# Indexed or not indexed?

Internal document written in 1997 by François Rochon

Index funds have proven very rewarding these last few years and one question that can arise is “Are all these long hours of picking stocks worth the trouble?” Even if professional investors don’t publicize it very much, money managing, as a whole, is a non-constructive profession. Plumbers, engineers or doctors add to our standard of living in many constructive ways. Money managers, on the other hand, receives a fee to beat an index that, obviously, the average professional can not beat: The average result has to be average.

So a realistic investor could be wise to consider simply indexing. These last few years around 80% of money managers have been unable to beat the Index S&P500 fueled, in part, by the flow of money into the biggest stocks bought by indexed funds. In other words, the act of getting out of active funds and going into passive funds, “self-created” more active manager’s underperformance. The index fund has, in practice, fuel its own overperformance.

So indexing does, both on the short and long term horizons, look like a wise investing decision. But on the other hand, one that considers indexing should be opened to try to find out if an active, intelligent and sustainable way to beat the market does exist. Many do not believe so: In the 1970’s, there was a popular way of thinking called the “Efficient market theory”. The theory was that it is impossible to beat the market since every relevant information is already known by the financial community and that superior returns must be coupled with higher risk. The idea has become less fashionable lately but “indexing” should be viewed as another way of accepting that an investor (or its advisor) can’t beat the average.

But, if it seems impossible to some theoreticians to beat the averages how would they explain the existence of many investors that have done it for decades? For example, Bill Ruane has earned around 18% per year since 1970, around 6% more than the S&P500. Peter Lynch earned 29% per year

from 1977 to 1990. John Templeton earned 17% for almost 40 years. And, the Pioneer Fund, managed by Philip Carret, the Cal Ripken of investing, has earned around 14% per year since its creation in 1927! And Warren Buffett, the Picasso of investing, has make his holding, Berkshire Hathaway, grow its value by more than 24% per year in the last 32 years.

Obviously, theoreticians could argue that anyone can be lucky "playing" the market as you can be lucky in a casino for many nights in a row. But if you took 50 American casino players that have won continually over the last 5 years and found out that 30 of them came from a small village in Oregon, you would think that there must be something worth investigating out there. Well, it seems that there is a common origin to many "market beaters", not a geographical origin but an intellectual one: *Value investing*.

What is Value Investing? Charles Munger, CEO of Wesco, liked to compare the value investing model to the pari-mutuel system at the race track. Anybody can figure out which horse has the most chances of winning using its track record, its weight and so on. But horse fundamentals are priced within odds: Usually, the good horse pays only 3 to 2 as a bad horse would pay 100 to 1. But if you could find a horse that has an even chance of winning that pays 3 to 1 you would have found a mispriced bet. So that is what value investing seems to be all about: Finding mispriced securities. But, like at the horse track, opportunities are not common and are the exception rather than the rules. So the wise ones should bet heavily when the market system offers them a wide, easily recognizable opportunity to beat the odds.

The first investor to hold a "value" label was Ben Graham. He thought that that the market was a manic-depressive entity and that mispriced securities were quite common. Then, all he had to do was to buy undervalued securities and wait until the market repriced his holdings in line with their proper value. He believed that in the short term, the stock market was a "voting machine", where fluctuations were caused by investor's sentiments, but in the long run it was a "weighting machine", where every security was eventually priced in line with its underlying value. "Voting" in the stock market needs only money not intelligence: one dollar, one vote! But Mr. Graham thought that over many years, the business value of a company would be mirrored by the stock price. He bought hundreds of undervalued stocks that helped him earned 20% per year from 1927 to 1955 (and he lived through the horrible bear market of 1929-1932).

Many investors were influenced by Graham. A Graham "disciple" considers a stock as a part of a business and to properly value the stock - even very roughly - he really has to understand the underlying economic fundamentals of the business. Once the stock has been valued, the investor compares the company's value to what the market thinks the stock is worth. Most of the time, the two are in the same ballpark. But in some cases, the market will not reflect the fundamentals of the business and in rare cases by an extraordinary margin. Graham proposed such a "Margin of safety" to distill in a few words the key of intelligent investing. *True Value investors don't swing at every pitches, they wait for the almost perfect ball.*

So if we use Graham's theory in the case we're interested in, the late overperformance of indexed funds, it seems that as long as investors cast their votes for index funds, they will beat active management. But in the long run, each stocks, part of the index or not, will be valued fairly. Since indexing seems to have created some "upward value imbalance", the bigger stocks, those mostly bought by indexed funds could do worst than the average, not because the underlying business will do poorly but because their valuation could be drown downward. In the long run - inevitably - the market should correct excesses and a valuation equilibrium should be reached. But, as Philip Fisher once wrote, "It is easier to know what will happen then when it will happen". Intelligent investing is not about timing but about long-term economics analysis.

But if we would accept that "value investing" is rational and seems to have worked quite well in the past, how can it be applied into stock selection with a high level of certainty? What does create a mispriced stock? Why do they exist and how can they be identified?

In my opinion the "Performance game" is what creates opportunity. When you buy a stock, you are buying part of a business. When someone invests in a private business, usually he thinks that the long term economics are strong and that in many years he will have make a lofty return on its investment. But on Wall Street, it is so easy to buy and sell companies that you can become an owner of Microsoft at 10h00 am and sell it at 11h00 am and then became part owner of General Electric instead. The ease of changing securities creates the illusion that you can fly from flower to flower and earn superior returns not based on what the business does but what other investors are doing. This should be labeled speculation, a losing game where the only ones to earn a real return on this exchange of paper are the brokerage firms.

Of course, no fund managers would say he speculates. A manager just wants to "add value" to the index by switching from stocks to stocks or from sectors to sectors all with proper and rational reasons. But in reality, a stock that has not "performed" well compared to the average, for a reason or another, will be sold not because the business is doing poorly but just because the stock is not performing adequately. And this is where basic psychology comes into play. When a stock has been going down, analysts and managers that have been buying the stock thinks "I must have missed something". So they look at the economics of the business with another eye. They search for problems and when you search for something to worry about you usually can find some. And again, the downward movement of a stock creates more "search" for worries.

In many cases, "rationalization" doesn't even go that far: A stock is sold solely because it is going down and reducing one manager's chances of beating the index (and earning a big bonus). It is also simple psychology to understand that, when you make $325 000 a year by managing a portfolio, self-preservation can be heavily weighted into stock selection. So short-term expectations - both on the sell and buy side - create mispriced securities. Opportunity arises when the gap between reality and perception becomes significant.

But to identify a mispriced stock, obviously, you have to be able to value it. To value a business, you have to understand its underlying future economics. This is not a science because no one really knows the future earnings of a company which is the real parameters to value a business. But this is where the concept of horse track comes in play. If you can find a horse that has a 75% chance of winning (earning much more dollars in 10 years) put that pays two for one (seems to be priced at half its value), the odds should favor you. To really win over the long term, you will need more than one horse of that kind because a 25% chance of failing is still not an interesting destiny. But finding a dozen of such mispriced securities greatly reduces the chances of losing in the long run.

Let's take a simple past example of such opportunities. In 1966, the Disney Company sold in the stock market for $80 millions. They have just made a bundle of profits with "Mary Poppins" and the common view on the Street was that 1966 EPS had peaked and it was reflected in its P/E of 9x. The quoted stock was at that time the equivalent of $0.25 or 320 times less than today. Disney's stock had some regular set back like in 1966 when it was

down 33%. It also went down 80% in 1974 and 45% in 1983. The risk level must have looked high...for somebody that never saw a Disney cartoon or never had a kid begging for a Disney related toy. But when you knew that Disney's assets are Mickey Mouse and other unchallenged heroes, what were the real risk in owning Disney? Would they be challenged by new microprocessors as was IBM? Would a "new and improved" mouse surpass Mickey? Would parents stop bringing their kids at Disney World if the entry passes were inflated by $5? These are real business risk measurements and, even today, they look very small. But even with that small risk level, Disney's stock has beaten the "unbeatable" S&P500 by a factor of 15 to 1 over 30 years.

In 1957, Philip Fisher, an experienced investor in high-tech stocks, decided to put a big part of its client's holding in a small company called Motorola. He knew how good their technology was but also how keenly the management had established a strong culture. During the 20 years following his purchase, he wrote three books where he explained why he tough that Motorola was a superior company. He has kept its stock all those years: Every $10 000 he put in MOT stock in 1957 is worth today $3 000 000, a 15% annual return. But the stock had some "volatile" swings as it went down 40% in 1990 and almost the same percentage last year. But patience had paid off and Motorola's long-term investors that concentrated their study on the underlying business (and not on the stock quotations) have done extremely well: They have beaten the average by a factor of 6 to 1 or by 500 points per year. And because he clearly understood Motorola's leadership position and the quality of the management, Fisher felt that the risk level - over many years - was low.

I have two personal examples (that obviously did well). In 1994, Intel, a company as an engineer I clearly understood the underlying strengths, was trading at 9 times earnings despite stellar past results. At the time, the market considered Intel's operation as cyclical as they had been for a few years in the past. But a clear understanding of the new economics underlying Intel's business showed that the company was brilliantly managed by CEO Andy Grove and that Intel had an uncommon profit potential for many years to come. In only two years, EPS doubled and the company continued to increase its market leadership and widen its margins against its competitors. But, at the time of my first purchase, the stock had just gone down 20% and had (and still has) a high beta. Did that Greek letter reflected risk? To me, there was no relation at all. You could invest in a company that is dominating a fast growing industry managed by an outstanding CEO at a

huge discount to the average market valuation. I bought Intel for a client and he did more than 400% in three years. And today (April 1998), INTC stock still has a lower P/E than the average…

In 1992-1993, I invested in Bombardier at the adjusted price of $6. I knew the company very well from friends that worked there and understood how strong the philosophy of the management was. I studied their strategic plan for the 5 years that were to come and it seemed realistic to believe that they could sustain a 20% growth rate within that period. But the market did not agree: the stock carried throughout 1993 a P/E as low as 10 times. Today, the stock is almost $36, an increase of 500%, a 35% annual return. The market now adequately recognizes the fundamentals of the company with its stock trading at 25 times earnings. But how can a market be efficient when you can buy a strong company like Bombardier at 40 cents on the dollar? Why would an investor (or its advisor) think about buying all the companies when he can buy one the best at a huge discount to the average?

If all this look easy, it is far from the case. Selective stock picking is not easy. Obviously, companies that grow 15% or more a year for decades - the one that are most likely to bring the biggest rewards to investors - are very rare; Undervalued ones are not easy to find. But, patience and careful studies combined with good judgment can help find the kind of companies that can improve dramatically results over the average or over an Index fund. And many investors have done it and they shared some or all of these characteristics:

- They view a stock as part of a business.
- They look for clear business leadership with economic advantages.
- They wait for the market to misprice those businesses.
- They concentrate of few securities as they know that true superior companies are rare.
- Once bought, they hold these securities for many years.
- They don't worry about short-term stock movements and don't care about what is not relevant to the business.

Perhaps, one way of synthesizing these ideas is through Charles Munger's message to Wesco's stockholders in 1996: "Being prepared, on a few occasions in a lifetime, to act promptly in doing some simple and logical thing will often dramatically improve the Financial results of that lifetime. A few major opportunities, clearly recognizable as such, will usually come to one who continuously searches and waits, with a curious mind, loving

diagnosis involving multiple variables. And then, all that is required is a willingness to bet heavily when the odds are extremely favorable, using resources available as a result of prudence and patience in the past".

Based on previous exposed theories, a wise intellect could conclude that the greatest quality in money managing is perhaps not intelligence but courage. As a matter of fact, Graham concluded his book "The Intelligent Investor" by stating that: "If you have formed a conclusion from facts and sound knowledge, act on it - even though other may hesitate or differ. You are neither right nor wrong because the crowd disagrees with you. You are right when your reasoning proves to be sound. In the World of securities, courage becomes the supreme virtue after adequate knowledge and a tested judgment are at hand".

So, how do a typical value investor should feel about indexing? There is some logic that value investors should not care much about indexing. In fact they could even like it. As Warren Buffett said: "In any sort of a contest - financial, mental or physical - it's an enormous advantage to have opponents who have been taught that it's useless to even try. It's like playing chess with somebody who does not believe he should think about the game". But even Buffett recognizes that an investor with no interest in company studies would probably do better with an index fund than with an actively managed fund. But, investors (or advisors) that can differentiate good from bad businesses and value from stock quotation could do better over the averages and even at a lesser risk level - in the case where risk is defined in Buffett's way. Most theoreticians link risk with market quotations. But Buffett defined risk in a quite different way.

"In assessing risk, a beta purist will disdain examining what a company produces, what its competitors are doing, or how much borrowed money the business employs. What he treasures is the price history of its stock. But the real risk are company specific: The competitive strengths of a Coke or Gillette for example are obvious to even the casual observer of business. Yet the beta of their stocks is similar to that of a great many run-of-the-mill companies who possess little or no competitive advantage. The theoretician bred on beta has no mechanism for differentiating the risk inherent in, say, a single-product toy company selling pet rocks or hula hoops from that of another toy company whose sole product is Monopoly or Barbie. But it's quite possible for ordinary investors to make such distinctions if they have a reasonable understanding of consumer behavior and the factors that create

long-term competitive strength or weakness" (Berkshire Hathaway's annual report 1993)

Buffett has earned an average annual return of almost 30% on his investments in the last 40 years. So is he a statistical anomaly? Or has he become the master of value investing as his many disciples have come to believe? More important, he had very few losers over the years which would indicate that he did not took big risks to achieve his outstanding results. His simple combination of a "value" framework and a careful study of businesses were the ingredients for over performance in the long run.

But perhaps in these days of advanced computers, Internet and mega-markets this philosophy could look out of date. But not to one of the best fund manager of the last 5 years: Robert Sanborn. He has managed the Oakmark Fund since 1991 and has compiled a 29.2% return, doubling the 14.3% annual gain notched by the average stock fund[1]. Unafraid to bet heavily on companies he believes in, Sanborn has more than half of his $5.6 billion portfolio in just 10 stocks (that he holds on average for four years). As he put it: "My strategy is to buy pieces of businesses for the long term, not pieces of paper for the short term. Since I like to know a few selected companies as well as any outsider could, I have no interest in being a closet indexer". Value investing looks alive and well but, strangely, Sanborn is an exception rather than the rule. Value Investing has clearly proven to be very rewarding but it's still used very seldom.

Of course all these nice words are futile without a proper attitude toward market fluctuation. If one recognizes that some stocks are mispriced, it doesn't mean that the imbalance will be corrected just after he had decided to buy the stock. In fact, the stock can go much lower. Patience plays a cornerstone role in this craft: Again, Fisher insisted that it is easier to know *what* will happen than *when* it will happen. It is true that time is not something that all clients are willing to give to their advisors. But clients should realize that great companies are not built in a few months. So why is there some needs to make money faster by trading papers instead of just holding parts of good businesses as they slowly prosper? Again, basic psychology can help solve the puzzle. It is a big decision to choose an advisor as there are thousands of funds. Also, fund marketers are selected in a Darwinian process to sell themselves very well and this tends to confuse clients more than anything else. So positive short term results tends to comfort a client about his fund selection decision. Market quotes and

[1] According to Barron's, July 24th 1997 edition

portfolio performance are the only data a client has to make a post-selection judgment.

This is where the advisor can improve the chances of success for both him and his clients. He has to clearly explain his philosophy and be selective of his clients. The problem is that many managing firms are ready to take anyone that will pay them a fee even if he doesn't really share his long term view (every investor is a long term one until deceiving performance in the short term). If an advisor hold enough of such "short-term money", he could be affected by severe redemption at some point. In fact, it is very likely to happen since long-term horizons, as explained above, can be in conflict with short-term results. *In the art of money business, reckless clients selection can bring its own reckoning*.

Plain logic should dictate that when you have planted a tree, the only rational thing to do is just watching it grow. You won't get much of a garden when every six months you remove all the trees and plant new ones. *So in the field of common stock, most of the time, "genius" is simply disguised patience.*

In conclusion, it seems from past experiences that an astute investors (or its advisor) can do much better than the average at a much lesser risk if he uses a combination of careful business analysis and a proper attitude toward stock quotations. Of course, if one (or his advisor) is not inclined to do so, he would probably do better to buy an Indexed fund than dilute its return through management fees that are not likely to bring him any value.

We at Montrusco believe it's *worth thinking* when buying securities and that in the long term, we should do better than the average for our clients that want to share our attitude toward the securities market. It is not an easy task; But we think that the unlimited wealth available to our clients through intelligent common stocks purchases is definitively worth it.

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