The VIEW *from* BURGUNDY

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Rooney's Believe it or Not

Richard Rooney, the President of Burgundy, delivered the following speech on the Firm's Client Day, May 13, 2003.

Rooney's Believe It or Not

I'm sure when you opened your first-quarter report you had a moment when you thought (among other things), "I wish I hadn't been in stocks last year." And the shorter your experience with our company, the worse you felt, because we have not generated strong positive annual returns since the first quarter of 2002. The fact that very few long equity managers in the business did better, and that your managers shared your pain by being invested alongside you, is cold comfort at best. And you felt even worse when you heard about how some of your friends did last year.

One of the perennial features of being an investor is that you are always running into people who did something bold and imaginative with their investments, and who made more money than you did. This morning, I'd like to examine some of the ways that your friends may have done better than you did in 2002. I want to think through the logic behind those investment approaches with you, and ask if you believe that logic still holds.

There is a field of study called behavioural finance that examines how people actually invest. Behavioural finance shows that people at one and the same time overestimate the returns they will receive on an investment, but compensate for that optimistic bias by almost never making bold moves with their money. For example, almost everyone accepts that equities give higher long-term returns than other asset classes. And despite this belief, almost nobody has all their money in equities all the time. So bold and decisive moves in investing are extremely rare, and the people that say they liquidated their holdings and went into another asset class in 2002 are probably not telling the whole truth. They probably did something, but just enough to feel good about.

What were some of the things people could have done in 2002 to feel good about? Well, in increasing order of risk, they could have stayed in T-bills, bought bonds, bought income trusts, bought gold stocks, bought hedge funds or sold their equities planning to re-enter the equity market at a later date.

When you make any of these moves, you are saying you believe something about the world. Let's think through what those beliefs are, and you can decide whether you share them sufficiently to put your hard-earned money on the line.

I. Stay in T-Bills

The most risk-averse strategy over the past year has been to stay in T-bills. Sure the yield was lousy, but the satisfaction of not losing money was pretty high. The behavioural finance people tell us that a loss is over twice as painful as a gain is pleasurable. So you may feel a pleasant glow of satisfaction when you see a 10% or 15% positive annual return, but you feel a 15% loss like a kick in the stomach. I know I do.

T-bills have the great advantage that they are relatively deflation and inflation proof. If the economy deflates, you get your money back, while if it inflates, your yield follows inflation up, with a lag.

But at current yields, if you stay in T-bills, you are saying you believe that the risks in the capital markets and the economy are so great that you are willing to sacrifice almost all possible returns for capital safety. Do you believe this, or not?

If you had a lot of cash in the last year, congratulate yourself, tell your friends about it and by all means exaggerate. But remember, what worked last year, especially with an extreme strategy like going to cash, will probably not work two years in a row.

II. Buy Government Bonds

With the economy floundering in 2002, bonds did pretty well, giving you a blended return of about 9%. Yields are down to lows not seen since the 1960s.

But if you own only government bonds at these yield levels, you are making a one-way bet on deflation. With the sole exception of the last decade in Japan, there has been no period of deflation since the gold standard was abandoned in 1945. Warren Buffett claims that inflation is only "in remission because of the human nature of legislators." †

Inflation is murder for bondholders. When I started in this business, after the great inflation of 1966-1982, bonds were still often referred to as "certificates of government confiscation." So, do you believe in deflation, or not?

As with treasury bills, the return sacrifice from going into bonds could be significant. Collecting a 5% taxable coupon is a tough way to compound your capital. Even with quite conservative assumptions, equities should do better than that, especially after tax.

III. Buy Income Trusts

Income trusts appeal to people who see the derisory returns from T-bills, bonds and most equities, and look for alternatives. Burgundy has become identified as being against income trusts on principle. In fact, we think they are a great idea for the very limited number of companies that can sustain their payouts for the long term.

But the factors that will enable income trusts to sustain higher yields are exactly the same ones that will drive the stock market. Income trusts are essentially just calls on corporate cash flows, and so you need growth in the economy and growth in corporate earnings to keep them paying out those cash flows.

If you own income trusts rather than equities, you must feel income trusts are a better structure than a share capital corporation to deliver returns to shareholders. Do you believe that, or not?

The returns on income trusts currently look pretty attractive relative to what is available in traditional yield investments like bonds, treasury bills and preferred shares. The problem is that the class is very heterogeneous and has a short track record. So nobody knows what to expect. In our view, high-quality common stocks should outperform income trusts over the long haul because, as an asset class, their performance characteristics are a known quantity.

IV. Buy Gold Stocks

As the only monetary asset that is not someone else's monetary liability, gold has a unique position in finance. I feel that if I really understood the psychology of gold investing, I would be so wealthy that I would be listening rather than talking at functions like this. As you can see, that is not the case.

Investing in gold equities is a hedge against monetary inflation and global catastrophe. But valuations of gold stocks are usually so high that it is very difficult to justify them without resorting to dubious methods.

If you own a lot of gold stocks, you are betting either that the government will print money and cause inflation, or that the world financial system faces complete collapse. Do you believe that, or not?

From a returns standpoint, gold equities are volatile performers, and are world-beaters only about one or two years out of every decade. After a huge run since September 11, the group has probably had its day for a few more years.

V. Buy Hedge Funds

From a fringe industry 10 years ago, hedge funds have now become mainstream for many institutions, and are gaining market share with individual investors as well. The fact that just about anything can be designated a hedge fund has perhaps obscured the original purpose of these products. The concept of hedging is, according to my dictionary, "to protect oneself from losing or failing by a counterbalancing action." This implies that a true hedge fund would not be a return maximization vehicle, but rather a risk management vehicle. Most of the ones I have seen that sell to private investors do not look like that. Most of them are taking big risks.

The risk they have usually been taking is selling short. Selling short is a scary process. Your return is capped at 100% since the most you can make by going short is the price at which you sold the stock. On the other hand, if the stock you have sold short goes up in price, your losses are potentially unlimited. So to us, the risk/return tradeoff is against the short seller. Nevertheless, since the spring of 2000, it has been almost impossible not to make money by shorting stocks. And if it's impossible not to make money doing something in the capital markets, financial people will be attracted to that activity like vultures to carrion, and the public will flock to it like sheep. Note my different similes.

There are now more than 6,000 hedge funds in North America, up from perhaps 500 a decade ago. The fee structure that is charged is extremely generous and sometimes extortionate. These managers are generally not held to any benchmark absolute return and they take home 20% or more of the total pretax return on their clients' funds. Disclosure is usually minimal and regulation, especially of offshore-domiciled products, is non-existent. Track records of longer than three years are rather rare.

If you put all your money in hedge funds, you must believe that this new and opaque investment category can earn outsize returns without outsize risks. Do you believe that, or not?

There are many capable hedge fund managers around. But for every good one, there are probably a dozen bad ones, and for every careful and well-executed strategy, there are likely a dozen high-risk ones involving short exposure. This area is new, underregulated and lacks transparency for investors. Caveat emptor.

VI. Sell Stocks and Get Back In Later

Once in a while, you meet someone who claims they successfully timed the market. As my previous remarks about behavioural finance will indicate, you should be skeptical about their claims. But you should be even more skeptical about their strategy. Of all the ways to use the stock market, market timing is the most risky and most likely to lead to foregone returns.

If you are going to invest in common stocks, you must invest in them continuously. In the long run, the market tends to recognize the appropriate value for a company. But there are large leads and lags in the process, and value is recognized on a shockingly small number of days.

Nicholas-Applegate surveyed the 10-year period from January 1, 1983 to December 31, 1992. Over this period, there were 2,526 trading days. The compound rate of return on common stocks was 16.2%. If by poor market timing you missed just the best 40 days of that market, and had been fully invested for the other 2,486, your return would have fallen from 16.2% to 3.6%. Those 40 days, 1.6% of the trading time, accounted for 78% of the returns.

To sell equities and look for a later re-entry point, you have to believe that you can successfully time the market. Do you believe this, or not?

The stock market climbs a wall of worry. By the time the risks disappear, the returns will have already been realized. Getting out of the market in order to get back in is a loser's game.

VII. Buy and Hold a Diversified Portfolio of High-Quality Common Stocks

This is the strategy that most people in this room have followed over the past several years.

The reason that common stocks are so unreliable as a short-term source of returns is that they cannot adapt instantly to changes in the economic environment. But the reason that they are so reliable as a long-term generator of returns is that they can and do adapt to long-term trends in the economy. They are human institutions. That means they are prone to make mistakes. It also means that they are resilient and amazingly adaptable. A couple of years ago, we put out an issue of *The View from Burgundy* that updated the Nifty Fifty growth stocks of the early 1970s. Lo and behold, the great majority of these companies had delivered outstanding long-term returns to their shareholders for more than 30 years. Think about the challenges these companies faced over that time frame. Oil shocks, stagflation, fluctuating currencies, brutal monetary disinflation, interest rate spikes, stock market crashes, recessions, booms, bubbles and September 11th were all included in the measurement period. And shareholders made money. They didn't make it in a straight line, they weren't always above water, but they earned strong returns, especially from businesses with high barriers to entry.

We think that this is the ultimate argument for owning stocks in good companies. They have survival instincts, they have mind and management, and they can adapt. The adaptation process may not be immediate, but it is reliable and effective. None of the other strategies offer this feature. Bonds and treasury bills are, in the last analysis, only fixed streams of cash flows. Gold is a commodity, albeit an odd one. Nobody knows what hedge funds are. Companies are living organisms – active rather than passive investments. They alone of these investments have the capacity to learn and to grow.

And the investment environment, unlike the economic environment, is better today than it has been in many years. During the 1990s, there was a huge abdication of responsibility by those who are supposed to make the capital markets function. Auditors and accountants forgot their obligations to shareholders and became doormats and sometimes accomplices of managements. Boards of directors likewise forgot themselves, often because they were aligned with option-holding managers rather than shareholders. Managers indulged in accounting and share price manipulations, and even fraud, due to corrupt accounting and grossly misguided incentive systems. In a political environment of deregulation and laissez-faire, regulators were starved of funds, and had great difficulty keeping up with advances in financial technology. Money managers were too busy taking personal credit for returns generated from a runaway stock market to look after the interests of their own clients.

In other words, shareholders had few real friends in the 1990s.

Today, by contrast, everyone is trying hard to be on the side of the shareholder. Accountants, horribly embarrassed and ashamed by the events of the 1990s, are more likely to stand up to corporate pressure than at any time in history, since the future of their profession depends upon it. Regulators are getting more funding than they ever have, and will put more resources to work. Many businesspeople lament the increased regulatory scrutiny, but when the system proves that it cannot be trusted to produce equitable outcomes, increased regulatory activity is both inevitable and desirable. Managements are fighting a rearguard action against these changes, but it is clear that the golden age of options and share price manipulation is over. And shareholders are finding champions among money management organizations.

An example is the Canadian Coalition for Good Governance. We believe that this watchdog will help protect shareholder interests in Canada. It has a potentially huge role to play in advocating shareholder-friendly policies to accounting standard-setters, regulators and legislators. It is also not afraid to pick a fight when management strays from the straight and narrow. And other such organizations have sprung up in other countries.

So the system is much more vigilant against fraud and manipulation than it was in past years. And you have the adaptive qualities of equities on your side. One last building block has to be in place for us to get excited about equities. That is value.

There is a pretty good story here as well. You have no doubt seen the articles lamenting how expensive the stock markets are today. The S&P 500 sells at 27.4 times next year's earnings, and 3.5 times book value, yielding only 2%. That is quite true. Fortunately, we do not invest in the S&P 500 Index. The blended price-to-earnings multiple of our portfolio in the U.S. is about 17 times on next year's earnings. The vast majority of the overvaluation in the market is in the technology sector, where multiples are sky high after the recent rally. And our exposure here is minimal. We have recently been able to buy really good companies on sale, and that is good news for future returns. And this is true in all markets where we invest, whether the U.S., Canada, Japan or Europe.

Our approach of owning a diversified portfolio of good companies in the world's major markets, with bond and money market exposure tailored to your circumstances, will work better than any of the extreme moves that gave your friends bragging rights in the last year. In equity investing, as the present darkens, the future brightens. Three years of bear market declines have produced some good value among the reliable, well-managed companies we like to invest in. The regulatory and governance framework has been repaired and will function better than it has in many years. And you have the ace in the hole – the superb adaptive capabilities of public corporations are on your side to build wealth through share ownership. So despite or because of a sloppy world economy, despite or because of the world political situation, despite or because of the three-year bear market and the universal dislike of equities as an investment class, as a diversified equity investor, you are better off today relative to the investment alternatives than at any time in the past decade. Believe it or not!

Endnotes

†. Buffet.

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