WHEN BAD THINGS HAPPEN TO GOOD PORTFOLIOS

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Can 'bad' things happen to an otherwise 'good' investment portfolio? To answer this question, I looked at the performance of a very large and well-known investment portfolio that has a long history of exceptional results. This particular portfolio provides a good 'test case' because its history goes back more than 50 years. Therefore, its success clearly cannot be attributed to mere luck. Furthermore, given its lengthy track record, this portfolio has been subject to every market condition and economic environment imaginable.

Over its lengthy tenure the portfolio I studied has widely outperformed its benchmark, adding significant value for investors over time. As such, by any reasonable person's measure, this is a 'good' portfolio. However, as the saying goes, *'nobody said it would be easy'*. All sorts of bad things happened to this portfolio all along the way. Here are a number of examples:

There were 11 calendar years over its tenure, where this 'good' portfolio would have lost you money. Even if an investor in the portfolio had refrained from looking at their results on a short-term basis (i.e. monthly or quarterly), they would have routinely experienced negative results when looking at the performance on an *annual* basis. With 11 negative calendar years, that means the portfolio lost money one in every five years, or 20% of the time.

To add insult to injury, in seven of those negative years the portfolio also underperformed its benchmark. And to add further misery, during five of those negative years, the overall stock market had actually gone UP in value. It's one thing to lose money in a broad-based 'take no prisoners' market sell-off, when everyone else is too. But to lose money in a year where the overall market had actually gone up in value is a whole other matter.

Finally, on this note, there was one particularly bad year where the portfolio dropped in value by a whopping 19.9% *while the overall stock market had gone UP by 21%*. So in that specific year, the manager lagged his benchmark by almost 41%. Talk about a bad thing happening to an otherwise good portfolio!

There were 17 years in total where the portfolio underperformed its benchmark. That's almost 1/3rd of the time. And during those 17 years where the portfolio underperformed the markets, it did so by an *average* of 15%. In other words, when things went bad, they went really bad!

There were 21 years where this otherwise 'good' portfolio experienced a calendar year return that was negative and/ or worse than its benchmark. A long-term investor, measuring the merit of the portfolio on an annual basis, would have been disappointed almost 40% of the time.

There were 20 calendar years where the portfolio returned less than 10%. Throughout history the stock market has averaged around 10% per year. So, one might suggest it could be reasonable for an investor in this well diversified portfolio of large 'blue chip' stocks to expect similar results in any given year. And they would have been disappointed, again, almost 40% of the time.

And finally, in addition to all the bad things that happened to this good portfolio mentioned above, *it also experienced a couple of prolonged periods of particularly poor results.* Throughout its history this portfolio experienced two separate periods of time where it had either a negative rate of return and/or underperformed its benchmark ***for four years in a row*.** In other words, if you had hired this particular portfolio manager at the start of either of these periods, and looked back at your results four years later, you would have experienced either negative or relative underperformance *in each and every one of the previous four years.*

How is that for getting off to a bad start? In fact, I think it's quite safe to say that in either of these scenarios, many investors would have promptly pulled their money and fired the manager! But before you start calling me 'Captain Obvious', let it be known that the "portfolio" we've analyzed above is none other than that of Berkshire Hathaway, and the *'portfolio manager' you'd have fired would have been the world's greatest investor himself – Mr. Warren Buffett!*

Here are some other details about the performance of Buffett's holding company; Berkshire Hathaway (ticker BRK.A):

Over the 54 year period from the beginning of 1965 to the end of 2018 *(in other words, no flash in the pan!), Buffett/ Berkshire returned an average of 20.5% per year, more than doubling the* S&P500 Index, which returned a very respectable 9.7% per year over the same period.

***A $10,000 investment in Berkshire Hathaway made at its inception back in 1965, would have grown to an almost unfathomable $236,000,000 by the end of 2018.* By comparison, a $10,000 investment in the S&P500 index, over the same period, would have grown to $1,483,000.**

In hindsight, I was obviously being overly facetious when I referred to 'the portfolio' as a 'good' or even a 'great' one. *The results of Warren Buffett's portfolio (Berkshire Hathaway) have clearly been beyond spectacular!* However, please take a moment to go back and read again, all of the bad things that happened to Berkshire Hathaway and its investors along the way.

In conclusion, can bad things happen to good, or even great, investment portfolios? Of course, the answer is an unequivocal 'YES'. *But there is a silver lining…*

Truly bad things can only happen to good investment portfolios through our own behaviour; i.e. how we react to "bad" events such as temporary underperformance. If the portfolio itself is indeed a 'good' one by definition, it won't do bad things to you. *Only you can do bad things with it.*

(Source: http://www.berkshirehathaway.com/letters/2018ltr.pdf)

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