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Investors in the Outhouse

The recently released *Lincoln* film directed by Steven Spielberg highlights one of the President's favorite stories (Lincoln loved to share jokes and anecdotes):

> Mr. [Ethan] Allen had occasion to visit England, and while there the English took great pleasure in teasing him, and trying to make fun of the Americans and General Washington in particular… One day they got a picture of General Washington, and hung it up in the Back House [outhouse]. Mr. Allen could see it and they finally asked Mr. A if he saw that picture of his friend in the Back House. Mr. Allen said no, but said he thought that it was a very appropriate [place] for an Englishman to keep it. Why? they asked. For, said Mr. Allen, there is nothing that will make an Englishman s*** so quick as the sight of General Washington.[1]

We could perhaps modernize the story by replacing "Englishman" with "entrepreneurs and investors" and General Washington's portrait with a picture of the fiscal cliff. Turn on any business channel and you can listen to hours of speculation on the potential outcome of deal negotiations. CNBC even has a countdown with the days, hours, minutes and seconds until the end of the year. The stock market has remained resilient, but as the debt ceiling debacle illustrated last fall, hope can quickly turn to fear. The fiscal cliff is just part of a broader environment of uncertainty that includes rising health care costs, the European crisis and China's slowdown. We have long argued that this recovery would be slower than previous ones due to the pain that accompanies the deleveraging process. Yet heightened uncertainty seems to be holding back greater capital investment on the part of businesses and individuals and accordingly, a stronger recovery.

We often caution investors about believing that any specific period of time is fundamentally riskier than an earlier one. It is often the risks that we can't see that do the most damage. However, we understand why investors are nervous about the years to come. The most common question we receive is "what can be done to *protect* our assets." The emphasis here isn't on return *on* capital but return *of* capital. Our response – "stay the course" – sometimes leaves the questioner unsatisfied. There are a lot of advisors in the industry today throwing around buzzwords in the name of wealth protection: managing downside, gold, commodities, emerging markets, etc. These may help sell products and attract clients, but sound bites don't produce superior results.

We see no reason to abandon our core investment principles, which include:

- *A balanced portfolio that is diversified across different asset classes*. Because those asset classes respond differently to different economic environments, the portfolio will hopefully be robust across varying economic conditions.
- *A commitment to stocks consistent with the investor's time horizon*. We have researched and invested in many different asset classes, but we still believe the long-term investor should focus the core of his portfolio in equity holdings.
- *Rebalancing the portfolio back to target weights and deviating only when an asset is clearly cheap or expensive*. In most environments, we will stick to our asset allocation targets based on the investor's risk and return objectives, deviating only when we think we can improve risk-adjusted performance.
- *In-depth research on our individual stock positions*, so that we are comfortable enough to hold our businesses for the long-term, through thick and thin, and purchase more when prices are attractive.

This approach isn't exciting or sexy, but we fail to see any viable alternative. Specifically, we still think core holdings in domestic stocks should be the vehicle of choice for the long-term investor. Below we respond to some of the more recited themes brandied about in the financial industry.

[1] Northern Illinois University Libraries; http://lincoln.lib.niu.edu/cgi-bin/philologic/getobject.pl?p.6432:4.lincoln.

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I need to do something drastic in my portfolio to protect my wealth from inflation.
We understand why investors are concerned about future inflation risks. While higher rates of inflation will require a much stronger economy which is probably still a few years away, the monetary stimulus programs implemented by the Federal Reserve may be difficult to reverse in time to avoid inflation. Yet precisely due to the fact that many investors are worried about inflationary pressures, there is no silver bullet to protect investment portfolios. Typically, investors look to õreal assetsö to protect portfolio value during times of inflation ó Treasury Inflation Protected Securities (TIPS), real estate, farmland, commodities, etc. Because of the high demand for inflation protection, the prices of these assets have been bid up. For instance, the yield on 10-year TIPS, which are U.S. Treasury bonds with yields that adjust with inflation, has fallen from a long-term average of 2% to -0.85%; this means that the investor is *guaranteed* to do worse than inflation by -0.85% per year!

This õreal yield compressionö can be witnessed in real estate and farmland markets, where income yields have fallen from historical levels of 6-8% to 3-4% and lower. Commodities are another beast altogether; the typical commodity products distributed on Wall Street suffer from severe flaws, which we discuss in our white paper published last January entitled *Thoughts on Investing in Commodities* (available on our website). While it may make sense to have some exposure to real assets in an investment portfolio, we think that given the initial circumstances stocks may do just as well in an inflationary environment. While businesses are no doubt hurt by inflation, high-quality companies that require minimal ongoing capital expenditures could perhaps be classified as real assets. The price of Coca-Cola, for instance, will rise alongside rents and crop prices and the stock owner should likewise do okay in inflation-adjusted terms over time. For the first time since publicly-traded Real Estate Investment Trusts (REITs) became popular in the 1970øs, an investor can construct a portfolio of blue-chip stocks that carries a dividend yield that competes with a basket of REITs.

I should put a large portion of my portfolio in gold because its value is safe.
While we arenøt gold bugs ourselves, we can see why some investors may want to put a portion of their investment portfolios in gold as a sort of insurance hedge. But we would keep such commitments modest at best. There are a lot of enthusiastic gold bulls, in large part due to the fact that gold prices have risen from around $300/ounce a decade ago to over $1,600/ounce today while the stock market has done little. We always ask gold bulls two questions: How much do you think an ounce of gold is worth? Why do you think that? Weøve yet to hear an answer to the second question that gives us confidence in the answer to the first question. Gold has little productive value, costs approximately $800/ounce to extract from the ground and has a negative yield (produces no income and costs money to store). The 1980øs was a period of high inflation, unemployment that rose above 10%, and large, persistent fiscal deficits, yet gold peaked at a real value of $1,940 in early 1980 (in todayøs dollars), fell 25% over the next two months, fell another 60% over the next two years, continued falling until 1999 and even with the drastic rise since then is *still 15% below the 1980 inflation-adjusted peak*. The gold investor of 1980 had no objective basis to judge whether gold was cheap or expensive. With no basis to tell if gold is over- or undervalued today, we would be incredibly nervous to put a meaningful portion of our wealth in the precious metal.

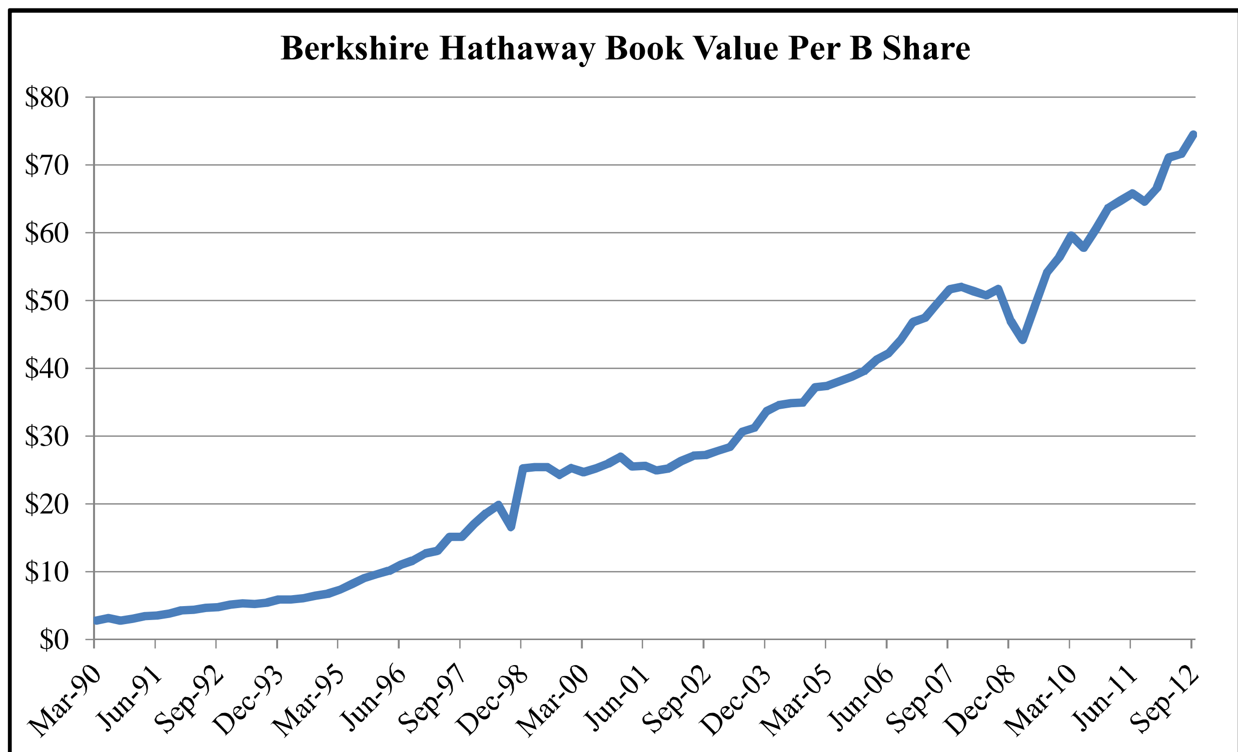
I need to diversify away from the U.S. dollar because it is doomed.
Some investors may not realize that in order to be negative on the U.S. dollar, you have to be positive on some other currency. Currencies only trade *relative* to one another. Should investors favor the euro or the yen over the dollar? Europe and Japan appear to have even greater issues than the U.S. Many analysts argue that emerging markets have stronger balance sheets and better economic fundamentals, but they also work to depress the value of their currencies so as to favor their export-oriented economies. We also arenøt convinced yet that countries such as China that still rely at least to some extent on central planning are as safe as advertised; Japan was also seen as a bastion of strength in the 1980s before it proceeded to produce a õlost decade.ö We think that investors are well served to diversify their portfolios with foreign stock holdings, but we donøt feel that fleeing U.S. stocks is warranted. Despite our countryøs challenges, we still have a superior rule of law, relatively strong corporate governance and familiar industries and companies. Further, many domestic firms have meaningful exposure to foreign countries and currencies.

I should put my money in a safe asset that won't be as volatile as the stock market.
If one defines risk as the probability that an investment will be worth less next week or next month, then the stock market is riskier than some other asset classes, such as fixed income or unlevered real estate. But what if we define risk as the probability that an investment will be worth less in inflation-adjusted terms in ten years? In that case, one could argue that some stocks are less risky than the alternatives. Right now 10-year U.S. Treasuries yield just 1.69%; it seems that inflation will easily average more than that over the next decade and the investor will be poorer in inflation-adjusted terms a decade hence.

Consider as a comparison Berkshire Hathaway, one of our larger portfolio holdings. While Berkshire isnøt as attractively priced as it was when we last wrote about it (a drop of 10% would make us more enthusiastic), it still strikes us as a superior alternative to many other investment opportunities, such as gold, real estate or fixed income. Berkshire has a current market capitalization of $216 billion. The company has a fortress balance sheet with nearly $48 billion in cash and $185 billion of shareholderøs equity. We are highly confident that their businesses, which include railroads, utilities, insurance, banking, retailing, and manufacturing, will still be around in 10 years. We are partnered with an aligned, intelligent, rational management team that has shown the commitment to do what is right for shareholders, has their personal net worth invested in the company, and is focused exclusively on maximizing per share

intrinsic value. Berkshire will generate over $20 billion in operating cash flow this year that it can use to purchase capital, acquire businesses and buy stocks. Warren Buffett has publicly stated that he thinks Berkshireøs stock is worth much more than book value (he seems to favor 1.7-1.8x) and that the company will look to repurchase its shares in size if the stock trades below 1.1x. Currently, it trades at just 1.15x estimated intra-quarter book value, only slightly above Buffettøs stated buy range.[2]

This obviously does not mean the stock wonøt go down. Berkshire is subject to a myriad of risks, including Buffettøs eventual death, large potential underwriting losses from catastrophes, and others. But given the current plate of investment alternatives, we would bet that Berkshire will be worth more in inflation-adjusted terms in ten years than many other asset classes available for investment. Berkshire is a compounding machine ó it throws off cash flows that are continually re-invested at attractive rates of return. Since Berkshire is so large, the company wonøt be able to grow nearly as fast as it did when it was a smaller entity. But we think of it as a big, durable ship that is always moving forward and growing per-share value. (The graph below shows the consistency of Berkshireøs growth in book value per share over time.) We believe that book value will be meaningfully higher in ten years than it is today and that by purchasing at a slight premium to book value, we will realize satisfactory rates of return.



[As this piece was going to press, Berkshire announced that it had repurchased approximately $1.2 billion of stock from the estate of a long-time shareholder. The company also raised its repurchase threshold to 1.2x book value versus the previous 1.1x book value. While the news drove the stock 2.4% higher and therefore slightly more expensive, it also demonstrates Buffettøs confidence in Berkshireøs value proposition.]

In the conventional since, stocks, including Berkshire, are riskier than bonds because of their greater volatility. But we donøt consider volatility the best measure of risk. Should you view your house or farm as risky if some manic neighbor shows up on your porch each morning and offers you widely varying prices for your land? Indeed, if a mortgaged real estate investment were priced daily in an open auction market as is the case for publicly-traded stocks, it may show even greater volatility than equities. Daily market quotes on stocks are there for the investorøs convenience, not his detriment. He can choose to ignore them or take advantage of them. Ben Graham, Warren Buffettøs mentor, wrote:

> A serious investor is not likely to believe that the day-to-day or even month-to-month fluctuations of the stock market make him richer or poorerí

[2] Book value as of September 30, 2012 was $74.49 per B share. We adjust it to $75.98 by estimating book value has grown 2% intra-quarter.

> Basically, price fluctuations have only one significant meaning for the true investor. They provide him with an opportunity to buy wisely when prices fall sharply and to sell wisely when they advance a great deal. At other times he will do better if he forgets about the stock market and pays attention to his dividend returns and to the operating results of his companies.[3]

I should implement a program of switching to cash when stocks are going to fall.
If stocks are so volatile, wouldnøt the investor benefit by avoiding stocks when they are poised to fall? Well, sure, and basketball players would benefit from taking shots only when they knew they were going to make them. It is simply impossible to forecast which way the market will go over the next six to twelve months. Our view is that financial advisors who claim such prescience are charlatans. Sure, every now and then they get a big market call right, but if we say there is going to be a tornado every day should we be praised when one finally hits?

This doesnøt mean that investors should never reduce their equity participation. In the face of clearly overvalued markets as determined by standard concepts of value (e.g. price in relation to cash flows or book value), it may make sense to take risk off the table. But this should be based on the long-term value of the market with no regard to short-term dynamics. Indeed, in many cases such decisions are enacted in the midst of a bull market that can persist for some time (consider the late 1990s).

The challenge with this approach is that (a) it is difficult to measure value in aggregate and (b) markets can grow into value. Even if an omniscient investor could declare with certainty that the stock market was overvalued, it isnøt clear how the predicament would resolve itself. The stock marketøs price could rise at 2% a year, its value could rise at 6% a year, and within a few years price would equal value with no meaningful drawdown having necessarily occurred. The investor who sat in cash in the face of an overvalued market ends up worse-off than the investor who remained committed to equities. Graham explains:

> It is far from certain that the typical investor should regularly hold off buying until low market levels appear, because this may involve a long wait, very likely the loss of income, and the possible missing of investment opportunities. On the whole it may be better for the investor to do his stock buying whenever he has money to put in stocks, *except* when the general market level is much higher than can be justified by well-established standards of value. If he wants to be shrewd he can look for the ever-present bargain opportunities in individual securities.[4]

Cash is a risky asset to hold because it earns nothing at current yields and its value is consistently eroded by inflation. Stocks on the other hand, even if they are overpriced, are consistently paying dividends, reinvesting earnings, and building value. Therefore, it is only with great caution and in the face of clear over-valuation that we would decide to meaningfully underweight stocks. We donøt think that is the case now, even though all-time high corporate profit margins are a concern.

While we generally donøt time our participation in stocks, we do run relatively balanced, conservative portfolios that include some cash and a fair amount of short to intermediate-term bonds. Even our more aggressive portfolios often have just 60-70% in domestic and international stocks. In the case that stocks do fall precipitously, we are comforted by the fact that we have dry powder as part of our strategic portfolio design to put to work. In any event, our frequent rebalancing activity ensures that we are buying low and selling high, adding to stocks when their allocation falls below target levels and reducing them when their allocation rises above target levels. Conservative investors may be well served to keep some dry powder in the form of cash or short to intermediate-term bonds, but we believe that a large underweight in stocks is a danger to the protection of long-term wealth.

Conclusion
Investors surveying todayøs investment environment may consider their options unappetizing. Yields on income producing assets are low, stock valuations have risen and many are worried that geopolitical uncertainties could introduce large drawdowns in portfolio values. But we remain steadfast in our belief that a commitment to a diversified, regularly rebalanced portfolio with a core weighting in stocks remains the best course of action. Over the long-term, we are confident that shares of high-quality, conservatively priced stocks will rise in value. Investors should approach any claims of silver-bullets with caution; we believe the patient, disciplined investor that sticks to his knitting will be the one who wins the race. If an investor is focused on protecting and enhancing wealth, we fail to see alternatives superior to owning shares of appropriately priced businesses that compound value over time.

The *Lincoln* movie helps put todayøs problems in perspective. President Lincoln presided over a Civil War that saw 750,000 Americans lose their lives, managed a cabinet staffed with rivals, shouldered the death of one of his sons during his administration, and withstood frequent threats on his life before his eventual assassination. In short, he was given a crummy lot. Yet Lincoln persevered, famously calling for the country to reunite after the War õwith malice toward none, with charity for all.ö

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[3] Graham, Benjamin, *The Intelligent Investor*, p. 196, 205.
[4] Graham, Benjamin, *The Intelligent Investor*, p. 206.