The VIEW from BURGUNDY

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CONFESSIONS OF A BUFFETTEER

Richard Rooney, President and CIO of Burgundy Asset Management Ltd., delivered the following presentation at the London Value Investor Conference on May 22, 2014.

THE VALUE INVESTING TENT IS INHABITED BY SEVERAL DIFFERENT TRIBES: the Orthodox, the Bears, the Gold Bugs and the "Buffetteers." These groups are united by a common admiration for Ben Graham, the first and still the greatest proponent of the philosophy, but far from unanimous on some other things.

The Orthodox

The largest group, and the original inhabitants, practise the orthodox statistical-value method of scouring the markets for the dollar bill trading for 50 cents, and owning a diversified portfolio of cheap securities. This is a reliable way to invest with a margin of safety and produce good returns over the long term. Most of these value investors look to the masters of this approach for their methods. Ben Graham, William Ruane, Walter Schloss and Peter Cundill are their models, though almost all of us lack the flexibility and creativity of these exceptional investors. Please recognize that I am not using the idea of orthodoxy as a pejorative; rather, it is the mainstream from which the others derive.

The Bears

As the name implies, the bears approach the market with characteristic pessimism. Usually espousing the doctrine of statistical cheapness, but overlaid with macroeconomic disaster scenarios and a healthy dose of Oswald Spengler, these folks never find a market cheap enough to be fully invested. Any crisis is assumed to be a prologue to catastrophe; and therefore, even better values always wait. As a consolation prize for never being fully invested, bears have an acute sense of absurdity, which makes them among the most penetrating and hilarious critics of a business that can always be relied upon to create fresh absurdities. And, as part of the old saying goes, bears do make money.

The Gold Bugs

Gold bugs are usually also accorded a section of the value tent. It is entirely understandable that people obsessed with value should worry about the value of their units of account. As we all know, Ben Graham was disturbed by the tendency of governments to debase the currency and several times presented his idea of the ever-normal granary to congressional committees. So, this concern with monetary integrity has deep roots in our philosophy. The deep concern for permanence and inflation protection means gold bugs can have unique insights and, like the rest of the tent, make money.

The "Buffetteers"

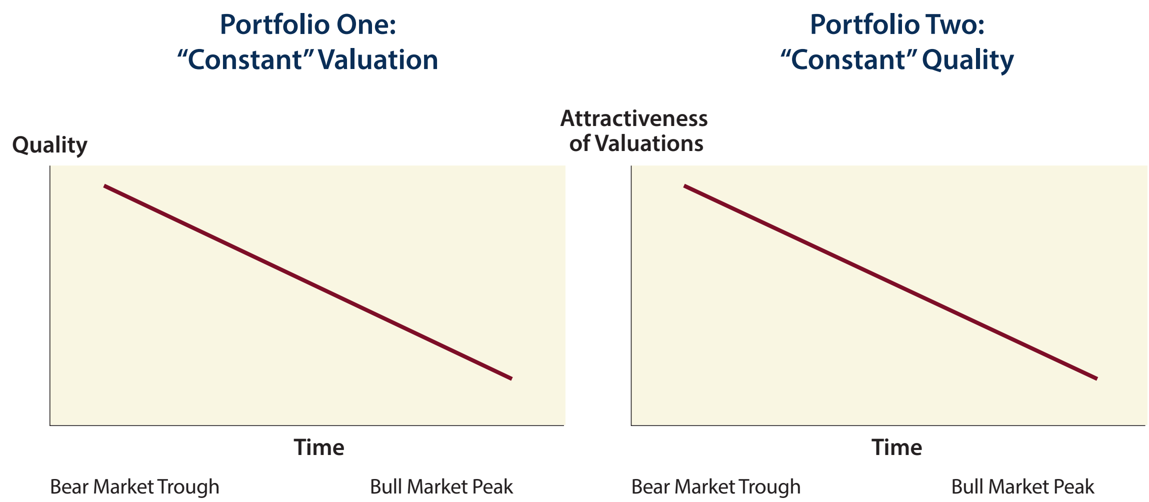
Finally, there is a group that the others tend to look upon with a certain suspicion. These investors own equities that often trade at multiples of book value, and whose balance sheet accounts rarely support the market valuations of their investments. They incorporate some assumptions about future earnings into their valuation work. They tend to own concentrated portfolios of high-quality companies with low turnover. These are the investors that I label Buffetteers, and among whom I number myself.

A large number of value investors are conflicted about Warren Buffett's legacy. They cannot deny his closeness to Benjamin Graham, since he was literally Graham's student at Columbia, and the only student to whom Graham ever gave an A+ in his course; he was an employee of Graham-Newman, that incubator of great value investors; and he was a lifelong associate and admirer of Mr. Graham. He is also the most successful investor of all time, and the only one who became one of the world's richest people mainly by compounding capital in the public securities markets. So certainly nobody wants to disown him.

But Buffett's methods are very different from those outlined by Graham and Dodd. They are so different that some more orthodox value investors find them rather suspicious, and tend to treat Buffett as a one-off – a brilliant but wayward disciple whose methods were peculiarly suited to one specific place and time, rather than as the exemplar of a legitimate branch of value investing. I was trained in a deep-value Graham shop, but migrated later to the quality-value approach, so I have always sought ways to reconcile the statistical- and quality-value camps.

I do not speak for Mr. Buffett in any way. I have attended his annual meeting in Omaha on eight occasions, but he doesn't know me from Adam. And our capabilities are not remotely comparable. In fact, one of the titles I considered for this topic was "Trying to Invest like Warren Buffett when you're not Warren Buffett." But then, all of us are trying to live up to the giants of our field and few, if any of us, will measure up. My task today is to present what I consider to be the principles of the quality school of value investing, and to show its line of descent from the teachings and experience of Benjamin Graham and Warren Buffett.

Constant Valuation and Quality



Constant Valuation vs. Constant Quality

I invite you to undertake a thought experiment with me.

Consider that you are running two portfolios. In one portfolio, you propose to keep low statistical valuations constant throughout the market cycle, adhering rigidly to a program of low price/earnings ratios (P/Es), low price/book ratios, etc. In the other, you wish to keep quality constant, as measured by strong balance sheets, high returns on invested capital and low volatility streams of free cash flow.

Assume that you start the process in a bear market trough, when there are plentiful undervalued stocks in the capital markets. There may initially be some overlap in the portfolios. But as the bull market unfolds, the portfolios will diverge in several respects.

In the statistical-value portfolio, as price targets are reached and multiples expand, the manager must scour ever deeper for discounts of all sorts. Activity can be quite high in this portfolio. As the risk preference of the market rises, by the late cycle it is only risky securities that remain cheap and it is likely that there is a decline in the quality of the statistical-value portfolio over time. Remember, I am making this a purely statistical exercise so this portfolio will never see a discount it does not like, be it due to cyclicality, complexity, secular decline, managerial incompetence or geopolitical tensions.

In the quality portfolio, some positions will be falling by the wayside as the relentless forces of capitalism lay siege to businesses through technological change, shortened product life cycles or globalization. In the case of American companies, managements will be pillaging the business and diluting shareholder value through their compensation arrangements. Turnover will be lower than in the statistical-value portfolio, but valuations will tend to rise significantly from the trough of the market. Given the rather homogeneous nature of the quality investment universe, there are very few pockets of opportunity to improve valuation in the portfolio without sacrificing quality.

Consequently, in one portfolio, if statistical valuations are held constant, quality declines. In the other, where quality is held constant, valuation suffers.

This brief and highly simplistic parable seems to sum up the gulf that separates statistical-value investors and quality-value investors. I believe both approaches, when capably implemented, will produce excess returns for investors and I also believe that both these approaches can be traced back to the methods and investment experience of Benjamin Graham. As an opening argument, let me quote from Chapter 20 of *The Intelligent Investor*:

> "The risk of paying too high a price for good-quality stocks – while a real one – is not the chief hazard confronting the average buyer of securities. Observation over many years has taught us that the chief losses to investors come from the purchase of low-quality securities at times of favorable business conditions."

Clearly Mr. Graham undertook our thought experiment long ago.

Investors who focus too much on quality and not enough on valuation can end up with no margin of safety in their investments. In the Nifty Fifty market of 1972 and the quality mini-bubble of summer 1998, valuations of quality companies became extreme. As a result, a buy-and-hold portfolio of quality stocks underperformed for several years afterward, before advancing beyond the price levels reached in those years. But even in those two extreme cases, the strong business characteristics of the companies usually ensured that quotational losses were eventually reversed, and long-term returns were satisfactory.

But investors who focus too much on statistical-value and not enough on quality can find themselves in an even worse position. The last business cycle gives us a great example of this. In 2007 and 2008, many statistical-value buyers tended to own a lot of financials and credit cyclicals that were statistically cheap, and commodity cyclicals with low P/Es. Such investors often lost more money than the market averages in the downturn, frequently taking irreversible losses on their positions.

A calculation of margin of safety that does not sufficiently consider quality is at least as risky as a calculation that relies too much on quality and not enough on valuation.

GEICO

AN EXAMPLE OF THE QUALITY-VALUE APPROACH

I promised earlier to show how the quality-value approach derives from the Graham tradition.

The key lies in Ben Graham's investment in GEICO, and especially in his analysis of it. GEICO is a somewhat disturbing aspect of Graham's career for the orthodox. He appeared to violate several of his most sacred tenets in the GEICO case.

To recap, in 1948, Ben Graham was offered a chance to purchase 50% of GEICO, a direct seller of insurance that concentrated its marketing on government employees, who were proven lower risks. He put 25% of the Graham-Newman partnership's capital into the investment. Forced by regulators to spin off the shares to his investors shortly thereafter, it became one of the investment wonders of the world. As Graham wrote in the late 1960s:

> *"It did so well that the price of its shares advanced to 200 times or more than the price of the half interest… almost from the start the quotation appeared much too high in terms of the partners' own investment standards. But since they regarded the company as a sort of 'family business' they continued to maintain substantial ownership of the shares despite the spectacular price rise… Ironically enough, the aggregate of profits accruing from this single investment decision far exceeded the sum of all others realized through 20 years of wide-ranging operations in the partners' specialized fields, involving much investigation, endless pondering and countless individual decisions."*

I believe that unsparingly honest paragraph contains the germ of a new way of thinking about investing. There are three striking things I take away from the GEICO story.

First, the size of the investment. Graham was normally adamant on the subject of diversification, suggesting that investors own at least 30 securities in their portfolios, and usually owning up to 75 positions in Graham-Newman portfolios. Buffett, of course, famously referred to diversification as "a defence against ignorance" and proudly concentrates his investments to an unusual extent in securities he believes he understands.

Second, there is the brilliant way Graham reasoned his way to holding the position despite higher valuations than he was normally comfortable with. He decided to treat the investment as a family business. This is elegant. Looking around the world at great fortunes built on free capital, the norm is family ownership of large positions in companies with superior economics. Buffett has prioritized his investments the same way, once referring to three of his positions as, "a permanent part of Berkshire rather than merchandise to be disposed of once Mr. Market offers us a sufficiently high price."

Of course, one of those three investments was GEICO.

Finally, there is the rather wistful remark about the return from this one decision versus that on 20 years of constant labour and frequent decisions. Here, I believe, is the genesis of the idea that fewer decisions can be better. Buffett popularized this idea by saying that if everyone had a 20-punch bus ticket of lifetime investment decisions, our decision-making would be much better.

Graham has another sentence in his assessment of the GEICO story, one that any investor would be wise to take seriously:

> *"Behind the luck, or crucial decision, there must usually exist a background of preparation and disciplined capacity."*

To recognize and take advantage of opportunities, the intelligent investor must be familiar with, and able to apply, the basic techniques of value investing. I do not feel that anyone can successfully practice the quality-value approach if they are not fully trained in Graham and Dodd valuation methods.

GEICO
TAKEAWAYS

So what can we learn from the GEICO story, both Chapter One by Ben Graham and Chapter Two by Warren Buffett?

First of all, there is concentration of positions. I mentioned above that Buffett once said, "Diversification is a defence against ignorance."

He is not known as the "Oracle of Omaha" for nothing. And like the oracles of old, his utterances can be read in several different ways. This one, it seems to me, can be interpreted as a warning as well as a pejorative. The average investor cannot be expected to bring the same level of knowledge and skill to his decisions that Buffett or Graham did – not even close. In any position one enters into, there will be huge areas of ignorance for the average investor. That doesn't mean he should not do his utmost to correct the situation, but concentrating investments as much as Buffett does routinely, or Graham did in his GEICO position, is not for everyone.

Quod licet Iovi, non licet bovi.[i]

The norm at Burgundy is a portfolio with about 20 to 25 equities represented. It seems to work for us.

Second, there is the buy-and-hold preference. This one is particularly troublesome to our statistical-value colleagues, since we can appear insufficiently contrarian and value conscious. Great companies are not always great investments. For example, Gillette reached a price in 1998 that was about the same price as Procter & Gamble paid to acquire the company five years later. Clearly, there was no margin of safety in 1998, and investors should be willing to sell investments where there is no margin of safety. However, a quality company can be held almost indefinitely as long as there is some margin of safety; a great deal more patience should be exercised with an excellent company than with a company whose economics are inferior.

Related to the buy-and-hold preference is the bias against transacting. Transactions always involve costs and the buy-and-hold strategy is a very low-cost way to compound capital. Recent revelations have confirmed that trading today hugely benefits parasitic intermediaries. Inactivity has never been more satisfying.

Finally, it is clear that the very best quality investments are made when they are also compelling value investments. In 2009, when we saw some of our deep-value friends loading up on high-quality stocks, we knew we were going to make a ton of money for our clients. When everybody in the value tent is on the same page, the results will usually be excellent.

Burgundy in Japan

As an illustration of this truth, I would like to talk about Burgundy's experience in Japan, which has been both instructive and reasonably profitable. We have made more money in Japan over the past 10 to 15 years than we have in U.S. large caps, and vastly more than if we had invested in a broad-based index of Japanese stocks. A big reason for that was that we got off to an absolutely wonderful start, thanks in large part to Peter Cundill.

My business partner, Tony Arrell, had dinner with Mr. Cundill in late 1997. Peter was very excited about the values appearing in the Japanese market, and of course he was a man whose excitement about investment opportunities was highly contagious. As it happened, Tony and I had been looking for an opportunity to expand our investment footprint outside North America.

All of our clients were Canadians in those days, and Japan is as different an economy from Canada's as you could find. So we felt Japan would offer great diversification to Canadian investors, as well as a great value opportunity.

In 1997 Japan, there was a full-scale financial crisis in progress. An indiscriminate bear market had taken Japanese equity valuations to extraordinarily low levels. This appeared to Tony and to me as a perfect opportunity to start our foreign equity investing in a low-risk fashion, with investments whose prices did not remotely reflect either asset values or earnings power.

Accordingly, we set off for Japan and spent most of January 1998 in that country. It was a rather depressing trip. I had forgotten how obtuse Japanese managements could be, and how little they cared about shareholders. Clearly there would be major obstacles to applying the quality-value approach there.

On the way back to Canada, I started sifting through the Japan Company Handbook, that invaluable aide to Japanese investing for the foreigner. I was immediately re-engaged as I began to realize what a treasure trove of value the Japanese small- and mid-cap areas were.

Bearing in mind Buffett's warning about diversification and having some idea of the extent of my ignorance, I decided to set up a portfolio of 60 stocks, of which 20 would be net-nets,[ii] 20 would be cash-heavy low-multiple companies that had been able to grow sales and earnings over the previous five years, even if only slightly, and 20 would be better known, larger-cap issues trading at low earnings multiples.

There were about 1,800 issues trading at or below net-net working capital in Japan at that point. We were able to steadily raise the bar on the quality of the net-nets. We could, for example, require that a company have at least 40% net-net cash, have not had a loss in the preceding five years and have earned a return on equity (ROE) of at least 5% over that span. It was, in a phrase, hog heaven for a value guy.

In March we hired Craig Pho, who acted as Analyst on the Fund until mid-2001 when he assumed control of the portfolio. When he joined, I told him our dirty little secret: we were profoundly ignorant and needed some years to get up to speed.

We got six months. In the autumn of 1998, the Japanese government injected capital into the remaining Japanese banks and engineered mergers for the weaker ones. The stock market went vertical. By September 1999, the one-year return in our Japan Fund was 130.2% (in Canadian dollars), still an all-time record one-year return for a Burgundy fund. Thank you, Peter Cundill.

Generally, the larger companies in the portfolio were a bust. They did not appreciate to anything like the extent of the small- and mid-cap names. The better quality net-nets performed very well, while some of the very deep discount working capital net-nets did not do much. The real revelation was the small growing companies we had added to the portfolio. For example, Park 24, a parking lot company in Tokyo, went from ¥1,440 to ¥8,000. Colin Corporation, a small manufacturer, went from ¥900 to ¥9,720. Wildest of all was a tiny company called Drake Beam Morin Japan, which got hyped as a play on Japanese outplacement. We bought it in July 1998, when its market cap was about US$30 million. We sold it in April 1999 at seven times that price and it almost tripled again by the autumn.

Of course we had to sell all these stocks. After 1999, the Japanese market went into a long funk. The unit value in our Fund did not get back to autumn 1999 levels until 2006, and finally breached them decisively in March 2010. You need patience to play in Japan.

But the first year had set the tone for our strategy. We played high-quality net-nets when we could find them, which was less and less frequently over time. We tried to find cash-rich companies that had been able to grow their businesses and, where we could, engaged the company managements in discussions about capital allocation. Despite some glaring exceptions, we believe capital allocation in Japan has improved almost beyond recognition. Share buybacks and dividends have been more and more generous among our Japanese portfolio companies, with good performance effects.

As our ignorance diminished, our portfolios became more and more concentrated in high-quality and well-managed Japanese companies. These do exist, though they are uncommon. Our all-cap portfolio, which has a small-cap bias, today contains 34 equities, while our portfolio with a minimum market cap of US$1 billion contains only 15.

In the 16 years to March 31, 2014, our Asian Equity Fund[iii] has returned 8.3%. The benchmark MSCI Japan Index has returned 1.0%. The absolute numbers may not be that impressive, but they are better than the 16-year return on the S&P 500 Index, which has returned 3.7% to Canadian investors over the same period. I include this information since the S&P 500 is the gold standard among benchmarks worldwide from a quality standpoint, and I think outperforming it over the long term with Japanese assets is a decent accomplishment.

Our investment in Japan has really done the job from a diversification standpoint. In 2008, when worldwide stock markets were plummeting, the yen strengthened against the Canadian dollar and our Fund returned positive 17% (in Canadian dollars) in that year.

While the currency effect was overwhelming, our Fund outperformed the Japanese index by 26% that calendar year. The quality approach has been quite reliable as a downside protector. There have been 180 monthly year-over-year measurements since we launched the Fund in February 1998. Of those, 87 showed negative year-over-year results for the benchmark. So, more than 48% of the time we were investing in a market that was down year over year. In 82 of those cases, or 94% of the time, when the annual market return was negative, the one-year return from the Burgundy Fund beat the benchmark return with either a smaller loss or an actual gain. Our quality investments have effectively protected our clients from the frequent and extensive downside in Japan.

Our impression is that many investors, who flocked to Japan at about the same time we did, had very negative experiences and often found that the market remained irrational longer than their clients could remain patient. In a country where there is no market

Burgundy in Japan

	1 Year (%)	5 Years (%)	10 Years (%)	16 Years (%)
Burgundy Asian Equity Fund	21.8	13.5	5.7	8.3
MSCI Japan Index	17.1	7.7	0.6	1.0
S&P 500 Index	32.4	18.0	5.6	3.7

Annualized as at March 31, 2014
Reported in C$, gross of fees

for corporate takeovers, where businesses are run for the employees or communities instead of shareholders, where growth is too slow to act as a catalyst and where financial sophistication is amazingly low, many of the normal value arbitrage functions are simply not active.

This would be the time for me to show you a really great current investment in Japan. Would that I could. The extraordinarily aggressive monetary policies of the Abe government have led to a massive lift in Japanese equity prices. Whereas Japan was reliably the best value of all Burgundy's geographies for many years, today our margin-of-safety work shows it to be the most expensive. Our cash positions are rising to levels that are historically high for us.

Conclusion

My goal was to show that the quality school of value investors, despite our obvious differences in portfolio construction and behaviour, is based on the principles of Ben Graham, including and most importantly the principle of margin of safety. It derives from the experiences of both Graham and Buffett, particularly from the GEICO case. When applied with discipline and constant attention to valuation, the quality-value approach allows above-average capital compounding at low cost, and has proven to be successful at protecting the downside of our investors.

To illustrate our approach, I have used the example of our effort in Japan, which gave us an unusual opportunity to use the statistical-value approach as a starting point and migrate to our quality-value approach as we gained in experience and knowledge. The statistical-value approach gave us a protected downside when we started off and unusually good returns when a crisis ended. But even after the extraordinary undervaluations disappeared, the performance of quality Japanese companies has continued to allow us to compound capital for our clients, largely through protecting their downside.

I believe this means we are consistently investing with a margin of safety, and that kind of investing, whether you are a deep-value investor, a bear, a gold bug or a Buffetteer, is the hallmark of a value investor.

Endnotes

i. *Quod licet Iovi, non licet bovi*, translated from Latin, essentially means gods may do what cattle may not.

ii. Net-net: an investment where a company's current assets exceed both its current and long-term liabilities. For Graham, an attractive equity investment is one where a company's market value is below the value of its net-net working capital.

iii. Originally known as the Burgundy Japan Fund and restricted to Japanese equities up until December 2006. While still highly focused with no less than 85% invested in Japan, the strategy has since been broadened to include investments in other parts of Asia.

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