

A Tougher Game, and Perhaps Even a New Game

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Lengthy bull markets, especially when they have spread far and wide, tend to create challenges for our investing approach. For one, it usually becomes increasingly difficult to find new investments selling for prices that I find attractive. And while we may still get adequate returns—from sticking with investments that were bought when prices were more attractive—modest outperformance relative to the indexes, and perhaps keeping pace with Berkshire, is the best we can hope for. Let's consider a few parameters to see why this is true:

I'd estimate that our current investments—in aggregate and on average—are likely to increase in value by about 8% annually over the next 10 years. And given that my estimate for the S&P 500 and TSX is closer to 6%, this would be no small achievement. Furthermore, an 8% return for the partnership means 7.5% net to you (or at best 7.75%, where the lower allocation applies), so any potential outperformance would be limited. And in the case of Berkshire, which I estimate will average about 9%, we would almost certainly underperform.

(FYI: Since SA's inception on September 1st of 1999, the S&P 500 and Berkshire have returned 5.9% and 8.7% respectfully, compounded annually and as measured in U.S. dollars.)

The only way we can avoid that fate is to find more rewarding opportunities. The good news is that we tend to bet big, so we don't need many. But we do need a few, and the last 5 years has been my longest dry spell, by far. Let's look at how this could impact our results.

First imagine an investing environment where we could, on average, do the following: turn-over what we own every 3 years; buy at 50% of intrinsic value; have what we own increase in value by 8% annually; and then sell at 90% of value. The happy outcome of all those dreams coming true would be a Buffett like return of 31%.

Now let's envision a world where Buffett groupies (takes one to know one) have spanned the globe, all doing their best to follow his lead. In that end-of-days scenario, opportunities are likely to be much harder to find; and turning our holdings over every 10 years, buying at 66% of value and selling for the same 90% may be the best we could hope for. The outcome, while not terrible, would be a much more pedestrian 11% annualized return, with most of the return (8 out of 11) coming from growth in the value of the businesses. As for my contribution, well, at least the mail wouldn't pile up as much.

Interestingly, in both instances we are working with the same material (equities providing an 8% tailwind). And while maintaining either one of the two elements (buying at 50 vs 66% of value, or three vs ten year holding periods) increases the returns, the real magic happens when you are lucky enough to get both.

Sadly, today's world feels a lot more like the latter than the former or when SA got started. Back then, the cohort making the trip to Omaha each year was smaller and for a short time, may have even been shrinking. And while we can always hope for some type of event that

brings back the glory days, I fear the odds are no better than those of our Northern PM passing on a photo-op. So we should adjust our expectations to what is likely our new reality: a world where competition has increased, such that an 11% return may be just as much of an accomplishment, as 31% used to be. (Search: The Paradox of Skill by Michael Mauboussin for a better explanation).

This also explains why I have lowered my investment goal—but still, by no means promise—to beating the S&P 500 and TSX by 6% and Berkshire by 3%. If, and that is a big if, we are able to do so and my expectations for their returns are correct, then your net returns would come in at 10.5% and still manage to outperform all three. Wish us luck.

Perhaps a New Game

Value investing, as a discipline, got its start thanks to Ben Graham. His approach focused primarily on buying at large discounts to value, with less regard for the quality of the businesses themselves. Buffett spent several years following Graham's lead but then, in part based on necessity, he evolved, with quality becoming a much more important factor.

It is this second version, call it value investing 2.0, that we have practiced over the last 18+ years. And unlike Buffett, we have never had to adapt in order to succeed. That may no longer be the case.

Hyped up industries (think pot stocks) or even activities that deserve a less flattering moniker (cryptocurrencies) are nothing new and all just seem a bit dopey to me. But an approach to both running and investing in companies that appears to be working and is growing in popularity, has me feeling, for the first time, out of touch.

Ironically, this approach has managers and investors focusing on building and investing in businesses over the long term—something I have often cheered and said we are trying to do ourselves. But when the hoped for profits are stretched out in to an indefinite future, well that is when my resolve is tested. Yet, some of today's leading and most beloved companies are pursuing just such an approach. And success spreads, as a number of smaller, less well known firms are following their lead.

In terms of sales and market share many of these firms have been widely successful, as have their shareholders. And in some cases these firms may well establish sustainable, dominant and profitable positions. But as far as I can tell, even if they can, in most cases this is more than baked in to their current stock prices.

On the other hand, it could also be that my skills are outdated and some new way of evaluating companies is required (version 3.0?). For now I am still hopeful, but if it becomes clear the game has indeed passed me by, your money will be returned.