The VIEW from BURGUNDY

AUGUST 1994

BONDS – VALUE INVESTMENTS?

CLIENTS, READERS OF *THE VIEW FROM BURGUNDY* and friends of this firm will know that our approach to investing is to emphasize equities. We look for equities in quality companies that are selling for less than their intrinsic value, with a large margin of safety. Historically, equities have had twice the annual return of bonds over the past 50 years. We tend to give short shrift to overview forecasts, including interest rate forecasts. In our experience, such forecasts are highly unreliable. There is a lot in what Peter Lynch of Fidelity said in a speech given in Toronto a year ago: "If you spent 15 minutes worrying about economics last year, you spent 12 minutes too much."[1]

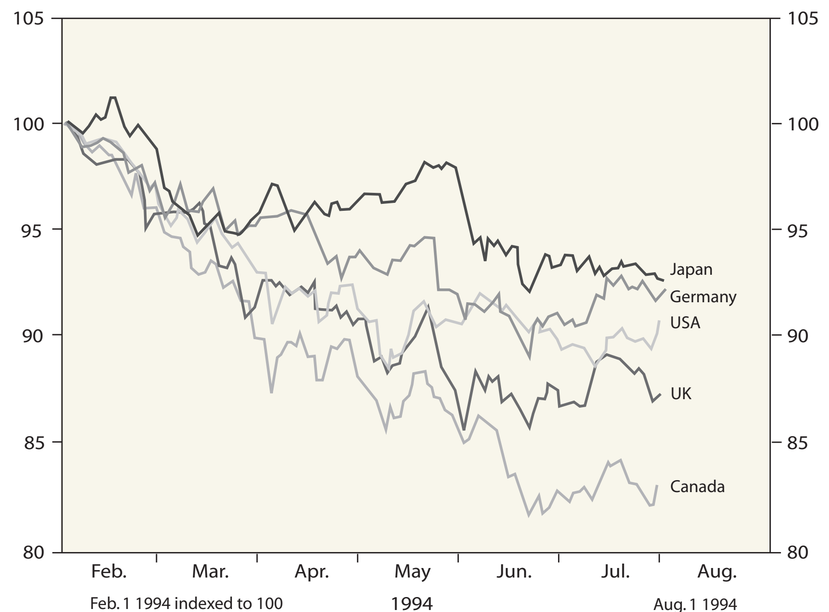
But what has happened to both bond prices and to bond yields in the past three to four months has been dramatic. It may become a big factor in how stocks are priced in the period ahead. We thought the subject very important and worthy of some analysis and comment.

Bond prices have sustained a tremendous decline so far in 1994. All countries have experienced this same phenomenon as interest rates have gone up, and bond prices of all types have fallen. Canadian bond prices have been hit especially hard: in part because of how weak our dollar has been, in part because of uncertainty in Quebec and of increasing concern about the financial solidarity of the country as a whole. The chart on this page, which is courtesy of John Atkins of DFI Securities, shows that 10-year Canada government bond prices have now fallen by about 18% in the past six months, compared to a decline of 14% in Britain and 10% in the United States.

The result of falling bond prices is, of course, that interest rates go up proportionately.

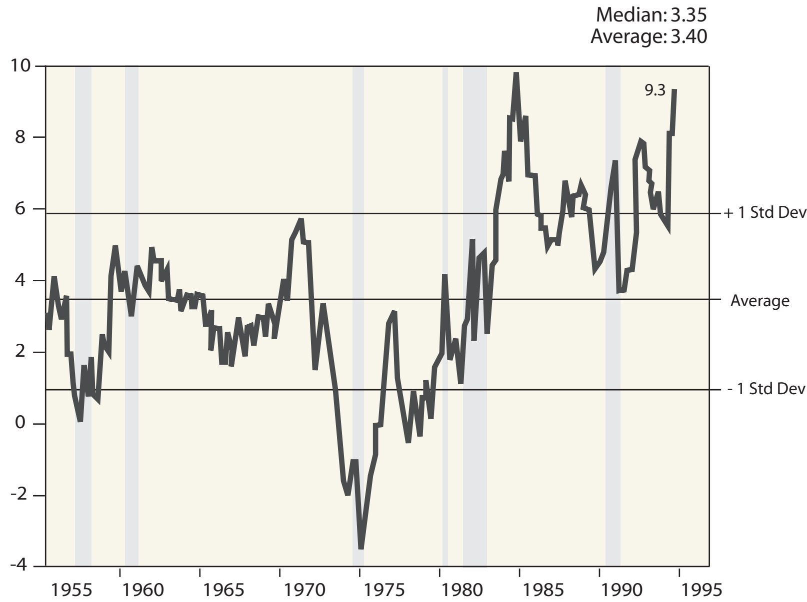
"Real" interest rates are the nominal or apparent interest rate, less the prevailing rate of inflation. For Government of Canada bonds of 10 years, the "real rate of interest" has historically averaged 3.35% over the past 40 years. Right now, the real interest rate on these bonds is 9.0% in Canada – part of the reason is obviously that we have almost no inflation at the present time.

BOND PRICE INDEXES
10-Year Government Bonds



Source: DFI Securities

The next chart shows the picture clearly. Notice that real rates have gone up by 50% in the past six months, from 6% in December 1993 to 9% today.



Source: Burgundy Investment Team Research

Another way to think about bond values versus stock values is to compare the dividend yields on stocks to the interest yield on bonds. The chart below (also from DFI) compares stock yields as a percentage of long-term bond yields for the past 15 years.

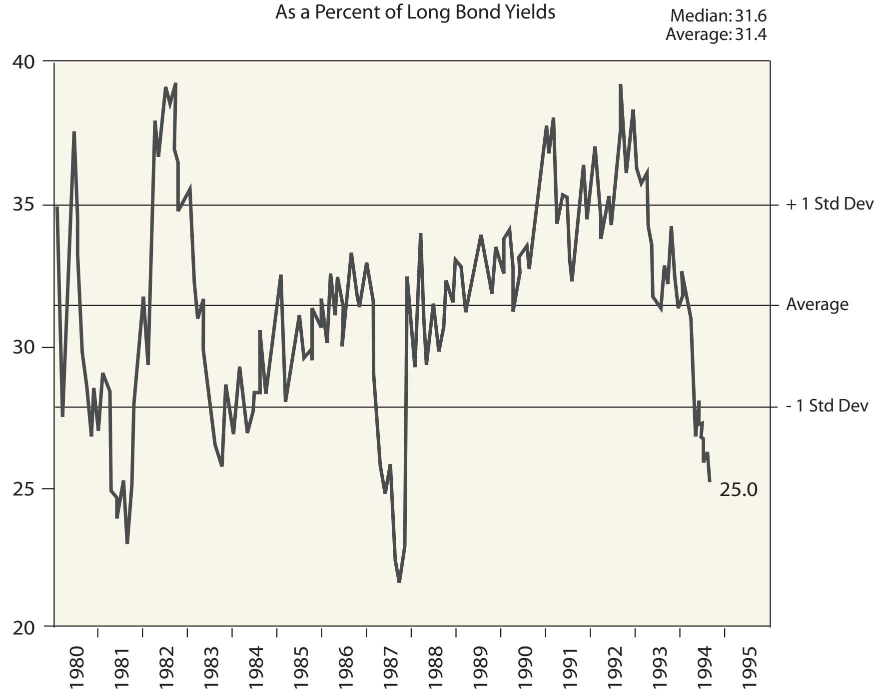
On average in Canada, stocks yield 31.4% as much as bonds. Today, stocks are yielding only 25.6% as much as bonds.

Without trying to predict the future, it is pretty obvious that with real returns of 9%, bonds will likely be a big competitor for money that might otherwise be bound for the stock market.

We would like to remind you of the long-term results of different classes of investments, which are kept track of by Ibbotson Associates, whose statistics go back to 1926. They show that, during the past 68 years, annual rates of return have been:

- Stocks (small): 12.4%
- Stocks (large): 10.3%
- Long-Term Government Bonds: 5.0%
- Treasury Bills: 3.7%
- Inflation: 3.1%[18]

Stocks, long term, have earned 10-12% per annum, only a little more than what bonds are currently earning. As the previous chart also shows, real interest yields of 9% are a "two-standard deviation event." The only other time in the past 40 years that real interest rates were so far above the norm was in the early 1980s.



Source: DFI Securities

A Management Scorecard

There is no doubt that the capability of the senior management is perhaps the most important variable in the success of a business enterprise. As a result,

management is ultimately critical in how the shares of a company perform over the long run.

Yet assessing management is extremely difficult for someone who isn't really on the inside of an enterprise. Unfortunately, this is the position of most investors or investment analysts. In our own case at Burgundy, we view any attempt to assess management of companies in which we invest to be one of the most important, yet most difficult, things that we do. It is certainly the least scientific part of the investment research process!

Despite its importance, little has been written about judging management from the point of view of the investor. Warren Buffett speaks to this subject occasionally and, as with most subjects he discusses, he has some highly useful things to say. Below is a collection of comments he has made in earlier Berkshire Hathaway annual reports:

- Our share issuances follow a simple basic rule: we will not issue shares unless we receive as much intrinsic business value as we give. Such a policy might seem axiomatic. Why, you might ask, would anyone issue dollar bills in exchange for fifty-cent pieces? Unfortunately, many corporate managers have been willing to do just that.
- The first choice of these managers in making acquisitions may be to use cash or debt. But frequently, the CEOs' cravings outpace cash and credit resources (certainly mine always have). Frequently, also, these cravings occur when his own stock is selling far below intrinsic business value. This state of affairs produces a moment of truth. At that point, as Yogi Berra has said, "You can observe a lot just by watching." For shareholders then will find which objective the management truly prefers – expansion of domain or maintenance of owner's wealth.
- But when the buyer makes a partial sale of itself – and that is what the issuance of shares to make an acquisition amounts to – it can customarily get no higher value set on its shares than the market chooses to grant it.
- Although our form is corporate, our attitude is partnership. Charlie Munger and I think of our shareholders as owner-partners, and of ourselves as managing partners. (Because of the size of our share holdings we also are, for better or worse, controlling partners.) We do not view the company itself as the ultimate owner of our business assets but, instead, view the company as a conduit through which our shareholders own the assets.
- We do not measure the economic significance or performance of Berkshire by its size; we measure by per-share progress.
- Accounting consequences do not influence our operating or capital-allocation decisions. When acquisition costs are similar, we much prefer to purchase $2 of earnings that is not reportable by us under standard accounting principles than to purchase $1 of earnings that is reportable. This is precisely the choice that often faces us since entire businesses (whose earnings will be fully reportable) frequently sell for double the pro-rata price of small portions (whose earnings will be largely unreportable). In aggregate and over time, we expect the unreported earnings to be fully reflected in our intrinsic business value through capital gains.
- A managerial "wish list" will not be filled at shareholder expense. We will not diversify by purchasing entire businesses at control prices that ignore long-term economic consequences to our shareholders. We will only do with your money what we would do with our own, weighing fully the values you can obtain by diversifying your own portfolios through direct purchases in the stock market.
- We feel noble intentions should be checked periodically against results. We test the wisdom of retaining earnings by assessing whether retention, over time, delivers shareholders at least $1 of market

value for each $1 retained. To date, this test has been met. We will continue to apply it on a five-year rolling basis. As our net worth grows, it is more difficult to use retained earnings wisely.

- We do not see this long-term focus as eliminating the need for us to achieve decent short-term results as well. After all, we were thinking long-term thoughts five or ten years ago, and the moves we made then should now be paying off. If plantings made confidently are repeatedly followed by disappointing harvests, something is wrong with the farmer.[2]

Tony Russ and his team called The Value Group, at Shelby Cullom Davis in New York (NYSE members, etc.), have devised a "Management Report Card" and for four years have published their report card, applying it to 20 or so public companies in which they are interested. Each company is given a score for each sub-category.

The categories and the scoring are as follows:

MANAGEMENT REPORT CARD	
Category	**Possible Score**
Shareholder Democracy	
One share, one vote	10.0%
Defenses	5.0%
	15.0%
Act Like an Owner	
Compensation – cash vs. options	8.0%
Performance bonus	8.0%
Prerequisites	4.0%
	20.0%
Use of Owner's Earnings	
Dividend policy	5.0%
Economic value added	25.0%
Generation of net free cash	10.0%
	40.0%
Board Direction	
Independent managers' evaluation	5.0%
Shareholders' representation	5.0%
Restraint of dilution	5.0%
Shareholder communication	10.0%
	25.0%
Total:	**100.0%**

Source: Burgundy Investment Team Research

We think this management scorecard has plenty of room for improvement, but at least it is a starting point of something to work with. For example, we would add to the list large shareholdings by senior management and the Board as an important factor. In our experience, managers and directors with big stakes are more focused on long-term wealth creation. This is a real plus to the investors.

We view companies favourably that engage in share buybacks, if executed at favourable prices.

Also, small Boards generally seem more effective than large Boards and should be scored accordingly.

You might be interested in the score results of Shelby's list. Berkshire Hathaway received the top score (96) and Time Warner received the bottom result (28). In between, Shelby closely followed 18 other companies. Of note, Salomon Inc., Sallie Mae, Reebok and Philip Morris all received very high scores on the Management Report Card, all of which – together with Berkshire Hathaway – are investments in The Burgundy Partners' Fund; all are also in The Burgundy Partners' RSP Fund, except for Sallie Mae.

Endnotes

1. Lynch, speech, 1993
2. Buffett, Warren E. Berkshire Hathaway Annual Report. 1983.

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