

Holland Views

Damn you, Buffett!

As a number of prominent media publications seem ready to write the obituary of value investing, we are minded to reflect a little.

A short reflection on value investing

Occasionally we are asked to speak at value investing conferences and in recent years we found in evidence something we thought alarming; a number of value investors were almost proud of their under-performance. Seemingly this very fact confirming them as true believers. As custodians of other people's hard-earned savings this logic makes us uncomfortable, and leads us to reflect on the dangers of ideology. We all need to be constantly learning asking ourselves what we can learn today from the mistakes we made yesterday.

"Another thing I think should be avoided is extremely intense ideology because it cabbages up one's mind. ... When you're young it's easy to drift into loyalties and when you announce that you're a loyal member and you start shouting the orthodox ideology out, what you're doing is pounding it in, pounding it in, and you're gradually ruining your mind."

Charlie Munger 2007

It is all too easy for the value investor to point his ideological finger at other types of investors seeing them as herd followers or momentum junkies and assuming they, the disciplined value brigade, hold the upper moral ground. Having been close to its inner sanctum we can state that there is plenty of blind ideology in value investing also. Indeed, the recent year under performance of the style suggests they (we) have been the patsy in poker game – sure of ourselves but ultimately the losers at the table.

[The journey](#)

We will be generous to ourselves and suggest that in the last ten years we travelled the same journey as a number of high-quality, thoughtful investors who have a focus on intrinsic value and compounding. Indeed, we can still recall vividly the considerable resistance with which numerous money managers (of large sums) put up to the 'good quality compounder' ideas we identified in c. 2010-2012. Companies such as Unilever, Becton Dickenson and Coke (*Holland Views - Better bet a bucket - July 2010*). At that time, those businesses were not worshiped as they are today but rather ignored as they had 'not performed' as well as recovery type share ideas in the year's post 2009.

For us, and many like us, their superior compounding prospects when then offered at sensible prices (15x or less in some cases) was too good to refuse. Others just could not see it, until they did... and then there was no looking back

Then came the greatest mistake of our investing careers. This was to lose our enthusiasm for such companies when their PE ratings grew. Others with a mind to Margin of Safety thinking did the same. Collectively we saw less mispricing than before and thus moved our attention elsewhere. The few that did not sell and 'just sat on their ass' as Munger would say, have seen spectacular performance and this has rightly resulted in admiration of them (even a cult like following). Their wisdom/luck, as we can now all see in hindsight, was that such companies

remained attractive even if offered at a PE of c.20-30x due to the relative valuation they offered vs. ever lower bond yields. The rarity of their secular growth being even more valuable than before.

Has margin of safety thinking killed your performance?

Today's believers in 'quality at any price' find investing life perhaps almost easy we opine for they only analyse and invest in a small defined proportion of the investable stock market. They also, it seems, believe that the growth of the entity itself is the key metric to focus on, as multiples will be unlikely to fall. As such it is seemingly obvious to them where new capital should be deployed i.e. in those very same businesses. That these company valuations are higher than 3, 5, 10 years ago is not seen as a hurdle but instead as re-enforcement (bias). *"Their share rating is going up because they are good businesses and we are right"*.

What is amusing (read frustrating!) about this whole episode is that we actually agree with 95% of it, i.e. the buying of great businesses and then not selling them. The problem has been that if you did sell, and you now cannot find other similar quality mispriced companies, what the hell do you invest in? a) You either buy the same type of shares back again, at a higher price and rating than you sold them at. (We think a large number of global investors, who do not want to miss out have done this) or b) you buy the discarded rump of the stock market that no one else wants. I.e. value.

"What the wise man does in the beginning the fool does in the end" Anon

Follow the money

"A second important reason to examine the behaviour of other investors and speculators is that their actions often inadvertently result in the creation of opportunities for value investors. Institutional investors, for example, frequently act as lumbering behemoths, trampling some securities to large discounts from underlying value even as they ignore or constrain themselves from buying others. Those they decide to purchase they buy with gusto; many of these favourites become significantly overvalued; create selling (and perhaps short-selling) opportunities. Herds of individual investors acting in tandem can similarly bid up the prices of some securities to crazy levels, even as others are ignored or unceremoniously dumped. Abetted by Wall Street brokers and investment bankers, many individuals as well as individual investors either ignore or deliberately disregard underlying business value, instead regarding stocks solely as pieces of paper to be traded back and forth." – Seth Klarman, *Margin of Safety*, 1991

The above quote is extracted from Seth Karman's' *Margin of Safety*. For those that have never read it, get in touch with us. The section on investor psychology, from which this is extracted is a must-read and especially helpful at times like these of market extremes. These words were written by Klarman in 1991, but they could have been written yesterday.

When he states *"abetted by Wall Street brokers and investment bankers"* we think today's readers should add in *"pension/fund consultants"* as today these fund advisers play a key role in supposedly giving objective advice to the end client.

It is very important that we see the investing world for what it is at its heart, the flow and allocation of new and old capital, arriving and leaving an asset class. The longer a cycle (be it 1980's Junk Bonds, Mortgage CDO's in 2000's or the 1970s Nifty Fifty) continues the more powerful the money flows towards it are. As ABC pension fund redeems the investment it has with Mr X Value Manager it sends the sum raised to Mrs Y Growth Manager. Those managers then sell and buy the matching amount of shares in their underlying portfolios, thus helping to further each assets class move higher and lower respectively. If managers are active in their stock selection process and wide in their search then this re-allocation would likely have little effect on underlying market

values, but what if they were not. If the growth managers are too focused on a small subset of the shares they admire (tech and high-quality growth companies) there is a real danger that the money flow tails could wag the security valuation dog. The value manager is left selling shares to meet redemptions despite their record low valuation levels. Whilst we cannot *know* that this is driving share valuations higher and lower, we suspect it is a contributing factor.

Thinking about such money flow issues adjacent to your analytical thinking we think is crucial today. That investing in good (or preferably 'best') companies is a good idea is of course right. Indeed, companies like Moody's or Mastercard that look to have a high probability of achieving +/-12% pa intrinsic value growth per share, high valuations can be justified for their shares. However, these are the exceptions not the rule. Many other companies that are today priced highly may not either grow so fast or so consistently.

Learning from the best

With all this running through our heads we recently read an account of Stan Druckenmiller's experiences at the height of the 1999/2000 tech bubble. As you read them we want you to remind yourself that this is one of the most experienced and best-performing investors on the planet (realising 30% cagr over 30 years and if that's not enough to impress you, the man never had a down year in 40 years).

I made a lot of mistakes, but I made one real doozy. So, this is kind of a funny story, at least it is 15 years later because the pain has subsided a little. But in 1999 after Yahoo and America Online had already gone up like tenfold, I got the bright idea at Soros to short internet stocks. And I put 200 million in them in about February and by mid-March the 200 million short I had, lost \$600 million on, gotten completely beat up and was down like 15 percent on the year. And I was very proud of the fact that I never had a down year, and I thought well, I'm finished.

So, the next thing that happens is I can't remember whether I went to Silicon Valley or I talked to some 22-year-old with Asperger's. But whoever it was, they convinced me about this new tech boom that was going to take place. So, I went and hired a couple of gunslingers because we only knew about IBM and Hewlett-Packard. I needed Veritas and Verisign. I wanted the six. So, we hired this guy and we end up on the year — we had been down 15 and we ended up like 35 percent on the year. And the Nasdaq's gone up 400 percent.

So, I'll never forget it. January of 2000 I go into Soros's office and I say I'm selling all the tech stocks, selling everything. This is crazy...at 104 times earnings. This is nuts. Just kind of as I explained earlier, we're going to step aside, wait for the next fat pitch. I didn't fire the two gunslingers. They didn't have enough money to really hurt the fund, but they started making 3 percent a day and I'm out. It is driving me nuts. I mean their little account is like up 50 percent on the year. I think Quantum was up seven. It's just sitting there.

So, around March I could feel it coming. I just — I had to play. I couldn't help myself. And three times the same week I pick up a — don't do it. Don't do it. Anyway, I pick up the phone finally. I think I missed the top by an hour. I bought \$6 billion worth of tech stocks, and in six weeks I had left Soros and I had lost \$3 billion in that one play.

You asked me what I learned. I didn't learn anything. I already knew that I wasn't supposed to do that. I was just an emotional basket case and couldn't help myself. So, maybe I learned not to do it again, but I already knew that. — Stanley Druckenmiller

Crucial we think is the last line. *“You asked what did I learn? I didn’t learn anything. I already knew that I was wasn’t supposed to do that. I was just an emotional basket case and I could help myself”*. For all of the learning we can make from the smooth and eloquent tongues of Buffett/Munger et. al. this admission is right up there with one of the greatest quotes’ investors can learn from, especially at times like this. By the way, Druckenmiller still had a positive year in 2000. If you are finding today’s investing market easy, you might not know what you are doing. If you are finding it hard, you are in good company.

“Say it loud – say it clear”

For c.12 years now, we have been saying loud and clear what we think matters to investors. Namely:

- Compounding
- Growth of intrinsic value per share
- Allocation of capital
- Moats and Flywheels
- Businesses that use deferred gratification
- Owner managers
- Reasonable starting prices
- Searching in places that others are not (hated sectors like hotels and leisure, or seen to be cyclical sectors like Plant Hire, Housebuilding or Financials)

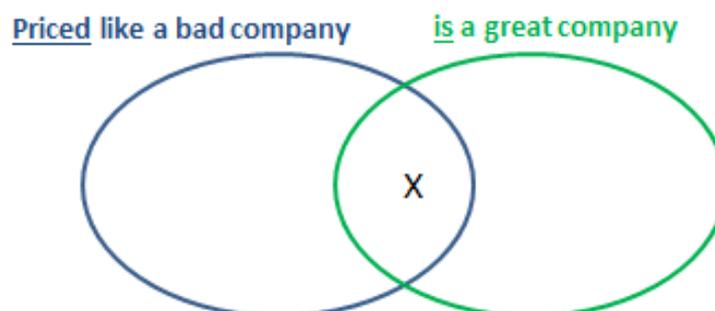
That many of these traits are in line with those many growth-oriented investors seek we are more than happy with. That the last two (reasonable starting prices/look where others do not) has cost us money in missed opportunities is evidential. We are not, however inclined to change them.

Thank you (and damn you!) Buffett

In truth we have always found the ‘value’ investing moniker somewhat useless. All investors are trying to buy something for less than they think it will be worth at a point in the future. Those that correctly guess the future demand and cost of production for a new product/service will win when they bet on it in its early stages.

Whilst we admire such businesses and people, we know from experience and a study of history that such estimations of the future are very hard to be successful at. As such we have stuck to the more mundane world of established businesses, trying to find ones we think are better than Mr Market prices them at or ones that will fade slower than Mr Market anticipates. In that sense maybe the ‘bad company’ label on Venn diagram below chart should re-labelled *“priced by Mr Market like a worse company than it is”*, but that is not so catchy.

Fig.1: What we look for in one chart



Source: Holland Advisors

We remind readers of a few Buffett adages that might help you remain strong in your resolve at such times,

“there is nothing worse than watching a friend get rich”

“The less prudence with which others conduct their financial affairs the more prudence with which you should conduct your own”

We thank you Mr Buffett for all we have learnt about investing, and we damn you for teaching us. Perhaps a higher level of ignorance about Margin of Safety might have made us far more money in recent years! We believe our investment process is good, but we are always open to learn. To others in the same spot we think Mike and the Mechanics put it best:

“If you don’t give up and don’t give in, you might just be OK”

(Released in 1988 – when the average price of the S&P500 was 265!).

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