REVISITING "THE SUPERINVESTORS OF GRAHAM-AND-DODDSVILLE"

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In 1984 Warren Buffett wrote an article titled *"The Superinvestors of Graham-and-Doddsville"*, as based upon a speech he gave at The Columbia Business School. The speech was given in honor of the 50th anniversary of the groundbreaking book '*Security Analysis*', written in 1934 by Benjamin Graham and David Dodd.

In the article Buffett described an elite group of investors who shared a common characteristic - all of them were disciples of the Graham and Dodd value investing approach. And while none of these "superinvestors" followed the exact same approach (i.e. their actual underlying stock selections varied significantly), by adhering to the *guiding principles* of value investing ALL of them set themselves apart from the investing masses of their time. While most investors struggled to simply match the overall market's performance, this group of superior investors established proven track records of significant *outperformance*. As such, Buffett refutes any suggestion that their results could have been any sort of blind luck or coincidence.

Surely much has changed in the world of investing since 1984, let alone 1934! *Or has it?* To answer this question, let's revisit the guiding principles that worked so well for the superior investors of yesteryear, as espoused by none other than the world's greatest investor himself.

SUPERIOR INVESTOR PRINCIPLE #1: The stock market is, in fact, very INEFFICIENT (...and these inefficiencies can, and should, be exploited by the superior investor)

In the past, some observers came to the conclusion that the stock market is somehow 'efficient', in what became known as the "Efficient Market Hypothesis". Its followers believe that all relevant information about a publicly traded business is widely known by all market participants. And in turn, as that information comes available, investors will react *rationally*, making their buy/sell decisions based solely upon the facts. This 'efficiently' adjusts market prices to reflect the widely disseminated information, thus quickly eliminating any gap between the market price and the actual, underlying per share value of the stock. In other words, *at least as the theory goes*, investor emotions like greed and fear are (somehow?) removed entirely from the decision making process. As a result, efficient market theorists concluded that any attempt to outperform the broad market is nothing more than a fool's errand (...sing it with me now, "*Things that make you go hmmmm*").

I have to say that from my own personal point of view the idea of "market efficiency" is one of the most laughable and easily refutable investment theories I have ever encountered. I regularly witness giant gaps between the price "the market" gives to a business, and its underlying value – as extreme short-term volatility whips share prices up and down like a never-ending yo-yo! Clearly the underlying fundamentals of any business do not change daily to such extremes. The premise here is that we should (at least in the short-term) ignore what the market is telling us. Rather, we should seek to take advantage of the gaps in price and value that the market continually provides. As per Benjamin Graham…

"The sillier the market's behavior, the greater the opportunity for the business-like investor."

Let's take a quick look at a real life example that we should all be familiar with. If the "pricing mechanism" of the stock market were somehow "efficient", I would ask how it could be possible that Warren Buffett himself has so widely outperformed the market over the past **fifty plus** years. As any "superinvestor" of today would know, shares of Buffett's Berkshire Hathaway have outperformed the benchmark (the S&P500 Index) by more than **double!**

According to Buffett's most recent annual Shareholder Letter, shares of Berkshire Hathaway have averaged 20.8% per year from 1965 to 2016, versus the index up 9.7% per year. On a cumulative basis, this represents an overall gain of an almost unfathomable 1,972,595% versus the S&P500's overall gain of 12,717% over the 51 years. Clearly, attempting to outperform the market has been no "fool's errand" in this case! (Insert another "*hmmmm*" right here).

Of course, Buffett's results provide an *extreme* example by anyone's measure. After all, he IS known as "the world's greatest investor". Regardless, the "theory" that emotions like greed and fear are somehow removed entirely from the decision making process is beyond laughable. To the contrary I would suggest that market prices are *routinely* driven by human emotions like greed and fear. This is also commonly referred to by the media as "risk on" and "risk off", like as if underlying business fundamentals somehow change with the flick of a switch? *Prices* might; *fundamentals* don't.

So, it would seem that much to the contrary of the efficient market hypothesis, the stock market is in an almost constant state of being overbought (i.e. greed driven) or oversold (fear driven), as loosely tied to the business/economic cycle.

However, let us not just take my word for it. Referring back to the "Superinvestors" article, here is what Buffett had to say on the matter:

> **"I'm convinced that there is much inefficiency in the market. These Graham-and-Doddsville investors have successfully exploited gaps between price and value. When the price of a stock can be influenced by a "herd" on Wall Street with prices set at the margin by the most emotional person, or the greediest person, or the most depressed person, it is hard to argue that the market always prices rationally. In fact, market prices are frequently nonsensical".**

There are countless additional (and very obvious) reasons as to why the markets are often in fact very inefficient. I'd be happy to share these with you, but for the sake of your time (and my carpel carpal tunnel) I'd like to put this to bed with yet another quote from, you guessed it, Mr. Warren Buffett (as only he could so eloquently put it):

> **"I'd be a bum on the street with a tin cup if the markets were always efficient".**

Enough said! Let's move on to the next principle.

SUPERIOR INVESTOR PRINCIPLE #2: "Always buying the business, not buying the stock"

As I've mentioned in past missives, most investors *invest* in a business (somehow doing so *unknowingly*, it would seem?), and then almost immediately proceed to treat that investment like it's a blip on a radar screen. In other words, they do not have the '*business-like*' approach that Benjamin Graham had professed to be a *prerequisite* to any sort of long-term investment success. And as I've also mentioned in past missives, "investing" is by definition a long-term proposition. You don't "invest" for the "short-term"! As such, "Buying the business" - it should go without saying - implies a long-term proposition (requiring at least a modicum of patience!).

"*Buying the stock*" is when you invest in a business and then you immediately begin to follow the *long-term* investment you just made - on a daily, weekly, or monthly basis. Worse yet, is when you do so on the premise that you'll sell your supposedly *long-term* "investment" if it *temporarily* "blips" downward, or back up the truck if it "ticks" up (…and is therefore now more *expensive*).

This can only be described as a very short-term, and short-sighted approach. Further (and please forgive me for stating the obvious), I'd like to take this opportunity to respectfully suggest that it is a very foolish one to boot. And yet this is the approach I most frequently witness among many so-called "investors" in the stock market. As you sense my frustration here, please allow me this opportunity to glean more wisdom from Benjamin Graham on this topic:

> **"Stocks will fluctuate substantially in value. For a true investor, the only significant meaning of price fluctuations is that they offer an opportunity to buy wisely when prices fall sharply and to sell wisely when they advance a great deal."**

…and that leads us to our third and final principle for long-term investment success.

SUPERIOR INVESTOR PRINCIPLE #3: Buying with a Margin of Safety

It is an integral part of my job as a Portfolio Manager (and wannabe "superinvestor") to come up with an estimate of the underlying value of the business in question. When a good – or ideally, exceptional -- business can be purchased in the market at a significant enough discount to its actual value (i.e. with a margin of safety), we buy.

In an effort to make clear how buying with a margin of safety can, in effect, *lower* the 'risk' AND enhance returns (the 'holy grail' of investing), please allow me to reference, once again, from the "Superinvestors of Graham-and-Doddsville"…

> **"If you buy a dollar bill for 60 cents, it's risker than if you buy a dollar bill for 40 cents, but the expectation of reward is greater in the latter case. The greater the potential for reward in the value portfolio, the less risk there is".**

So, why is it that all investors don't simply follow this seemingly obvious approach, you may ask? For, is it not simply common sense that, if given the opportunity to buy a dollar for 60 cents, much less 40 cents, *any* investor would jump at the opportunity!? The simple answer is that most investors clearly do not take this 'common sense' approach. Rather, much to the contrary, many seem to find comfort only when they can buy dollars (i.e. stocks) at a premium? And clearly the stock market is strangely shunned by the 'herd' when great businesses find themselves temporarily 'on sale' (go figure?).

Buffett had this to say:

> **"It is extraordinary to me that the idea of buying dollar bills for 40 cents takes immediately with people or it doesn't take at all. It's like an inoculation. If it doesn't grab a person right away, I find that you can talk to him for years and show him records, and it doesn't make any difference. They just don't seem able to grasp the concept, simple as it is."**

In a nutshell, buying with a margin of safety requires the conviction to buy the business when it is temporarily out of favour and unpopular. It is only under these, shall we say "opportunistic", circumstances that the business is attractively priced, and therefore can be purchased with the prerequisite margin of safety.

I will provide that conviction. It is incumbent upon both of us – knowing that the market rarely closes the gap as quickly as we might like – *to exercise patience*. And finally, might I suggest, *it is incumbent upon you to provide the temperament necessary for any real and sustainable investment success*. Allow me one final quote from Ben Graham in order to emphasize this point…

> **"To invest successfully over a lifetime does not require a stratospheric IQ, unusual business insights, or inside information. What's needed is a sound intellectual framework for making decisions and the ability to keep emotions from corroding that framework."**

Buffett's stellar track record in his early days as an investor is among those highlighted in the original "Superinvestors" article. His annual letter to Berkshire shareholders provides his incredible track record more recently (from 1965 to 2016). *Nothing* seems to have changed on that front. As such, he is among the 'superinvestors' of both the past AND the present. And while it seems almost everything is now different in the world of investing, perhaps nothing has really changed, at least - within the context of what it takes to do it *successfully*.

References…

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