Discipline: Your Secret Weapon

T.J. Troutner, Equius Partners

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The recent rocky period in financial markets has brought to the surface some familiar emotions for many, including a strong urge to try to time the market. The temptation, as always, is to sell into falling markets and buy into rising ones. What’s more, the most seemingly well-informed people—the kind who religiously read the financial press and watch business television—are the ones who feel most compelled to try to finesse their exit and entry points.

This suspicion that “sophisticated” investors are the most prone to try to outwit the market was given validity recently by a study, carried out by London-based Ledbury Research, of more than 2,000 affluent people around the world.¹ The survey found that 40% of those questioned admitted to practicing market timing rather than pursuing a buy-and-hold strategy. Yet the market timers were more than three times as likely to believe they traded too much.

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This perspective has been reinforced recently by one of the world’s most respected policymakers and astute observers of markets—Ian Macfarlane, the former governor of the Reserve Bank of Australia and now a director of ANZ Banking Group. In a speech in Sydney,² Macfarlane made the point that the worst investors tend to be those who follow markets and the financial media fanatically, extrapolating from short-term movements big-picture narratives that fit their predispositions.

“Most people experience loss aversion,” he said. “They experience more unhappiness from losing $100 than they gain in happiness from acquiring $100. So the more often they are made aware of a loss, the unhappier they become.” Because of this combination of hyperactivity, lack of self-control, and loss aversion, investors end up making bad investment decisions, Macfarlane noted.

¹Last 10 yrs. returns are ended 12/31/10.

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These behavioral issues and how they impact investors are well documented by financial theorists. Commonly cited traits include lack of diversification, excessive trading, an obstinate reluctance to sell losers, and buying on past performance.3

Mostly, these traits stem from overconfidence. Just as we all tend to think we are above-average in terms of driving ability, we also tend to overrate our capacity for beating the market. What’s more, this ego-driven behavior has been shown to be more prevalent in men than in women.

A study quoted in The Wall Street Journal4 shows that women are less afflicted than men by overconfidence and are more likely to attribute success in investing to factors outside themselves—like luck or fate. As a result, they are more inclined to exercise self-discipline and to avoid trying to time the market.

The virtues of investment discipline and the folly of “performance chasing” are highlighted year after year in the survey of investor behavior by research group Dalbar. The latest edition showed that in the twenty years ended December 2010, the average U.S. stock investor received annualized returns of just 3.8%, well below the 9.1% delivered by the S&P 500 Index.5

We also see destructive market timing behavior in mutual fund cash flow data. As the first chart below illustrates, significant withdrawals from stock funds usually occur near market bottoms. The experience of investors in DFA funds, however, is typically quite different, as illustrated in the second chart.6

What often stops investors from realizing returns that are there for the taking are their very own actions—lack of diversification, compulsive trading, buying high, selling low, going by hunches, and responding to media and market noise.

So how do we get our egos and emotions out of the investment process? One answer is to distance ourselves from the daily noise by appointing a financial advisor to help stop us from doing things against our own long-term interests.

An advisor begins with the understanding that there are things we can’t control (like the ups and downs in the markets) and things we can. Some of the things we can control include ensuring that our investments are properly diversified—both within and across asset classes—ensuring that our portfolios are regularly rebalanced to meet our long-term requirements, keeping costs to a minimum, and being mindful of taxes. Most of all, an advisor helps us all by encouraging the exercise of discipline—the secret weapon in building long-term wealth.

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3 Barberis, Nicholas and Thaler, Richard, “Survey of Behavioral Finance,” University of Chicago
4 “For Mother’s Day, Give Her the Reins to the Portfolio,” The Wall Street Journal, May 9, 2009
6 For illustrative purposes only. Industry net new cash flow data provided by Investment Company Institute. Quarterly cash flows are estimates that are adjusted to represent industry totals, based on reporting covering 95% of industry assets. Dimensional figures are based on net new cash from financial advisors in U.S. funds.
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Berkshire Hathaway released its 2010 annual report, including the letter to shareholders from Chairman Warren Buffett that is always eagerly awaited by the investment community. We are gratified to find that Mr. Buffett’s legendary ability to simplify complex issues remains undiminished and his trademark wit is as sharp as ever.

Financial journalists, eager for clues that might reveal Buffett’s thoughts on where markets are headed, focused on Buffett’s optimistic outlook for the future (“America’s best days lie ahead”) and his appetite to make further large acquisitions (“my trigger finger is itchy”).

We prefer to focus on a number of issues touched on in the letter that offer investment wisdom that should be just as useful ten years from now as it is today.

As of year-end 2010, Berkshire held positions in excess of $1 billion on fourteen common stocks. Five of these were non-U.S. firms: BYD Company Ltd. (China), Munich Re (Germany), POSCO (South Korea), Sanofi-Aventis (France), and Tesco plc (UK). Five years ago a similar list of twelve companies contained just one non-U.S. firm, and ten years ago there were none.

In his comments about the future of America, Mr. Buffett remarked that “human potential is far from exhausted” and that, despite many setbacks, the American system “has worked wonders for over two centuries.” Judging by Berkshire’s portfolio, it appears this notion applies with equal force throughout the world.

Many investors might assume that such adventurous and unconventional thinking in equity assets would be matched by an equally unorthodox approach in fixed income. On the contrary, Buffett’s strategy for investing Berkshire’s cash ($38 billion at year-end) is so conservative that some might accuse him of excessive caution. We suspect that any institutional money manager with a balanced account mandate who maintained most of the fixed income assets in Treasury bills despite yields approaching zero would be fired for lack of imagination.

Such an approach makes sense only if the role of fixed income is to preserve liquidity and limit the potential damage associated with riskier equities, rather than to generate satisfying returns. Mr. Buffett cites an observation from financial writer Raymond DeVoe that “more money has been lost reaching for yield than at the point of a gun.”

For those who ponder why it is that stocks are expected to provide a positive rate of return even if they pay no current dividend, one number cited in the letter offers a clue: $1 billion. That is the approximate amount of cash that shows up in Berkshire’s mailbox each month from its collection of seventy-six businesses. Mr. Buffett’s job is to invest that cash in new projects that carry an attractive rate of return, and history shows that these may come in a variety of shapes and sizes.

Last year, for example, Berkshire spent $50 million to buy Alabama’s largest brick manufacturer and $22 billion to complete its acquisition of the nation’s largest freight railroad. Mr. Buffett reports that the rail acquisition is working out “even better than I expected,” and to the extent any chief executive can invest a firm’s retained earnings more profitably than we can, dividends are not just unnecessary, they are undesirable.

Since taking control of a floundering Massachusetts textile mill in 1965, Warren Buffett has assembled an extraordinary record of business success. His oft-stated goal has been to grow Berkshire’s book value at a faster rate than the total return of the S&P 500 Index, and he has certainly succeeded. While many have focused on his facility with numbers and his
ability to identify attractive business opportunities, it seems to us there is a lot more to the story.

Mr. Buffett may never forget a number you give him, but he also appears to be an astute judge of character and has a knack for quickly sizing up individuals whose business acumen and management style will make for a good fit within the Berkshire confederation.

What are the investment implications of this appealing story? Should we be confident that Berkshire shares will continue to outperform the market, at least as long as Mr. Buffett is at the helm?

To address this question, we should consider to what extent Mr. Buffett’s skills are already reflected in Berkshire Hathaway’s stock price and whether the S&P 500 Index is the most useful basis of comparison.

Let us first acknowledge that Berkshire’s long-run price performance relative to almost any benchmark is sensational—over the last twenty-five years it has compounded at 16.9% per year compared to 9.9% for the S&P 500 Index with reinvested dividends. The margin of superiority relative to the S&P 500 narrows for more recent time periods, however, and disappears altogether in comparison with broader-based equity strategies.

Over the last fifteen years, for example, Berkshire shares have still outperformed the S&P 500 by 276 basis points per year, but fall a smidgen behind a globally diversified Dimensional Balanced Equity Index (16 basis points). Over the last ten years, Berkshire shares have underperformed the Balanced Index by an even larger amount: 295 basis points per year.

Since Warren Buffett is well known as a “value” investor, let’s compare Berkshire’s performance to DFA’s core value funds. The table below shows the performance for the past ten years.

Without making huge bets on concentrated positions, asbestos lawsuits, floundering financial firms, and the profitability of nineteenth-century technology (low-speed rail), highly structured, passively managed, and broadly diversified funds offered a solid alternative to Berkshire and the talents of essentially one man.

Some might be tempted to conclude from these results that Mr. Buffett’s legendary skills are waning, but if markets are working properly the numbers should come as no surprise and are no reflection on Mr. Buffett’s talents. Berkshire’s book value has grown from $48 million in 1965 to $157 billion in 2010, making it larger, by this measure, than oil giant Exxon Mobil.

Mr. Buffett has gone from piloting a speedboat to commanding an aircraft carrier; the ever-increasing amount of capital Berkshire oversees makes it difficult to earn above-average returns. Moreover, Berkshire Hathaway is not a mutual fund, but a public company with a share price that reflects expectations for the future. Now that Mr. Buffett’s admirable qualities are understood and acknowledged by so many market participants, it seems likely that his perceived value is already reflected in Berkshire’s stock price, just as Apple’s current stock price reflects the genius of founder Steve Jobs.

We wish Mr. Buffett well and hope to be reading his letters for many years in the future. And investors who have a soft spot for Berkshire Hathaway shares can take comfort in the knowledge that if they own a truly diversified equity strategy, they own a piece of Berkshire.

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2 Dimensional Equity Balanced Index: Dimensional Fund Advisors.
3 This information is for illustration purposes only and is not a recommendation of particular mutual funds or investment strategies. Source: Morningstar Principia mutual fund database and Dimensional Fund Advisors Returns program.

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<th>Performance: July 2001- June 2011</th>
<th>Annual Return</th>
<th>Total Return</th>
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<tbody>
<tr>
<td>DFA International Small Value fund</td>
<td>13.3%</td>
<td>250.0%</td>
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<tr>
<td>DFA U.S. Small Value fund</td>
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<tr>
<td>DFA International Value fund</td>
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<td>Berkshire Hathaway Class A</td>
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<tr>
<td>DFA U.S. Large Value fund</td>
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