

HAS THE ORACLE OF OMAHA LOST HIS MIDAS TOUCH?

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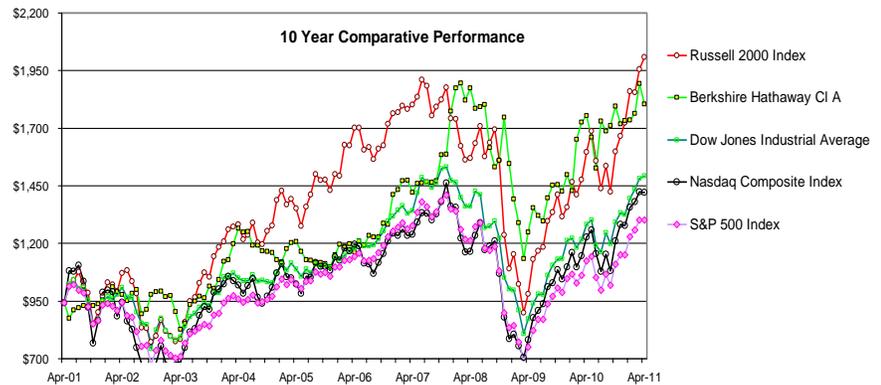
Warren Buffett is widely regarded as one of the most successful investors in the world. He ranks as one of the world's wealthiest people and is commonly referred to as the "Oracle" or "Sage" of Omaha or as the "Legendary Investor" or "The Master" due to his investment expertise.

Noted for his adherence to a 'value' based investing philosophy he started managing money in the late 1950's, eventually acquiring control of Berkshire Hathaway (BRKA). He now serves as the Chairman and CEO of Berkshire and is the primary shareholder. Some consider him the best stock investor ever – and thousands of investors attend his annual shareholder meeting to listen to his investment commentary.

Berkshire Hathaway Underperforms the Russell 2000. Many of Mr. Buffett's early investors became quite wealthy as the company's stock grossly outperformed the market indexes – but over the last ten years the excess returns on Berkshire Hathaway stock have been much more modest. In fact, over the last ten years Berkshire Hathaway stock has underperformed the Russell 2000 small cap index!

In theory an investor in an exchange traded fund which tracked the Russell 2000 index would have had better returns than an investor in Berkshire stock! While he still outperformed the Dow Jones and Nasdaq and S&P 500 indexes the outperformance by Mr. Buffett's investment vehicle was much smaller than it has been historically.

As one young fan exclaimed to a player involved in the Chicago Black Sox baseball scandal almost a century ago: 'Say it ain't so Joe'.



Has the Babe Ruth of investing struck out? The relative underperformance of Mr. Buffett's Berkshire Hathaway share price over the last decade – not a short time frame – raises the academic question: Has Warren Buffett lost his Midas touch?

To answer that question we have to examine what he has done to generate excess returns historically – and his strategy for success.

Wealthy Educators: Ms. Anderson & The Othmers. In September, 2007, the George School, a preparatory school in Bucks County, Pennsylvania, received a \$128 million donation from Barbara Anderson, an alumna of the high school. The administrators of the private, 500-student institution set on a leafy 240-acre campus were stunned.

Ms. Anderson, who now lives in Fresno, California, is a retired kindergarten teacher. Her parents were well educated but not considered wealthy. At 75, and diagnosed with Alzheimer's, she wanted to make the gift to the school for the fine education she received and the work ethic the school encouraged.



Separately, living quiet, unpretentious lives Dr. and Ms. Othmer – he was a professor of chemical engineering at Polytechnic University in Brooklyn and she was a former grade school teacher - died in the late 1990's. They had no children. When the Othmers died, friends were shocked to learn that their estate was worth close to \$800 million – to say nothing of colleagues at Polytechnic University when they learned of their \$175 million gift to the institution.

What is the connection between the Othmers and Ms. Anderson? How did these teachers acquire so much wealth?

In Ms. Anderson's case, her father happened to be a finance professor at Columbia University. He became well known in academic circles for the textbook he co-authored with another professor entitled "Security Analysis". His name was David L. Dodd and the co-author was another professor named Benjamin Graham. The textbook sales generated a good profit, but did not make either wealthy.

A prospective student who had been rejected from Harvard's MBA program supposedly wrote to Dr. Dodd in 1950 and was admitted to Columbia, eventually graduating. The student was Warren Buffett, and Professor Dodd invested for himself and his daughter in his student's private investment partnership. The investors were eventually given the option of liquidating their investment when the partnership dissolved – or taking Berkshire Hathaway shares priced in the open market under \$50 per share. Dodd elected to take the shares.

The Othmers invested their money into small, well managed, undervalued companies. Like the Dodds, the Othmers had an additional benefit: in the early 1960's they each invested \$25,000 in a private investment partnership run by Warren Buffett.

The Othmers received thousands of shares of Berkshire Hathaway at \$46 a share when Mr. Buffet dissolved his partnership. Today those shares trade around \$125,000 a share. Mrs. Othmer's shares were worth \$578 million on her death; her husband's, sold on his death when the price was lower, were worth \$210 million.

A graphical representation of the Othmer's and Dodd's investment in Mr. Buffett's Berkshire Hathaway is set out in the chart at right.



Common thread. The common thread for both educators was Warren Buffett - arguably one of the best investors of all time. Mr. Buffett managed his private investment partnerships from 1957 until roughly 1969. When he shut down the partnerships investors could either 'cash out' or roll over their investment into Berkshire Hathaway. Over a 13 year period Buffett outperformed the market by an average 21.8% before his costs, fees, and expenses. Those who cashed out did very well. Those that rolled their investment over into Berkshire Hathaway stock did incredibly well.¹

Buffett's Rules & Strategies for Investment Success

A summary of the investment strategies utilized by Warren Buffett were published by a law professor at Cardozo University. Entitled "The Essays of Warren Buffett: Lessons for Corporate America" it is a compilation of Buffett's annual reports and other communications. Some of Buffett's investment strategies are as follows:

1. **Buy a Good "Business Boat"** - Buffett points out the importance of choosing a company situated in a growing and profitable industry. He identifies his largest investment mistake - buying the small company his firm was named after (Berkshire Hathaway) - not because the company was flawed, but because the industry it was in (textiles) was so unattractive. The company was cheap by most valuation metrics, but there was a good reason.

The textile industry provided very meager returns for Berkshire. No matter how well managed the company was it would always have subnormal returns. The textile industry was a commodity business, competitors had facilities located overseas that were low cost producers, and substantial excess capacity existed worldwide. Buffett notes "a good managerial record (measured by economic returns) is far more a function of what business boat you get into than it is of how effectively you row . . . Should you find yourself in a chronically leaking boat, energy devoted to changing vessels is likely to be more productive than energy devoted to patching leaks."

2. **Compound Returns by Deferring Taxes** - One reason that investors in Berkshire stock did so well was that their investment was compounded and their capital gains taxes were never realized. "Tax-paying investors will realize a far, far greater sum from a single investment that compounds internally at a given rate than from a succession of investments compounding at the same rate. But I suspect many Berkshire shareholders figured that out long ago" according to Buffett.

¹ Buffett started his first private investment partnership in 1957. He convinced a number of Omaha individuals to invest \$25,000 each. Buffett put in \$100 of his own money, appointed himself general partner and began to purchase small undervalued stocks. His goal was to beat the Dow Jones Industrial Average by an average of 10% a year. When he dissolved the partnership in 1969 Buffett's investments had ballooned at a compound rate of 30.4% annually, compared to just 8.6% annually for the Dow. The return on Buffett's initial \$100 investment would certainly be described as "incredible". Mr. Buffett is currently Chief Executive Officer of Berkshire Hathaway (NYSE symbol: BRKA).

3. **Concentration of Investments** - Professor Cunningham notes that "contrary to modern finance theory, Buffett's investment knitting does not prescribe diversification. It may even call for concentration . . . a strategy of financial and mental concentration may reduce risk by raising both the intensity of an investor's thinking about a business and the comfort level he must have with its fundamental characteristics before buying it." Other articles have noted the tendency of Buffett to concentrate his investments, and claim that this is part of his success. If nothing else, concentration allows an investor to follow a company much more closely – which allows them to better judge when a stock is undervalued.

4. **Good Business Judgment, Mis-valuation, & Small Companies** - Buffett subscribes to the theory that the market is not always efficient, and that at certain times companies will be grossly undervalued or overvalued. The market allows an astute investor to buy positions in companies well below intrinsic values. In the long term, such value will be recognized.

"An investor will succeed by coupling good business judgment with an ability to insulate his thoughts and behavior from the super-contagious emotions that swirl about the marketplace . . . The speed at which a business's success is recognized is not that important as long as the company's intrinsic value is increasing at a satisfactory rate - in fact, delayed recognition can be an advantage: It may give us the chance to buy more of a good thing at a bargain price."

Few people realize that during the period Buffett managed his partnership he focused on small, illiquid, microcap firms. Such companies were more likely to be mis-valued, and more likely to contribute to the growth of shareholder value.

5. **Small Asset Base** - Due to the size of the funds Berkshire now manages Buffett recognizes that the return he will obtain from his investments will be lower than when he was managing much smaller sums. Using analogies to the growth of bacteria, he notes that growth from a small base can continue at a much faster pace for much longer than from a large base. The larger sums now being managed limit the size of companies Berkshire can invest in - using a concentrated investment approach meaningful investments cannot be made in small and micro-cap companies.



Munger's Rules & Strategies for Investment Success

Charles Munger, Vice-Chair of Berkshire Hathaway and long time Buffett partner in the investment world, is also an incredibly talented investor. An attorney by trade, Munger began investing in real estate then founded a small investment partnership, Wheeler, Munger & Company. Mr. Munger actively managed this investment partnership from 1962 to 1975, then played a key role in building Berkshire Hathaway. He provided a significant influence on Buffett's investment theory and strategy. Over a 14 year period Munger outperformed the market by 17.9% per year before his costs, fees, and expenses.

Janet Lowe, author of a book on him entitled "Damn Right!", sets out several themes explain Munger's incredible success generating excess returns and accumulating wealth:

1. **Live Below Your Means** - Munger notes that it is very important to consistently underspend your income, especially when starting a career, investing the excess funds wisely. The most difficult part of building wealth is "accumulating the first \$100,000 from a standing start, with no seed money" according to Munger. Making the first million is the next big hurdle.

2. **Understand Your Risk Tolerance** - Every investor has to know the level of risk that they can comfortably assume. Since losses are inevitable - and the book discusses numerous mistakes made by both Munger and Buffett - an investor must adopt a strategy that fits their risk profile. Since recent behavioral finance studies indicate that losses are three times as painful as gains for most investors, many investors may want to adopt a relatively conservative strategy.

3. **Research Opportunities** - Investors must be able to process a massive amount of information effectively, and must learn to evaluate the risks and rewards of potential investments. Business magazines are a great resource for evaluating trends, and Munger notes that "I don't think you can get to be a really good investor . . . without doing a massive amount of reading."

4. **Invest for the Long Term in Small Companies** - Volatility has not been a major concern of Munger, provided the long term odds of success are in his favor. In fact, volatility can allow an investor to accumulate positions in a viable enterprise at prices below intrinsic value. He tended to focus on very small companies that were

not well known or followed by Wall Street and tended to be illiquid. A long term focus is essential when ignoring the volatility of markets and individual stocks, and can provide impressive gains that tend to compound over time.

Both Munger and Buffett ignore beta - the measure professional investors use to gage volatility and hence "risk" - preferring to focus instead on the risk/reward relationship of the business over the longer term. "Volatility over time will take care of itself" according to Munger, provided favorable odds exist that the business will grow.

5. **Mutual Funds Are No Substitute** - Americans are oversold on the benefit they receive from money managers, especially mutual fund managers, and "that bothers Munger enormously." Transaction costs, taxes, and fees can significantly reduce total returns. Munger advocates buying index funds, or alternatively buying high quality stocks that are not overvalued and holding for the long term.

6. **Patience, Coupled With Decisive Action** - Excellent investment opportunities are not common. Investors should continually search and evaluate opportunities. Utmost patience is required, until one is found that has extremely favorable odds of success. Munger was an expert at applying the Kelley formula to investment decisions. "People underrate the importance of a few simple big ideas" according to Munger. Extreme decisiveness, once the commitment is made, dramatically improves financial results over a lifetime.

7. **Tax Planning** - Taxes and tax planning play a major role in wealth accumulation. As a lawyer drawing an income Munger was subject to relatively high income tax rates, significantly above what he paid on capital gains, which reduces the ability to build wealth. The recognition of any capital gains on investments many times can be delayed or offset by investment losses, allowing the investment to compound at an accelerated rate.

8. **Love the Process** - Because investors must initially be willing to live below their means, have the skills to conduct a massive amount of due diligence, exhibit patience, read voraciously, manage risk effectively, and make decisive actions when the odds are in their favor, an investor must love the evaluation and investment process since it is not without a massive amount of work.

9. **Pay a Reasonable Price** - While value is important, investors should buy good businesses that are in sectors that exhibit favorable business characteristics. Management can only do so much with a company in a declining industry. Good businesses will grow in value over time.

10. **Choose Good Partners** - Every investor relies on the advice of others in making investment decisions - whether those are investment advisors, brokers, newsletters, or business partners. Munger was fortunate to have selected some of the best partners available to assist in evaluating investment issues. Successful investors will have top quality investment partners.



Common Elements of the Investment Strategies of Two 'Super-Investors'

Several common themes emerge when examining the strategies of Mr. Munger and Mr. Buffett. Common elements of their strategies to generate excess returns include the fact that they both:

- (1) focused on very small publicly traded companies,
- (2) ran concentrated portfolios,
- (3) looked for companies with niche markets,
- (4) allocated capital based on a risk/reward analysis (Kelly formula),
- (5) were not afraid to buy illiquid stocks,
- (6) bought firms with growth potential,
- (7) looked for a firm's ability to generate attractive margins,
- (8) bought their positions at reasonable valuations,
- (9) managed a limited amount of assets (so they could take advantage of the small company sector),
- (10) acted decisively and invested heavily when odds were in their favor,
- (11) bought firms that they felt they understood,
- (12) purchased only after conducting extensive due diligence,
- (13) were not concerned at a lack of Wall Street coverage or interest,
- (14) evaluated dozens of firms for each one they bought,
- (15) tolerated above-average portfolio volatility, and
- (16) focused on the longer term.

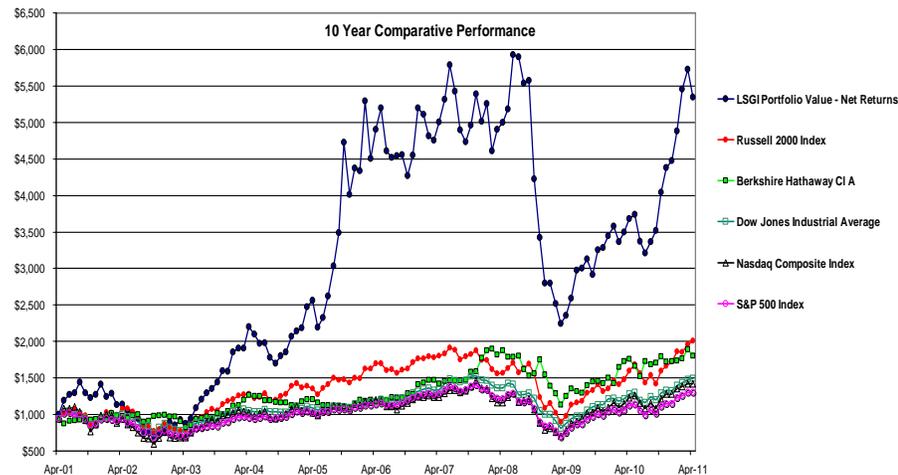
Losing the Statistical Advantage – The Pitfalls of Success

The fact that Berkshire stock has underperformed historical growth rates and the Russell 2000 index should come as no surprise. In fact Mr. Buffett has warned repeatedly that the performance of Berkshire stock will never approach what it was two decades ago. He notes that due to the size of his company he can no longer target the small, illiquid, volatile, undervalued, un-noticed firms with solid margins and a good market niche like Nebraska Furniture Mart, See's Candies, GEICO Insurance, and others that would have a significant impact on overall company performance.

These unloved and ignored small companies were a major factor contributing to Berkshire's growth as they allowed Mr. Buffett to identify investment opportunities where the risk/reward relationship was tilted heavily in his favor. This gave him a huge statistical advantage. When the odds were strongly in his favor he invested heavily. Due to the current size of Berkshire (\$200 billion market cap) investments in small companies will no longer have a major impact on financial performance. In short, he last lost his statistical edge due to his success as an investment manager. The inability to buy small companies that will meaningfully impact corporate performance means the statistical edge is gone – or is much smaller than it has been. So investor returns are more in line with the market indexes.

While Berkshire Hathaway assets are much too large for them to continue using the time-proven tools of success noted above most investors don't have that problem. In fact, for a number of reasons, we think this is one of the best times ever for investors. Numerous academic studies indicate that the factors of success listed above, utilized by both Buffett and Munger, have historically generated excess returns for investors – maximizing returns and providing for the exponential growth of wealth. If the Buffett/Munger strategies are successfully implemented the returns can be impressive – well above the major market averages.

Using a similar strategy we have tilted the risk/reward relationship in our favor and increased our statistical advantage. As a result the LSGI portfolio has generated substantial returns over and above the major market indexes over the last decade. We plan on continuing to implement this strategy for the next decade – and expect to obtain similar results. Others, utilizing this strategy, would most likely obtain similar results.



Investment implications. Like the early prospectors in Michigan's Copper Country who found great challenges and difficulties, and in some cases great wealth², the small company sector is rich with opportunities for those who decide to prospect therein. Small companies are, in every sense of the word, the investor's Mother Lode. Market inefficiencies create the opportunity to tilt the risk/reward relationship and statistical advantage heavily in your favor.

General Lessons for Investors

When we examine Mr. Buffett's and Munger's historical performance several lessons are apparent:

- An investment manager that can outperform the market has an incredible impact on total long term returns
- Strategies that have a high probability of outperforming the market are extremely valuable to investors with a long term time horizon
- Time is one of an investor's most valuable assets
- Even small differences in annual returns can have enormous longer term impact on total returns due to compounding³
- You don't have to be a Harvard MBA to be a successful money manager, but need persistence

² Shareholders in successful mining ventures in the Keweenaw Peninsula could do quite well. Henry Hobart, school teacher at Clifton (a ghost town located near Eagle River), wrote on February 3, 1864 that: "Many have made a fortune by investing their money in stock. This is an easy way but it also an easy way to lose a fortune. But it is said that a man must run some risk if he wishes to make anything." Hobart references the wealth created by investing in mining stocks numerous times in his diary – and indicates that he purchased shares in the North Cliff mine during this time period. See: Hobart, "Copper Country Journal, The Dairy of a Schoolmaster, 1863-1864" (republished 1991).

³ Had Mr. & Mrs. Othmer invested in the S&P 500 index instead of with Mr. Buffett they would have an account worth roughly \$2.7 million (a return of around 11.8% a year) – very impressive. But not anywhere near the almost \$800 million obtained with Mr. Buffett (annual returns of 24.1%)