Buffett-ites or Bluff-it-ites?

Warren Buffett needs no introduction – he's probably the most quoted man in finance. He has a great turn of phrase and often relates the stock market to real life – baseball ("the problem when you're a money manager is that your fans keep yelling , 'swing, you bum!'"), grooming ("never ask a barber if you need a haircut") and even procreation ("you can't produce a baby in one month by getting nine women pregnant"). He's also added to the lexicon of investing, probably most notably with the phrase "economic moat". He explained this in the 1993 Berkshire letter to shareholders: *'**Coke** and **Gillette** have actually increased their worldwide shares of market in recent years. The might of their brand names, the attributes of their products, and the strength of their distribution systems give them an enormous competitive advantage, setting up **a protective moat around their economic castles**. The average company, in contrast, does battle daily without any such means of protection.'*

Economic moats take many forms and include those bestowed by governments through a licence (such as a national lottery operator), ones formed through economies of scale (e.g. food retailing), or through branding (e.g. Nestle, Coke) or through patents and know-how (e.g. pharmaceutical / medical industry). Companies with genuine moats can sustain high margins and returns on investment; sometimes they can grow sales and profits without the need to invest heavily.

Buffett was schooled by Ben Graham, a man who was almost formulaic in his investment approach. For him, if a stock traded at a material discount to his appraisal value (typically a steeply impaired book-value), he bought it. If and when the stock rose by a certain amount, he sold it. Graham realised his approach was mechanical – in fact he viewed the mechanics as a way taming human emotions. A business trading at a fraction of book was likely to have some material weaknesses and therefore emotionally difficult to buy. And lest an investor "forget" how poor a business is (a rising share price can do this to you!) he should sell after a 50% gain or after 2 years, whichever came first. Graham put relatively little effort into understanding the business behind the stock, to guage its competitive position, its advantages and disadvantages.

Buffett has an extraordinary brain and has perhaps a personality (unemotional) better suited to investing than most. He reads voraciously. When asked how he and Charlie Munger, his Berkshire Hathaway "partner", became so successful in investing, Buffett answered *'We read hundreds and hundreds of annual reports every year'*. He became interested in the newspaper industry in the early 1970s and subsequently immersed himself in its economics, finding out everything he could. He discovered that between 1910 and 1971 the number of US cities with daily newspapers had gone up 25% (from 1,207 to 1,511), but that the number of cities with two or more competing papers had fallen from

689 to just 37[1]. This was a dramatic, incredible insight. Gathering that data likely involved copious amounts of reading and analysing, a level of diligence not often undertaken by many other money managers (how many regularly look back 60 years of industry data before forming a stock view?). At the time most investors on Wall Street were focused on the fact that, already in the 1970s, paper circulation was not growing much (if at all). However, Buffett knew that cities were slowly converging towards a single daily "title" – and that "title" had incredible pricing power. The local newspaper was the advertising instrument of choice for the local business. Added to that, newspapers were not a capital intensive business, which led to fantastic returns on investment. Such a company could justify a higher valuation than one without a moat.

As we speak, the internet is bypassing newspapers' moat – perhaps like the new technologies of gunpowder and cannons rendered castles and moats redundant in the 16th century. Buffett made lots of money from newspapers and his major newspaper investment, **The Washington Post**, has since diversified into education businesses with strong moats. Nevertheless, the internet was something Buffett – *even* Buffett – simply could not have foreseen. That makes me nervous.

For Buffett, notwithstanding his recent experience with newspapers, businesses with moats on modest valuations are his investment of choice. He explains why in his 1989 Berkshire Hathaway annual shareholder letter. He calls Graham's investment style *'the "cigar butt" approach to investing. A cigar butt found on the street that has only one puff left in it may not offer much of a smoke, but the "bargain purchase" will make that puff all profit'*. Sounds good. He goes on to say *'Unless you are a liquidator, that kind of approach to buying businesses is foolish. The original "bargain" price probably will not turn out to be such a steal after all. In a difficult business, no sooner is one problem solved than another surfaces…..Time is the friend of the wonderful business, the enemy of the mediocre'.*

Jean-Marie Eveillard may not be as famous – or as great – as Buffett, but he sure packs a punch in the investment world. His credentials are clear from his long, positive performance track record (15.8% p.a. between 1979 and his 'semi-retirement' in 2004). In a 2008 interview given to the Columbia Business School investment newsletter *Graham and Doddsville*, Eveillard said *'Over the past almost 30 years, we (First Eagle) have sort of floated between Ben Graham and Buffett. We began with the Graham approach which is somewhat static and less potentially rewarding than the Buffett approach, but less time consuming. So as we staffed up, we moved more to the Buffett approach, although not without trepidation because the Buffett approach yes, you can get the numbers right, but there is also a major qualitative side to the Buffett approach. We, or at least I, surely do not have the extraordinary skills of Buffett, so one has to be very careful when one moves to the Buffett approach'*.

Li Lu, founder of Himalaya Capital Management, is most definitely a Buffett-ite. His investment track record since 1998 – while still relatively short – is phenomenal, compounding clients' wealth at a rate of around 30% per annum since 1998 (bear in mind that 2000-2010 is known as the "lost decade", as stocks were generally flat or declined). His mantra: accurate and complete information. And when he says complete, he means going to pretty extraordinary lengths. For example, in order to understand the character of the CEO of a company under research, he would advocate attending the CEO's local church and

quizzing his neighbours. He's quite dismissive of the Graham approach, which he believes deliver returns in the order of 'only' 15-20%, while his best career ideas could deliver *'maybe 10,000%'*[1] Li Lu manages all of Charlie Munger's money and was recently invited to work with Buffett and Munger at Berkshire (he declined).

Other value investors have been more or less forced to adapt a Buffett approach, as the market typically trades on a higher multiple of book than during Graham's time. Computers and financial software has made it very easy to set up screens to search for "mechanical value" stocks, resulting in fewer Graham-ite investment opportunities. It's probably also true that brands are more prevalent now than in Graham's time, so many companies are genuinely worth more than the tangible value of their equity (total tangible assets less total liabilities). However, it's important to remember that companies with real sustainable moats are not the norm. Collectively, humans are creative and greedy and, where possible, others will try to muscle in on attractive opportunities (particularly in fast growing industries). Inevitably, some high return businesses will be made ordinary. Corporate history is littered with moats-that-weren't. I've already mentioned the newspaper industry's current difficulties. Another example is the once-great auto industry, which made a return on capital of 46% in the 1960s, 38% in the 1970s, 9% in the 1980s 6% in the 1990s and in the 2000s it was negative. Other examples include **Citigroup**, **Xerox**, **IBM** and television broadcasters, to name but a few. The consequences of a mis-diagnosis can be severe. Companies perceived to have moats are typically valued on high multiple of earnings – the faster the growth, the higher the multiple. Very often a "de-throned" business will be valued lower by both reduced earnings and a less generous multiple of earnings.

For me, the beauty of the Graham approach is that the investor buys into companies which are already known to be moat-less; fewer heroic assumptions need to be made. "Cigar butt" investing can burn your fingers from time to time, but overall this approach still yields good, low risk results[1]. Buffett's "motherhood and apple pie" style of communication belies a complex investment approach, something that is often forgotten by his followers. True, the return potential is higher, but the risks are greater and all but the best money managers run the risk of over-estimating their analysis and belief in the existence of a moat. For "Bluff-it-ites", this strategy can verge on speculation, not investing.

Between 1930 and 1940 France constructed the "Maginot Line", named after French Minister of Defence Andre Maginot, a fortification built along its border with Germany. The Line was based on France's "trench warfare" experiences from World War I and was built as a defence against future German attacks. We now know that the Line failed spectacularly. New technologies (aerial artillery), clever strategies (diversionary tactics) and a highly mobile army enabled the German army to round the Maginot line and take Paris – almost unimpeded – in just 4 days. Jean-Marie Eveillard's warning to wannabe Buffett-ites should be taken very seriously. Who among us is *capable* of distinguishing a moat from a Maginot line?

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