The View *from* Burgundy

DECEMBER 1994

A Sure Fire Recommendation

Serious students of investing, and particularly those who share Burgundy's philosophy of investing in undervalued companies with superior fundamentals, should stop worrying about what to ask for as a Christmas present. We have a great suggestion. It is a book just released by Robert Hagstrom, Jr. entitled *The Warren Buffett Way*. We feel that it is the best book on investing that we have read in several years. Peter Lynch wrote a five-page Foreword to the book, offering his assessment of why Buffett is so successful as an investor, and this Foreword alone is worth the price of the book. Given that Buffett has accumulated a net worth of $8.3 billion through his investment activities, we think that a very careful study of this man and his methods is of vital importance.

The book offers many insights into Buffett and his thinking. An interesting chapter entitled "The Two Wise Men" suggests that Buffett is a product of two outstanding investors: Benjamin Graham and Philip Fisher.

Graham is considered to be the father of security analysis. He was a hardcore value investor who focused on asset value, and he was very statistically oriented. He invested in stocks that sold below their book value per share and favoured stocks that sold below their "liquidation value." (Basically, working capital less total debt, calculated on a per share basis.) Buffett studied under Graham in 1954-1956 while taking his Master's degree in Economics at Columbia Graduate Business School in New York, and he worked for Graham at his investment firm, Newman & Graham Corporation. It was here that Buffett refined his skills at analysis, with particular emphasis on the balance sheet. Watch out for an important new book on Graham by Janet Lowe entitled *Benjamin Graham on Value Investing*, soon to be released in New York. Warren Buffett is endorsing this book and is giving a rare speech on December 6, 1994 at the New York Society of Financial Analysts as a special tribute to Graham and to help launch the new book.

The second big influence on Buffett came from Philip Fisher, author of a very important book called *Common Stocks and Uncommon Profits*, originally published in 1958. Fisher also believed in buying undervalued stocks, but he defined value in a different way than Graham. He felt that the best investment results were obtained by investing in companies with strong potential to grow sales and profits. He placed important emphasis on the ability of a company to launch new products and on its research and development capability. He emphasized investing in low-cost producers with outstanding management. Fisher introduced the idea of "circle of competence," which means investing only in companies that you really understand and can evaluate with confidence. He also believed in taking large positions in your best ideas, and in not overly diversifying. That way, you avoid having only superficial knowledge about a lot of companies.

In his book, Hagstrom has carefully reviewed Buffett's past investment decisions and he has tried to create a kind of checklist that Buffett uses when looking for companies in which to invest. Hagstrom divided the checklist into four categories:

1. Business Tenets:

- Is the business easy to understand?
- Is there a consistent financial history?
- Are the future prospects of the company attractive?

2. Management Tenets:

- Is management sensible, especially in allocating earnings retained in the business versus returning it to the shareholders by way of dividends or share purchases?
- Is management candid with the shareholders in their reporting?
- Is the management group resistant to the "institutional imperative"? Buffett sees the "institutional imperative" as a big impediment to business success. It is the tendency of company executives to imitate the decisions and behaviour of other managers, no matter how irrational they may be.

In the 1989 Berkshire Hathaway Annual Report, Buffett said that the institutional imperative exists when: "(i) an institution resists any change in its current direction; (ii) just as work expands to fill available time, corporate projects or acquisitions will materialize to soak up available funds; (iii) any business cravings of the leader, however foolish, will quickly be supported by detailed rate of return and strategic studies prepared by his troops; and (iv) the behaviour of peer companies, whether they are expanding, acquiring, setting executive compensation or whatever, will be meticulously imitated." [1]

How many companies can you name that suffer from the institutional imperative? We think that it's a long list.

3. Financial Tenets:

- Return on equity is the key. This is more important than earnings per share.
- "Owner earnings" – or what we at Burgundy would call "free cash flow"(net income, plus depreciation and amortization less capital spending for maintenance) – is probably the best reflection of economic value, as opposed simply to earnings.
- Seek out companies with high profit margins!
- Be sure that $1.00 or more of market value is created for each dollar of earnings that are retained by the management to reinvest in the Company. This is the concept of Economic Value Added (EVA), a tool we at Burgundy feel is very useful and that is gaining credibility in management circles.

4. Market Tenets

- What is the intrinsic value of the business?
- Can the business be purchased at a significant discount to its intrinsic value?

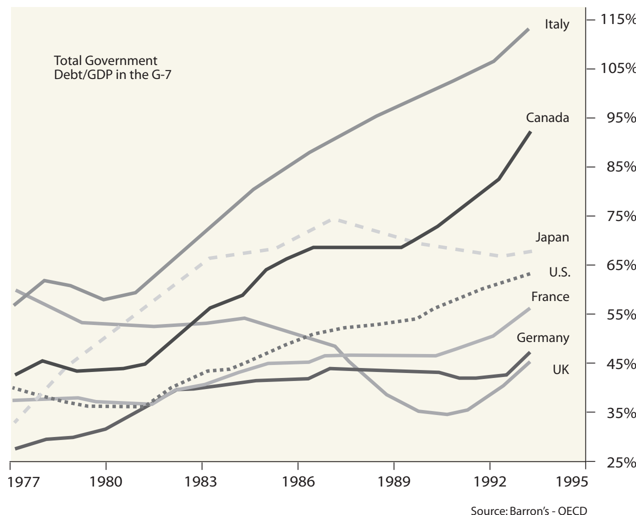
In conclusion, *The Warren Buffett Way* is an unusually interesting and informative read.

Our Nation's Balance Sheet

The balance sheet of Canada as a country is very poor and it is deteriorating rapidly. One way to measure a country's balance-sheet strength is to measure the nation's total debt as a percentage of Gross Domestic Product (GDP). The chart on the next page appeared in Barron's two weeks ago and we think it is worth a thousand words. The chart compares the debt as a percentage of GDP in the "Group of Seven" countries over the past 18 years, from 1977 to 1994.

Take a minute to study the graph on the next page and note the following:

- Canada's debt currently is roughly equal to 95% of our annual GDP. As recently as five years ago it was 67%.
- Only Italy has a higher (worse) ratio than Canada.
- The slope of Canada's ratio (i.e., the rate of increase) is worse than Italy's in the past two years.
- The Group of Seven has all had a worsening balance sheet, except for the United Kingdom, which has improved materially, mainly during the Margaret Thatcher era.



Randall Forsyth, the author of the Barron's article, used the term "debt trap," and he defines the term as follows:

"A debt trap occurs when a government's total debt equals roughly 80% of annual economic output. Though there is some debate about exactly when a debt trap is triggered, it is generally agreed to be in force when interest on the government's debt continues to rise even when the government's other spending is held in line with government revenues." [2]

Forsyth adds:

"The Swedish and Italian examples demonstrate that financial markets can and will severely curtail governments' power of the purse. The U.S., to be sure, has enormous advantages over these countries. U.S. Treasury debt is all in dollars, which can be printed to cover these obligations. Greenbacks also remain the world's reserve currency and the preferred medium for international exchange. Sweden and Italy, by contrast, have borrowed heavily in nearly every foreign currency, which eliminates their ability to satisfy their debts with the printing press." [3]

The Bank Credit Analyst (BCA), a highly respected publication and observer of economic and financial matters, published a special article in July 1994 on Canada's debt situation. It noted that, "Canada's extreme levels of public sector and external indebtedness place it firmly in the ranks of the Third World in terms of debt burden." [4]

BCA believes that Canada has gotten to this high debt level because "international investors have continued to regard Canada as a reasonably good credit risk and their past willingness to buy Canadian debt (albeit with a large risk premium) has delayed the necessary and inevitable retrenchment." [5] BCA also points out the high debt level of the households and business sectors in Canada, which represented 127% of GDP at the end of 1993, compared to 98% at the end of 1983. According to BCA, household borrowing rose at twice the rate of disposable income during this period.

It is obvious to us that we have a serious problem in Canada. We are raising the issue not to alarm people, but rather to encourage and support tough action on the part of Paul Martin, who is certainly talking tough. We also present these facts as support for the very conservative approach to investments that we are following at Burgundy. This approach emphasizes undervalued companies with strong earnings; insures against significant market risk using "puts"; uses real rate of return triple A government bonds; and, where appropriate, invests in strong, undervalued companies outside of Canada.

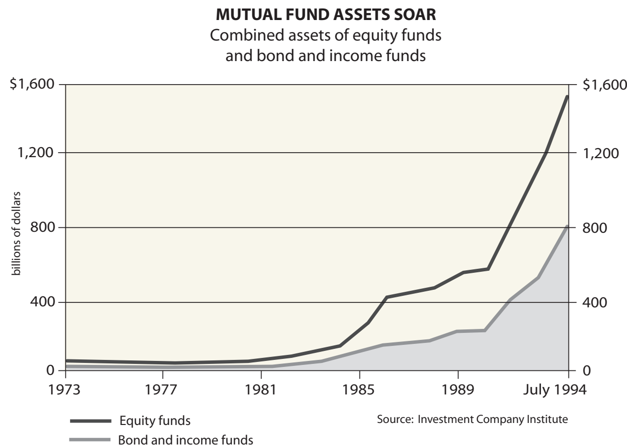
The Mutual Fund Bubble

The chart on the next page is from the Investment Company Institute in the United States and shows the growth of mutual fund assets over the past 20 years.

A few points seem noteworthy to us:

- Mutual fund assets have grown at astonishing rates since 1991. The line is nearly vertical. According to Ned Davis Research, 73% of the inflow into stock mutual funds since 1960 has occurred in the past three years.

• In 1993, equity fund assets grew by $226 billion or 43%, and bond assets grew by 32%. For the first time in a decade, assets of equity funds have overtaken those of money and income funds.



As James Grant said in an issue of his fine publication, *Grant's Interest Rate Observer*, "People have stopped reaching for yield and instead are buying for capital gains." [6] He points out that at the beginning of 1982, the public had almost 70% of its mutual fund assets in income funds.

No one knows what the future will hold. But we suspect that many of the recent buyers of mutual funds may lack the foresight and stomach for the inevitable volatility that will occur. A significant market drop could cause a big flow out of mutual funds with a dramatic impact on security prices.

This is additional argument for a conservative, value-oriented approach to investments.

Endnotes

1. Buffett, Warren E. Berkshire Hathaway Annual Report. 1989.
2. Forsyth, Randall. Barron's. 1994.
3. Forsyth, Randall. Barron's. 1994.
4. Bank Credit Analyst, July 1994
5. Bank Credit Analyst, July 1994
6. Grant, James. Grant's Interest Rate Observer.

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