be yours (1, 2, 4, 8,..., 1,048,576).

My last memory of the strip is Abner entering a roadhouse, dropping his dollar into a slot machine, and hitting a jackpot that spilled money all over the floor. Meticulously following Mose's advice, Abner picked up two dollars and went off to find his next double. Whereupon I dumped Abner and began reading Ben Graham.

Mose clearly was overrated as a guru: Besides failing to anticipate Abner's slavish obedience to instructions, he also forgot about taxes. Had Abner been subject, say, to the 35% federal tax rate that Berkshire pays, and had he managed one double annually, he would after 20 years only have accumulated $22,370. Indeed, had he kept on both getting his annual doubles and paying a 35% tax on each, he would have needed 7-1/2 years more to reach the $1 million required to win Appassionatta.

But what if Abner had instead put his dollar in a single investment and held it until it doubled the same 27-1/2 times? In that case, he would have realized about $200 million pretax or, after paying a $70 million tax in the final year, about $130 million after-tax. For that, Appassionatta would have crawled to Dogpatch. Of course, with 27-1/2 years having passed, how Appassionatta would have looked to a fellow sitting on $130 million is another question.

What this little tale tells us is that tax-paying investors will realize a far, far greater sum from a single investment that compounds internally at a given rate than from a succession of investments compounding at the same rate. But I suspect many Berkshire shareholders figured that out long ago."[4]

Many of our most successful clients have made their fortunes by owning their own companies. Usually these companies were not publicly traded, at least for the first few years. This is an enormous advantage! These private-company owners don't pay much attention to the valuation of their business, only to its operations and markets in which it operates. They get the advantage of "compounding" without "frictional costs." When they decide to sell, it usually takes a long time and involves detailed negotiations to arrive at a fair price – these decisions are not made lightly. But in the world of publicly traded stocks, you can buy or sell quickly by just calling your broker, or even transacting through the Internet. This kind of liquidity sometimes encourages transactions and activity, often to the detriment of the investor.

The advantages of long-term investing with a more reflective attitude were well explained by Buffett in the famous *Mr. Market Story* in the 1987 Berkshire Annual Report:

"Whenever Charlie and I buy common stocks for Berkshire's insurance companies… we approach the transaction as if we were buying into a private business. We look at the economic prospects of the business, the people in charge of running it, and the price we must pay. We do not have in mind any time or price for sale. Indeed, we are willing to hold a stock indefinitely so

long as we expect the business to increase in intrinsic value at a satisfactory rate. When investing, we view ourselves as business analysts – not as market analysts, not as macroeconomic analysts and not even as security analysts.

Our approach makes an active trading market useful, since it periodically presents us with mouth-watering opportunities. But by no means is it essential: a prolonged suspension of trading in the securities we hold would not bother us any more than does the lack of daily quotations on World Book or Fechheimer. Eventually, our economic fate will be determined by the economic fate of the business we own, whether our ownership is partial or total.

Ben Graham, my friend and teacher, long ago described the mental attitude toward market fluctuations that I believe to be most conducive to investment success. He said that you should imagine market quotations as coming from a remarkably accommodating fellow named Mr. Market who is your partner in a private business. Without fail, Mr. Market appears daily and names a price at which he will either buy your interest or sell you his.

Mr. Market has another endearing characteristic: he doesn't mind being ignored. If his quotation is uninteresting to you today, he will be back with a new one tomorrow. Transactions are strictly at your option. Under these conditions, the more manic-depressive his behaviour, the better for you.

But like Cinderella at the ball, you must heed one warning or everything will turn into pumpkins and mice. Mr. Market is there to serve you, not to guide you. It is his pocketbook, not his wisdom, that you will find useful. If he shows up some day in a particularly foolish mood, you are free to either ignore him or to take advantage of him, but it will be disastrous if you fall under his influence. Indeed, if you aren't certain that you understand and can value your business far better than Mr. Market, you don't belong in the game. As they say in poker, "If you've been in the game 30 minutes and you don't know who the patsy is, you're the patsy." [5]

Conclusion

We have outlined in this article a common thread running through all human behaviour patterns. Mood swings, peer pressure, restless activity, lack of foresight and impulsive pursuit of unclear goals are all characteristics of human behaviour in crowds, and it is well known that crowds sink to their lowest common denominator. For some reason, the stock market has the same effect on people. That is why great bull markets are associated with bouts of euphoria and wild speculative greed, and bear markets with attacks of black depression, fear and anger. In either case, the best approach is to distance yourself from the crowd, pick your opportunities shrewdly and buy good merchandise when it's on sale.

When you buy your stock in a good company, tuck it away and check the price on your birthday every year. (But be sure to read the annual report and vote your stock. Shareholder democracy is what it's all about these days, and even the best managements sometimes fall prey to the temptation to screw the shareholders.) Or consider hiring a trustworthy professional money manager who follows a common sense investment philosophy and stays away from the crowd.

Endnotes

1. Graham, Benjamin. Ladies' Home Journal.

2, 3. Buffett, Warren E. Berkshire Hathaway. Letter to Shareholders, 1990.

4. Buffett, Warren E. Berkshire Hathaway Annual Report. 1993.

5. Buffett, Warren E. Berkshire Hathaway Annual Report. 1987.

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