The VIEW *from* BURGUNDY

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INVESTING AT BURGUNDY

THE WORLD OF INVESTING can be a very lonely place at times. We have learned over the years, however, that successful investors have developed their own philosophy that guides their investment approach and their actions through that sea of market sentiment. At times, the most important decision is not the individual buy or sell order, but the decision to stick with the investment philosophy you feel is right.

Clients of Burgundy will be familiar with our philosophy of investing: to diligently search out companies of quality that are selling for significantly less than their intrinsic value. Conversely, we sell securities that have become overpriced. While our philosophy is simplistic, it is far from simple to implement. We regularly calculate the intrinsic value of hundreds of companies, and compare those values to what the market is willing to pay for them. Out of all of those calculations, there will be a few companies that will appear to be undervalued. Then the real work starts. Each of the companies that appears to be undervalued will be examined extensively for financial soundness, investor-oriented management and clarity of financial reporting. We regularly interview the management of companies we are interested in and maintain those contacts once we have bought shares of that company. When we do decide to buy a company, we do so because we are confident in our own evaluation, not because we hope that market sentiment will move the share price higher.

At Burgundy, we have invested in the tools we need to perform these numerous evaluations independently, such as databases, computer hardware and other source documents. We read widely and talk to many executives and analysts to understand the business environment of specific companies. But the real key to the successful implementation of an investment philosophy, we think, lies in having good judgment, patience and the right temperament.

The most difficult aspect of investing is to have the confidence and courage to do what is usually quite unpopular. This is because investing in shares of companies that are significantly undervalued often means investing in stocks that the investing public is currently avoiding. Often, some of the best opportunities occur when the economic outlook is bleak and when each day in the newspaper there is a long list of stocks hitting new lows. Suffice to say, today's environment is quite the opposite; the new-lows list has seldom been shorter.

But no investment philosophy, like other philosophies of life, is static. Occasionally, you must revisit your beliefs to reinforce currently held assumptions and glean new perspectives. Such a reinforcement, in our case, can come from a review of some of the great literature on investing and a careful study of successful value investors such as Warren Buffett.

Warren Buffett is one of the great businessmen of our day and a great thinker on investments. He is the Chairman of Berkshire Hathaway and an eminent investor. Forbes (October 1993) declared that he is the richest man in America, with $8 billion of net worth. So strong is our confidence in his ability to invest that several Burgundy Funds are shareholders of Berkshire Hathaway.

We are particularly fond of an essay Buffett prepared for a class at Columbia University in 1984 commemorating

the 50th anniversary of Security Analysis, the famous book written by Benjamin Graham and David I. Dodd. The talk dealt with the merits of value investing and the success of some of Ben Graham's students. It also pokes fun at some of the institutional investing maxims of our day, such as volatility. Here were some of his comments:

"In this group of successful investors that I want to consider, there has been a common intellectual patriarch, Ben Graham… The common intellectual theme of the investors from Graham-and-Doddsville is this: they search for discrepancies between the value of a business and the price of small pieces of that business in the market. Essentially, they exploit those discrepancies without the efficient market theorist's concern as to whether the stocks are bought on Monday or Thursday, or whether it is January or July, etc. Incidentally, when businessmen buy businesses – which is just what our Graham & Dodd investors are doing through the medium of marketable stocks, I doubt that many are cranking into their purchase decision the day of the week or the month in which the transaction is going to occur. If it doesn't make any difference whether all of a business is being bought on a Monday or a Friday, I am baffled why academicians invest extensive time and effort to see whether it makes a difference when buying small pieces of those same businesses. Our Graham & Dodd investors, needless to say, do not discuss beta, the capital asset pricing model, or covariance in returns among securities. These are not subjects of any interest to them. In fact, most of them would have difficulty defining those terms. The investors simply focus on two variables: price and value.

I always find it extraordinary that so many studies are made of price and volume behaviour, the stuff of chartists. Can you imagine buying an entire business simply because the price of the business had been marked up substantially last week and the week before? Of course, the reason a lot of studies are made of these price and volume variables is that now, in the age of computers, there are almost endless data available about them. It isn't necessarily because such studies have any utility; it's simply that the data are there and academicians have worked hard to learn the mathematical skills needed to manipulate them. Once these skills are acquired, it seems sinful not to use them, even if the usage has no utility or negative utility. As a friend said, to a man with a hammer, everything looks like a nail.

I think the group that we have identified by a common intellectual home is worthy of study. Incidentally, despite all the academic studies of the influence of such variables as price, volume, seasonality, capitalization, size, etc. upon stock performance, no interest has been evidenced in studying the methods of this unusual concentration of value-oriented winners.

While they differ greatly in style, these investors are, mentally, always buying the business, not buying the stock. A few of them sometimes buy whole businesses. Far more often they simply buy small pieces of businesses. Their attitude, whether buying all or a tiny piece of a business, is the same. Some of them hold portfolios with dozens of stocks; others concentrate on a handful. But all exploit the difference between the market price of a business and its intrinsic value.

I'm convinced that there is much inefficiency in the market. These Graham-and-Doddsville investors have successfully exploited gaps between price and value. When the price of a stock can be influenced by a "herd" on Wall Street with prices set at the margin by the most emotional person, or the greediest person, or the most depressed person, it is hard to argue that the market always prices rationally. In fact, market prices are frequently nonsensical.

I would like to say one important thing about risk and reward. Sometimes risk and reward are correlated in a positive fashion. If someone were to say to me, "I have here a six-shooter and I have slipped one cartridge into it. Why don't you just spin it and pull it

once? If you survive, I will give you $1 million." I would decline – perhaps stating that $1 million is not enough. Then he might offer me $5 million to pull the trigger twice – now that would be a positive correlation between risk and reward.

The exact opposite is true with value investing. If you buy a dollar bill for 60 cents, it's riskier than if you buy a dollar bill for 40 cents, but the expectation of reward is greater in the latter case. The greater the potential for reward in the value portfolio, the less risk there is.

One quick example: The Washington Post Company in 1973 was selling for $80 million in the market. At the time, that day, you could have sold the assets to any one of ten buyers for not less than $400 million, probably appreciably more. The company owned the Post, Newsweek, plus several television stations in major markets. Those same properties are worth $2 billion now, so the person who would have paid $400 million would not have been crazy.

Now, if the stock had declined even further to a price that made the valuation $40 million instead of $80 million, its beta would have been greater. And to people who think beta measures risk, the cheaper price would have made it look riskier. This is truly Alice in Wonderland. I have never been able to figure out why it's riskier to buy $400 million worth of properties for $40 million than $80 million. And, as a matter of fact, if you buy a group of such securities and you know anything at all about business valuation, there is essentially no risk in buying $400 million for $80 million, particularly if you do it by buying ten $40 million piles for $8 million each. Since you don't have your hands on the $400 million, you want to be sure you are in with honest and reasonably competent people, but that's not a difficult job.

You also have to have the knowledge to enable you to make a very general estimate about the value of the underlying businesses. But you do not cut it close. That is what Ben Graham meant by having a margin of safety. You don't try and buy businesses worth $83 million for $80 million. You leave yourself an enormous margin. When you build a bridge, you insist it can carry 30,000 pounds, but you only drive 10,000-pound trucks across it. And that same principle works in investing.

In conclusion, some of the more commercially minded among you may wonder why I am writing this article. Adding many converts to the value approach will perforce narrow the spreads between price and value. I can only tell you that the secret has been out for 50 years, ever since Ben Graham and Dave Dodd wrote *Security Analysis*, yet I have seen the trend toward value investing in the 35 years that I've practiced it. There seems to be some perverse human characteristic that likes to make easy things difficult. The academic world, if anything, has actually backed away from the teaching of value investing over the last 30 years. It's likely to continue that way – ships will sail around the world but the Flat Earth Society will flourish. There will continue to be wide discrepancies between price and value in the marketplace, and those who read their Graham & Dodd will continue to prosper."[†]

Endnotes

†. Buffett, Warren E. "The Superinvestors of Graham-and-Doddsville". [transcript] May 17, 1984. Speech to the Columbia Business School.

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