Small is beautiful; unpopular helps

"The most common cause of low prices is pessimism – sometimes pervasive, sometimes specific to a company or industry. We want to do business in such an environment, not because we like pessimism, but because we like the prices it produces. It's optimism that is the enemy of the rational buyer."

- Warren Buffett, 1990 Chairman's letter to shareholders of Berkshire Hathaway.

The shareholders of Berkshire Hathaway have just celebrated their latest 'Woodstock for capitalists' in the form of the company's annual general meeting. Fund manager Jeffrey Miller of Eight Bridges Capital Management made the following comments having watched Berkshire's webcast, which found their way into Barron's:

"The most interesting part was when he was asked why Berkshire had changed from investing in companies with high returns on capital and no-or-low capital requirements to those that require massive amounts of capital, like railroads and pipelines. His answer: because **Berkshire is too big now to invest in those great low-capital businesses** (even though they are superior to what he is buying recently and are what created the track record of which so many are envious). My takeaway: **smaller is better in asset management, because it opens up many more opportunities that are unavailable to investors that grow too large** – like Berkshire Hathaway. Buffett hesitated before he answered, because the answer revealed an uncomfortable truth – that Berkshire is no longer able to maximize returns for its shareholders, but Buffett is unwilling to return the capital to them to go and find other investments." [Emphasis ours.]

That size can be a barrier to high investment returns is no secret, and it's an observation that Warren Buffett has himself made before:

"If I was running $1 million today, or $10 million for that matter, I'd be fully invested. Anyone who says that size does not hurt investment performance is selling. The highest rates of return I've ever achieved were in the 1950s. I killed the Dow. You ought to see the numbers. But I was investing peanuts then. It's a huge structural advantage not to have a lot of money. I think I could make you 50% a year on $1 million. No, I know I could. I guarantee that."

But Berkshire Hathaway today is a $350 billion company, and elephants don't gallop.

Aside from Buffett's success as a capital allocator over a period of more than fifty years – which has clearly paid off for his longstanding shareholders – perhaps his most impressive achievement has been the transparency with which he's discussed how he went about building that track record. Forget any number of 'How Buffett did it' books; the letters to the shareholders of Berkshire Hathaway are firmly in the public domain. Few value investors have made their investment philosophy so widely and freely accessible, or taken such pains to articulate it as clearly and simply as possible.

But the longer you consider how Buffett created such extraordinary wealth for himself and others, the more you come to appreciate how the structure of most institutional fund management companies today is unfit for purpose. (This presumes that the primary economic purpose of fund management companies is to deliver attractive returns to their clients, as opposed to generating attractive levels of fees for their managers.)

David Swensen, CIO of the Yale Endowment, in his book 'Unconventional Success' also touches on the conflicts of interest and contradictions inherent in institutional fund management. The fund management 'industry' involves the

"interaction between sophisticated, profit-seeking providers of financial services and naïve, return-seeking consumers of financial products. The drive for profits by Wall Street and the mutual fund industry overwhelms the concept of fiduciary responsibility, leading to an all too predictable outcome: except in an inconsequential number of cases where individuals succeed through unusual skill or unreliable luck, the powerful financial services industry exploits vulnerable individual investors."

The nature of ownership is crucial.

"Mutual fund investors face the greatest challenge with investment management companies that provide returns to public shareholders or that funnel profits to a corporate parent – situations that place the conflict between profit generation and fiduciary responsibility in high relief. When a funds management subsidiary reports to a multiline financial services company, the scope for abuse of investor capital broadens dramatically. In contrast, private for-profit investment management organizations enjoy the option of playing the role of a benevolent capitalist, mitigating the drive for profits with concern for investor returns."

The short version ? Favour investment boutiques.

Even the language of institutional fund management is dishonest. The term "mutual fund" implies shared ownership, along the lines of mutual societies that are collectively owned by their members. But almost every mutual fund group so-called is a for-profit business. The rare exceptions in North America are the likes of the Vanguard Group and TIAA-CREF.

The relative attractions of investment boutiques are even more powerful when those businesses are engaged in genuine value investing. Value investing almost by definition is limited in terms of asset size and subsequent investment capacity. The most disciplined value investors make a conscious decision to cap the size of their funds in order to concentrate on maximising investment returns.

Which is the most compelling value opportunity today ?

First you need a market that has been out of favour for years. Next you need a market that has been largely shunned by both domestic investors and foreigners. Then you need attractive bottom-up valuations partly reflecting that mixture of retail and institutional revulsion. It helps to have a government determined to promote corporate governance and improve returns to shareholders. It also helps to have "a massive disconnect between corporate reality [profits growth] and market valuation and sentiment".

That market is Japan. Greg Fisher, manager of the Halley Asian Prosperity Fund, points out that investors in Japanese stocks now have two very powerful factors on their side:

"First.. the companies we own and meet know full well their market valuations are ridiculous and are acting on it. Stock buybacks are accelerating further in addition to dividends going up and up."

The fund holds several Japanese stocks now yielding almost 5%, with payout ratios likely to rise, that are acquiring as much as 10-15% of their own shares and cancelling them. Secondly,

"These dividend yields are becoming increasingly attractive to domestic institutions and individuals in the face of negative interest rates.. There is no other market in the world offering such a remarkable set of valuations, earnings and dividend growth."

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