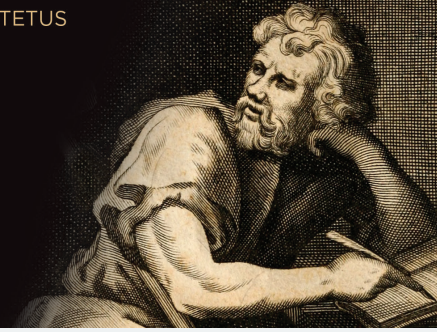


The VIEW from BURGUNDY

**“A man must think hard
and live simply to do well”**

EPICTETUS



STOICISM AND THE ART OF PORTFOLIO INTERVENTION

Warren Buffett and other successful quality/value investors have given us a capital compounding system that works. But few follow the program.

In this issue of *The View from Burgundy*, we will outline some reasons why so few mimic these great investors. For those who want to, we will suggest some investing principles that should be agreed upon before implementing a similar approach. Finally, we will use these principles to develop a portfolio intervention protocol to help us execute the system on a day-to-day basis.

QUALITY/VALUE INVESTING WORKS — SO WHY ARE THERE SKEPTICS?

Buffett's system is simple. Identify a handful of franchise businesses – those with persistent competitive advantages and great management. Wait for them to get cheap, then buy them. And almost never sell. It has worked like a charm, but if it really is so simple, why don't more investors mimic him?

There are two reasons:

1. Some may not agree that this is the best investment system
2. Investors get blown off track while trying to implement it

Let's handle each of these in turn.

First, there are those who may not agree that Buffett's quality/value approach is optimal. Some feel it is not complicated enough. How can anything so simple be the right way to approach something as complex as investing? When we are sick, we would much rather take an expensive batch of pills, with side effects, than eat well, rest and let the body's natural predilection for self-healing work. That is too simple.

The same is true with investing. We would rather jump in and out of stocks and the market, and invest in complex instruments and alternative investments with high fees, because we are convinced that investment success must involve some very sophisticated solutions. By nature, humans are suckers for sophistication.

Humans are famously overconfident – 90% of us think we are better-than-average drivers.ⁱ

Second, others who disagree with the Buffett approach feel that they can do a lot better. Humans are famously overconfident – 90% of us think we are better-than-average drivers.ⁱ The fact that none of us are as rich as Buffett doesn't seem to matter.

Maybe it should. But it is tough to change our minds, even when compelling evidence is presented. Humans tend to prefer their own views and discount anything that does not confirm their biases. Instead we seek out confirming data, even if it is spurious.

"I believe therefore I see,"ⁱⁱ rather than the other way around. But make no mistake, the evidence that the Buffett system works is compelling.

The first evidence is Buffett's track record. He has created a \$50-billion fortune in one lifetime of investing, from scratch. He has also not been shy along the way about telling us how he's doing it – by owning quality stocks.

Evidence that quality investing works also comes from recently published studies. A paper published in the *Financial Analysts Journal* in 2011 concluded that over the past 41 years, lower-risk (i.e., higher-quality) stocks substantially outperformed higher-risk stocks.ⁱⁱⁱ A June 2012 white paper by Boston-based investment firm GMO entitled "Profits for the Long Run: Affirming the Case for Quality" came to the same conclusion.^{iv}

So, even as quality approaches like Buffett's pass the tests of time and academia, many people still retain their own views, expecting that they will be the exception that proves the rule. Most are still waiting.

A final reason people disagree with using the Buffett system is that they cannot sit on their hands. Humans have an overwhelming compulsion to act. For most of us, Franklin D. Roosevelt summed up our core instincts when he famously chided that we should, "least of all, do *something*." The Buffett buy-and-hold system, which relies on a large dose of "lethargy bordering on sloth," seems counterintuitive. Instead, we are programmed to take action, despite the evidence that almost all of our investment actions subtract value.^v

Let's now turn to those investors who buy into Buffett's simplicity, but get blown off course. There are lots of things that can upset the investing apple cart, like macro events causing perceptions about increased investment risk, volatility in asset and stock prices, and expert advice and predictions contrary to our plan. They could sidetrack Buffett too, of course, but they don't. He seems to understand when to perform a portfolio intervention and when to stand pat.

In *Antifragile*, the follow-up book to *The Black Swan*, Nassim Nicholas Taleb made the point that in modern life a great many expert "interventions" – whether in medicine or economics – subtract value, despite the intervener's best intentions.^{vi} Taleb calls these mistakes "naive interventions."

Taleb also suggested that what is needed is a systematic protocol to help us make "non-naive interventions." Buffett's success is helped by his use of such a tool, even if it is subconscious. For the rest of us non-Buffetts, a portfolio intervention protocol could help us deal with the day-to-day portfolio pressures. Let's take Taleb's advice and develop one.

FOUR UNDERLYING INVESTING PRINCIPLES

The first step in our protocol development is to agree to the facts and assumptions underlying the Buffett approach. If we cannot agree on the basics, then the quality/value system is not for us.

1. Long time horizons are absolutely necessary. If we want to earn returns that are better than bond yields, then we need to adopt the very long time horizon that is appropriate when investing in stocks. If that is not possible, then this is a signal to opt out of the Buffett system.

2. Earning equity returns without being exposed to equities is impossible. We must own equities to earn equity returns. Expecting to jump in at market bottoms and out at tops is unrealistic and risky because equity returns are discontinuous. We don't want to miss the few really big "up" days. While there may be many ways to get to heaven, there are no shortcuts.

Success at "timing the market" could only come from success at repeatedly predicting the short-term future. In a complex, adaptive world where any spontaneous order is temporary and many of our earthly systems are often operating at the edge of chaos, predictions about the future are more difficult than they seem. Repeatedly getting them right is impossible. In financial markets, as in life, surprise is the rule, not the exception.

We are not aware of any study or long-term track record concluding that anyone has repeatable expertise in market timing. Even Buffett likes to say he attempts to price, rather than time, his investments. Again, if we cannot agree with being long-term stock owners, here is another chance to opt out of this approach.

3. Quality stocks are the only way to go. While there are always a few who get lucky guessing on speculations, there are many more who lose it all. We must agree that only quality franchise companies with persistent competitive advantages and strong management will be owned.

4. A buy-and-hold approach is best. We will buy these quality franchises when they are cheap, with the plan to hold them forever if nothing changes.

Our long-term investment success will be decided by how well we honour these principles. Rest assured: our commitment to these principles will be tested. Markets will fall, economies will recess and experts will constantly advise us to get out of the market. With reference to these principles and our concomitant intervention protocol, we will be able to withstand the pressures and stay on plan.

THE PRINCIPLES HELP US WITHSTAND THE PRESSURE TO ACT

With these principles serving as a template, let's go back and consider some pressures – macro risk, market volatility and contrary expert advice – that can potentially knock our system implementation off track.

Success at "timing the market" could only come from success at repeatedly predicting the short-term future. Predictions about the future are more difficult than they seem.

Let's start with the big picture. Many feel that the macro world is more uncertain and risky today than ever before. The implication is that portfolio exposure to equities should be limited as a result. What do our underlying principles tell us?

Our principles conclude that if we want equity returns and have adopted the appropriate long time horizon, we need to own equities. Full stop. Consider the macro uncertainty and risks Buffett experienced in his 60 years of investing: a world war, hyperinflation, oil shocks, recessions, etc. He never wavered, and if we stick to our principles, neither will we.

So as far as our first outside pressure – macro risk – goes, we can ignore it. Why? We have agreed to invest only in quality companies for this very reason: they are robust and can adapt to whatever the macro environment throws at them. This is why they outperform over the very long haul.

But what about market volatility? After the market crash of 2008, many investors just don't have the stomach for it. Again, let's go back to our principles. They say nothing about volatility. Buffett lived through a lot of that too – including historic bear markets in the early 1970s and 2000s as well as the crashes in 1987 and 2008. In fact, rather than change our plan, volatility is a source of tremendous opportunity. Our principles state that we should buy our quality franchises when they are cheap. Rarely are these companies as cheap as they are during times of market volatility.

So as far as volatility goes, we can ignore that too, except where it provides a buying opportunity.

The last pressure occurs when “experts” offer us advice and near-term predictions that run counter to our principles. Let's get short-term predictions out of the way first, as they are all useless. Complex, adaptive systems like our world and financial markets will always be uncertain and unpredictable. Anyone who attempts to tell you any different has an axe to grind.

Looking forward from any point in time, the immediate future is always uncertain. Historically, investors in equities have been well-compensated for this over the very long term. This is the reason that our principles insist on equity exposure. Riding out the uncertainty and volatility is simply the entrance fee that must be paid to win the long-term prize.

As far as other advice goes, we all are subject to an overwhelming amount of information and data, almost all of which is meaningless noise. When noise is mistaken for valuable information, this can easily knock us off course.

The investment industry doesn't help. Indeed it feeds off of clients' anxieties. Most industry advice and chatter is just noise designed to part clients from their money.

BLOCKING OUT THE NOISE: A STOIC'S APPROACH TO INVESTING

Think of how good it would feel to be indifferent to the vast majority of investment hype and noise around you. A useful model is that of the Stoics, especially those who lived in the first few centuries AD, and were led by Epictetus.

By understanding what was irrelevant and outside their control and learning to ignore it, the Stoics were able to lead wilful lives characterized by self-control and fortitude. By being totally indifferent to anything that wasn't within their control or relevant, they were able to live lives filled with “tranquility, fearlessness and freedom.”

Sounds good to us.

The vast majority of industry advice, predictions and other noise can be safely ignored.

In many other instances, we are fine living in a noisy world, and remain able to focus on our objectives – working, raising a family, etc. – without too much distraction. It is even pleasant to seek out a little distraction like a favourite TV show to unwind with after work. And some cannot sleep without white noise – the constant background hum of the modern world.

But the investment industry works very hard to tie us into the noise trap. The industry makes gargantuan profits by perpetuating its own form of noise – we call it “green noise” given all the commissions and fees industry players coin from promoting client activity.

In the short run it may not matter if the noise is wrong or ridiculous – all the industry needs is enough customers who don’t know any better. One look at industry profits and compensation suggests that there are more than a few of these customers around.

So just like with the other pressures, the vast majority of industry advice, predictions and other noise can be safely ignored.

THE PRINCIPLES FORM A PROTOCOL FOR PORTFOLIO INTERVENTION

After applying our underlying principles, we should ignore almost everything that we read and hear about the stock market, economy and “expert” advice. But there are a few instances when we should take action, and discussing these appropriate interventions will help us round our principles into a clear intervention protocol. We will then understand what kind of information we should be paying attention to. Importantly, the “non-noise” that can lead to “non-naïve interventions” is on a company-by-company basis.

There are three scenarios in which a portfolio intervention is justified:

1. **Valuation.** If a stock holding becomes excessively valued, it may warrant sale. Valuation is a judgment call, and we will do our best to heed Buffett’s aim to be “approximately right rather than precisely wrong.” In some cases Buffett has held on to seemingly overvalued shares, while in others he has sold them. For our protocol, it is enough that we highlight excessive valuation as a filter to force us to make the decision to sell or hold.

The inverse is just as true. When one of our franchise businesses is undervalued, it should be bought. As valuations at the beginning of a holding period are the key determiner of eventual investment returns, taking advantage of cheap stocks is critical to our long-term success.

2. **Changes in competitive advantages.** When the “moat” around a holding’s economic castle begins to fill in, it is often time to sell. This is another filter we can apply to our industry research. And new moats can emerge, giving us potential franchises to study. We will watch closely for changes in industry and competitive dynamics.
3. **Changes in senior management.** Famed Fidelity fund manager Peter Lynch has said that he likes to own businesses even an idiot can run because one might take over. Management changes are another filter to take note of, as it might lead to an appropriate portfolio action.

In a nutshell: ignore everything unless it impacts our portfolio companies' valuations, competitive advantages or senior management.

So there we have it – a portfolio intervention protocol that comes directly from our investment principles: ignore everything unless it impacts our portfolio companies' valuations, competitive advantages or senior management. We can now use the protocol as a template to extract useful data from the overwhelming information and noise.

Adhering to this protocol should help us implement a simple Buffett-like approach to investing. But even this new tool won't make it easy. The approach – identifying a handful of franchise businesses, waiting for them to get cheap, then buying them and almost never selling – is hard work. Doing it well takes a tremendous amount of focus and attention.

It is a lot easier to do it poorly or get sidetracked if we are overwhelmed by constant streams of noise and irrelevant information. Our portfolio intervention protocol will help us ignore all of the distractions and leave more time for the essentials of implementing the approach. Like Taleb says, it is not optimal if when crossing the street you miss the truck coming because you are observing the different eye colours of fellow street crossers.

Indeed, the essence of a quality/value approach is one of reduction. The number of franchise companies that meet the quality criteria is limited. The number of these that are cheap enough to buy is fewer still. We can only make these decisions robustly if we are paying attention only to what we need to know, but no more. Understanding the difference is what separates Buffett from the rest of us. This is where our portfolio intervention tool can earn its stripes.

IMPLEMENTING A QUALITY/VALUE APPROACH

Let's recap. Investors aiming to implement a Buffett quality/value approach should first agree on the following investment principles:

1. Adopt a long enough time horizon
2. Owning equities is the best way to compound capital
3. Quality stocks are the only way to go
4. "Buy cheap and hold" is the method

If we cannot agree with these, then the Buffett system is not right for us.

We used these underlying principles to develop a portfolio intervention protocol to help us understand what can be safely ignored – and what must be the focus – in a world where we are inundated with information, most of it useless. In a nutshell: ignore everything unless it impacts our portfolio companies' valuations, competitive advantages or senior management. If we follow our protocol, then tranquility, fearlessness and freedom – worthy of a Stoic – are sure to follow.

How will we know when we have arrived? When we perform fewer portfolio interventions, we are halfway there. And we will be even closer when we realize – upon hearing others fret of recession fears, market volatility and experts telling them to get out of the market – that we are truly indifferent to it all. Because by using a quality/value approach – aided by our protocol – our portfolio will be set up in such a way that we wouldn't do anything different anyway, regardless of the volume or content of the noise.

ENDNOTES

- i. Bathurst, J. and D. Walton, “An Exploration of the Perceptions of the Average Driver’s Speed Compared to Perceived Driver Safety and Driving Skill,” *Accident Analysis and Prevention*, 1998.
- ii. Shermer, Michael, *The Believing Brain*. New York: Times Books, 2011.
- iii. Baker, Malcolm, Brendan Bradley and Jeffrey Wurgler, “Benchmarks as Limits to Arbitrage: Understanding the Low Volatility Anomaly,” *Financial Analysts Journal* (January/February 2011): Vol. 67, No. 1.
- iv. Joyce, Chuck and Kimball Mayer, “Profits for the Long Run: Affirming the Case for Quality,” GMO White Paper, June 2012.
- v. Bogle, John, “The Mutual Fund Industry 60 Years Later: For Better or Worse?,” *Financial Analysts Journal* (January/February 2005): Vol. 61, No. 1.
- vi. Taleb, Nassim Nicholas, *Antifragile: Things That Gain from Disorder*. New York: Random House, 2012.

Original publication date February 2013.

DISCLAIMER

This issue of *The View from Burgundy* is presented for discussion purposes only and select securities may be used as examples to illustrate Burgundy’s investment philosophy. It is not intended to provide investment advice and does not consider unique objectives, constraints, risk tolerances or financial needs. Under no circumstances does it suggest that you should make investment decisions based on the content. Past performance is not indicative of future results. Investors are advised that their investments are not guaranteed, their values change frequently and past performance may not be repeated. The information contained is the opinion of Burgundy Asset Management and/or its employees as of the date of publication and is subject to change without notice.

Burgundy Asset Management exists
to protect and build our clients' capital.

We strive to achieve strong, long-term
absolute results, while providing
outstanding client service.

BURGUNDY

ASSET MANAGEMENT LTD.

TORONTO

Bay Wellington Tower, Brookfield Place
181 Bay Street, Suite 4510
PO Box 778, Toronto ON M5J 2T3
Main: (416) 869-3222
Toll Free: 1 (888) 480-1790
Fax: (416) 869-1700

MONTREAL

1501 McGill College Avenue
Suite 2090, Montreal QC H3A 3M8
Main: (514) 844-8091
Toll Free: 1 (877) 844-8091
Fax: (514) 844-7797

info@burgundyasset.com
burgundyasset.com