

THINKING OUTSIDE THE BOX: LESSONS TO BE LEARNED FROM WARREN BUFFET IN INVESTMENT MANAGER SELECTIONS

Jeffrey H. Mitchell, CFA
Consultant

Introduction

Proponents of passive investing have much in their favor. Study after academic study has shown that the vast majority of active managers fail to match the returns of passive benchmarks – returns that are easily replicated in low cost index funds. Those on the active side of the debate point to the many managers who have managed to outperform over time. But the passive camp has an answer for this as well: the all too familiar, “past performance is not indicative of future results.” Again, the academic literature supports this conclusion—past performance is not, in fact, a reliable predictor of future excess returns. When trying to identify managers who will deliver future excess returns it is necessary to look beyond performance to the other 3 P’s—people, process, and philosophy.

This, however, is no easy task. The investment management industry is filled with hard-working, intelligent people in impressive organizations, the majority of which will deliver returns below their stated passive benchmark.

In this regard, we believe that Warren Buffett has much to teach us. This paper will discuss what we deem to be the key determinants of Mr. Buffett’s success. Further, we’ll explain why these attributes are not widely emulated within the investment management industry. In our opinion, their absence helps to explain why active managers in aggregate fail to outperform passive benchmarks. Not only do we believe institutional plan sponsors would do well to hire more managers exhibiting such traits, they also might think about incorporating these practices into their own decision making processes.

In our view the following attributes go a long way to explaining the success of Warren Buffett:

- He follows a flexible, opportunistic approach rather than adhering to a strict asset allocation discipline
- He buys businesses when they trade at significant discounts to his estimate of intrinsic value
- He is focused on downside protection
- He manages a concentrated portfolio of his best ideas
- He is an independent, often contrarian thinker
- He is a buy and hold investor

THIS PAPER WILL DISCUSS WHAT DEEMS TO BE THE KEY DETERMINANTS OF MR. BUFFETT’S SUCCESS.

We provide quotes from Mr. Buffett followed by a bit more color on each of these attributes below:

“Investors should judge stocks, bonds and other investments on their merits and their price, changing their allocations as circumstances change.”

As the quote above indicates, Mr. Buffett follows a flexible, opportunistic approach that allows him to invest wherever the expected returns are

greatest. While most managers focus on a narrow group of stocks to analyze (small capitalization value stocks, or large capitalization growth stocks, for example), Mr. Buffett searches far and wide for investment opportunities. Not only will he buy stocks (or entire companies) of any market capitalization, some will be considered value stocks and others growth stocks. In addition, he'll even go further afield - at times amassing large stakes in cash, foreign stocks, high yield bonds, currencies, even precious metals (enough to make a consultant's head spin)! We will elaborate on this topic later in this paper.

FOR AN ABSOLUTE RETURN INVESTOR SUCH AS MR. BUFFETT, THE ONLY RISK THAT MATTERS IS A PERMANENT LOSS OF CAPITAL.

"The critical investment factor is determining the intrinsic value of a business and paying a fair or bargain price."

In looking at such a diverse portfolio, it might appear that there is not a clearly defined process that guides the investment decision. This could not be further from the truth.

In theory, in order to determine what a stock is worth, one must estimate the future cash flows to equity holders and discount them back to the present. Many best-of-breed managers (including Mr. Buffett) go through this process and buy stocks only where a significant difference (a "margin of safety") exists between their estimate of the company's intrinsic value and the market's. This is not to say that this is the only way to pick stocks. In our experience, however, success is more likely to be achieved by managers who focus on a company's current and historic fundamentals (historical revenue growth, current margins and margin trends, capital efficiency, etc.), make reasonable estimates about growth rates, and factor those estimates into a disciplined valuation framework. The same process can be applied to assets other than domestic stocks.

"Rule No.1: Never lose money. Rule No.2: Never forget rule No.1."

With investors such as Mr. Buffett, their focus is not on what could go right, but what could go wrong with the companies they own. As legendary investor Jean Marie Eveillard has said, "I'd rather lose clients than lose clients' assets." These managers have an intense aversion to losing money, and thus a focus on generating positive absolute returns regardless of which direction markets may head.

When Mr. Buffett does not find enough compelling investment opportunities, he will allow his cash position to build. Again, while many would view this as a lack of discipline, instead it is a strict adherence to his "margin of safety" discipline that creates this outcome. Allowing cash to build, only buying at significant discounts to intrinsic value and searching far and wide for investment opportunities are all ways for a manager to limit his losses when stocks are out of favor.

In today's investment management industry, most managers view their benchmark as their default portfolio. They will then manage around the benchmark in an attempt to add value. So, for example, they will "overweight financials," or "underweight Dell" - positions that are taken relative to the benchmark. These managers view risk in terms of the benchmark as well. Thus a portfolio that holds cash, or owns no technology stocks when they comprise 20% of their benchmark, is a "risky" portfolio.

For an absolute return investor such as Mr. Buffett, the only risk that matters is a permanent loss of capital. Managers with an absolute return focus build their portfolios from the bottom up, without consideration for the benchmark chosen. Most will be benchmark agnostic—essentially indifferent to which index is chosen to benchmark performance.

"Diversification is a protection against ignorance. It makes very little sense for those who know what they're doing."

It may seem counterintuitive that a manager focused on downside protection would manage a concentrated portfolio. If the manager has an



absolute return focus and an intense aversion to losing capital, however, his largest positions will be those with the largest margins of safety. Concentrated portfolios, then, not only offer the possibility of higher returns, but also potentially lower risk. In Buffett's words, "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." Concentration can also decrease risk (again in Buffett's words), "if it raises, as it should, both the intensity with which an investor thinks about a business and the comfort-level he must feel with its economic characteristics before buying into it."

Concentrated portfolios can help a manager deliver positive returns regardless of market direction, as the performance of a few well-chosen stocks will have an out-sized impact on the overall portfolio. We believe that best of breed managers are more likely to run concentrated portfolios. These are managers that have the courage of their convictions to put significant sums of money in their best ideas. While we are not averse to managers who run concentrated portfolios, NEPC continues to advocate broad diversification in the context of the overall portfolio.

FOR MR. BUFFETT, HIS PREFERRED HOLDING PERIOD IS FOREVER.

"We simply attempt to be fearful when others are greedy and to be greedy only when others are fearful."

Of course, both having an absolute return focus and running concentrated portfolios are signs of independent thinking. This is not the established way of doing things for many portfolio managers because it represents significant career risk. Managing with a high tracking error (i.e. having a portfolio that looks unlike any benchmark) increases the odds of underperformance—underperformance that may be bad enough to put one's job at risk. Most managers are unwilling to take this risk.

Mr. Buffett's forays into high yield bonds, precious metals, foreign currencies, etc., are examples of independent thought in action. Many of these investments also represent contrarian thinking—the tendency to buy when most others are selling, and vice versa. Those who believe in active management mostly believe that markets are not efficient on account of the dual emotions of fear and greed. Many best of breed managers take advantage of these emotions by buying into fear and selling into greed. Doing so requires going against conventional wisdom and buying stocks that are currently in the news for all the wrong reasons while selling the latest stock market darlings.

"Lethargy, bordering on sloth should remain the cornerstone of an investment style."

Mr. Buffett may epitomize this trait best of all. For Mr. Buffett, his preferred holding period is forever. Having a longer-term holding period relates to being a contrarian thinker: it can take a long time for a market or a stock to go from fear to greed. For many of the best investors patience (along with discipline) is the key to their success. They do not tend to know when the market will turn in their favor, only that their discipline has helped them uncover an undervalued stock that is likely to provide an attractive long-term return.

In essence, there are two ways to beat the market: either you have to uncover better information, or you have to use the existing information better. In our opinion, gaining an information edge is much more difficult. Those that do tend to be shorter-term investors who own stocks on account of a near-term catalyst (the company is likely to miss its earnings target; it's going to be investigated by the SEC; etc.). Those in the second camp utilize their patience and long-term views to take advantage of investors who are far too focused on near-term results.

Despite the amazing success of Mr. Buffett, his style of investment management is not widely followed by the vast majority of professional investors today. Why is this? Essentially, we see two reasons, the first of which—career risk—we discussed above. Now we'd like to turn our attention to the second reason.



In our opinion, the investment consulting community contributes to the lack of managers following an approach such as Mr. Buffett's. In fact, if Warren Buffett were managing a mutual fund today (which essentially he is, in the form of Berkshire Hathaway common stock) he would likely *not even be considered* by the vast majority of investment consultants when searching for best of breed managers. How could someone widely regarded as one of the most successful investors in history not even appear on the radar screen of most investment consultants? The answer boils down to two words: style boxes.

CLIENTS WHO ARE WILLING TO UTILIZE MANAGERS WHO FOLLOW THE "BEST PRACTICES" LISTED ABOVE ARE APT TO EXPERIENCE IMPROVED RESULTS.

Style boxes – the familiar 9x9 grid that divides the equity investment universe along the dimensions of market capitalization (large, medium and small) and style (value, core, growth)—have long been a staple of the investment consultant's tool kit. Recommend a fixed allocation that covers all areas of the grid (for example: 35% large cap growth, 35% large cap value, 15% small cap growth, 15% small cap value), then go about hiring managers to select stocks in each of those areas.

With the widespread adoption of style boxes, more and more managers aimed to be "style pure," unwilling to stray beyond the confines of their style boxes. The idea, of course, has its merits. Such a strategy ensures that the investment program will be adequately diversified. It also allows for tight control over the asset allocation decision. For example, if one believes that large cap growth stocks are undervalued and small cap value stocks are overvalued, the investor can take money away from the small cap value manager and add to the large cap growth manager. Finally, it enables each manager to focus on a more narrowly defined universe of stocks to analyze.

Yet if the construct automatically dismisses investors such as Warren Buffett, it clearly has its downside. Simply by holding the same portfolio over time, a manager can exhibit "style drift," as securities that were once small cap, for example, migrate into the mid cap category as they achieve success. Should a manager, who is intimately familiar with such a company and continues to believe in the merits of holding the stock, be forced to sell, in order to maintain style purity? In our opinion, such an approach is sub-optimal and thus likely to limit a manager's ability to add alpha over time.

While this sounds logical enough, there are a number of drawbacks to incorporating non-style specific managers. First, they are not easy to benchmark. Deciding which benchmark to use is not an easy decision and performance can look vastly different depending on which benchmark is chosen.

No matter which benchmark is chosen, the manager is likely to have a high tracking error to that benchmark. Because their portfolios are so different from the benchmark, these managers are likely to go through extended periods when their positions are out of favor, and thus, their performance can badly lag that of the benchmark. Consultants and clients must truly buy in to the manager's ability in order to stick with the manager through inevitable periods of underperformance.

The consultant and client also lose the ability to tightly control the asset allocation decision. Much more work is required to determine just what the underlying exposures are. Also, with more flexible managers, today's exposures may be different tomorrow.

These are all drawbacks to be sure. The question is whether one's belief in the ultimate ability of such managers to deliver value over time offsets these "costs." With careful selection of such managers, we believe the answer is yes. This is not to say that a plan should only employ managers who exhibit the traits listed above. In investing there is more than one way to achieve success. Just as diversification of investments is important, so too is diversification of investment approaches. Our point in writing this paper is



that the investment approach described herein ought to comprise a larger portion of overall plan assets than is typical today.

Institutional plan sponsors might also consider incorporating these “best practices” into their own decision-making processes. In our view, a few attributes in particular—acting opportunistically, having patience and thinking independently—tend to differentiate high performing institutional plan sponsors. Not only do such plan sponsors hire opportunistic managers, they also are apt to act opportunistically themselves. They

INSTITUTIONAL PLAN SPONSORS MIGHT ALSO CONSIDER INCORPORATING THESE “BEST PRACTICES” INTO THEIR OWN DECISION-MAKING PROCESSES.

also tend to have more patience, resisting the urge to terminate underperforming managers at what often turns out to be the most inopportune times. Finally, these high performing plan sponsors have exhibited independent thought by being quick to embrace non-traditional investment approaches.

In our opinion, Warren Buffett’s process and philosophy go a long way to explaining his success. Yet, on account of the construct of style boxes and the career risk involved, his approach is not widely emulated within the investment management industry. The fact that most managers construct portfolios that largely mimic an index, and charge management fees, dooms these funds to underperform low cost passive investing. Although there are drawbacks, we believe that clients who are willing to utilize managers who follow the “best practices” listed above, and also to incorporate these attributes into their own decision making processes, are apt to experience improved results.

Going beyond style boxes is often referred to as the concept of relaxing constraints; the idea being that the more arbitrary constraints which are placed on a manager, the lower the excess returns are likely to be. For NEPC, this has largely meant carving out separate allocations for hedge funds or global tactical asset allocation products, while maintaining the existing structure for domestic and international stock and bond components of client’s asset allocations. For those clients willing to take the next step, NEPC recommends considering loosening the constraints on their existing managers, as appropriate, and/or evaluating more non-style specific managers for the traditional stock and bond asset classes.

