The VIEW *from* BURGUNDY

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REFLECTIONS FROM THE FUNHOUSE

TOP CORPORATE MANAGERS AND ELITE INVESTORS both specialize in capital allocation. Whether in the corporate sector or in securities investments, the most successful capital allocators follow some surprisingly similar behaviour patterns. When confronted with an overwhelming number of investment choices, they step back, assess the commercial realities they face, and then define the strategic orbit within which they, or their organizations, can outperform over the long term. Success flows from that process. In this *View from Burgundy*, we will delve into how the best managers set such boundaries. Using the same principles, we will then offer suggestions on how to frame investment decisions so that better choices can be made.

Legg Mason's Michael Mauboussin became intrigued with the success of a small number of securities investors who had generated excess returns for their clients over a very long-time horizon.[1] He found some interesting similarities in their approaches: all of these successful investment firms adhered to a "value" approach, tended to hold a limited number of stocks, and held their positions for a long time.

Most "professional investors" do not behave this way at all. They handle the mind-boggling array of investment options by spreading their bets widely and jumping around among holdings at a dizzying pace. Consider this: the average mutual fund's annual turnover is more than 110% today versus only about 20% in the 1960s. And since these funds tend to hold a large number of positions (more than 100 is probably normal) this means that, on average, they are selling and replacing more than two positions per week. Of course, many managers transact much more frequently.

Incidentally, clients are not much more disciplined than their own professional managers. Today, the average mutual fund holders only keep their units in a given fund for about 30 months, compared to an average of more than 10 years in the early 1970s. Managers and clients alike are constantly distracted by the noise, the information overload, and the sheer volume of choices presented by today's inordinately complex capital markets.

And these shareholders have a pronounced effect on the managements of the companies in which they ephemerally "invest." With this hyperactivity of investors has come a demand for short-term gain that places huge pressures on managements of public companies to do something, whether that something is an acquisition, a stock buyback, or a disposition of assets. Given their normal empire-building instincts, corporate managers are always trolling for deals and looking for ways to offer short-term gains to shareholders. They too face a huge variety of choices, and they do not always choose wisely.

A recent book focused on the subversive nature of having too many options and too many opportunities to choose from. This book, *The Paradox of Choice: Why More is Less*, by Barry Schwartz, concludes that having almost unlimited options encourages people to make too many decisions, and to feel worse about the ones they have made. In turn, this propels people to

change their minds a lot, leading to a vicious cycle of change and regret. Mr. Schwartz's book focuses on daily life and its many decisions, but it has obvious applications for investors and corporate managers.

From watching Warren Buffett and the other great investors on Mr. Mauboussin's list, we know that the surest way to create wealth is to follow a consistent value approach. Such investors own a limited number of high-quality companies for a long time, preferably after buying them cheap. Yet Mauboussin has concluded that only about 8% of public funds are managed in this fashion.[2] Why is this approach practiced so rarely?

MAINTAINING DISCIPLINE IN A WORLD OF PROMISCUOUS CHOICE IS REALLY HARD.

The answer, according to Mr. Schwartz, is that maintaining discipline in a world of promiscuous choice is really hard. There are elements of human nature that seem to militate against intelligent restraint. Superior investors are doing something that others cannot or will not do. They are defining and remaining within boundaries, within which they can outperform over the longer term. Buffett calls these boundaries a circle of competence.

The Best Investors Stay Within a Circle of Competence

Staying within a circle of competence implies that choices will be limited. The outer limits are pretty clearly defined. No investor can be all things to all people, nor is anyone capable of valuing all securities. Investing money without investing adequate time to truly get to know the inherent risks will often lead to permanent capital losses. Staying within a circle of competence forces focus on a limited number of investments and leads to the steady accumulation of knowledge about a business and its inherent risks. As the value investors on Mr. Mauboussin's list have shown, this necessarily long-term approach can be a recipe for great long-term returns.

What behavioural issues make value investing so difficult? There are several, all of which flow from the many paradoxes that define human nature. At one extreme the human mind is unique in the animal world for its ability to plan for the future. This has allowed for huge advances, technological and otherwise, and it has also given us an imagination, which differentiates humans from others in the animal kingdom.

On the flip side, our brain is poorly designed when it comes to dealing with fast-changing capital markets. Humans can be at the same time overconfident and paralyzed by uncertainty. Our physical response to stress, which manifests itself as fight or flight panics when faced with surprise, has evolved to prepare us for the short term. The human mind's systematic contradictions cause most of us to fail when making long-term decisions in conditions of uncertainty.

So nearly everyone has a time horizon that is too short to deal intelligently with the capital markets. Most market participants chase the same "timely" investments, whose popularity bids up their prices. Low subsequent returns are the result. Cheap stocks get cheap precisely because they are unpopular. Since there is rarely an obvious catalyst to close the gap between intrinsic value and price, the timing of value realization is unpredictable. Value investing is a get-rich-slow approach that rewards patience above all, a quality that human nature ensures is in short supply.

Value investing is also unpopular because it comes with social pain. The best investors all concur that being in a small minority is necessary for an investment to be a big win. Yet human evolution has programmed us to feel unsafe and uncomfortable when we are alone, and most people cannot stand to remain that way for long. It is infinitely more comfortable to be part of a crowd than to be alone. Again, we see an intense pressure towards the short term.

In addition, most investment firms that adopt the value discipline assume a lot of business risk because so many clients and potential clients compare short-term performance to an index or other benchmark. Value investors' portfolios look nothing like an index, so there are inevitably periods of time when the investment results do not compare well to the benchmark. And the end-date sensitivity of returns means that most clients can deceive themselves into believing that a manager has done badly for a long period, when it may be only one poor year relative to the index that distorts the returns. A lot of business can be lost in such years and the principals of most investment firms conclude that the cost of a long-term time horizon is simply too high to bear.

Human nature being what it is, defining and remaining within a circle of competence is much harder than it looks. The necessary disciplines, such as long-time horizons, a willingness to undergo social ostracism, and acceptance of lost business in "out periods," are too difficult for most investors to follow. That is why value investing is practiced by only a minority and why the long-term payoffs are so great.

The best corporate managers tend to apply a lot of the same disciplines as value investors do. They set and stay inside boundaries for the company's activities. But these boundaries are to some extent naturally dictated by the company's business position. The rough boundary is defined by the barriers to entry that a business possesses.

The Best Companies Use Barriers to Entry to Define Their Circle of Competence

Barriers to entry are structural forces that prevent new competitors from entering a market and eroding profitability. Warren Buffett calls it a moat around the business. Companies operating in this protected position are able to generate high returns by doing things that competitors cannot or will not do, much like the circle of competence used by the best investors.

Although there are important similarities between the two circles, there are also differences. Note the defensive implications of the words "barriers" and "moats." While the implication of a circle of competence is one of staying inside, a barrier to entry implies keeping threats out, since it is in the nature of capitalism to erode entry barriers and eliminate excess profits in most circumstances. Investors need the discipline to stay within a circle defined by their understanding of economics and businesses; the corporate managers need the discipline to stay within an economic fortress defined by their business. So the two are mirror images of each other, where the mirror is slightly curved, like those found in the funhouse at a carnival.

The best CEOs of companies with moats share a critical insight: a durable barrier to entry is a scarce and extremely valuable asset. There is an important corollary – don't stray outside the moat. Because competitive advantage only exists in areas inside the moat, investments outside the moat face a high risk of failure. Yet business history is rife with tales of companies that have wasted the shareholders' money making undisciplined forays across the drawbridge. (Just think of Time Warner's catastrophic merger with AOL, or BCE's disastrous acquisition of

Teleglobe.) The same behavioural issues plaguing investors are evident.

Most investors and CEOs alike, being human, default towards behaviour with a focus on the short term. Just as investors are under pressure from competitors, clients, brokers, and consultants to participate in booms and diversify beyond the circle of competence, managers are under pressure from short-term shareholders, investment bankers, and competitors to do something. Too often that "something" involves making dramatic strategic moves outside the moat. Moreover, with the tenures of corporate leaders getting shorter every year, there is an intense pressure to cash in during this brief period at the top. As a result, the behaviour of CEOs often reflects that of typical high-turnover professional investors. These shareholders get the CEOs they deserve, and vice versa.

MOST CEOS AND INVESTORS DEFAULT TOWARDS BEHAVIOUR WITH A FOCUS ON THE SHORT TERM.

The appropriate time horizon for an owner is forever. We have often seen the best long-term corporate performance come from family-controlled companies, where the CEO is fully aware of this enduring planning horizon. The typical hired-gun manager, like the typical investor, is under tremendous temptation to behave very differently. In our experience, they do not often resist the temptation successfully.

At that small minority of investment firms and companies that consistently outperform the long-term averages, the leaders resist these pressures in a similar way. They define and remain within a circle of competence. The best investment firms use a value approach to set the boundaries, while the CEOs of the best companies use barriers to entry to outline their limits. Adopting this discipline is the only way to ensure that a long-term planning horizon will be used.

So the key to having the patience to make long-term decisions is discipline. In that way, companies and investors are linked. Company CEOs need patient investors who give them the time for long-term decisions to bear fruit. And investors need patient CEOs to make the tough decisions in the best long-term interest of the owned companies. From this virtuous circle investment success can follow.

We have mentioned Mr. Schwartz's book *The Paradox of Choice* before. His focus is the problem of intelligent decision making under conditions of minimal constraint, and the psychological effect of that "free choice" environment on most people. His book looks at the modern American consumer as the avatar of this trend, and places widespread feelings of helplessness, depression, and self-blame squarely at the door of an environment that provides too many choices. He concludes his book with a number of decision rules to help people deal with their complicated daily lives. We found several of his decision rules so applicable to the world of corporate and securities investing that we adapted them for this article. The four that are most germane to our theme are included here.

1. Learn to love self-imposed constraints. Most people might be surprised by this rule since they may feel that value investors must have unrestricted access to any area where value can be found. But the success of the best investors and CEOs is achieved within very stringent, self-imposed constraints. Mr. Schwartz classified these constraints in several categories: in declining order of stringency, they are rules, standards, and presumptions.

One rule comes before all others. Never invest outside the circle of competence. This rule is self-perpetuating, since it forces the manager to define the circle of competence carefully. For corporate managers, the rule should be to focus as much as possible within the moat around the business.

An example of standards would be the constraints under which Warren Buffett invests. He uses not only stringent standards of barriers to entry and high returns on capital, but also assessments of management character and capabilities that he is uniquely equipped to make. Simply by stating at the outset that his minimum standards do not include lower quality, marginally profitable, or outright speculative companies, Buffett is left with far more time to spend learning about the outstanding businesses that make the cut.

ONE RULE COMES BEFORE ALL OTHERS: NEVER INVEST OUTSIDE THE CIRCLE OF COMPETENCE.

A corporate minimum standard might be to undertake no investments that earn less than the cost of capital, using extremely conservative assumptions. While not rocket science, this management discipline is about as rare as outstanding companies, which suggests it is worth thinking about.

For a corporate manager, a presumption might be that since acquisitions generally subtract value, none will be made. Since presumptions are less restrictive than rules, they leave more room for exceptions. In a rare case, such as an in-market merger that builds economies of scale, an acquisition may be an excellent opportunity.

A presumption for an investor may be that what he already owns and knows well is a better investment than something new. Again, this presumption can be abandoned when valuation or opportunity dictate, but it is a useful starting point.

2. Be a Chooser, not a Picker. Mr. Schwartz states that "choosers are people who are able to reflect on what makes a decision important, on whether, perhaps, none of the options should be chosen, and on whether a new option should be created."[3] Every investment decision should be important, and they will be if investors restrict the number of decisions.

Warren Buffett has said that everyone should make their investment choices as if they were only allowed to make 20 investment decisions in a lifetime. Choosers are like baseball players who can take the time to sit back and wait for the fat pitch. After they "swing" and make the investment under the most favourable possible conditions, their only job is to continue to learn about the business in which they have invested, keeping a wary eye on competitors, regulators, and customers for signs of eroding barriers to entry. This monitoring is not nearly as exciting as switching into something new and fresh. In fact most people find it deadly dull. Daring to be dull is not something most people want to do, but it can lead to big rewards in the long term, as Mr. Mauboussin has shown.

Choosers that stick to high standards of quality and valuation will avoid bubbles and cycles to a significant degree. As Mr. Schwartz observes in another context: "Only choosers have the time to avoid following the herd."[4] Taking that time is critical to capital preservation. Somehow the number of people who hang on to any of the money generated from bubbles and cycles is pretty small.

Instead, when faced with a plethora of choices and a cacophony of noise, most market participants become "pickers" who select relatively passively from whatever options are available. They spread their bets widely and jump around. Decisions become reactive, as surprising

information is constantly forthcoming that overwhelms their limited understanding of the situation. It's pretty clear to which category an investor should seek to belong.

3. Presume that your decisions are irreversible. What would investors do if told the stock they were buying could never be sold? They would take some care with the decision, wouldn't they? They might even start acting like "choosers" with all of the concomitant benefits.

Note that this is a presumption, meaning that in cases where a company's moat starts shrinking (a common occurrence, by the way) the holding could be sold. But we would still contend that assuming an indefinite holding period is the best place to begin framing investment decisions.

For CEOs the same reasoning applies. The big strategic choices will be given the appropriate time and analysis if it is presumed they are irreversible. Relying on investor amnesia to consign past errors to oblivion is not an effective strategy for a manager who wants to excel. Writedowns of past errors may disappear from the financial statements immediately, but they are not victimless crimes.

4. Curtail relative comparisons. Ignoring what others are doing at any given time removes the "grass is greener" effect from decision making. While always a useful prescription for investors, it is particularly so during peaks, troughs, and bubbles in the market, when maintaining discipline is most difficult. Independent thinking will give better conclusions in any situation. But it is a rarity in corporate life and in the capital markets.

We have all witnessed the tendency of investors and companies to do what their competitors are doing – especially in boom times. The two disasters we referred to on page three, by Time Warner and BCE, both occurred during the tech bubble, when these companies decided that their stable, powerful, profitable, and unexciting core businesses needed to merge with dynamic new businesses of unproven worth. And most money managers in that period were behaving the same way, looking for excitement and popularity rather than for quality and reliability. Those who stayed focused did their shareholders and clients a great favour.

Warren Buffett advises investors to completely ignore conventional wisdom. By the time it is conventional, it is rarely wisdom. It simply does not matter if others agree or disagree with your conclusion. What matters is that the analysis is correct. The same holds true for corporate strategy.

It does make sense to keep track of how the winners are defining their boundaries. But it is best to curtail peering over the fence to see if in the short term you are keeping up with the Joneses. Behavioural finance theory suggests that the optimal period between reviews of your portfolio should be 13 months. Very few of us could say we obey that rule!

DECISION RULES TO FRAME INVESTMENT DECISIONS

1. Learn to love self-imposed constraints
2. Be a Chooser, not a Picker
3. Presume that your decisions are irreversible
4. Curtail relative comparisons

Using these four rules of thumb can help investors and CEOs define the boundaries of a circle of competence. This is one way to withstand the intense pressure towards adopting short-term planning

horizons that is caused by deep-seated behavioural issues. The best CEOs and investors are doing it already. It is called discipline.

These investors and corporate managers need each other, because a CEO cannot make long-term decisions without the support of long-term shareholders, and an investor cannot generate superior returns without owning companies run with long planning horizons. Thankfully, it is easy for each to recognize the other. The reflection staring back from the funhouse mirror is a person with a really long-term time horizon, the only appropriate view for investment success.

Endnotes

1. Mauboussin, Michael. *More Than You Know.* "Investing – Profession or Business?" Columbia University Press. 2006.

2. Mauboussin, Michael. *Mauboussin on Strategy.* "Long-Term Investing in a Short-Term World." Legg Mason Capital Management. May 18, 2006.

3,4. Schwartz, Barry. *The Paradox of Choice: Why More is Less.* Harper Collins. 2004.

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