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Challenging Conventional Wisdom

NEWSLETTER

Monthly Newsletter – March 2015

Early in March, Warren Buffett's annual letter to Berkshire Hathaway shareholders was published. We regard this newsletter as a must-read, especially for the principles and lessons it contains.

The following sentence in the newsletter sets the tone: "Through dumb luck, Charlie [Munger, his partner since the 1960s] and I were born in the United States and we are forever grateful for the staggering advantages this accident of birth had given us."

To place that statement, and their phenomenal investment success in perspective, if you had invested US$100 in Berkshire Hathaway in 1965, it would be worth US$1.8m today. If you'd invested that same US$100 in the S&P 500, it would be worth about US$11 196 now. Berkshire Hathaway is currently the third biggest listed company in the US (after Apple and Exxon) and owns nine companies within the group that would have been part of the S&P 500 if these companies were separately listed.

Here are a few of the most important points made in the newsletter:

1. "Stock prices will always be far more volatile than cash-equivalent holdings. Over the long term, however, currency-denominated instruments are riskier investments – far riskier investments – than widely-diversified stock portfolios that are bought over time and that are owned in a manner invoking only token fees and commissions. That lesson has not customarily been taught in business schools, where volatility is almost universally used as a proxy for risk. Though this pedagogic assumption makes for easy teaching, it is dead wrong: volatility is far from synonymous with risk." He goes on to underline that cash-equivalent holdings can outperform equities over the period of a day, a week or a year, but that's not the case in the long term.

   If we look at the South African experience over the past 115 years, shares have performed at 7.4% above inflation per annum, while cash has given you 1% above inflation. Over the past 10 years, shares have returned 18.2% (before inflation) and cash 7.2% (before inflation). During the past 10 years, the inflation rate has been on average 6.05%, which you subtract from the 10-year figures to work out if you have made any progress. Furthermore, interest earned is usually subject to tax, and on an after-tax basis, the return usually does not really keep pace with inflation.

2. "The reason for our conservatism, which may impress some people as extreme, is that it is entirely predictable that people will occasionally panic, but not at all predictable when this will happen. Though practically all days are relatively uneventful, tomorrow is always uncertain. (I felt no special apprehension on December 6, 1941 or September 10, 2001.) And if you can't predict what tomorrow will bring, you must be prepared for whatever it does."

We regularly see people making emotional and senseless decisions when the markets make sudden moves either up or down. In most cases, it's actually these decisions that raise their risk exposure in their investments over the long term. The advice here is that you should decide on a long-term strategy and then be disciplined about sticking to it. This kind of strategy also needs to have inbuilt provisions for times when the markets are volatile or when panic reigns.

3. "Active trading, attempts to "time" market movements, inadequate diversification, the payment of high and unnecessary fees to managers and advisors, and the use of borrowed money can destroy the decent returns that a life-long owner of equities would otherwise enjoy. Indeed, borrowed money has no place in the investor's tool kit: Anything can happen anytime in markets. And no advisor, economist, or TV commentator – and definitely not Charlie nor I – can tell you when chaos will occur. Market forecasters will fill your ear but will never fill your wallet."

   There are a few healthy, core principles that have worked for investors for years. These principles are usually simple and relatively conservative. In most cases, if investors stick to these principles and don't use unnecessarily risky strategies, most of them should reach their goals.

4. "Forget what you know about buying fair businesses at wonderful prices; instead, buy wonderful businesses at fair prices." Along with this insight, Warren Buffet emphasises that he doesn't invest in businesses that he doesn't understand, including IT companies. He also prefers to have a minority shareholding in an outstanding business rather than wholly owning a so-so business.

   At the beginning, Buffett was insistent that he only made investments if he could get them at a really low price. He refers to this as his "cigar-butt strategy" where he gets the business at a dirt cheap price, and then gets a few free sucks on the cigar. But Munger persuaded him to change from this strategy in the 1960s, and he believes this strategy change contributed hugely to his success.

   When it comes to businesses he doesn't understand he says there are three piles on his desk – his inbox, his outbox and the 'too difficult' box, which is far and away the biggest pile. He doesn't make an investment if he doesn't understand it, and quite easily passes on opportunities he doesn't fully understand. He describes his interest in a business like this: it's better to own part of a diamond than a whole chunk of rock.

5. "Cash, though, is to a business as oxygen is to an individual: never thought about when it is present, the only thing in mind when it is absent."

   Businesses that don't generate cash, whether it's an interest in a listed company, or a private business, farm or rental property – if it doesn't generate cash, then the writing is on the wall. A strong cash flow is usually a sign of good management and a strong business.

6. Buffett doesn't shy away from mistakes, and emphasises that he has made many mistakes, and continues to do so. He says one of his biggest mistakes was so big it should be in the Guinness Book of World Records. In 1993 he bought out Dextor Shoes for US$433m. Dextor went completely under, and his investment was written off to zero. He paid the owners with Berkshire Hathaway shares, and those shares are worth US$5.7bn today.

   Buffett refers all the way through the newsletter to the mistakes and wrong decisions they've made and continue to make. During the 2014 AGM he emphasised how important it is to address mistakes immediately as a way of minimising the eventual impact of those mistakes.

The lesson is that if you issue shares to buy businesses, the value of the share you're issuing should never be more than the value of the businesses you're buying.

Here's a link to the full newsletter (pay special attention from page 24 to the end, for both Warren and Charlie Munger's letters to shareholders): http://www.berkshirehathaway.com/letters/2014ltr.pdf