

**Columbia Law School**  
**The Center for Law and Economic Studies**  
435 West 116<sup>th</sup> St.  
New York, NY 10027-7201

Working Paper No. 255

**Searching for Rational Investors  
In a Perfect Storm**

Louis Lowenstein

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Draft 7/17/04

## Searching for Rational Investors In a Perfect Storm

By Louis Lowenstein<sup>n</sup>

### Abstract

In October, 1991, there occurred off the coast of Massachusetts a “perfect storm,” a tempest created by a rare coincidence of events. In the late ‘90s, there was another perfect storm, an also rare coincidence of forces which caused huge waves in our financial markets, as the NASDAQ index soared, collapsed, and bounced part way back.

What had happened to the so-called “rational” investors, the smart money, whom economists have for decades said would keep market prices in close touch with the underlying values? Despite the hundreds of papers on markets and their efficiency, no scholar, not one, has looked to see who are these rational, i.e., value investors, how they operate, and with what results.

I decided to see how a group of ten value funds, selected by a knowledgeable manager, performed in the disorderly boom–crash–rebound years of 1999-2003. Did they suffer the permanent loss of capital of so many who invested in the telecom, media and tech stocks? How did their overall performance for the five years compare with the returns on the S&P 500?

For most managers, mimicking the index, it was difficult *not* to own Enron, Oracle and the like, but the ten value funds had stayed far away. Instead, they owned highly selective portfolios, mostly 34 stocks or less, vs. the 160 in the average equity fund. They turned their portfolios at one-sixth the rate of the average fund. Bottom line: every one of the ten outperformed the index over the five year period, and as a group they did so by an average of 11% *per year*, the financial equivalent of back-to-back no-hitters.

The article closes with a discussion of the clearly large implications for investors, market watchers and public policy. As for those economic models, let the chips fall where they will.

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<sup>1</sup> Rifkind Professor Emeritus of Finance & Law, Columbia University; member of Panel on Audit Effectiveness, created at the instance of SEC Chairman Arthur Levitt, 1998-2000; director Institutional Inv. Project, Columbia Law School, 1986-94. My hearty thanks to Andrew Larrick of the Law School Library and Kevin P. Laughlin of the Vanguard Group, for their unstinting research help. Special thanks to Roger Lowenstein for the skillful insights and editing, not once but twice.

In October 1991, there occurred off the coast of Massachusetts a “perfect storm,” a tempest created by a rare combination of events, primarily an Arctic cold front colliding with a hurricane, that would create waves 30 meters high and of course wreak havoc and death among the fishermen caught in its path.<sup>1</sup> In the late ‘90s, there was another perfect storm, a rare coincidence of forces which created such turbulence in our financial markets that stock prices were distorted out of all relationship to their normal patterns. Like that nor’easter, there were huge costs to the innocents caught in its grip.

The speculative excesses of the ‘90s threw a harsh light on efficient market theory (EMT), which for decades has been a cornerstone of economic theory and scholarship.<sup>2</sup> No B-School student has escaped it; no economics professor has won tenure without paying his respects. EMT has also had significant impact on public policy and investment practices. It is, indeed, an appealingly simple idea, that in order to make money in the stock market one must compete against the “smart money,” the so-called rational investors, who are constantly scouring the market for opportunities. Because of them, all relevant new information is quickly captured by the market. No point in doing research oneself. Trust prices; the rational investors will already have erased most any discrepancy between price and value.<sup>3</sup> Since you cannot beat the market, buy a diversified portfolio, say the Standard & Poor’s 500 index fund, and save yourself the cost and sweat of an actively traded account.

Obviously the theory was wrong – woefully so. In the late 1990s, stocks soared to levels out of all proportion to their underlying values, indeed to levels well beyond even the excesses of the 1920s.<sup>4</sup> If the NASDAQ Composite Index, for example was right at 1200 in April 1997, it surely wasn’t right at 5000 in March 2000, and then right again at 1100 two years later. (The rise and subsequent 50% decline of the broader based S&P 500, though widely noted, was also stunning.)

Where were those rational investors during these tumultuous years? The Crash of October 1987 had little impact on Main Street America, but this time the damage was severe. At one point retirees, endowments, and the rest of us had lost \$7 trillion, and the collective loss is

still about \$3 trillion.<sup>5</sup> We need to see how this tsunami affected academic thinking. Have scholars looked to see what the rational investors, the cornerstone of their analyses, were doing during these tumultuous years? Was the smart money policing the markets, as the textbooks say? And if so, why then did the markets spin out of control? Perhaps these rational investors experienced the same huge losses as the rest of us. But if they somehow escaped, we need to study the analytic tools, the investment philosophy, that enabled them to see through the speculative pyrotechnics that benumbed the rest of us.

Who are these “smart” investors, and how do they operate? Are they short-term traders? Are they simply better diversified than the rest of us?

This may not sound particularly brilliant, but there is little, if any, academic dissent from the proposition that, at the end of the day, the most efficient investment portfolio is fully diversified. Indeed, some scholars have suggested that for a variety of retirement plans, we consider making full diversification a requirement.<sup>6</sup> A younger generation of economists have carefully scrutinized the various psychological and sociological biases that distort how investors make their decisions. Even this group, however, readily concedes that when attractive investment opportunities come to light, it is hard to believe they are not quickly exploited;<sup>7</sup> investors should, therefore, thoroughly diversify.<sup>8</sup> But is that how the smart money manage their portfolios or, conversely, do they focus on only a relative handful of carefully selected companies? *It would help to know.*

Particularly troubling is the assumption throughout the literature that the smart money – those who on Wall Street and in business schools, too, would be called “value investors” – are merely traders, focused on the very short term.<sup>9</sup> It is blithely assumed that value investors measure risk by the short-term volatility of a stock, and that having found a price discrepancy, seek to capture it before the underlying fundamentals change. Are value investors in fact fearful of holding a stock for the long term? *It would help to know.*

As the reader may have suspected, no one has looked. It's a paradox; so much scholarly work premised on the role of rational investors, yet no one bothers to study them or seek them out. There is the occasional reference to Warren Buffett, but no close examination. One recent academic paper concluded that "financial economists have been generally unable to identify *any* reliably 'smart' investors."<sup>10</sup> Gosh, perhaps they've been hiding. While there are casual suggestions in the literature that the performance of value investors during these "obvious market frenzies" should be studied,<sup>11</sup> no one has seriously done so.<sup>2</sup>

So I decided to look for them. The conclusions are stunning. Yes, there really are rational investors out there. And no, they did not suffer the losses sustained by the rest of us. On the contrary, they beat the market averages by huge amounts. And they achieved those results by holding very undiversified portfolios, buying shares of a small number of companies. And whatever stocks they did buy, they were likely to hold for years to come.

The findings have big implications for every investor, armchair market savant, and day trader. And for academics, the results are simply huge.

### **A Simple Survey**

To bring a group of rational/value investors out of the closet, I asked Bob Goldfarb, the highly regarded chief executive of the Sequoia Fund, to furnish the names of ten "true-blue" value funds, those which, as they say on the Street, don't just talk the talk but walk the walk. (Had I

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1. Seven years ago, Prof. Lynn Stout tried to coax her academic colleagues to take a look at the poster-boy value investor, Warren E. Buffett, but none of them have. Stout, *How Efficient Markets Undervalue Stocks: CAPM and ECMH Under Conditions of Uncertainty and Disagreement*, 19 *Cardozo L. Rev.* (1997) 475, 491. To get away from the usual assumption that he is unique, I turned my attention elsewhere.

prepared the list, I would have included Sequoia, but Goldfarb's ten is Goldfarb's ten.) They are all mutual funds, except for Source Capital, a closed-end fund which invests much like a mutual fund. The funds are as follows:<sup>12</sup>

Clipper Fund	Mutual Beacon
FPA Capital	Oak Value
First Eagle Global	Oakmark Select
Longleaf Partners	Source Capital
Legg Mason Value	Tweedy Browne American Value

I wanted to see what they were doing in the five boom-and-crash years of 1999-2003 -- to see if, given the enormous pressures to follow the crowd as the market soared, they had stuck to their principles – and of course to see if they had escaped the ensuing debacle.

I have no sense that the managers of these funds talk to each other, except perhaps by reading what each other has been saying or writing to shareholders, as reported in the value investors' journal, *Outstanding Investor Digest*. (Usually they zealously protect their good ideas, except as disclosure is mandated.) But their intellectual roots, their common model, are derived from *Security Analysis*, by Ben Graham and David L. Dodd of Columbia, published just 70 years ago. References to that “bible” are sprinkled everywhere, and some of them openly describe their first encounter with Graham and Dodd as an epiphany.<sup>13</sup> Go to the Oak Value website ([www.oakvalue.com](http://www.oakvalue.com)), for example, and the reader is soon greeted by the cover page of Graham's companion book, *The Intelligent Investor*. Typically, they search with exquisite care for a handful of companies whose intrinsic value – that is, the discounted present value of their future free cash flows – can be calculated with some degree of assurance. They're looking to buy pieces, i.e., shares, at a substantial discount from the value an intelligent buyer would pay for the business as a whole. That's it – price, value, and what Graham and Dodd said time and again, the “margin of

safety” that allows for the inherent risk in estimating future cash flows and the proper discount rate.<sup>14</sup> As Charles Munger, the vice-chairman of Berkshire Hathaway, likes to say, if you’re building a bridge intended for 10,000 ton trucks, you build it to carry 30,000 tons.

### ***The Fortune 10 test***

The first test was quite simple. I looked to see if the funds had owned in the year 2000, when the market peaked, any of a group of very high profile stocks which the editors of *Fortune* had selected in an August 2000 article entitled “10 Stocks to Last the Decade.”<sup>15</sup> The subhead read “Here’s a buy-and-forget portfolio,” and the list represented the contributions of some “top stock pickers,” as well as due diligence by the staff of *Fortune*. The ten stocks were as follows:

Broadcom	Nokia
Charles Schwab	Nortel Networks
Enron	Oracle
Genentech	Univision
Morgan Stanley	Viacom

These ten stocks, which then had an aggregate market capitalization over \$1 trillion, represented the cream of the ballyhooed New Economy. They were not the small-cap stocks which, we know, crowd-following momentum investors might be prone to bid up to unsustainable prices. For investors looking for the “next GE,” the *Fortune 10* included some of the leading tech, media, and telecom stocks. They were the glory stocks of the fin de siecle bubble, and their high price/earnings ratios – only one under 50 – reflected the faddishness of the age. *Fortune*, swallowing the popular perceptions whole, said they were ten stocks to let you “retire when ready.”

What are the risks in assuming that market prices are rational? By year-end 2002, these ten stocks had declined *on average* by 80% from the July 2000 prices quoted in the article.<sup>16</sup> That

is, they had suffered a loss of \$800 billion. Even after the market resurgence of 2003, the decline was still 50%. Investors who bought the list suffered what Graham called a permanent loss of capital, the sort that value investors obsessively try to avoid.<sup>17</sup>

None of the ten funds, which were managing in the year 2000 more than \$20 billion in all, had laid a glove on the *Fortune 10* stocks at any time during that year, with two exceptions. Legg Mason Value owned Nokia, though the stock represented less than 2% of its portfolio when purchased in 1996. Since the stock was sold in mid-2000 at a gain of 1900%, it's hard to be too critical. And Mutual Beacon had *short* positions in Viacom and Nortel, as part of arbitrages, meaning that they had bet against the stocks. That's it.

#### *Why the funds didn't bite on the Fortune 10*

At a time when most of us were enthusing about Cisco, Enron and the like, why were these value investors not joining the party? Their responses about why they were elsewhere are quite consistent. Here are some samples of their reasoning:

-- Clipper Fund: "inability to perform a rational valuation. . . . [F]or example, we did not buy Enron because we could not understand its financial statements."<sup>3</sup>

-- FPA Capital: "ridiculous valuations"

-- Oak Value: At Enron, faulty disclosure and we didn't like management. At Broadcom, Nortel, Nokia, and Oracle, we didn't like the industry and price-to-value.

The others mainly contented themselves with the traditional Graham-and-Dodd response that the price relative to value was not attractive.

While these responses were made with the benefit of hindsight, their portfolio decisions at

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<sup>3</sup> The lack of adequate disclosure at Enron was clear well before the debacle. An analyst from TIAA-CREF had complained about the deficiencies, only to be told "We're Enron; we don't need good accounting." *Origins of the Crash*, supra, at 167.

the time speak for themselves. As the year 2000 opened – the bubble did not peak until March -- most of the funds were openly acknowledging to their shareholders that they were sorely out of step; on average, the group had significantly underperformed the market in 1999. Over a long period, a manager who trails the index is obviously not doing his job. And given the rapidity with which investors routinely cash out cold funds for hot ones, to underperform even in the short run is for many funds a serious matter, known in the trade as “tracking error.” One of our group managers facetiously described tracking error as “professional misconduct vaguely comparable to dealing drugs.”<sup>18</sup>

Even while agonizing over their tracking error, the fund managers were vigorously reaffirming their investment principles. Envy of the crowd never caused them to lower their standards. In its year-end 1999 report, Mutual Beacon summed it up as follows:

During 1999, we stuck “to our longstanding value and special situation approach. . . . [We] bought only when we saw substantial upside with relatively little risk. In our opinion, risk still matters.

*Old economy stocks were still cheap in 1999*

Although tech, media and telecom stocks soared in 1999, it remained a deeply bifurcated market, one in which many “old economy” stocks of traditional American companies could be bought at substantial discounts to intrinsic value. Indeed, though more stocks in the index were down than up that year, the soaring prices of stocks such as Cisco, Oracle, Intel and Yahoo, carried the S&P 500 21% higher. (It’s not widely understood, but because the S&P 500 is a dollar-weighted index, as a stock’s price rises, so too does its impact on the index.)

It might not have seemed a propitious time to buy any stocks; and Professor Robert Shiller, in his timely book, *Irrational Exuberance*, thought that even value stocks would be too risky.<sup>19</sup> For managers focusing on companies not markets, however, it was a time of great opportunity. The First Eagle Global presidents, sounding like a latter-day Graham and Dodd, said

to investors in their report for the year ended March 31, 2000:

“For five years now, and particularly [the six months to mid-March 2000], smaller and medium-sized ‘value’ stocks have been neglected, ignored, and – in our opinion – mispriced by investors. . . throughout the world.”

And while at the time it might have sounded like sour grapes to some, Longleaf Partners wrote to its investors that:

“The lackluster [performance, up 2.18% for 1999] should not overshadow the fact that 1999 was one of our best years from a buying perspective. . . . History has proven that over time stock prices, although volatile in the short-term, will converge with intrinsic business value.”

Or as FPA Capital put it:

“We strongly believe that the value style of investing is not dead, [merely] in a state of hibernation. . . . The last two years have been particularly difficult. . . .”

### ***The performance test***

The funds knew their model, and they were staying with it. And they were soon to be vindicated. The five years 1999-2003, one of the most volatile in history, make a fine test. Even after bottoming out in 2002 and racking up a substantial rebound in 2003, the S&P 500 index showed *negative* average annual returns of 0.57%.<sup>20</sup> If the stock market were the random walk described by academics, one would expect that for our ten funds it would be a roll of the dice, a 50-50 outcome, with perhaps five performing better than the index and the other five worse. On average, they should have done about the same as the index, except of course for the drag on performance of the funds’ sometimes significant management fees.

But I found some things that pure chance cannot explain. The ten funds all beat the index,

not just as a group, but each and every one of them did so. And on average, they beat the index by a stunning amount, what economists like to call a five-sigma event, meaning a statistical marvel that pure chance cannot explain. (For the lay reader, a perfect game in baseball is a random and rare event. Two such games back-to-back would be a freak—an occasion so rare it is outside the bounds of mathematical probability.) The ten funds showed positive average annual returns for those five years of 10.82%, or eleven percentage points *per year* better than the index. Not quite ten perfect games, but pretty close.

As one might expect, the average annual returns for the ten funds varied considerably, but even the least successful outperformed the index, and by a significant margin. The five-year 1999-2003 average annual returns were as follows:

Clipper	11.9%
FPA Capital	15.29
First Eagle Global.	17.02
Legg Mason Value	4.43
Longleaf Ptners	10.94
Mutual Beacon	10.28
Oak Value	2.63
Oakmark Select	15.43
Source Capital	15.42
Tweedy Br. Amer.	4.87

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Average annual returns for the five years:

Group Average	10.82%
S&P 500 Index	-0.57%

Value funds are likely to outperform the index when the market is falling, or even treading water; the “tracking error” arises primarily in the years that stocks soar. The Clipper Fund, for

example, suffered a loss of 2.0% in 1999, while the S&P 500 was rising 21%. Not surprisingly, Clipper suffered big redemptions. FPA Capital's redemption experience was similar. Clipper's senior manager, James Gipson, explained in his year-end 1999 letter to shareholders, "we concentrated on avoiding the (currently large) potential for permanent loss of your capital." In a prescient moment, he quoted John K. Galbraith's observation on the 1929 market peak, "the end was at hand but was not in sight."

### ***What's the model? Safety lies in careful choices***

In 1991, I wrote a book, *Sense and Nonsense in Corporate Finance*, in which I set out several criteria for selecting fund managers. The secrets haven't changed. Funds should (a) hold no more than 20 stocks; (b) hold their stocks on average for at least two years; c) eat their own cooking, i.e., the managers should personally invest in the fund, and of course (d) invest on Graham-and-Dodd principles.<sup>21</sup> Goldfarb's ten funds come quite close to these strict guidelines.

**(a) *A limited number of stocks.*** The average domestic equity fund holds about 160 stocks,<sup>22</sup> suggesting a good reason for the common academic criticism that fund managers as a whole should not expect to outperform the market index. Owning half of all the outstanding shares, mutual funds as a group will inevitably mirror the index. And given their fee structures and substantial transaction costs, they must in fact do slightly worse.

The ten funds in the study held at year-end 2003 only 54 stocks on average, barely one-third as many as the typical fund, and even that number is inflated by the geographically diverse, large foreign stock holdings of two of them, First Eagle Global and Mutual Beacon. Seven of the ten had 34 stocks or less. Contrary to the advice of financial economists, investment advisers, and stock market writers, value funds seem convinced that safety lies in careful selection, not random diversification.

The huge bonus of a concentrated portfolio is that you can buy a large amount of what you really like. Munger likes to say that when you find a really good opportunity, "don't buy just a

little, back up the truck.”<sup>23</sup> At calendar year-end 2003, the top five stocks in Legg Mason’s portfolio accounted for 34% of the total. Others with concentrated top-five holdings included Longleaf Partners – 28%; Oakmark Select–40%. Thus value funds need only a few good ideas out of the roughly 2,000 stocks of sufficient size, that is, those with market capitalizations over \$1 billion. With so many choices, it’s easy, as our group of funds did, to steer clear of the red flags that were flying high at Enron.<sup>24</sup> Highly diversified funds needed a reason *not* to invest in Enron. Those in our group needed a reason *to* invest. This very different approach naturally led to different results.

### *34 or 500: Indexing*

So where does that leave indexing? It’s the obvious choice for the neoclassical economists who still believe in EMT, but its popularity doesn’t stop there. Shiller, for example, recommended indexing, so as to diversify away “all risks.”<sup>25</sup> To be sure, an investor would have done worse than the index, if he had put all his eggs in the “buy-and-forget” *Fortune 10*. (Better to forget than buy.) And indexing does avoid the management fees and other costs that afflict most mutual funds. But timing really matters. Markets are efficient much of the time, they’re efficient in the long run, but they’re not efficient *all of the time*. As Ben Graham said, in a now celebrated passage:

The market is not a *weighing machine* . . . [but rather] a *voting machine*, whereon countless individuals register choices which are the product partly of reason and partly of emotion.<sup>26</sup>

Measured in real dollars, stocks did not return to their 1929 level until 1958, and did not return to their 1966 level until 1992.<sup>27</sup> And indexers, far from escaping the *Fortune 10*, would have owned eight of them – all but the two foreign stocks, Nortel and Nokia – and lots more like those eight.

Underlying the insistence on indexing is an often casual assumption or hope that the irrationality – the overconfidence, trend chasing and the like – operate only during the easily discerned “market frenzies,” or worse yet that these emotional biases might be self-cancelling,

leaving the smart money in control.<sup>28</sup> This is wishful thinking, dangerous stuff that has seduced the public to have a lazy confidence that one need not bother with the arduous task of patient, thoughtful selection<sup>29</sup> – and has encouraged fund managers to cater to those impulses.

John Maynard Keynes, perhaps the earliest value investor of them all, summed it up neatly:

To suppose that safety-first consists in having a small gamble in a large number of different directions . . . as compared with a substantial stake in a company where one's information is adequate, strikes me as a travesty of investment policy.<sup>30</sup>

An efficient market, as a popular finance textbook said, has no illusions;<sup>31</sup> *buy the index*. Because the wisdom is already in the price, the EMT model thus has no predictive or analytic value. But then neither does the newer discipline of behavioral finance.<sup>32</sup> Its focus is on the mistakes of the investors who have been wrong, not the skills of those who are right. The behavioral patterns have been built up from studies of readily quantifiable errors, such as the fact that Royal Dutch and Shell Transport which own fixed portions – 60/40 – in one combined enterprise, often trade in their respective markets at prices that diverge sharply from the underlying economic values.<sup>33</sup> Lacking the inherently qualitative tools of Graham-and-Dodd investors, their skills lie in hindsight analysis; hence they, too, fall back on indexing.

Neither of these popular academic models –EMT or behavioral finance – would have enabled one to do what First Eagle Global and others of our group did so successfully in the early days of 2000, that is, selectively pick up the good values in old economy stocks even while staying far, far away from the *Fortune 10* and the like.

These concentrated portfolios reflect the oft-repeated tenet amongst value funds that they invest “bottom-up,”<sup>34</sup> company by company, with an almost insouciant disregard for macroeconomic trends, and utter disdain for the market predictions of the day. It is often said that

everything is difficult to predict – particularly the future. The value investor copes with this amorphous, unquantifiable uncertainty by focusing on what’s close at hand – a company’s products and market position, the quality of its management and their identification with shareholder interests, profit margins and balance sheets – rather than the prospects for global oil prices, war and peace, interest rate and currency fluctuations, and the like.

There is a note of humility – or is it humble arrogance? – as they remind investors of their insistence on staying within a narrow circle of their personal competence,<sup>35</sup> a phrase borrowed from Buffett. Bill Miller of Legg Mason Value likes to cite behavioral finance studies in commenting on market follies. And the scorn is palpable when he talks about the average portfolio manager’s mistakes, such as trying to forecast macroeconomic events, trading too much and, yes, owning too many stocks.<sup>36</sup>

*Sitting on cash is better than doing “something dumb”*

For a value investor who invests in companies one by one, what happens when prices are universally so high that they cannot find value, not even a few good companies selling at discounts to intrinsic value? Happily for our study, if not for some of these funds, the beginning of 2004 was just such a period. In the year-end 2003 report of Longleaf Partners, Mason Hawkins described an intensifying struggle – “little or no margin of safety exists in the prices of those businesses that meet our qualitative criteria.”<sup>37</sup> Tweedy Browne and Oakmark Select were saying much the same.<sup>38</sup>

Some of the funds were holding very large amounts of cash. In March 2000, even while the market generally was peaking, the presidents of First Eagle Global had cheerily noted that “so many stocks [were] below their ‘intrinsic’ value.”<sup>39</sup> Now, four years later, First Eagle Global was 22% in cash or equivalents, and the Clipper and FPA Capital funds were 32% and 37%, respectively. Not because they were predicting a *market* decline, but simply because they couldn’t find anything cheap.<sup>40</sup> The yield on Treasuries was pitifully small, but it was better than doing “something dumb.”<sup>41</sup> As Seth Klarman of the Baupost Group said in the year-end 2003

letter to his investors, his hedge funds were heavily invested in cash solely as a “result of a *bottom-up* [and failed] search for bargains.”<sup>42</sup> (Ital added)

It’s nothing new, of course. In 1987, as stocks soared in the months before the Crash, many Graham-and-Doddgers were doing just the same thing, holding fistfuls of Treasury bills.<sup>43</sup>

**(b) *Low portfolio turnover***

According to Morningstar, the average domestic equity fund held its stocks in 2003 for an average of ten months, equivalent to a turnover ratio of 121%. Of course, at a fund that likes to “back up the truck” from time to time, the turnover will be far less. Our group had average turnover in 2003 of only 20%, meaning that they were holding their stocks on average for five years.

These turnover figures speak volumes. The difference between taking momentary fliers and selecting long-term buys is the difference, truly, between speculation and investing. It is a commonplace of academic wisdom that information is costly and difficult to come by, so that investors, having learned something new and valuable about a company, quickly “arbitrage” – buy or sell – the stock so as to capture the new value.<sup>44</sup> Those five-year average holding periods, however, tells us that the funds are not looking to capture small differences between market price and value. Buffett put it succinctly, “You don’t try to buy businesses worth \$83 million for \$80 million.”<sup>45</sup> Writing to investors after the year 1999, Bill Nygren commented that Oakmark Select’s new Washington Mutual investment had in fact dropped in price. But the business results had been excellent, and he was there for the long pull, much as Graham would have advised.<sup>46</sup> At calendar year-end 2003, with earnings still growing and the stock up now, too, Washington Mutual had grown to 16% of the portfolio. And that’s just one of our sticky-fingered group of funds.

How costly could the information be? Anyone can discern the holdings on the Internet for free, and their portfolios don’t change that often. Oak Value’s website states flatly that in

value investing there are neither difficult formulas nor inside or otherwise non public information. Martin Whitman of Third Avenue Value Fund, too, says that the fund doesn't have superior information; "the trick" is to use the publicly available information in a superior manner.<sup>47</sup> Moreover, the funds' staffs are not large. For the first ten years of its 20-year existence, FPA Capital was managed solely by Rodriguez, and for the second ten by him and three associates. All the First Eagle funds – over \$10 billion in all – are managed with just six staff analysts. The information is easy (too easy) to come by. Using the information selectively, discriminating between the telling fact and the mind-numbing flow of daily statistics, is the trick.

Value funds don't just buy and hold, of course. Legg Mason sold the Nokia shares mentioned above, at almost the precise moment the *Fortune 10* list was being recommended for purchase. By then, according to *Fortune*, Nokia's price-earnings ratio had reached the stratospheric level of 75. Price-and-value. And margin of safety, which by then had evaporated for Nokia.

Implicit in their longer holding periods is the fact that value funds define risk as business risk – profit margins might shrink, the flow of new products might dry up – not the market fluctuation risk which has consumed so much scholarly attention. Twenty years ago, when Buffett did a fund study similar to this one, he noted that the managers of the nine funds in question never bothered to calculate the *beta* of their holdings, the *beta* being a statistical risk measurement based on a stock's short-term volatility.<sup>48</sup> Rodriguez of FPA Capital explained this to some Wharton students and professors in 2004, saying that because of his fund's tight investment concentration, he is able to define his investment time frame as three to five years. And thus he is "willing to accept greater portfolio volatility. . . ."<sup>49</sup> Or as Whitman put it, "the only risk that we ever guard against is [business] risk. . . . We absolutely *ignore* market risk."<sup>50</sup> (Ital in original) And the managers of the Tweedy Browne American fund almost chortle as they recite the results of a study some years ago which highlighted the fact that a group of highly successful value funds had underperformed the market *one year in three*.<sup>51</sup> They live comfortably

with the market's manic/depressive patterns; it's the long-term results that matter.

*(c) Eating your own cooking.* It is obvious that fund managers should invest significant dollars of their own in their funds, so as to align their personal interests with their investors'. And it's become even more obvious as the pervasive market-timing, late-trading and other abuses at mutual funds have come to light. But it's not just the blatant conflicts of interest that are troublesome. Management fee structures are out of line with their actual costs; according to Jack Bogle, former CEO of the Vanguard Group, mutual fund management fees total \$72 billion, of which less than 10% is spent on research.<sup>52</sup> Agency costs are what economists call the range of temptations for someone entrusted with other people's money. It's an inherent problem, but one that has gotten worse. Some fund families, such as Alliance, conceive of themselves as financial supermarkets for the masses, dicing their funds into ever smaller cubes, so as to harvest more investor dollars.<sup>53</sup> The sense of a fiduciary duty has dried up. I can recall a discussion some while back with the senior manager of a large, brokerage firm family of funds, in which he said quite candidly, he was not trying to achieve particularly good results, just not to look bad, just to stay with the crowd. It's that fear of tracking error, again.

A number of the ten funds have made a point of commenting on their partners' personal investments in the funds they manage – the ones I caught were Longleaf, Clipper, Oakmark Select, FPA Capital, and Tweedy Browne. One would think all mutual fund managers would do the same, but think again. (And we should know more about the size of those investments than we do.) It's not just that a manager should not allow market timing and the like.<sup>54</sup> By investing their personal dollars, they inevitably manage the fund with the acute interest in profit *and* the extreme aversion to loss that only someone with skin in the game will experience.

Several managers in our group have passed a further test of fiduciary duty, having closed their funds to new investors, rather than dilute the results for those already there. No manager bent on gathering assets would do that. Oakmark Select and FPA Capital are closed now, and

First Eagle Global has been closed in the past. Longleaf Partners recently closed its international fund, as did First Eagle its fund that is exclusively foreign.

Size impairs the object; it shrinks the number of companies with market capitalizations large enough to permit a fund to amass a significant position. It's not how much money you manage but how you succeed with what's there. Our small group seems to have latched onto that precept.

### **Graham and Dodd: Theme and Variations**

The philosophy of these Graham-and-Dodd, value investors reflects some of the same insights that underlie behavioral finance. Graham, for example, recognized that subjective factors and market prices influence not just speculators but also those committed to a purely investment program. A few excerpts may capture the spirit of it.

The merits of an issue reflect themselves in the market price not by any automatic response . . . but through the minds and decisions of buyers and sellers.<sup>55</sup>

One of your [business] partners, named Mr. Market, is very obliging, indeed. Every day he tells you what he thinks your interest is worth and . . . offers either to buy you out to sell you an additional interest on that basis. . . .Often . . .Mr. Market lets his enthusiasm or his fears run away with him, and the value he proposes seems . . . little short of silly.<sup>56</sup>

The margin of safety is the central concept of investment. A true margin of safety is one that can be demonstrated by figures, by persuasive reasoning, and by reference to a body of actual experience.<sup>57</sup>

While their philosophy is similar, the funds in our group apply it in quite different ways.

(Buffett came to the same conclusion in looking at his group of nine value funds twenty years ago.) Some focus on small and mid-cap stocks, others invest in large cap stocks. One of the group follows a highly quantitative approach, which closely echoes the techniques used by Graham. Thus the ratio of market price to book value, working capital, earnings, cash flow, revenues, are primary factors in defining value. Several of the funds look for value overseas as well as in the U.S. Another buys deep discount debt and does risk arbitrage.

At least one of the funds has moved much closer to the principles first enunciated by Philip Fisher in his celebrated “Common Stocks and Uncommon Values” in 1958.<sup>58</sup> He was contemptuous of the constant attempts to forecast economic and market trends. But for Fisher, value investing was more than a simple quantitative analysis, such as the price/earnings ratio, or price/book value ratio. Unlike Graham, whose approach had been forged in the dark years of the Great Depression, Fisher believed that value investors could succeed by finding growth companies at reasonable, if not cheap prices, and staying with them over time. The fact that a stock might sometimes seem overpriced, he wrote, needed to be considered in the context of its long-term business prospects and growth potential. In words much like those of Buffett and Munger at Berkshire Hathaway years later, “If the job has been correctly done when a common stock is purchased, the time to sell it is –almost never.”<sup>59</sup>

There are thus many roads to heaven -- many more than the easy quantitative tests, such as a low price/earnings ratio, that financial economists simplistically equate with value investing. For example, a company’s price/earnings ratio may indeed be attractive, but the quality of the earnings – meaning the free cash flows available to pay dividends, expand the business, and the like – might be poor. Or it might have, say, a strong balance sheet, perhaps even net current assets per share in excess of the stock price, but then again management gives signs of squandering resources on ill-conceived acquisitions. The qualitative, judgmental aspects of how value funds operate constitute huge obstacles for the mathematical modeling so favored by economists.

Some years ago, Bill Ruane of the Sequoia Fund ventured a guess that value investing accounted for about 5% of all professionally managed money. Given the growth of privately run hedge funds, Rodriguez thought that the 5% figure was still about right. Whatever the precise figure, it simply takes too much analytic effort and independence of spirit to appeal to more than a handful. While their techniques vary, however, the group of ten all stand on the common ground of patient, company by company analysis, always mindful that the stocks they are buying are part interests in a business.

### **Economic theory attributes far too big a role to value investors**

At the start, we noted that scholars believe the smart money keeps the market honest for the rest of us. They hypothesize that a band of rational investors assiduously buys underpriced stocks and avoids (or shorts) dear ones and thus keeps prices at reasonable levels.

The scholars never looked for these rational investors, but we did, and found a representative group. And yet, as we have seen, stock prices are often manifestly *irrational*. So the question remains: if Clipper and the rest of the group are, so to speak, doing the Lord's work (or at least the work of the Invisible Hand), why are there these monstrous bubbles, crashes, and so forth?

For reasons that are familiar by now, value investors are not remotely up to the task of keeping the market prices of \$10 trillion or more of stocks in line with intrinsic values. Let me briefly summarize:

–not only do value investors account for but a small part of the market, but there are some almost perverse factors keeping them small. When value investing is in vogue, they are tempted to close a fund (“or two, or three. . .” as First Eagle recently intimated) to new investors, and when they are sorely out of step with the prevailing mood, as happened in

the late '90s, they seem content to see their pool of assets shrink, rather than abandon their principles.

–for stocks that are priced too high, hedge funds may sell short, but mutual funds rarely do. Instead, many of them sit on their hands, holding a bundle of cash, as some are doing even now. Not much help for the market from here.

–for stocks that are priced too low – ah, now we're talking, but only if the market price is at a deep discount to the intrinsic value. This group is very, very picky. Think of Ted Williams waiting for a pitch he can hit on the sweet spot. When economists speak of arbitraging price differentials, they are often referring to modest discounts that would not remotely tempt investors who have been disciplined to buy only when it's a very fat pitch. It's that margin of safety.

–underlying all of this is the snail's pace of their trading, only about one-sixth that of the average mutual fund. What the economic model requires is red-blooded activists, and these patient value investors operate on an altogether different tempo.

–finally, and not least, value fund managers need investors who share their investment philosophy and are not distracted by the inevitable tracking errors or the mind numbing chatter on CNBC. Scholars like to dwell on the fact that the individual investor tends to be an uninformed trend follower, but an equally intractable problem is the CFO who hires vast numbers of managers and advisers to deflect any potential criticism of the near-term performance of the corporate pension plans.

### **Where do we go from here?**

The younger, behavioral finance academics have convincingly demonstrated that perverse psychological and emotional factors often distort how investors and markets function. What scholars have not done, *any of them*, is to look at the positive side of the process, to see how value

investors operate and the severe limitations on their ability to achieve that cherished goal of an efficient market. What scholars should not now do is fall back on that tired cliché that if you put 1,000 monkeys in front of a dart board, ten or twenty will hit the bulls-eye. We're talking about a group of investors who, because of their common philosophy, their selectivity, knew enough to steer clear of Enron and the like and to find deep values. They should be seen as a challenging group. After all, value investors are precisely the rational folk who people the economic models; and paradoxically, their very success casts a long shadow on the classical model. Take a look.

More importantly, for the investing public the lesson is that there is simply no escape from the need to think hard about what to do with those savings and retirement accounts. EMT may have eliminated some risks, but like any too simple solution it creates others, as those now poorer retirees and other investors have discovered. Think about the fact that turnover on the New York Stock Exchange has soared in recent years. Does this spinning suggest that perhaps an indexer is simply riding piggyback on the uninformed whims of the crowd and that the risks are still very much with us? Stocks are not *always* a good buy. And, listen, what is the public getting for that \$72 billion in mutual fund management fees, if it's so largely a game of musical chairs? And yes, let's take another look at the financial advisers who try to look useful by rotating client monies on one day from here to there, and then the next . . . to God knows where. Listen, it's your money.

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1. Sebastian Junger, “The Perfect Storm,” 130 (Harper Paperback 1998).

2 See, e.g., Paul A. Samuelson, *Proof That Properly Anticipated Prices Fluctuate Randomly*, 6 *Indus Mgmt Rev.* 41, 48 (1965); Eugene Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 *J. Fin.* 383, 392 (1970)

3 For an overview of the literature and cogent dissent from EMT, see Lynn A. Stout, *The Mechanisms of Market Inefficiency: An Introduction to the New Finance*, 28 *J. Corp. Law* (2003) 636.

4 Robert J. Shiller, *Irrational Exuberance* (2000) (“Irrational”) 5-12; see generally Roger Lowenstein, *Origins of the Crash* (Penguin 2004) (“Origins”).

5 See this author’s “A Perfect Storm: Changing a Culture,” *Swedish Corp. Gov. Forum*, Dec. 2003.

6 Ronald J. Gilson & Reinier Kraakman, *The Mechanisms of Market Efficiency Twenty Years Later: The Hindsight Bias*, 28 *J. Corp. Law* (2003) (“MOME”) 715, 739 (and papers cited).

7 Nicholas Barberis & Richard Thaler, *A Survey of Behavioral Finance*, in *Handbook of the Economics of Finance* (Geo. Constantinides, Milt Harris & Rene Stolz eds., 2003) [“Survey”]1051, 1055.

8 “Irrational,” *supra*, at 215, 231; Fox, *Is the Market Rational?* *Fortune* Dec. 9, 2002, 116, 126 (Shiller and Thaler advise investors to diversify completely); cf. Choper, Coffee, & Gilson, “Cases and Materials on Corporations” 6<sup>th</sup> ed. (Aspen 2004) 191.

9 See, e.g., Charles M.C. Lee, Andrei Shleifer, & Richard H. Thaler, *Investor Sentiment and the Closed-End Fund Puzzle*, 46 *J. Finance* (1991) 75, 80-81 and materials cited.

10 Alon Brav & J.B. Heaton, *Market Indeterminacy*, *J. Corp. Law* (2003) 517, 534 (n.66) (ital in original).

11 See, e.g., MOME, *supra*, at 737-9.

12. Goldfarb suggested either of Mutual Shares or Beacon, both managed by the same person, and I arbitrarily chose the one with the slightly larger equity concentration. Two weeks later, he

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reaffirmed the ten-fund list. The author's son Roger Lowenstein is on the board of directors of Sequoia, and at the time, family members owned shares of Sequoia and Oakmark Select.

13 Robert Rodriguez, *Discipline* (Wharton School speech, Feb. 23, 2004) ("*Discipline*"), 2; see also Warren E. Buffett, *The Superinvestors of Graham & Doddsville*, 11 *Hermes* (Columbia Bus. School, Fall 1984) 4.

14 See, e.g., First Eagle Funds Prospectus, March 1, 2004, at 3; Longleaf Partners Fund Annual Report, Dec. 31, 1999, at 11. Buffett reminds investors in each annual report that while intrinsic value can be defined simply – it's the discounted free cash flows --the calculation is anything but simple. Berkshire Hathaway 2003 Annual Report, 73.

15 David Rynecki, *10 Stocks to Last the Decade*, *Fortune*, Aug. 14, 2000, 114.

16 *Origins*, *supra*, at 166.

17 Clipper Fund, annual report, Dec. 31, 2003, at 2.

18 *Ibid.*

19 Shiller, *supra*, at 245.

20 The Morgan Stanley Capital International index, which is a relevant yardstick for First Eagle Global and Mutual Beacon, showed negative average annual returns of 0.77%, almost precisely the showing of the S&P 500.

21 *Sense & Nonsense in Corporate Finance* (Addison-Wesley, 1991) 234-8.

22 Paul J. Lim, "Investors Do Not Try This At Home," *NY Times*, March 14, 2004, Sec. 3, p.1, col. 2 (169 stocks in average domestic stock fund).

23 Rodriguez, *Discipline*, *supra*, at 4.

24 See Marianne M. Jennings, "A Primer on Enron: Lessons from *A Perfect Storm* of Financial Reporting, Corporate Governance and Ethical Culture Failures," 39 *Cal. West. Law Rev.* (2003) 163, 176 (company burning through cash, very low returns on equity, etc.); see also Anthony H. Catanach, Jr. & Shelley Rhoades-Catanach, *Enron: A Financial Reporting Failure*, 48 *Vill. L. Rev.* 1057.

25 Shiller, *supra*, at 215, 231.

26 Benjamin Graham and David L. Dodd, *Security Analysis* (1<sup>st</sup> ed. 1934), 23.

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27 Shiller, *supra*, at 9-12.

28 MOME, *supra*, at 725, 731-2; Mark Rubinstein, *Rational Market: Yes or No? The "Affirmative Case,"* 57 *Fin. An. J.* (May/June 2001) 15.

29 Shiller, *supra*, at 173-4 (EMT implies the smartest people will not be able to do better than the least intelligent; one might as well pick stocks at random).

30 XII *The Collected Writings of John Maynard Keynes* 82 (Donald Moggridge. ed., 1983).

31 Brealey & Myers, *Principles of Corporate Finance* (6<sup>th</sup> ed. 2000) 372.

32 Stout, *Mechanisms*, *supra*, at 664; Brav & Heaton, *supra*, at 518-9.

33 Survey, *supra*, at 1059-61.

34 See, e.g., *Discipline*, *supra*, at 5.

35 James Gipson, *Outstanding Inv. Digest ("Outstanding")*, April 30, 2004, at 46 (responding to an investor query about currency plays); see also Seth A. Klarman, Baupost 2003 Year end Letter, Jan. 23, 2004, @12 (Baupost is a value-oriented hedge fund); Berkshire Hathaway 2003 Annual Report, @21 (when there's nothing exciting in which to invest, our "default" position is U.S. Treasuries.)

36 Legg Mason Value Trust, 2003 Annual Report, May 5, 2003, at 6, 14.

37 Longleaf Partners Fund, Annual Report at Dec. 31, 2003, at 1. The fund's cash and equivalents were over 15% of total assets.

38 Tweedy, Browne Investment Adviser's Report, March 31, 2004, at 7; Oakmark Funds, Prospectus dated 1/31/04, p. 1.

39 First Eagle Global annual report, March 31, 2000, at 1.

40 *Outstanding*, *supra*, at 44, 64; *Discipline*, *supra*, at 6; see Gregg Wolper, "Why Legendary Investors Are Drowning in Cash," Mar. 25, 2004, Morningstar.com..

41 James Gipson, Michael Sandler, et al., Clipper Fund letter to shareholders, April 2, 2004 (reported in *Outstanding*, *supra*, at 64). See also Charles de Vaulx, First Eagle Funds, comment at Mar. 31, 2004 annual meeting, *Outstanding*, at 64 ("everything out there – is quite pricey"). The

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funds were not shorting stocks, because as one of them said to me, the gains are limited and the losses might be severe. Cf. MOME, *supra*, at 726-9, 738. Query, whether the recent SEC relaxation of the rules governing shorts will have much of an impact.

42 Baupost, *supra*, at 14.

43 This author's "What's Wrong With Wall Street" (1988) 35.

44 See, e.g., MOME, *supra*; "Hedge Funds: From alpha to omega," *The Economist*, July 17, 2004, p. 69 (hedge funds trade heavily to arbitrage between markets or individual securities).

45 Buffett, *Superinvestors*, *supra*, at 8.

46 Benjamin Graham, *The Intelligent Investor* (Harper, 1973, 4<sup>th</sup> rev. ed.) 87-8.

47 *Outstanding*, *supra*, at 15.

48 Buffett, *Superinvestors*, *supra*, at 13-4.

49 *Discipline*, *supra*, at 3-4.

50 *Outstanding*, *supra*, at 16.

51 Tweedy Browne Co., *10 Ways To Beat an Index* (1998), 7.

52 "Mutual Funds: The 'Other' Big Scandal," *Consumer Reports*, March 2004, at 12.

53 Roger Lowenstein, "Unconventional Wisdom: The Wrong Diagnosis," *Smart Money*, March 2004, at 50, 51.

54 One of the ten funds, Mutual Beacon, has reported a SEC staff recommendation to the Commission with respect to alleged market timing involving an affiliate of the fund's adviser, but not implicating the Mutual group.

55 *Security Analysis*, *supra*, 2, 13.

56 *The Intelligent Investor*, *supra*, at 108.

57 *Id.* at 277, 283.

58 Philip Fisher, *Common Stocks and Uncommon Profits* (Harper & Row, 1960, rev'd ed.)

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59 Id. at 91.