

# T H E L O N G V I E W

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## *Focusing on the Long Run*

What is the hardest part of successful investing? At Manitou, we think it may be the discipline of focusing on the long run.

Taking a long term view of one's investments sounds like it should be easy. But in fact it is extremely difficult – because human beings are hardwired to think short term.

We see this all the time. Depending upon whether our favourite NHL team has won or lost the last six games in a long season, we predict they will be in the Stanley Cup finals or miss the playoffs altogether. If we experience two cold weeks in July or two warm weeks in January, we suspect that the weather patterns have permanently changed. And the media feeds on this bias. Readers of the Globe and Mail Report on Business are treated each Saturday to a “Stars and Dogs” section which dubs the management of five companies as either geniuses or dunces, *based on the performance of the stock over the past week.*

## *Behavioural Economics*

How and why do people think short term and otherwise make illogical decisions when they spend or invest money? A relatively new academic discipline, usually called behavioural finance or behavioural economics, is dedicated to this question.

Traditional economic theory (expected utility theory) envisioned humans as highly rational, consistent and self-interested beings who act to maximize their financial wealth. You don't have to think about this for long before you realize that very few people are uniformly rational or consistent in their financial decisions.

About 40 years ago psychologists began to conduct research into how people behave in the real world. The pioneers, who first described how human beings display sub-optimal economic behaviour, were Nobel laureate Daniel Kahneman and his colleague, Amos Tversky. They and their successors have been able to identify instinctive mental habits that most people fall back on – often to their disadvantage.

For example, in their daily life people have trouble estimating the probability of an event. Most people tend to focus on the *imagined impact* of the event rather than its likelihood. This leads to expenditures on items such as lottery tickets and accidental death insurance sold in airports.

Research has shown that people are more negatively affected by a financial loss than they are positively affected by a financial gain of the same magnitude. The consequent focus on short term loss aversion explains, in part, why many people instinctively prefer to invest in bonds rather than stocks. Given the historical after-tax returns from these two asset classes, this has usually proven to be an expensive error.

People also tend to focus more on the immediate than on the important, and to instinctively follow the crowd. Studies have shown that investors who tune out the majority of financial news fare better than those who subject themselves to an endless stream of information, most of it meaningless. In part this is because the tuned-out investor is less likely to react emotionally to the short term fluctuations in the securities markets.

### *Evolution Explains Everything*

Perhaps our non-rational behaviour can be explained by our evolutionary history.

Our brains are built to allow us to survive in a world far different from the world of today. Evolution happens slowly, and the environment for which humans have developed is not the one in which we now find ourselves. We have evolved as a separate species over 130,000 years. For more than 98% of that time, we lived as hunter-gatherers. And the way our minds work today probably reflects that fact.

Hunter-gatherers have no need to spend a lot of time looking far into the future or calculating the probability of an event. Moving around in tribes to find

one's next meal (short-term reward) ranks as a high priority. And loss aversion is a useful survival instinct.

Given our evolutionary background, it's not surprising to discover that we still naturally focus on the immediate, fear short term loss, are inclined to follow the crowd, and instinctively believe that activity, in and of itself, is likely to produce returns. For an investor, however, this approach is highly counter-productive.

Most investors prefer buying a stock that is currently moving up because they believe they will, in the short run, be able to sell it to someone else at a higher price. They don't spend much time thinking about holding the investment for five years or more. That is beyond their mental horizon.

Over time, the result of this short term approach is almost always unhappy. The purchase of fashionable companies (i.e. companies that are expensive relative to their earnings) has proven, over and over, to lead to subpar returns. And the high portfolio turnover which results from short term thinking increases both trading costs and the effective average tax rate payable on capital gains.

#### *What Would Darwin Make of Warren Buffett?*

The prevalence of short-term thinking clearly presents an opportunity for investors who can think and act with a long-term perspective. Warren Buffett comes to mind. By looking farther into the future, Buffett has, over the past 50 years, outperformed all other investors.

How does Buffett approach investing? In his letters to Berkshire Hathaway shareholders, he has laid out his method in a remarkably straight-forward manner. It can be boiled down to a few simple rules:

- Confine your universe of possible investments to understandable and predictable businesses having both strong economic prospects over the long term and effective, owner-oriented managers.
- Buy shares only when the company is trading for less than the present value of its likely future cash flow.
- Don't own too many companies.
- Understand the advantage of owning a company for the long run.

The premise underlying each of these rules is that successful investors must take a long term view and exercise patience.

Let's examine each of Buffett's points.

### *High Quality Companies*

Buffett confines his investments to understandable businesses with a sustainable competitive advantage – what he calls a moat. The moat can take a number of forms including brand strength (eg. American Express), operating within an oligopoly (eg. Canadian banks), superior know-how (eg. Progressive Corporation) or a higher quality product or service (eg. Walgreens). Often the moat is maintained through a deeply ingrained corporate culture. Ideally the company will widen and deepen its moat over time.

As it is almost impossible for a company which produces commodities to maintain a competitive advantage over time, Buffett avoids natural resource businesses (eg. energy producers, mining companies etc.) This has hurt his relative returns over the past three years, but over the long haul it has helped them greatly.

Highly effective leaders are obviously an advantage to any company. Equally important is that the company have managers who think like long term owners. In cases such as Leon's Furniture or Mullen Group, the managers and their families are owners of a significant piece of the company. In others, managers make decisions with the long-term interest of the owners in mind. When a company such as IGM Financial or Great-West Lifeco is controlled by highly competent owners such as the Desmarais family, everyone knows that management will be mindful of the long term interest of the shareholders.

### *Applying a Value Discipline*

Even the highest quality company can be priced so high that it would make a poor investment. At Manitou, we recognize that any business, public or private, is worth only what you can take out of it. In other words, the economic value of the business is simply the present value of its future free cash flow. Without getting into the mathematics of this calculation, most of the economic value comes from the free cash flow more than five years in the future. So a key part of value investing is identifying not just excellent, but highly

predictable, businesses that can be counted on to increase their cash flow at above average rates for many years to come.

As the long term earnings of cutting-edge technology businesses are unpredictable, no one can estimate their economic value with confidence. Consequently, Buffett avoids this type of business. This hurt his relative performance in the late 1990s, but, over time, has improved it.

At any time, the stock market may significantly overprice or underprice a company. (Think of Nortel trading at \$122 or Mullen Group trading at \$7 – both seven years ago.) Consequently it is possible, from time to time, to buy a piece of a company for substantially less than its economic value. Value investors wait patiently for just such an opportunity.

### *Intelligent Concentration*

Investors who confine their investments to 15 or 20 high quality companies in a variety of sectors should incur less risk than they would with a widely diversified portfolio. Setting the bar high in terms of both the quality of the company and the price to be paid increases the chance of a successful investment. Intelligent concentration also permits the investor to get to know each investment well.

### *Buy and Hold*

If investments are confined to the highest quality companies, they can be held for the long run. Time will further increase the informational edge that accrues to those with a concentrated portfolio.

A much underestimated additional advantage for investors who hold companies for the long run is that the payment of capital gains tax can be deferred. Unlike pension funds, individual investors live in an after-tax world. Postponing the payment of capital gains tax allows the investment to compound on a before-tax basis. This substantially increases investment returns. An investment that grows at 10% per annum for 50 years increases more than one hundredfold.

### *Seeing Further*

Although the choppy waves of market turbulence will periodically be with us, they are much less important than the deeper economic currents.

Ultimately, investment success will belong to those who can break the pattern of short-term thinking, and identify companies that will flourish over the very long run.

What types of business are likely to survive and prosper over the next several decades? We are confident that banks, insurance companies and pharmacies will continue to produce growing profits 50 years from now. And we expect that excellent companies like the Toronto-Dominion Bank, Great-West Lifeco, Progressive Corporation and Walgreens will continue to outperform for many years to come.