9th February 2010

Indecent haste

“..approval is not the goal of investing. In fact, approval is often counter-productive because it sedates the brain and makes it less receptive to new facts or re-examination of conclusions formed earlier. Beware of investment activity that produces applause: the great moves (when made) are usually greeted by yawns.”


“Individuals who cannot master their emotions are ill-suited to profit from the investment process.”

- Benjamin Graham, the ‘father’ of Value Investing.

Consider the following, real life, example of comparative returns (for which I am indebted to Kokkie Kooyman of Sanlam Investment Management). Imagine you invested $10,000 into shares of Warren Buffett’s now legendary holding company, Berkshire Hathaway, at the end of 1971. Then imagine you (or better still, a sibling, or friend) invested $10,000 into the S&P 500 Index. The table below shows how your investments fared.

<table>
<thead>
<tr>
<th>Year</th>
<th>Value of $10,000 invested in Berkshire Hathaway stock</th>
<th>Value of $10,000 invested in the S&amp;P 500 index</th>
</tr>
</thead>
<tbody>
<tr>
<td>1971</td>
<td>$10,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>1974</td>
<td>$5,708</td>
<td>$7,456</td>
</tr>
<tr>
<td>1975</td>
<td>$5,422</td>
<td>$10,229</td>
</tr>
<tr>
<td>1976</td>
<td>$13,392</td>
<td>$12,643</td>
</tr>
<tr>
<td>1991</td>
<td>$1,361,805</td>
<td>$92,940</td>
</tr>
<tr>
<td>2008 (17 Nov)</td>
<td>$14,387,737</td>
<td>$259,068</td>
</tr>
</tbody>
</table>

Where to begin ? The raw data suggest that Buffett had a miserable 1973/74 Crash. Our hypothetical end-1971 investor would have seen his pot invested in the S&P 500 depleted down to $7,456 by 1974. But his shareholding in Berkshire Hathaway would have underperformed even a lousy market, with a value of just $5,708. Many investors would doubtless have thrown in their hypothetical towel by this stage. It gets worse. By 1975, the broad stock market had recovered its losses, and was trading at a value back above the initial $10,000. Berkshire Hathaway stock, on the other hand, was down even more, to a value of just $5,422. Those investors who didn’t cash in their chips in 1974 would have been sorely tempted to do so by the following year.
That would have been a mistake. Investors – and there are doubtless hundreds if not thousands of them – who kept the faith with Buffett were amply rewarded. By 1976, Berkshire stock had bounced back like a coiled spring, vaulting above the S&P 500’s return. By 1991, the outperformance had started to become silly: $1,361,805 in market value for Berkshire stock by comparison with a perfectly respectable $92,940 from the S&P 500. Subsequent returns are also shown in the table above.

Sanlam’s Kooyman cites Shelby Cullom Davis, diplomat and investor:

“You make most of your money in a bear market, you just don’t realize it at the time.”

The tone of Buffett’s 1974 chairman’s letter to shareholders of Berkshire Hathaway is sober, but neither panic-stricken nor defeatist. Buffett was simply sticking to his knitting and maintaining the business for the long run.

There is a quote from author John Naisbitt that aptly addresses the problems facing the modern investor:

“We are drowning in information but starved for knowledge.”

Taking in information, whether about the global economy, or financial markets, or just the affairs and prospects of a single company’s stock is, thanks to data and commentary provision like that available from the Internet, akin to drinking from a fire hose. Our cave brains, evolutionarily poorly adapted to process information about remote subjects, are bombarded with spurious inputs. Other modern media are also complicit in this permanent assault on the senses. Fund manager Tony Deden and financial analyst Barry Ritholtz both make reference to the following quote from a senior portfolio manager at UBS:

“Isn’t it funny when you walk into an investment firm, and you see all of the financial advisers watching CNBC – that gives me the same feeling of confidence I would have if I walked into the Mayo clinic or Sloan-Kettering and all the medical doctors were watching General Hospital.”

The blizzard of data – and opinion – now available in real time to anyone with the interest, time or budget to subject themselves to the likes of Bloomberg or CNBC is not merely a distraction, but a constant invitation to overtrade or otherwise second-guess investment decisions made within a more objective and unassailed calm. This is just another example of how many supposed professionals in finance have allowed themselves to be become slaves to, rather than rulers over, technology.

Another investment distraction hyper-enabled by modern media is the over-confident pundit. Nassim Taleb, author of ‘The Black Swan’ (if you haven’t read it yet, you don’t really need to; its essential message could be captured by an alternative title, ‘Surprising things can and do happen’; the same author’s earlier ‘Fooled by Randomness’ is a much better read). Taleb resurfaced last week seemingly wearing Bill Gross of Pimco’s shoes; what Gross did for the UK Gilt market (“resting on a bed of nitroglycerine”), Taleb has now done for the US Treasury market, stating that “Every single human being” should bet that US Treasury bond prices will fall, at least as long as Federal Reserve chief Ben Bernanke and White House economic adviser Lawrence Summers remain in office.

Taleb certainly has a point. As Bloomberg points out, the Federal Reserve and US agencies have lent, spent or guaranteed $9.66 trillion to lift the US economy and its financial system out of their
two-year funk. President Obama has increased the level of US marketable debt to a record $7.27 trillion with the same end in mind. The US budget deficit is projected to rise to a record $1.6 trillion in the fiscal year 2011.

But we are in an extraordinary environment. While many of the largest western banks are probably technically insolvent, they enjoy a backstop bid from governments that have impoverished themselves to bail them out. The next step in this shell game is to “encourage” those same banks to use their government funds to invest back into the government bond market. Separately, the Chinese continue to recycle at least some of their foreign reserves into the US Treasury market. And for as long as the US dollar remains the pre-eminent global reserve currency, the US Treasury market is underpinned by the fact that Chinese and Asian selling would amount to mutually assured destruction. The great Treasury bubble, in other words, can go on inflating for quite some time. So while the prudent course is simply to get out of the way, encouraging every investor on the planet to short Treasuries, as Taleb does, could be dangerous.

What conclusions, then, can we draw from this discursive ramble through market history and the current investment landscape?

1. Reacting to mark-to-market movements in securities’ prices is like making pronouncements about climate change from watching the clouds scud by.
2. Market downdrafts can, per the Berkshire Hathaway example cited above, last for longer than many investors’ bounds of tolerance. But mentally marking a longer term investment portfolio to market on a monthly basis, or even an annual basis, runs the risk of jeopardizing a fundamentally sound diversified portfolio — and meaningful longer term returns — for the sake of an easy night’s sleep.
3. If you cannot understand or rationalize a given market or its price and yield level, then don’t invest in it. But by the same token, actively shorting it could prove disastrous. Particularly when it represents the full faith and credit of the world’s sole economic and military superpower, during a time of tectonic credit market upheaval.
4. The constant tide of financial news and data is a tool but hardly a directive strategy.
5. Humility in investment commentators is rarer than a unicorn.

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