The VIEW from BURGUNDY

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WISE PASSIVITY, CAUTIOUS OPPORTUNISM

"'To enjoy the benefits of time' was one of the chief maxims of the statecraft of the age. Time untied so many knots, cancelled the necessity for so many desperate decisions, revealed so many unexpected shifts of pattern in a kaleidoscopic world, that the shrewdest statesmen were glad to take refuge in a wise passivity, a cautious opportunism." [1]

The above quotation, though far from its context, could stand as a brief manifesto for the kind of value investing we try to practice. We sometimes tell our clients that we would like to have the same portfolio at the end of a year that we had at the beginning, and try to explain to them how hard we had to work to achieve that level of apparent inactivity. They usually think we are kidding, but we're not. Behaving as an active owner is not the same as just buying and holding.

As the record of index investing over the past couple of years demonstrates, passivity is not a difficult thing to accomplish, nor is it a virtue in itself. Attaching wisdom to passivity is the goal, and it is one that very few investors have achieved. The goal of finding a stock that can be prudently bought and wisely held forever, where we can enjoy the benefits of time, is an elusive one. One attempt to identify a group of such stocks was the famous Nifty Fifty.

The Nifty Fifty

The Nifty Fifty was a group of stocks that constituted the major investment theme of the early 1970s. That was a particularly difficult stock market, where small capitalization stocks were being brutalized and many large companies were floundering as the effects of inflation began to be felt in the broad economy. Just about the only exception to this gloomy rule was the Nifty Fifty, a group of large cap growth stocks with stellar growth records, which seemed to be able to outperform the market averages under any circumstances. They were known as "one-decision" stocks because you could supposedly buy them at any price and never sell them. We thought that it would be instructive to go through the list of Nifty Fifty stocks to see how they have performed over the past 30 years. Our goal is to determine why some companies have prospered and some have faltered, and to draw lessons for investing today.

The origin of our quest was in Jeremy Siegel's 1994 book, *Stocks for the Long Run.* In one chapter, Siegel shows that if you had bought the Nifty Fifty on January 1, 1972 and held the stocks until May 31, 1993, you would have outperformed the S&P 500 Index, despite the excessive valuations of those stocks on the purchase date. Even buying them at their peak prices in January 1973 would have generated a return over the holding period just below the S&P 500 return. So it would appear that investors were right about the general quality of the Nifty Fifty stocks, to the extent that even purchasing at very high valuation levels was a small relative penalty in the very long term.

EXHIBIT 1 – THE NIFTY FIFTY

3M
Am. Home Prod Corp.
Am. Hospital Supply Corp.
American Express Co.
AMP Inc.
Anheuser-Busch, Inc.
Avon Products, Inc.
Baxter Intern'l Inc.
Black & Decker Mfg.
Bristol-Myers Co.
Burroughs Inc.

Chesebrough-Pond's Inc.
Citicorp
Digital Equip. Corp.
Dow Chemical Co.
Eastman Kodak Co.
Eli Lilly & Co.
Emery Air Fght. Corp.
General Electric Co.
Gillette Co.
Halliburton Co.
Heublein Inc.
IBM
Intern'l Flavors & Frag
ITT
J.C. Penney Company, Inc.
Johnson & Johnson
Jos. Schlitz Brewing Co.
K-Mart Corp.
LA Land & Exploration Co.
Lubrizol Corp.
McDonald's Corp.
Merck & Co.
MGIC Investment Corp.
PepsiCo Inc.
Pfizer Inc.
Philip Morris Cos. Inc.
Polaroid Corp.
Procter & Gamble
Revlon Inc.
Schering Plough Corp.
Schlumberger Ltd.
Sears, Roebuck & Co.
Simplicity Pattern
Squibb Corp.
Texas Instruments Inc.
The Coca Cola Co.
Upjohn Co.
Walt Disney Co.
Xerox Corp.

Our Sample

Time has not been kind to all members of this elite club. A number of its constituents have disappeared, either through takeovers (Squibb, Digital), breakups (ITT) or bankruptcy (Polaroid). Several others were excluded because they are now rather small relative to their former peer group. We ended up with a sample of 29 companies, most of which are still mainstays of corporate America. These 29 stocks are shown in Exhibit 2.

We subdivide the 29 stocks into seven industry groups, namely Financials, Retailers, Sin Stocks, Pharmaceuticals, Consumer Goods, Technology, and Industrial Products. The groupings are ours, and not those of any index.

In the right column, we show the total return since May 31, 1993. In the left column, we update the returns from Siegel's book to give a 29-year, 10-month compound return.

EXHIBIT 2 – SAMPLE RETURNS [2]

	Since Jan. 1, 1972	Since May 31, 1993
FINANCIALS		
American Express Co.	11.3%	18.0%
Citigroup	14.4%	29.4%
Average	**12.9%**	**23.7%**
RETAILERS		
J.C. Penney Company, Inc.	4.8%	-5.1%
K-Mart Corp.	0.7%	-13.0%
Sears, Roebuck & Co.	6.8%	11.4%
Average	**4.1%**	**-2.2%**
SIN STOCKS		
Anheuser-Busch, Inc.	12.8%	17.6%
Philip Morris Cos. Inc.	19.3%	18.7%
Average	**16.1%**	**18.2%**
PHARMACEUTICALS		
Merck & Co.	15.4%	17.9%
Pfizer Inc.	16.7%	27.9%
Schering Plough Corp.	14.6%	21.7%
Bristol Myers SQ	15.8%	20.5%
Eli Lilly	10.2%	26.4%
Johnson & Johnson	13.8%	23.5%
Average	**14.4%**	**23.0%**

EXHIBIT 2 – SAMPLE RETURNS (CONTINUED)

	Since Jan. 1, 1972	Since May 31, 1993
CONSUMER GOODS		
Avon Products, Inc.	7.0%	18.2%
Gillette Co.	15.2%	15.2%
The Coca Cola Co.	13.6%	11.8%
McDonald's Corp.	12.8%	9.9%
Walt Disney Co.	10.3%	3.5%
Procter & Gamble	12.6%	16.1%
PepsiCo Inc.	16.0%	15.3%
Average	**12.5%**	**12.9%**
TECHNOLOGY		
Xerox Corp.	0.1%	-4.6%
Texas Instruments Inc.	12.6%	26.7%
Eastman Kodak Co.	3.5%	-2.8%
IBM	9.8%	29.5%
Average	**6.5%**	**12.2%**
INDUSTRIAL PRODUCTS		
General Electric Co.	15.5%	22.6%
Schlumberger Ltd.	11.8%	8.0%
Intern'l Flavors & Frag	7.3%	-0.4%
3M	10.0%	11.0%
Dow Chemical Co.	11.4%	11.1%
Average	**11.2%**	**10.5%**
Total Sample Average	**11.2%**	**14.0%**
S&P 500 Index	**12.0%**	**12.8%**

Source: Stocks for the Long Run, Bloomberg

The results are rather interesting. Sin Stocks did best, although the sample size is only two, and Philip Morris is the best stock of the 29. Pharmaceuticals are second best, and are the most consistent group from the standpoint of returns. Third is our small sample of two Financials, followed by two rather eclectic groups, Consumer Goods and Industrial Products. Technology finishes second last, and the "tail-end Charlies" are Retailers.

It is no surprise that Retailers are in last place. It is kind of nostalgic to look at what were considered hot retailing concepts in 1972 – J.C. Penney, K-Mart and Sears. Wal-Mart and the category killers were not even dreamt of at the time, let alone Amazon.com. The leadership of the whole industry has changed over to companies that were either embryonic or not even in existence in 1972. Retailing has no natural barriers to entry.

Our Technology sample is evenly divided between the good and the bad. Xerox and Eastman Kodak, two mainstays of the U.S. technology picture in 1972, both ran into strong headwinds in the 1970s and 1980s, and then stumbled badly in the 1990s. Both of these companies were victims of potent new entrants from Japan: Fuji Film, Konica, Ricoh, Canon, Toshiba and Sharp.

IBM and Texas Instruments both have done better, and IBM has done spectacularly well since 1993, but even if only those two companies were in the sample, the relative ranking of the group would not change. It is remarkable how susceptible the technology markets are to new entrants: Microsoft, Sun Microsystems, Cisco, Dell, Compaq and all the rest were not in existence at the inception of the sample. A sustainable competitive advantage is difficult to build in the technology area.

The Industrial Products group is led by Jack Welch's GE, which has generated the fifth-best long-term return among our 29 stocks. GE is also the only one of the Industrial Products companies whose compound return in the past eight years is substantially higher than its 29-year compound return. Clearly, 3M, Schlumberger, International Flavors and Fragrances, and Dow Chemical are not the businesses they were in the 1970s. But neither is GE – it has exited many of its traditional businesses, and has become a major force in financial services.

Our two Financials companies are an interesting pairing. American Express has a sample average long-term return. Its current vicissitudes in a contracting travel market probably make the stock look worse than it deserves. If we had been doing this survey a year ago, the long-term return would have been 13.4%, and it would have placed much higher in the sample. End date sensitivity has cost the company over 2% on its compound return!

Citigroup is a much different company than the Citibank of 1972, having turned itself from a money centre commercial bank into an aggressive, multi-line financial services company involved in insurance, banking, investment banking, consumer credit and stock brokerage.

Citigroup has been the most adventurous company in the post Glass-Steagall regulatory era, entering new segments of financial services with apparent success. Financial businesses are easy to enter if you pay too much and charge too little. It will be some time before we can judge if the new Citigroup really has a competitive advantage.

In our discussion so far, we have referred often to new entrants and barriers to entry. Barriers to entry are the only long-term determinant of profitability and therefore value. At the Value Investing Seminar at Columbia last June, Bruce Greenwald, the fine professor and practitioner of value investing, made a brief presentation on Professor Michael Porter's "five forces" model of profitability. The model sees industry competition as the prime determinant of profitability, and competition itself determined by the nature of the firm's customers, suppliers, competitors, potential substitute products and new entrants. Professor Greenwald said that the model had four forces too many, and *that only barriers to entry determine industry profitability*. A substitute product is a new entrant; customer or supplier behaviour only matters if they have a competitor to go to, or if the customers or suppliers set up a firm to compete with you. So it follows that the only competitive force that matters is that of new entrants into an industry.

That is the great strength of most of the consumer brands companies. If they define their businesses narrowly enough and resist the temptation to "di-worse-ify," they are extremely difficult businesses against which to set up new competitors. Those companies that stick to their core businesses usually generate superior long-term returns.

Yet within the Consumer Goods group there is a wide variability of returns. Avon has returned only 7.0% compound since 1972, but it is the most successful stock of the group since 1993 under the dynamic leadership of CEO Andrea Jung, who has focused and energized the company. At the other extreme is Disney, which has diversified away from its core theme park and children's entertainment business into merchandising, cruise ships, broadcasting and mass market movie production. Disney's recent performance has been deplorable. Management matters – even the best business can be damaged by an unfocused, empire-building CEO.

A big issue for the Consumer Goods companies today is the greying of North America. For growth, their products have depended on new consumers and new household formation. Both of those commodities have been abundant since World War II, but will be in short supply in the future as the population ages. The implications for the consumer brand companies are clear – they must go where the young people are, hence their interest in Asia and Latin America. It will be interesting to see if they can make the transition.

Barriers to entry have been decisive in the success of the Pharmaceuticals companies over the past three decades. Patents, the burdensome and expensive drug approval process, and the enormous marketing and research expenditures involved in this business all militate against new entrants and in favour of high and sustainable margins. And the medical business, unlike the consumer brands business, gets better as the population ages. The prime consumer of pharmaceuticals is the over-60 age bracket, which will see exploding growth in the next three decades. The major problem the pharmaceutical companies face is that the government is their largest customer and may regulate drug prices if it becomes politically expedient to do so.

The best returns have come from the Sin Stocks. (There's a moral in there somewhere.) Anheuser

Busch is a fine company and has a great track record, ranking firmly in the upper half of our sample. It has been the predominant winner in the beer wars in the U.S., developing strong brands and positioning itself as the low-cost producer of beer in America. It has relentlessly focused on the beer business, driving many former national brands out of business. The margins it generates have been far higher than those of its competitors. The combination of focus and economies of scale is a formidable one.

The unchallenged champion is Philip Morris. Its compound return since January 1972 is an astonishing 19.3%. To put it in terms that are easy to understand, $1,000 invested in Philip Morris in January 1972 with dividends reinvested in the stock would today be worth $191,950!

The tobacco industry is a stable oligopoly besieged by lawyers. The industry is routinely reviled in the mass media and in political campaigns. It has seen annual volume declines in tobacco consumption for over 20 years in the developed world. Class action suits abound and settlements are very expensive. The barriers to entry in this industry are insuperable – nobody in his right mind would contemplate setting up a new tobacco company. And that is why the industry is so incredibly, obscenely profitable.

The Big Question

Based on the experience of the Nifty Fifty, how can active owners assess their investments to identify potential problems and eroding business franchises?

Here are some good rules of thumb:

1. Watch out for new entrants, and define the market of your company fairly broadly. For example, IBM has always been paramount in the mainframe computer business, but its problems in the 1980s came from the new minicomputer and personal computer sectors. It recovered in large part by becoming more of a software and services firm. For another example, just when Eastman Kodak was settling into a stable duopoly with Fuji Film, along came digital imaging.

2. Examine the nature of competition in your industry – is it constructive or destructive? A market leader will always avoid destructive competition, but react forcefully to restore discipline when a weaker competitor deserves it. In 1993, Philip Morris was seeing its market share eroded by private label cigarettes offered at very low prices. On "Marlboro Friday," April 2, 1993, Philip Morris dramatically reduced the prices of its premium brands to compete head to head with the no-names. Many portentous articles were written about the death of brands, and Philip Morris stock sold off sharply. In fact, the prices of no-name cigarettes were swiftly adjusted upwards as order was restored to the market, and Philip Morris stock rebounded strongly. A branded product should always win a price war. But it is wise to avoid businesses like retailing where price wars are a way of life.

3. Make sure that the employees aren't hijacking all the value in the company. Some businesses are naturally run for the inmates, like professional services firms. There isn't much room for public shareholders in those companies. It was almost impossible to create lasting value in technology firms in the 1990s because employee stock options programs were so hugely dilutive to the shareholders' interests. And senior executives in all industries have become accustomed to ridiculous compensation packages, with dire effects on both the real earnings of their companies and on their own behaviour as managers.

4. Beware of managers who don't understand capital allocation. Almost all of our 29 companies have a rather checkered history of maladroit acquisitions and diversification attempts. Very few have added value through acquisitions. Many more have had to beat hasty retreats and refocus themselves around the core business. Most companies eventually produce CEOs who use the free cash flow from the great business to

acquire and expand inferior businesses. Such CEOs can do remarkable damage to even the best businesses.

So the essence of wise passivity is to select your companies carefully, then relentlessly monitor them for new entrants, destructive competition, employee rent-seeking and bad capital allocation. But there is another part to the story that would have made life much easier for the investor in Nifty Fifty stocks. That is cautious opportunism.

Caution was not a feature of Nifty Fifty investors. They bought stocks at absurdly expensive levels and paid the price. The average stock in Exhibit 1 was trading at over 37 times earnings and yielding 1.1% on January 1, 1972. In the savage bear market of 1973-1975, all of these companies saw their stock prices decline by at least 50%. At the bear market lows of the mid-1970s, these great companies were selling at knockdown prices. If you had bought a whole bunch of them at that time, and held them until today, your returns would have been amazing. The world would have beaten a path to your door. You would have built up enormous wealth. You would have been Warren Buffett!

How could Buffett stand back from the crazy market of 1972 and wait patiently for his time? It was because he had a frame of reference, and that frame of reference was value. An understanding of value imbued him with caution when prices were high, and spurred him to opportunism when prices were low.

Most of us have heard the old saying: "Talent borrows and genius steals." How's this for genius – select a few of the best Nifty Fifty stocks (Gillette, American Express, Coke) and wait until they are bombed out in a terrible bear market, or retrenching after failed diversification initiatives, then buy them and hold them. While most Nifty Fifty investors are today remembered only by their immediate families, Warren Buffett has become a household name. And justly so – he combines wise passivity with cautious opportunism.

It's an unbeatable combination.

Endnotes

1. Mattingly, Garrett. The Defeat of the Spanish Armada. London: Houghton, 1959.

2. Prior to May 31, data are taken from Stocks for the Long Run (Siegel). From May 31, 1993 to October 31, 2001, data are taken from Bloomberg.

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