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Why Value Investors Are Different

Today's mutual-fund manager and Warren Buffett, side by side

BY SETH A. KLARMAN • The most dramatic and valuable lesson from the fabulous (and still counting) 50-plus-year investment career of Warren Buffett is the legendary account of his steadfast conviction amidst the 1973-75 bear market. He had correctly identified by 1973 that the shares of companies such as the Washington Post were selling for but a fraction of the underlying business value represented by those shares. He observed that numerous buyers would readily pay several times the prevailing market price of Washington Post stock to acquire the entire company, but it was controlled by the founding family and not for sale. Buffett could acquire a minority interest in the business at a bargain price, but he could not force the valuation gap to close. For that, he was dependent on the passage of time to result in improved market conditions and/or on the behavior of management to successfully run the business and to act in the best interest of shareholders.

Fortunately for Buffett, the shares of Washington Post and other attractively priced companies failed to rise from 1973 bargain levels and in fact proceeded to relentlessly decline over the next two years, enhancing the opportunity by orders of magnitude. Roger Lowenstein, in his biography *Buffett*, describes the "impression of Buffett sweeping down the aisles of a giant store [buying stock]. . . . As the market fell, he raced down the aisles all the faster."

Bear Market Memory

Recalling this episode is important because it powerfully evokes the memory of what happens in bear markets: Good bargains become even better bargains. It is also inspirational testimony to the wisdom and necessity of staying power: Had Buffett worried about the interim losses in 1974 or 1975 from his earlier and more expensive purchases of Washington Post shares, he might have not only failed to add to his holdings but, conceivably, might also have panicked or been forced out of his steadily dropping position. That he didn't reflects the well-founded conviction a value investor is able to have, confident in the margin of safety that a bargain purchase is able to confer.

Back in 1974 and 1975, when the shares of Washington Post were declining so sweetly for Buffett, what might his daily experience have been like? As confident as Buffett was back then, projecting out his future wealth from currently depressed point A to future point B, there were almost certainly times that a bit of fear rose in his throat, too. He wouldn't be human or risk-averse if the near-daily markdowns of his bargain purchase didn't create room for reflection.

Buffett: They lined up to sell to him in the 'Seventies.

And profiting from his bargain purchases was not an immediate occurrence. Buffett was making no off-market purchase, odd lot or private sale he could immediately flip for sizable gain. He in fact bought very much on the market; he had simply decided that the market was wrong. His view was that the sellers were not thinking clearly, perhaps were not in a position to think clearly. In all probability, they were selling not because they believed the shares were fully priced or overpriced compared with the value of Washington Post as a business. On this they and Buffett may, perhaps surprisingly, have agreed. Their disagreement, if there was one, concerned the level of appropriate discount between share price and business value, a gap that Buffett saw as widening.

It is helpful to note that Buffett did not consider whether Washington Post was a component of a stock-market index, or about to be added to one (ironically, in a sense, since the possible inclusion of Buffett's **Berkshire Hathaway** in the S&P 500 Index is one of the speculative forces lifting that stock today). He did not weigh the market capitalization of the company or its daily trading volume in his purchase decision. He didn't worry about whether the stock was about to split or pay or omit a dividend. He most certainly did not evaluate the stock's beta or use the capital-asset pricing model or consider whether its purchase would move his portfolio to the efficient frontier. He simply valued the business and bought a piece of it at a sizable discount.

Was Buffett not concerned about risk? Of course he was, but not those risks that were most pertinent to the shorter-term-oriented, more rigidly constrained investors who were unwittingly making him wealthier every time they sold him another share. Those investors, quite like today's big mutual-fund complexes, were disproportionately worried about their short-term investment results and their clients' perception of same. In such a world, relative underperformance is a disaster and the longer term is measured by the frequency with which investment results are evaluated. Risk for them is not *being* stupid but *looking* stupid. Risk is not overpaying, but failing to overpay for something everyone else holds. Risk is more about standing apart from the crowd than about getting clobbered, as long as you have a lot of company.

History Doesn't Quite Repeat

History never repeats itself exactly. So in 1998 investors urgently seeking liquidity are selling not Washington Post but small-cap and emerging-market equities. Investors tired of underperforming don't sell Dell Computer (no one, it seems, sells Dell), which they love for what it has done for them no matter how expensive it has become. It is so much easier for them to sell whatever has recently disappointed investor expectations, no matter how inexpensive it has become. Mutual-fund managers, desperate to put cash to work, don't buy what is cheap but what is working, since what is cheap by definition hasn't been working.

It seems obvious that so long as there are inflows into the hands of institutional investors, there will be a telescoping of investment into the several dozen names that have reliably reported quarter-by-quarter earnings growth and almost constant share-price appreciation. It seems obvious, but is actually a slippery and very dangerous slope. When stocks are rising for no better reason than that they have risen, the greater fool is at work. Consider the Internet-stock mania, where the mere rumor of a stock split, as irrelevant to value as a rumor could be, sends not only that stock flying but a whole group of stocks rising in sympathy. This is no different from the

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Occasionally, one of Buff's shooting stars falls to earth; fortunately, his compatriots at other funds probably owned it in about the same proportion. Then he does what you should always do when a stock falls: He blows it out.

purchase of any investment based on how the market might possibly regard it in the future rather than on investment fundamentals. An investor who initially purchases based on value knows to buy more when an already undervalued stock falls and to sell when it becomes fully valued. An investor in an Internet stock or in the extraordinarily expensive shares of a very good company has no idea what to do when the price moves up or down. This creates a serious dilemma for the great majority of investors and a real opportunity for a few.

Necessary Arrogance

At the root of value investing is the belief, first espoused by Benjamin Graham, that the market is a voting machine and not a weighing machine. Thus an investor must have more confidence in his or her own opinion than in the combined weight of all other opinions. This borders on arrogance, the necessary arrogance that is required to make investment decisions. This arrogance must be tempered with extreme caution, giving due respect to the opinions of others, many of whom are very intelligent and hard working. Their sale of shares to you at a seeming bargain price may be the result of ignorance, emotion or various institutional constraints, or it may be that the apparent bargain is in fact flawed, that it is actually fairly priced or even overvalued and that the sellers know more than you do. This is a serious risk, but one that can be mitigated first by extensive fundamental analysis and second by knowing not only that something is bargain-priced but, as best you can, also *why* it is so. (You never know for certain why sellers are getting out but you may be able to reasonably surmise a rationale.) This is the position in which investors should, over and over, want to put themselves (and an astonishingly different type of consideration than the great majority of today's investors are bothering to make).

Now consider mega-growth-fund manager Buff T. Warren, who has been racking up year after year of great performance buying and holding the shares of expensive but steadily rising growth companies. Buff has consistently been and remains bullish, since that is what got him where he is today. High stock prices have long since ceased to worry Buff, who is nothing if not flexible. And what choice does he really have, anyway? The fundamentals are excellent as far as the eye can see, so share prices should be high. His portfolio companies are among America's greatest, they are in sync with the times and they beat analysts' earnings expectations every quarter. There is apparently nothing in the great demographic roller coaster to interrupt the steady cash inflows into the stock market. Almost no one, in fact, can even imagine a reason why these large, well-liked companies won't continue to command the greatest share of investor demand.

At the end of the Hall of Greater Fools is a mirror. Buff, unaware of entering the building, actually thinks of himself as a prudent investor. After all, he owns no junk, only the shares of great businesses. And the market's constant vindication of his judgment only reinforces his conviction and self-image. Obviously, selling his best performers to dabble in anything else would be wildly speculative and he has convinced himself that he is a risk-averse investor, even a "value" investor. Buying and holding, using inflows to add to positions, is his watchword.

Occasionally, one of Buff's shooting stars falls to earth; fortunately, his compatriots at other mutual funds probably owned it in about the same proportion. Then he does what you should always do when a stock disappoints and plunges in price: He blows it out. You can't, after all, trust a company that is incapable of massaging earnings into a steady growth pattern; why, the same thing might happen again. And he knows all his compadres are thinking the same thing and blowing it out, too.

Buff has a lot of company. His stocks are going up, not necessarily because they should but because they do. That no one can think of why they wouldn't is taken as evidence that they will rise further.

Lost Art of Contrary Thinking

Lost in Buff's world is the art of contrary thinking. Ignored, out-of-print titles about the madness of crowds (not to mention the importance of a margin of safety) suggest that the majority cannot be right in the long run. Being very early and being wrong look exactly the same 99% of the time, and early in Buff's line of work means unemployed. Anyway, it is Buff's job to be fully invested. It's hard to deviate from what has been working; and buying smaller, less liquid names really wouldn't make a dent in the mountain of cash that comes in every week. Maybe Buff even halfheartedly believes it is he who is the real contrarian, and that the rally has a lot farther to go.

The investment world today is turned upside down; what is seen as risky is almost certainly much safer than what is viewed as rock solid. Not only that, but in the ultimate irony, Warren Buffett's and Buff T. Warren's portfolios look a fair bit alike. Some of Berkshire Hathaway's largest holdings, including international consumer stocks like Gillette and Coca-Cola, now trade at over 40 times earnings and are among the favorite stocks of growth managers like Buff.

The preface to Benjamin Graham's *Security Analysis* contains the quote from Horace's *Ars Poetica*: "Many shall be restored that now are fallen and many shall fall that are now in honor." It does not say when. ■

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