The VIEW *from* BURGUNDY

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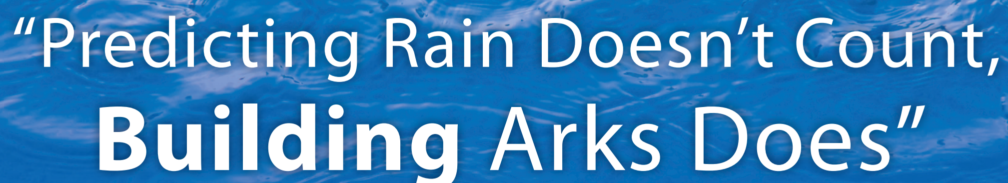

AN INVESTMENT LESSON FROM WARREN BUFFETT

PEOPLE OFTEN APPROACH INVESTMENTS without first understanding what they are trying to achieve. Many end up with poor long-term returns and even more confused than when they started. Warren Buffett, on the other hand, has accumulated a $44 billion fortune in one lifetime of investing, starting from scratch, and has never been confused about how he earned it.[i] In this *View from Burgundy*, we will uncover how Buffett frames his investment approach. The investment lesson learned, properly applied, is sure to help us generate improved long-term results.

A Defined Goal and Timeline

How did the Sage of Omaha create a huge fortune from scratch? First, he knew what he was trying to achieve. From a young age, Buffett's goal was to compound capital at the best possible rate over the very long term. So he had a clear and explicit goal: to grow his wealth. He had also defined an appropriate time horizon that was long enough to tackle this problem.

Capital Factors

With the end goal understood, the stage was set for Nebraska's legendary investor to begin his task by constructing an investment portfolio. But where to start? Buffett had two epiphanies that defined his approach to portfolio construction. First, that only ownership could generate the returns he desired, and second, that losses would erode compounding's "magic." Buffett would go on to apply these insights enthusiastically and with extraordinary success for many decades.

The Power of Ownership

The Oracle of Omaha's first epiphany was about the power of ownership and it came at a young age. As a teenager, Buffett purchased some farmland and split the annual crop income with the tenant farmer. After five years, when the land was sold and Buffett doubled his original investment, he learned that although the owner risks the initial capital, only the owner benefits from any capital gains.

Nebraska's legendary investor appreciated that only the investment returns from ownership, or equity, would allow for the opportunity to earn outsized long-term results. He couldn't compound capital at superior long-term rates by investing in debt securities such as bonds and money market instruments. As can be seen by the historical results of each asset class in the following table, stocks on average have compounded at rates close to double those of bonds since 1926. And, Buffett has done a lot better.

Historical Returns (1926 – 2011)

Asset Class	Compound Annual Return
Equities	9.8%
Bonds	5.4%

(Source: Morningstar SBBI)

Losses Hurt Way More than Gains Help

The second epiphany for Berkshire's chairman was how difficult it is to recuperate capital after a loss. Losses hammer the compounding equation and must be avoided at all costs. The table below shows how much the gain must be, after a given loss, to get back to where you started. For example, if you lose 50% of your money, you need to double it (make 100%) just to get back to square one. That's a tough task.

That's why Buffett codified two rules for investing:

1. Don't lose money.
2. Don't forget rule number one.

"No-Lose" Equities

These epiphanies helped the Sage uncover perhaps the most challenging investment problem, which many would call a paradox: how does one identify and invest in "no-lose" equities? Indeed, the words "no-lose" and "equities" haven't been used in the same sentence since the seedy days of the Vancouver Stock Exchange.

How did the Oracle solve this paradoxical problem? An examination of his historical investment portfolios uncovers a simple truth that helps reveal the answer. Buffett typically owned very, very few securities (see Appendix 1). Indeed, a big chunk of his fortune has come from a half-dozen huge wins. From the perspective of most people's far too diversified portfolios, the words "very few" hardly do it justice. For example, for most of the 1980s and 1990s, Buffett owned only a handful of stocks, and one of them, GEICO, accounted for up to half of his portfolio. In the early 1950s, GEICO made up three-quarters of his portfolio. That is portfolio concentration.

The Asymmetry of Negative Returns

Initial Loss of Capital	Subsequent Gain Needed to Get Back to Starting Point	Size of Necessary Gain Compared to Initial Loss
(10%)	11%	111%
(20%)	25%	125%
(30%)	43%	143%
(40%)	68%	168%
(50%)	100%	200%
(60%)	150%	250%
(70%)	233%	333%
(80%)	400%	500%
(90%)	900%	1,000%
(100%)	Impossible	N/A

Note:
Notice how the gap between the two grows as the losses get bigger, captured in the third column. We call it the asymmetry of negative returns. The more you lose, the worse it gets. And, if you ever lose 100%, it's all over.

So Berkshire's chairman articulated his goal (to compound capital at superior rates), set the appropriate long time horizon, and then went about picking very, very few "no-lose" equity investments to build a portfolio. Fast-forward 60 years and he has more than $40 billion. Sounds simple. Clearly Buffett picked the right "very few" investments. How did he do it? Very carefully.

Buffett's Favourite Holding Period is Forever

Buffett uses a mental model to summon an appropriately high level of examination and criticism to ensure that his investment decisions are made carefully. He has often said that an investor should act as though he had a lifetime decision card with just 20 punches on it. This certainly raises the bar for the decision-making process. The Sage has also committed to own many of his companies forever, which gets you to the same place.

This is an important difference from how most market participants go about it. Most own far too many investments, sometimes in the name of diversification and sometimes from being compelled to buy the next "hot" idea or product that the investment industry is touting. Many also jump around among holdings way too much. Indeed, trading activity and fund turnover have increased severalfold over the past few decades.

Many market participants seem to think they can outguess the market with short-term trading. This delusion stems from the misguided notion that one can repeatedly profit from short-term guesses rather than by managing risk. The industry's mediocre long-term returns, together with the tendency of clients to buy at the top and sell at the bottom (so their individual results on average trail far behind that of the funds they invest in),[ii] are evidence that this short-termism doesn't work.

Consider an example. We are thesis investors. After we have developed what we consider to be an airtight thesis about a company that includes a guess about its near-term prospects, many times our short-term guess proves to be exactly wrong. This common occurrence, which value investors call "being early," is what gives people fits about the stock market. But as long as the long-term thesis is correct, the investment will perform well.

There is a Big Difference between Uncertainty and Risk

Instead, the Oracle understands the difference between uncertainty and risk, and manages risk accordingly. Beyond the sun coming up tomorrow, everything is uncertain. No one can predict, with certainty, much about the short-term future in the complex, adaptive world we inhabit. So Buffett doesn't even try. On the other hand, risk can be defined and effectively managed, as Buffet's approach and track record highlight. Berkshire's chairman defines risk as the likelihood of a permanent loss of capital. Losses, according to Buffett's rule number one, are to be avoided at all costs since they hammer the compounding equation. Since Buffett wants to own select equities, he must manage equity risk successfully.

Three Sources of Equity Risk

For equity owners, there are three sources of risk of permanent loss:[iii]

1. **Business or earnings risk:** where the level of earnings power estimated for a company turns out to be too high.
2. **Balance sheet risk:** where equity owners are dealt losses on part or all of their investment by the investee company's inability to successfully refinance debt maturities as they come due.
3. **Valuation risk:** where one pays too much for an investment.

"Predicting Rain Doesn't Count, Building Arks Does"

To reduce the first source of risk, the Sage very carefully selects only those extremely few businesses where he judges that the long-term business or earnings power risk is as close to zero as possible. As for his appreciation for risk versus uncertainty, consider Buffett's Noah principle: "predicting rain doesn't count, building arks does." While business conditions, like the weather, will always be uncertain, he invests only in those companies that are strong and adaptable enough to thrive no matter what the outside environment throws at them.

While identifying the select few companies is no easy task, the Sage's predilection for a limited number of long-term holdings is a huge advantage when attempting to do so. With far fewer distractions than most over-diversified and fast-trading market participants, Buffett can work hard to identify and genuinely understand those few businesses, the "arks," that will stand the test of time. He places these companies within his circle of competence, which is a boundary inside of which he works to develop genuine and superior understanding. Given his very concentrated portfolios, Buffett's circle of competence may not be wide, but it is deep.

Examples of "arks" include well-managed and dominant consumer brands where the end product doesn't change. The Nebraskan super investor can be sure that these businesses, such as Coke or Wrigley's chewing gum, will still be earning economic rents in 10 or 20 years. He can also be certain that no other transcontinental railway will be built to challenge Burlington Northern Santa Fe and therefore impinge on its high profitability.

As for the second source of risk, that of the balance sheet, the Oracle's insistence on only investing in "arks" provides ample protection. By definition, these types of companies have steady earnings and strong cash flows that help to minimize balance sheet risk.

Patience Can Mean Waiting Decades to Invest

As for the final source of risk, that of valuation, Berkshire's chairman seems to have the patience of Job. Sometimes he has to wait decades before getting a chance to invest in an "ark" he has identified. That is the price one must pay to not overpay for an investment, which can penalize investment returns, or worse, violate Buffett's rule number one and result in an outright loss.

The Black Swan author, Nassim Taleb, has said that, "In science you need to understand the world; in business you need others to misunderstand it."[iv] As the essence of value investing is evaluating businesses, the misunderstandings of others about businesses and valuations are where the Sage's opportunities come from. He knows better than most which companies to select, and when they are undervalued and should be bought. This is his primary focus.

And he has the patience to wait. Buffett twice waited 20 years to make investments in insurer GEICO. It takes this kind of patience to accumulate a fortune.

A STUDY IN PATIENCE – GEICO

Buffett's investment history with GEICO is illustrative of his approach.[v] He first discovered the company in 1951 while studying under value investing icon Ben Graham at Columbia Business School in New York City. Noticing that Graham was the chair of something called Government Employees Insurance Company (GEICO), but not knowing anything about it, Buffett took a train to GEICO headquarters in Washington, DC one Saturday morning.

While the office was closed, Finance Vice President Lorimer Davidson happened to be at the office. Hearing from a security guard that one of Ben Graham's students was visiting, Davidson decided to give Buffett five minutes of his time. They ended up chatting for four hours, with Buffett coming out of the meeting with a good understanding of the insurance business and of GEICO's advantaged place in it.

To the Oracle, compounding capital is like rolling a snowball. "The important thing is finding wet snow and a really long hill." GEICO had both in spades.

The Sage learned a couple of important lessons that Saturday. First, he learned the value of using "other people's money." Insurance companies collect premiums when they sell a product and don't have to pay out any cash until claims are filed at some time in the future. In the interim period, the insurer can use the premiums as investment funds for their own benefit. This is called "float" and can be a source of free financing or better if the insurance operations are profitable. Buffett has been dining out on this idea ever since.

Second, Nebraska's legendary investor learned that GEICO had a sustainable competitive advantage, or what he called a "moat," around its economic castle. This is extremely rare in the financial services industry where most products are commodities.

By only selling insurance direct, thereby not using and paying hefty commissions to agents, GEICO's selling costs were way below its competitors. By only selling to government employees, who as a group reported far lower than average insurance claims, GEICO's claims costs were also far lower than average. GEICO's lower selling and claims costs allowed it to price its insurance products well below its competitors and still earn healthy returns for shareholders. The low prices made it an easy choice for more and more government worker customers to choose GEICO.

While in 1951 GEICO's share of the national auto insurance market was less than 1%, with its lower costs and prices, it was growing fast. Since government workers made up a big chunk of the potential market, Buffett could safely assume that GEICO would continue growing for several decades. He smelled opportunity (see Appendix 2).

To the Oracle, compounding capital is like rolling a snowball. "The important thing is finding wet snow and a really long hill."[vi] GEICO had both in spades. On the Monday morning after Buffett's weekend GEICO visit, he sold three-quarters of his investment portfolio and used all of the proceeds to make GEICO his largest holding by a long shot.

Berkshire's chairman sold his initial GEICO stake in the mid-1950s for a big gain. He had found another quality stock that was way too cheap to ignore. However, Buffett continued to follow GEICO very closely with the hope that he would get a chance to buy it cheap once again. That opportunity presented itself in 1976.

In the early 1970s, GEICO's management team made two errors in the name of "growth at any cost" that eventually hammered the stock. First, they started to accept all comers and sell insurance products to the broad market, rather than just to government employees. Second, they were pricing their products

too low, once again in the name of fast growth. These two errors caught up with the company in 1976, when it reported a large loss and fired the senior management team. The stock fell from a prior high of $61 a share to $2. After two decades of watching GEICO from afar, the Sage jumped at the opportunity.

A proven insurance CEO, Jack Byrne, was brought in to refocus the company on its core government employee business. While this corporate turnaround was as challenging as most, Buffett knew that its core business was a jewel hidden inside GEICO. He bought as much stock as he could and soon had spent $47 million to own 48% of the company. This represented about one-quarter of his (by this time much larger) investment portfolio.

With the right management team in place and still a long runway of wet snow to build an even bigger snowball, this time Nebraska's legendary investor didn't sell. In fact, as time went on and his own portfolio grew, he wanted to buy more. Almost 20 years later, in August 1995, Buffett bought the half of GEICO that he didn't own for $2.3 billion. Forty-four years after his discovery and initial investment in this "ark," Buffett finally owned 100% of an advantaged and still growing franchise. This is how fortunes are made.

So what can we learn from the Berkshire chairman's extraordinary success and apply to our own investment process? He identified his investment goal: long-term capital appreciation. With an appropriately long time horizon adopted, he came to realize that this was best achieved by exposing his capital to equities, but not to losses. Although this sounds too paradoxical to be realistic, Buffett has managed to square this circle by successfully understanding and managing equity risk.

The Oracle has succeeded in identifying the very few companies with almost no long-term earnings/business or balance sheet risk. He also has had the patience to wait – sometimes decades – until they were cheap enough to be bereft of valuation risk. Fast-forward 60 years and a $44 billion fortune is the result.

While $44 billion might be out of reach for most of us, simply turning our confusion into clarity is worth a serious examination of Buffett's investment lesson. With a long-term plan, exposure to a limited number of carefully chosen companies and patience, better investment results – and peace of mind – are sure to follow.

[i] Forbes staff, "The World's Billionaires," *Forbes Magazine*, March 26, 2012

[ii] Bogle, John, "The Mutual Fund Industry 60 Years Later: For Better or Worse?" , *Financial Analysts Journal* (January/February 2005): Vol. 61, No. 1

[iii] Montier, James, "Clear and Present Danger: The Trinity of Risk," *Mind Matters*, Societe Generale Strategy Research, January 27, 2009

[iv] Taleb, Nassim, *The Bed of Procrustes: Philosophical and Practical Aphorisms*, Random House, 2010

[v] Schroeder, Alice, *The Snowball*, Bantam Books, 2008

[vi] Schroeder, Alice, *The Snowball*, Bantam Books, 2008, back cover

Appendix 1

Warren Buffett's holding company, Berkshire Hathaway, had very concentrated equity portfolios. Over the 30 years between 1980 and 2010, the top five shareholdings made up between 58.7% and 93.1% of the total equity portfolio. That is portfolio concentration.

Berkshire Hathaway's Top Five Equity Investments as a Percent of Total Equity Portfolio (1980 – 2010)

(Source: Berkshire Hathaway's annual reports)

1980	
GEICO	19.9%
General Foods	11.3%
Handy & Harman	11.0%
SAFECO	8.5%
Washington Post	8.0%
Top 5 Holdings	**58.7%**

1985		1990		1995	
GEICO	49.7%	Coca-Cola	38.2%	Coca-Cola	33.7%
Washington Post	17.1%	Capital Cities/ABC	24.2%	Gillette	11.4%
Capital Cities/ABC	9.1%	GEICO	19.5%	Capital Cities/ABC	11.2%
Beatrice	9.0%	Washington Post	6.0%	GEICO	10.9%
Affiliated Publications	4.4%	Wells Fargo	5.1%	American Express	9.3%
Top 5 Holdings	**89.3%**	**Top 5 Holdings**	**93.0%**	**Top 5 Holdings**	**76.5%**

2000		2005		2010	
Coca-Cola	32.4%	Coca-Cola	17.3%	Coca-Cola	21.4%
American Express	22.1%	American Express	16.7%	Wells Fargo	18.1%
Gillette	9.2%	Wells Fargo	12.8%	American Express	10.6%
Wells Fargo	8.2%	P&G/Gillette	12.4%	P&G/Gillette	7.6%
Washington Post	2.8%	Moody's	6.3%	Kraft	5.0%
Top 5 Holdings	**74.7%**	**Top 5 Holdings**	**65.5%**	**Top 5 Holdings**	**62.7%**

Appendix 2

Growth in GEICO Insurance Policies between 1950 and 2010

When his first investment in GEICO was made in 1951, Warren Buffett felt he had uncovered a company with a lot of growth potential. He was right. Not many companies in history have demonstrated 60 years of annual growth in product unit volumes of more than 7% compounded. Of course, GEICO's value grew at far faster rates, given the ability of management (and later Buffett himself) to invest the ever increasing float.

	1950	2010	Compound Annual Growth Rate
Number of Insurance Policies	143,944	More than 10 million	7.3%

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