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Thoughts on investing - scale and skill in active management

Angela Ashton | PortfolioConstruction Forum | 17 March 2014

"Some thoughts on investing", by Warren Buffett, Berkshire Hathaway 2013 Annual Report, 1 March 2014

The Berkshire Hathaway Annual Report is always eagerly awaited, with Chairman Warren Buffett the closest thing to a Messiah that the financial industry has.

In amongst the financials and the discussion on various businesses owned by Berkshire Hathaway, the report features a piece by Buffett titled "Some Thoughts about Investing" (p17) in which he produces a memo he wrote nearly 40 years ago (p118). Both are worthy of a attention.

In the former, Buffett discusses two "instructive" small investments he has made over the years.

The first was a farm near Omaha, purchased in 1986 from FDIC (the US government corporation responsible for guaranteeing bank deposits and managing banks in receivership - this was a fire sale). Although he knew nothing about farming, his son was passionate on the subject. With his son's help, he worked out that the property's normalised return was about 10% per annum.

The second was in 1993, when a small group of investors bought a retail property near New York University. It was bought from Resolution Trust Corp, a company set up to sell assets of failed savings institutions after the S&L collapses of the early 1990s (another fire sale). The property was poorly managed and under-leased.

Both now provide income that is significant in comparison to their original purchase prices.

Buffett draws the following conclusions:

- Focus on the future productivity of assets or businesses, rather than potential short-term price changes;
- Macro and market opinions are a waste of time. These two investments were made in

periods where there was significant economic uncertainty (just before 1987 and 1994), but corn keeps growing in Nebraska and students keep going to NYU. So you should look through the short-term noise.

- Constantly changing valuations provided by liquidity should be ignored. They are not an invitation to do something. You should buy assets for the long term and put them in the bottom drawer.
- Only invest in your "circle of competence". Leave the rest to others.

Towards the end of this Annual Report, Buffett reprinted a "Memorandum Regarding Pitfalls of Pension Promises" dated October 1975. This is fascinating in a number of aspects - these pension plans remain a significant issue for many companies in the US today (and caused all sorts of problems through the GFC). Although very informative (and well worth reading), it's Buffett's comments on pension plan investment management that are much more pertinent. His thoughts are these three gems (remember, it was 1975!):

- Most fund managers will not outperform - it is a zero sum game;
- High turnover rates in funds reduces group performance significantly;
- There are some skilled managers but it is hard to discern skill from luck;
- It is virtually certain that above-average performance cannot be maintained with large sums of managed money;
- Large conventional managers can be retained. They are likely to underperform but there is little risk of anyone being sued for making a stupid decision;
- Index management should be considered;
- Find small managers with skill and hope no-one else does;
- A fixed income strategy can be followed (when interest rates allow it - effectively meaning liabilities should be immunised if possible); and,
- An unconventional approach might be considered - treat portfolio management like business acquisition decisions. That is, buy good companies and sell them when valuations are very high. This differs to standard investment management through a 'matter of attitude', with long time frames being part of the mandate.

Obviously, there is a lot more in this year's Berkshire Hathaway Annual Report. And

Buffett is a much better writer than I am, so it's worth your time to read his words!

Read the Berkshire Hathaway 2013 Annual Report

A recently published academic paper confirms at least some of these observations[1]. In "Scale and Skill in Active Management", authors Lubos Pastor (NBER), Robert Stambaugh (NBER), and Lucian Taylor (Wharton School) examine the nature of returns to scale in active funds management. They find "strong evidence of decreasing returns at the industry level" (i.e. that the industry as a whole is not performing as well as it used to now that it has become so large) although evidence at the fund level was more mixed. They also find that while the active management industry has become more skilled over time, performance deteriorates over a typical fund's lifetime - that is, newer funds generally outperform. It's not an easy read - but the introduction and results are unquestionably valuable, if not definitive.

Read "Scale and Skill in Active Management"

1. Hat tip to Australian Fund Monitors.