VALUE INVESTING and BEHAVIORAL FINANCE

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My partners and I at Tweedy, Browne have in the past been skeptical of academic studies relating to the field of investment management primarily because such studies usually resulted in the birth of financial paradigms which we believe have no relevance to either what we do or to the real world. A whole body of academic work formed the foundation upon which generations of students at the country's major business schools were taught about Modern Portfolio Theory, Efficient Market Theory and Beta. In our humble opinion, this was a classic example of garbage in/garbage out. One could have just as easily manipulated the data to show that corporations with blue covers on their annual reports performed better than corporations with green covers on their annual reports. Although none of the three of us was fortunate enough to have studied under the late Dr. Benjamin Graham when he taught at Columbia Business School, we were fortunate enough to have observed some of his best students who either worked at or were customers of Tweedy, Browne from the late 1950s through the present. Tom Knapp, who was a partner at Tweedy, Browne from 1958 until the early 1980s, both studied under Ben Graham and worked for Ben's investment firm, The Graham-Newman Corporation. Walter Schloss, another alumnus of Graham-Newman, has made his office at Tweedy, Browne since he set up his private investment partnership in 1955. Still going strong at 84 and still housed at Tweedy, Browne, Walter has what we believe is the longest continual investment record of any individual in our field. Among others, Warren Buffett was a frequent visitor to Tweedy, Browne in the 1960s and early 1970s. My father was the primary broker for Warren in his purchase of stock in Berkshire Hathaway, and I can remember posting trades in Berky at $25 per share when I started working in 1969. Our exposure to these legendary investors whose investment principles were based on the teachings of Ben Graham, was the reason for our skeptical view of more modern investment theories.

In more recent years, two schools of thought as regards investment have emerged that we believe do have significant merit to the investor. The first is highly empirical and is based on a body of work, principally academic studies, that show that stocks outperform bonds, and value outperforms both growth and the popular stock market indices over long periods of time. We have collected 44 of these studies in a booklet entitled, **WHAT HAS WORKED IN INVESTING,** which we are happy to provide to any present or would-be investor. The overriding conclusion of these studies is that value investing provides superior returns compared to all other investment styles. The second body of recent academic studies deals with the question of why the vast majority of both professional and individual investors ignore this empirical evidence when making investment decisions. This field is dominated by some of the leading behavioral psychologists in the country and is now a favorite topic of conferences, such as the annual Behavioral Finance Seminar at the John F. Kennedy School of Government at Harvard University. Despite the popularity of these seminars, we see little evidence that the lessons they teach are put into action in the field of investment.

Money management attracts some of the brightest and best educated people in the world. It is a highly lucrative field where success is most often measured at the close of the stock market. One need not wait for a highly subjective annual review of one's performance by one's superior. Mr. Market grades you on a daily basis. The smarter one is, the more confident one becomes of one's ability to succeed. Clients encourage this belief by seeking out those successful money managers whom they believe have some greater knowledge about the stock market much as lost souls seek out gurus who can impart the secret to personal happiness. What else would explain the portrayal of money managers like movie stars whose youth and physical prowess provide the stamina to navigate the turbulent seas of investment? How often are mutual fund managers pictured on the cover of investment magazines mountain biking, rock climbing or taking judo lessons? And how many times have I heard the expression, "He has a good nose for stocks" as if investing were an olfactory process? The truth is that few money managers take the time to figure out what works and develop a set of investment principles to guide their investment decisions before setting out to manage money. This is an issue that Charlie Munger spoke about brilliantly in an address where he spoke of the need to develop models to guide our behavior. Without models or principles, one is just flailing in the dark and mistaking luck for success.

ASSET ALLOCATION AND RISK AVERSION

Why money managers do not take the time to develop a valid set of investment principles is a topic addressed by the behavioralists. Their task is to analyze why we do what we do regardless of whether it is rational. For example, take the topic of asset allocation, arguably the first step an investor must take in choosing how to invest. In a paper entitled, **THE ROAD TO WEALTH: LONG TERM INVESTMENT IN STOCKS,** by my partner, John Spears, a comparison of the long-term returns of stocks and bonds is presented. From 1871 to 1992, stocks beat bonds in 80% of the rolling 10-year periods. In rolling 30-year periods, the approximate time one saves for retirement, stocks won out over bonds 100% of the time. The pre-tax returns from stocks further beat inflation in each of the 20-year periods measured. Bonds and bills, on the other hand, only beat inflation in 31% and 59% of the time, respectfully. In a National Bureau of Research working paper, *Financial Decision Making in Markets and Firms: A Behavioral Perspective*, authors Werner De Bondt and Richard Thaler found that the real rate of return on stocks from 1926 to the early 1990s was 7% while the return on bonds was 1%. This equity return premium, in their estimation, more than compensates for the risk associated with equities, and can only be explained if investors are extraordinarily risk averse.

In a survey of financial planners conducted a few years back, one-half of the planners were asked what should be the allocation between stocks and bonds for a couple with $5 million in investable assets who needed $60,000 per year to live. The other half of the planners were asked for the asset allocation for a couple with $20 million in investable assets who needed $120,000 per year to live. In the first case the couple's spending rate was a modest 1.2% per year which is highly conservative when one considers the spending rate of most university endowments runs approximately 5% per year. The second couple had a ridiculously low spending rate of 0.6% per year. In both cases their tolerance for risk based on their current spending needs was very high. The financial planners recommended an asset allocation of one-third bonds and two-thirds stocks in both cases.

A few years back, a long time client sought out my advice on how she should structure her investments. Her account at Tweedy, Browne was approximately $4 million, and she was fortunate to also own $34 million of Berkshire Hathaway stock at its then price. The client had heretofore lived off her salary of approximately $200,000 but was now retiring. She had made an estate plan which included bequests to her children and certain other charitable bequests. Because a significant portion of her estate was going to charity, a financial advisor had recommended a series of charitable remainder trusts which she could establish with her low cost basis Berkshire Hathaway stock. Once in trust, the stock could be sold without having to pay a capital gains tax, and the proceeds could be invested in bonds to provide retirement income. When I asked her if she thought her Berkshire Hathaway had been a good investment, she said, "It certainly has been." It was in fact the reason she was quite rich. When I asked why she would want to sell it, her accountant responded by saying all her assets were in the stock market and therefore, riskier than bonds. I said the stock market could decline 50% and she would not have any problem finding enough money to support her relatively modest life style. She then said, "So I should do nothing?" I said, "That's my advice." As of the close of the market last night, this woman now has in excess of $200 million and the ability to do more good than she ever dreamed of.

On another occasion in 1988, a friend sought my advice at the suggestion of another mutual friend. Our mutual friend had accorded me "genius" status because of some advice I gave him in 1987. In the summer of that year he asked if I would manage two trusts, one for him and one for his sister. I agreed and he had the two trusts moved over to Tweedy, Browne. The move was completed in September of that year. He then informed me that at the end of the year, the trusts expired. He planned to invest his in some real estate deals he was working on, and his sister was going to buy a house. My advice to him was that since he had such a short time horizon, we should liquidate the trusts immediately and invest the money in a money market fund. The liquidation was completed the first week of October 1987. After the crash of '87, which he rode out in cash avoiding a loss of $500,000, was when my halo was brightest in his eyes. To this day he credits me with foreseeing the crash and getting him out of the market. While there is absolutely no truth to his statement, who am I to argue?

Back to our other friend. He had a portfolio of municipal bonds worth $700,000. He was a successful commercial real estate broker who was able to save at least one-half of his earnings each year. His portfolio was truly long-term investable assets. However, he told me he had zero tolerance for losses. (He also had a strong aversion to paying taxes which accounts for his preference for municipal bonds.) If he owned a stock and it closed down on a particular day, he was deeply upset. I guess he did not realize that bonds also fluctuate in price; but since he could not look up their closing price each day, he was not worried. He got his regular interest check which he reinvested and was happy. Over the ensuing 10 years, I calculated his municipal bond portfolio would have grown to $1,140,226 at a assumed interest rate of 5%. If the same funds had been invested in the Standard & Poor's 500 Index, he would have $2,906,639 before taxes at a 15.3% annually compounded rate of return. If this investment was taxed at a 40% rate, his after tax nest egg would have grown to $2,023,983. His "loss" for not being invested in stocks was $883,757. However, since the loss was really only an opportunity cost, he did not feel it. Moreover, it is unlikely he would have had the stomach to stay invested after the crash of 1987. In explaining our friend's behavior, psychologists have found that the disutility of loss is twice as great as the utility of gain. To this day, I believe our friend does not own stocks.

As in the case of our friend with the municipal bond portfolio, the frequency with which an investor checks his investments plays a significant part in his or her level of risk aversion. As stocks go down on nearly as many days as they go up according to De Bondt and Thaler, stocks can be highly unattractive if they are observed on a daily basis. Other behavioralists have estimated that if an investor's time horizon was 20 years, the equity premium would fall to 1.5% from 6% as there is very little chance an investor would experience a loss after so many years, and stocks would be a much more appealing investment. University endowments would seem to be an ideal pool of funds to take a truly long-term view of investing. They have a perpetual existence, and most adhere to conservative spending rates of 3% to 5% based on a three year rolling average net asset value which is designed to soften any short term stock market volatility. However, nearly every endowment invests between 20% and 35% of assets in bonds without calculating the opportunity cost of not being in equities. It is an aversion to short-term volatility which explains why trustees are willing to accept below average rates of return on a significant portion of the endowment. Universities almost never run a budget surplus, which makes them dependent on a reliable level of endowment income. However, it should be possible to make contingent budget plans that would accommodate short-term market declines, such as deferring certain capital investments or new programs, until such time as the stock market recovers to more normal levels.

INVESTMENT STYLES

The vast majority of money managers are categorized as either value managers or growth

managers although a third category, market neutral managers, is gaining popularity these days and may soon rival the
so-called strategies of value and growth. Pension and endowment consultants love to put money managers

in style boxes and have convinced their clients that the greatest measure of success in investing comes from asset allocation rather than stock selection. As a professional money manager, I see analyses of our firm's results attributing a disproportionate share of our performance to asset allocation as opposed to stock selection. My partners and I find this a bit amusing as we do no asset allocation at all, but concentrate on pure bottom-up stock selection. Consultants have further convinced their clients that there is very little difference in the results of value managers as compared to growth managers; we just take turns leading the pack depending upon market conditions. We believe this conclusion results from the fact that the consultants force nearly all managers into one category or another, combine their results, and compare them over time. However, we do not accept the credentials of many managers who others call value managers. In our opinion, many are merely closet indexers who are more concerned with standard deviation than absolute returns. In fairness, these managers are acting rationally because standard deviation has become a more important determinant of manager selection than absolute return.

I think many money managers pick a style because they must be categorized as something in order to get into manager searches despite not having much real conviction about their style. Some investment management firms even hedge their bets by offering all styles. As my father used to say, "Some like chocolate, some like vanilla." What too few money managers do is analyze the fundamental financial characteristics of portfolios that produce long-term market beating results, and develop a set of investment principles that are based on those findings. GEICO is one of the most successful auto insurance companies in the world. They did not achieve this success by having some great insight into determining who would be a good driver based on some subjective standard one-on-one. Instead, they analyzed the characteristics of drivers who are less likely to have accidents and developed a model of the "good" driver. In its extreme, they might say any driver who lives in the suburbs, does not drink, takes public transportation to work, is between the ages of 30 and 60, has no kids of driving age, and drives a Volvo is a good risk. Some of those drivers will still have accidents, but far fewer than the population as a whole. And some of the drivers who do not meet their standards will also not have accidents and would have been good risks. Nothing is perfect. Money managers can do the same thing. Ben Graham did it back in the '20s and '30s. He found that buying stocks below net current assets (current assets less all liabilities), buying stocks where the earnings yield was greater than the long-term bond yield by a margin of 50% or 100%, and buying stocks at two-thirds of tangible book value when stockholders' equity was greater than all liabilities, produced better than market returns. Once one develops the principles or as Charlie Munger would call it, the model, the rest is easy.

We have done this, and we have observed that the money managers who have achieved long-term market beating results in this business, Walter Schloss, Warren Buffett, Bill Ruane and Rick

Cunniff, Mario Gabelli and John Neff, all have an investment philosophy based on their definition of value. Our booklet, **WHAT HAS WORKED IN INVESTING**, shows that both in the US and internationally, basic fundamental value criteria produce better than market returns over long periods of time. In a paper, *Contrarian Investment, Extrapolation And Risk*, authors Joseph Lakonishok,

Andrei Schleifer, and Robert Vishny found that value stocks outperform the market by exploiting the sub-
optimal behavior of investors. They further found that value stocks outperform growth stocks both pre-tax and after tax. In 1984, upon the occasion of the fiftieth anniversary of the publication of **SECURITIES ANALYSIS** by Benjamin Graham, David Dodd and Sidney Cottle, Warren Buffett engaged in a debate with Michael Jensen of The Harvard Business School about the efficient market theory. In a then recent issue of ***Fortune Magazine***, Jensen explained the 28-year investment record of Walter Schloss who had an annually compounded rate of return for his partnership of 21.3% versus 8.4% for the Standard & Poor's 500 Stock Index, as a matter of probabilities having nothing to do with investment style. Warren Buffet then presented the investment records of seven managers ranging in length from 13 years to 28- years with returns in excess of the S&P 500 of between 7.7% and 16.5% annually compounded. (Tweedy, Browne was included in Buffett's group of managers.) All seven managers traced the origins of their investment style to Ben Graham and value investing. A more complete report of this debate is available in an article by Warren Buffet, **THE SUPER INVESTORS OF GRAHAM AND DODDSVILLE** from the Fall 1984 issue of ***Hermes,*** the magazine of the Columbia Business
School.

In another paper, **WHAT DO MONEY MANAGERS DO?**, authors Joseph Lakonishok, Andrei Shleifer, and Robert Vishny examined the holdings of managers who are labeled either value or growth, and arrived at the same conclusion we have. Most portfolios are concentrated around the axis of value and growth, and large and small cap. In other words, the value and growth characteristics of the typical portfolio do not deviate much from the Standard & Poor's 500 Index. The reasons for this are two-fold, one being the practical reality of managing large sums of money, and the other related to behavior. As the assets under management of an advisor grow, the universe of potential stocks shrinks. In the view of most advisors, it is simply not worth the effort to research companies in which it is not possible to invest a substantial amount of capital. This results in a much smaller universe of large cap stocks which will, in large measure, be in most stock market indices. If you are going to construct a portfolio selected mostly from stocks in the Index, it is very difficult to produce a result that is significantly different from the Index.

The second, and perhaps more important reason professionally managed portfolios do not deviate from the Index is more directly related to behavioral psychology. Investment performance is generally measured against a benchmark, and claims to being long-term investors aside, the typical institutional client tracks performance on a monthly or quarterly basis versus the benchmark. Performance that deviates from the benchmark becomes suspect and can lead to termination of the money manager. Consistency of returns relative to the benchmark are more important than absolute performance especially in a world dominated by the hypothesis that asset allocation is more important than stock selection. Once the advisor figures out how he or she is being measured, they realize that tailoring the portfolio to the benchmark reduces the risk of relative underperformance and loss of the account. Unfortunately, the chances of significantly outperforming the benchmark are equally diminished.

BEHAVIORAL OBSTACLES TO PURSUING VALUE STRATEGIES

In **ARE SHORT-TERM PERFORMANCE AND VALUE INVESTING MUTUALLY EXCLUSIVE? THE HARE AND THE TORTOISE REVISITED** (an article in the Spring 1986 issue of Hermes Magazine), V. Eugene Shahan analyzed the investment records of the seven managers presented by Warren Buffett in his debate with Michael Jensen. Shahan found that despite the fact that all seven managers outperformed the S&P 500 extraordinarily, none of the managers outperformed it every year. Six of the seven managers underperformed the S&P 500 between 28.3% and 42.1% of the years covered. Often, the periods of underperformance lasted for several years in a row. In the case of Ruane, Cunniff's Sequoia Fund which has produced a total return of 12,500% versus 4,900% for the S&P 500 from inception through 1999, it experienced declines of 39% in the 1973-74 period, and 30% in 1979-1980. Periods of such underperformance would have resulted in termination by all but the most convicted value investor.

Returning to Lakonishak, Schleifer and Vishny, and their Paper, *Contrarian Investment, Extrapolation and Risk***,** their greater contribution to understanding investment behavior lies in an analysis of why more investors do not pursue value strategies. One reason offered is that investors may not be aware of the data despite evidence going back to the work of Graham and Dodd (1934), or that much of the evidence is refuted by the conclusions offered by pension consultants such as value and growth perform about equally over time. The authors further conjecture that the superior performance of value strategies versus what they call "glamour" or growth strategies is the preference for glamour strategies over value strategies by both individual and institutional investors based on their predisposition to extrapolate recent past performance with future performance.

"Putting excessive weight on recent past history, as opposed to a rational prior, is a common judgment error in psychological experiments and not just in the stock market."

Additionally, the authors posture that investors may just equate well-run companies with good investments.

Lakonishok et al go on to discuss the reasons why institutional investors who should be less prone to judgement biases and the enthusiasm for "good companies" than individual investors do not gravitate toward value strategies. The explanation parallels our own observation that institutional clients seem to prefer better companies on the theory they are more prudent investments. However, in this instance, the prudence may be on the part of the money manager who is more concerned with not losing an account than performing well for his or her client. As far back as the early 1970s, I can remember one of our former partners, Ed Anderson, explaining the herd instinct of professional money managers. If a manager held IBM and it went down, it did not matter because everyone else owned IBM. Is today's IBM Cisco Systems? If one owned a more obscure company with a recent poor track record that got into greater financial difficulty, there was a considerably greater risk of criticism and losing accounts. The concept that investment risk is less a function of the individual company than the price of its stock is not recognized by many investors.

The allure of more immediate gratification also plays an important part in investors' stock preferences. Value stocks often take longer to work out than investors who are seeking more immediate, abnormal returns are willing to wait. Here again, there is a significant body of research chronicling the individual's preference for more immediate gratification and the perception that life or circumstances are always improving. Understanding this behavioral trait makes it rather easy to understand the popularity of momentum investment strategies.

I am also of the opinion that the institutionally prescribed definitions of value and growth are flawed. Consultants using data from sources such as Barra have divided the universe of all stocks into either value or growth. Managers of either style had better take care to construct their portfolios from their style universe or risk losing the account because of committing the sin of "style drift." This institutional bias leaves many value managers with a list of large industrial companies, cyclical stocks, whose hey days of growth and high returns on capital are long past. My brother, Will, calls them the "hospice patients of corporate America." However, Ben Graham left plenty of room in the definition of value as is evidenced by the portfolio of his most famous student, Warren Buffett. Value is not only discount from book value, or low price/earnings ratio stocks. It is also discount from enterprise value, the price that a knowledgeable buyer would pay for a particular type of business. Applying the same price-to- EBIT- ratio to different businesses may well be incorrect as some types of businesses, because of growth potential or returns on capital, are simply worth more. Would an acquirer pay a higher EBIT multiple for Johnson & Johnson than Caterpillar? Of course. The consultants would tell you it is OK to own Caterpillar in a value portfolio, but not OK to own a growth stock like J&J. In 1993, J&J was selling for 12 or 13 times earnings. The stock market was in the doldrums and pharmaceutical stocks were suffering, in particular under the threat of Hillary Clinton and Ira Magaziner concocting a plan to bring socialized medicine to the United States. However, at its 1993 market price, one could buy J&J for the value of its consumer products, Tylenol, Band-Aides, Baby Oil, etc., alone and get the drug business for free. In addition, a very smart director, Tom Murphy, former chairman of Cap-Cities ABC, was personally buying millions of dollars of the stock. At 12 or 13 times earnings, was J&J a value stock or a growth stock? We thought it was both.

Growth stock investing may be more a philosophy of buying what is popular. Value investing is more a philosophy of buying what is out of favor. Surely, at the time we first bought J&J, pharmaceutical stocks were not in favor. Lakonashak and his co-authors would call it buying "glamour" stocks rather than value stocks. Last year Internet retailing stocks were glamourous. These stocks seemed to all have one thing in common: the stock market loved them. However, as Warren Buffett would say, "You pay a dear price for a cheery consensus." The practice of buying out-of-favor stocks, of being a contrarian, is a mind set few investors have. When it is not working in your favor as it will not a significant portion of the time, you risk being fired. Money managers are not stupid. They realize that sticking one's neck out and producing short-term under performance that differs from an index that is used as the benchmark is risky.

Adhering to value investment principles in periods such as 1998, 1999, and the first quarter of 2000 required a tremendous amount of conviction. You are derided for not adapting to a changing world, for failing to understand "new paradigms." How many times did we hear that the old methods of valuation were not relevant to the "new economy?" We were told that "hits," not profits, were what was important in valuing Internet companies. However, a business strategy that cannot ultimately produce a profit means the business is ultimately worth zero. For example, Priceline.com traded as high as $138 per share on May 7 for a market capitalization in excess of $22 billion. On November 14, 2000 it closed at $2.78 for an eye-popping drop of 98%. We asked ourselves, do we really want to fly from New York to Miami via maybe Minneapolis and Charlotte and risk getting in at midnight, or do we want a bit more specificity in our travel plans? However, we were told we were out of touch. Today, Internet companies are going bankrupt as fast as they went public just twelve short months ago. If nothing else, the speed with which the world changes is certainly accelerating.

In our own experience, we saw stocks we owned drop sharply between the Fall of 1999 and the Spring of 2000 for no apparent reason, while the NASDAQ was soaring. Names like J&J and Household International fell 25% to 35% without missing a single earnings estimate. Recently, we found out why. In the twelve months ended August, 2000, nearly $63 billion was redeemed from large cap value mutual funds, while $131 billion was put into large cap growth funds. In the first quarter of 2000, value fund redemptions were running at an annual rate of $120 billion and large cap growth funds were garnering assets at the annual rate of $200 billion. The first quarter seems to have been the peak of these cash flows which once again emphasizes the inaccuracy of the herd instinct. From its peak in March, 2000 at 5048.62, The NASDAQ Composite Index has tumbled more than 37.8% through November 14, 2000. Surely, all this money would not have flowed out of value funds and into tech heavy growth funds if any one even remotely thought the NASDAQ was about to plunge?

THE CONFIDENCE FACTOR

One of the more significant and irrefutable findings of psychologist is that people are overconfident in their judgements and tend to overestimate the reliability of their information. What else could explain the valuations of telecommunications, media and technology companies last year? People make changes in their lives and their portfolios because they are confident they are making a change for the better. Without that confidence, they would merely sit still. When I gave a talk similar to this one at Penn a few years back, the audience, all graduates of the same class and all of presumably reasonably equal intelligence, was asked to rate their investment abilities relative to the others in the room on a scale of one to ten. We know the average for the room has to be five, but the average of the respondents was 7.5. What else would explain the existence of active money management when the facts show that fewer than 15% of money managers beat the index. The managers and their clients must believe they can beat the index despite empirical evidence which shows the majority will not. Everyone just believes they will be in that top 15%. We suppose if money managers did not think they could beat the market, they would not try.

The same tendency towards over-confidence exhibits itself in portfolio turnover rates, which are largely a result of attempting to "time the market." Behavioralists have a term, "calibrated confidence," which means knowing what you can do and what you cannot do. It requires being comfortable with the knowledge of how limited our abilities really are. In a paper written by Brad Barber and Terrance Odean of the Graduate School of Management at the University of California, Davis, the authors found that over-confident investors trade more and make less. The greater the trading volume, the poorer the returns. In another study of 100,000 individual stock trades, they found that the stocks investors sold "on average" outperformed the stocks they bought by 3.4% after one year. It seems logical that a money manager who turns over his or her portfolio at a high rate must have confidence that all the individual investment decisions he or she is making must be right. A lack of confidence in one's abilities usually results in a lack of activity and low activity levels have been proven to produce better returns. Barber and Odean also found that investors who trade at a high rate buy riskier stocks. Perhaps all those investors who were trading Internet stocks thought they would know to get out before the game was over.

In the February 1, 1999 issue of Peter L. Bernstein's newsletter, *Economics and Portfolio Strategy*, Jason Zweig, mutual fund columnist of ***Money Magazine***, wrote an excellent piece entitled *The Velocity of Learning and the Future of Active Management.* Jason comments on the current speed of information and its influence on money management. He reports that in 1959, the turnover rate for the average mutual fund was 16.4% which equates to a six-year holding period. By 1979, the rate had increased to 63.3%. In 1998 it was 83%. We have now heard it exceeds 100%. Jason points out that as the flow of data "makes the future seem closer and more knowable," investment managers make ever shorter-term bets. Pressure is exerted on money managers to abandon long-term investment principles in favor of short-term strategies which have less risk of producing performance that deviates from whatever benchmark is used to measure results. I recently participated in an interview of a growth stock manager for a piece of an endowment on whose board I sit. The observation was made that the managers portfolio turnover rate was 70% in 1999, and the turnover in names was 57%. The question was asked, that if the purpose of owning growth stocks was to enjoy the benefit of the companies' ability to compound earnings for shareholders over the long term, why so much turnover? At first I thought the answer was a bit strange; I no longer do. He said that the consultants have actually criticized him for having a turnover rate that was so low.

Investment performance can now be calculated on a real time basis, and some actually do. This is because investors are increasingly trading, not investing. If my J&J is down a ½ point on a given day should not in my estimation lead me to trade it in on the theory I can buy it back a point lower on the next day? In the case of the growth stock manager mentioned above, he said much of the portfolio turnover was only "trimming" which sounds an awful lot like market timing to me. This should come as no surprise given the amount of media time that is devoted to predictions of where the market is going despite the proven inaccuracy of such predictions. In the July 17, 1997 issue of ***The Wall Street Journal***, 16 stock market strategists were surveyed about the future direction of the stock market. On average, this

group of experts were advising clients to put only 48% of their investment assets in stocks. An allocation below 50.1% is considered bearish. The author, Richard Bernstein of Merrill Lynch, said that market strategists had only been this gloomy on two other occasions: the year following the crash of 1987 and in January of 1995. Both times, the stock market soared to new highs as it did in 1998 and 1999.

Along with market timing predictions, the investment community has also become addicted to quarterly earnings estimates. Companies that "miss" the analysts' consensus estimates can see their stock price decimated. Is the quarter-to-quarter earnings target really more important than a company's ability to increase shareholder value long term? Apparently so. However, the ability of analysts to predict earnings is not very good. David Dreman has done considerable work analyzing the accuracy of analysts' earnings forecasts and found that for the most part their error rate is high. In one study, 67,375 earnings forecasts were observed. Errors of between 5% and 10% of actual earnings were reported 74.4% of the time. Errors of between 10% and 15% occurred 57% of the time, and 45.3% of the estimates missed actual earnings by more than 15%. Despite this lack of accuracy, in Dreman's opinion there is a greater dependency on finely tuned earnings estimates than ever before. Exceeding estimates by as little as a penny a share can send a stock soaring; coming in a penny shy can lead to horrendous declines.

SELECTING A MONEY MANAGER

In **WHAT DO MONEY MANAGERS DO?**, authors Lakonishak, Schliefer and Vishny make the statement that, "The process of selection and evaluation of money managers may actually distort their investment strategies." In making this statement, the authors are referring to the system of judging money managers which forces them to bunch their stock picks near the middle of the benchmark to avoid tracking error, and to stick with popular stocks avoiding the extremes of valuation discrepancies all of which makes beating the benchmark virtually impossible. As Robert Kirby of Capital Guardian once said, "If you are going to look like the benchmark, you can't beat the benchmark." My own observation of my peers has led me to conclude that this is an industry that favors activity which helps explain the dramatic rise in portfolio turnover rates. Activity is taken as a sign that the manager is decisive and has a view as to whether the market or individual stocks are rising or falling. Were a portfolio manager to just sit on his stocks, he would be considered indecisive. Forget the fact that he may just like what he owns, or that he has come to realize that short-term market or stock predictions are impossible, that is not what he is paid to do. In a world that thrives on 24 hours a day financial news, inactivity is seen as brain dead. Much the same is true of analysts; they want the portfolio manager to buy their stocks. That is how they are rewarded. Were the heavy materials analyst to walk into the Monday morning portfolio managers meeting and say, “All my stocks are overpriced. Avoid the group,” his value as part of the “team” would be called into question.

As a member of two investment boards, I have had the opportunity to observe my peers presentations. The same questions seem to arise in nearly all these meetings, questions that because of the consultant driven nature of our business, get answered in the same way.

1. Do you do your own in-house research? Absolutely! No one would ever admit to reading research reports from brokers. One has to wonder why all these analysts are paid six-and-seven figure salaries if no one admits to reading their reports. While we arrive at our own conclusions about stocks, we find taking advantage of analysts’work highly valuable. For example, there is an analyst at Sanford C. Bernstein who follows the tobacco industry. He eats, sleeps and breathes this stuff. He probably has more contacts at Philip Morris than I could ever have. And he keeps us informed whenever something happens. Why would I bother to duplicate that effort? A few years back, we researched Wells Fargo. The company had just taken some reserves against its real estate loan portfolio that were mandated by the Federal Reserve which could not accept the company’s claim that there were no extra ordinary problem loans. Two highly respected bank analysts on the street wrote reports on the company and came to exactly opposite conclusions. One agreed with the company and estimated that once the reserving was over, Wells Fargo was trading at a mere 4 ½ times earnings. The other analyst agreed with the Fed, cited empty office buildings in downtown Los Angeles, and concluded the company could be bankrupt. We discussed the loan problems with the company, but still could not get comfortable with the situation given the potential downside risk. We decided to pass until we found out that one of the world’s smartest analysts had looked at the situation presumably in great detail, and concluded the positive case was correct. That analyst was Warren Buffett. He did not call us with his report. He did something better; he bought $500 million worth of Wells Fargo stock.

2. Do you visit the companies you invest in? Absolutely, and we only talk to either the CEO or the CFO! One has to wonder why corporations keep investor relations people on staff if no one will talk to them. One money manager I interviewed claimed to have made 250 company visits in the previous year. I thought, “What did you do? Drive by and wave.” Another international manager laid claim to 400 visits in a year. Again, I thought, “What did you do? Fly over and wave.” This record held for several years until just a few weeks ago, another money manager claimed his “grass roots” research team had made 4,000 company visits in the past 12 months. You cannot even read 4,000 research reports that are worth anything in twelve months. Moreover, this manager with $85 billion under management admits his universe of stocks is only 400. That means they visited each one of their possible investee companies 10 times in the past year. The reality of the situation is that once you have found a company you would like to research be it through data base screening, a research report or news article, you first have to wade through the publicly available information like annual reports, 10Ks and 10Qs, etc. That can take a matter of days or weeks depending on the

complexity of the situation. Only then is one in a position to begin to ask any intelligent questions. If a company visit is then in order, that visit has to be scheduled. Usually, CEOs and CFOs are busy running their companies and may not be able to see us at the drop of a hat. Next, unless you have your own NetJet, you have to travel to your visit at the mercy of commercial airline schedules or turnpike traffic. This could eat up a whole day for what could be a one or two hour interview. We find it is much more efficient to do your research, develop a list of questions, and then call the company. One of our analysts is able to charm company officers into lengthy conversations which he records and has a court stenographer type up. We call them Frank's depositions. They contain a wealth of information and
all for the price of a long distance phone call. I recently asked Walter Schloss if he remembered Ben Graham making company visits. Almost never was the answer. Ditto for Walter in his 45 years of beating the market.

3. Do you have a succession plan? Despite the fact that the average length of time an institutional account stays with a given money manager is only a few years, we like to think we are embarking on a life time relationship. Knowing who will take over if the money manager is run over by a truck is very important. And knowing how the successors are compensated is important because if they don't have a piece of the pie, they will leave. The fact that someone may actually enjoy where they work counts for little in the job hopping world of investment management. Moreover, the succession question would eliminate some of the most successful money managers of all time, names like Warren Buffett, John Neff, Mario Gabelli and Peter Lynch who for years had no real successors. Four years ago, Walter Schloss walked into my office with a piece of paper on which he had typed out his then 40-year investment record of approximately 20% annually compounded. To my knowledge, this is an individual record without peer. I broke the record into decades and sent it around to the members of one of the investment boards on which I sit. I wrote that if we had found Walter ten years ago, we would not have hired him despite a 30- year record of compounding at 20% per year. He was nearly 70, he had no real succession plan, no staff, and no computers. His research library consisted of borrowing my copy of Value Line. And we would have missed another ten years of compounding at 20% per year.

4. What access will we have to the manager? This is where the face men or women, the client service people, come in. Attractive, well-spoken, perennially optimistic, they are there to answer any of your questions anytime. After all, the portfolio manager has to spend some time actually managing the money. The amount of access a client needs varies tremendously. Some require quarterly visits, some annually, some almost never. The client wants to know about any staff changes as if you did not know how to run your own business. Some want to know your view of the world or the market. Some require elaborate analyses of the previous quarters outperformance or underperformance by industry sector. In our view, if you really understand the manager's style, you need only watch the buy and sell slips in your account. If something seems unusual, call and ask for an explanation. Otherwise, leave them alone to do what you hired them to do.

I have another set of criteria which I use to judge money managers:

1. Can you understand their investment philosophy? If a money manager cannot explain in plain English what their investment principles are, they probably don't have any. And if they cannot explain their process for finding and researching an investment idea, they probably don't have that either. One international manager we interviewed claimed to buy both growth stocks and value stocks. He had elaborate charts showing the paths of reversion to the mean for both types of stocks with his perfectly timed buy and sell points on each path. When asked what database he used to screen stocks, he replied he did not use any databases. I asked him how he then decided which stocks to research. He replied that he sought value stocks that were about to come out of the doldrums and revert back to the mean, and growth stocks that were in their ascendency which he would sell before they reverted back to the mean of mediocrity. I pressed him for a different answer. I asked, “No, no. It is Monday morning. How do you decide which annual reports you want your assistant to bring to you?” He could not answer the question. More than likely, he just waited for brokers to call with tips on which stocks were moving up.

2. What is their ten-year track record? Ten years is a reasonable period of time to gain enough experience to manage money. I ask myself, would I have been happy with that result given the manager’s investment style. I also ask whose record is it. When Peter Lynch stepped down from managing Fidelity Magellan Fund, the record was not relevant. The new manager had a different style. A growth stock manager we recently interviewed had a record going back to the early 1970s. There was only one problem. In the early 1970s, he was in kindergarten. In fact he had only been a portfolio manager for two or three years. This might have been acceptable if the firm had clearly definable investment principles to which he adhered. It did not other than to invest in growth companies.

3. What does the manager do with his or her own money? If you think a manager is smart but invests their own money differently from how they will invest yours, you should ask how they invest their own, and would they please do the same with yours. If a money manager does not have enough conviction in his investment philosophy to co-invest with his clients, look elsewhere.

4. Is the money manager rich? This point was added by one of our clients. He figured that if after ten years of managing money, a manager had not accumulated any wealth of his own, he could not be very good, or was living so high on the hog, that he spent everything he made. In either case, our client would not be comfortable with such a manager.

CONCLUSION

The most obvious question that arises from this discussion is why investors, both individual and professional, do not change their behavior when confronted with empirical evidence which more than suggests that their decisions are less than optimal. One answer offered by Lakonishak, et al, is that being a contrarian may simply be too risky for the average individual or professional. If you are wrong along with everyone else, the consequences professionally and for one’s own self-esteem are far less than if you are wrong and alone in your choice of action. Sometimes called the herd instinct, it allows for the comfort of safety in numbers. The other reason is that individuals tend not to change courses of action if they are happy. Individuals can be happy with sub-optimal results so long as they are not too painful. Moreover, individuals who tend to be unhappy and prone to making changes often do so for the wrong reasons and end up being just as unhappy in their new circumstances.

Resistance to change and the fear of failure may simply be forces too great to overcome.