Wisdom pays off

The Warren Buffett approach stands the test of time, writes Roger Montgomery

AS THE MARKET IS STILL LYING in that middle ground – between science and superstition, and between the pit of man's fears and the summit of his knowledge[1] – I was inspired to ensure our compass was indeed pointing in the right direction. So I turned to a letter written in 1975 by Warren Buffett to Katharine Graham, who at the time was the chairman of *The Washington Post*.

But before I highlight the enduring beneficial guidance to investors provided by that letter, I want to go back to the future.

Last year, Amazon founder Jeff Bezos paid $US250 million to buy the *Post*. Often there's a sting in the tail when purchasing US companies because they run their own pension plans and, unlike super funds in Australia or 401(k) plans in the US, such employers promise or guarantee their employees a certain retirement benefit. Of course, in many instances the necessary returns couldn't be sustained and an unfunded liability formed.

Buffett has been criticising pension managers for decades. In the 1975 letter he warned: "There probably is more managerial ignorance on pension costs than any other cost item of remotely similar magnitude. And, as will become so expensively clear to citizens in future decades, there has been even greater electorate ignorance of governmental pension costs."

The GFC has left many companies, as well as state and local governments, struggling to meet their financial obligations to retirees. For example, Detroit cited a $US3.9 billion deficit in its pensions when it filed for bankruptcy 12 months ago, and pension and retiree healthcare liabilities made up half the city's $US18 billion debt.

Earlier this year, Buffett was again pointing out the issues associated with guaranteeing pension plan benefits: "During the next decade, you will read a lot of news – bad news – about public pension plans."

So what does this have to do with you? At the very same time that most pension plans in the US are struggling, the *Post* has $US1 billion more than it needs. Not all of it will go to Bezos, however – he'll receive $US333 million for the new newspaper company's pension fund, which the *Post's* current chairman, Don Graham, says is $US50 million more than Bezos needs to meet his current obligations.

What's really amazing is a report that Don Graham believes there are two words that explain why the *Post's* pension plan is unlike any other: Warren Buffett.

In the letter Buffett wrote in 1975 to Katharine Graham, he proposed a method and attitude for managing the company's pension fund. It was unconventional but,

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as promised, it produced a long-term result that has separated it from almost all other US corporate pension funds.

What is perhaps more valuable, however, is that you can apply Buffett's advice to your own investing, and likewise it too should produce long-term outperformance.

After looking at various possible models for managing the portfolio, he came to his final option – the one toward which he leaned. First, he observed that he differed more in attitude than anything else. It involved treating portfolio management decisions much like business acquisition decisions by corporate managers.

He noted that over the long run, the returns to purchasers of entire businesses, or of smaller positions through stocks, will be similar and will approximate the economic results of the business.

He also noted four disadvantages that emerge from buying stocks. They were: 1) there is no right to manage or select managers; 2) there is no right to decide how much of the profits are distributed nor where they are reinvested; 3) the ability to borrow against the business assets is absent and; 4) the opportunity to sell the business on a full-value, private-owner basis is forfeited.

But then he noted a benefit that arguably offset the disadvantages; it related to the "periodic tendency of stockmarkets to experience excesses which cause the businesses – when changing hands in small pieces through stock transactions – to sell at prices significantly above privately determined, negotiated values".

Stock prices in the short run are invariably determined by popularity, fads and fashions. The nature of its participants will always ensure short-term market prices reflect their bipolar disposition, gyrating wildly at times. But provided a reasonable estimation of the internal performance of a group of businesses is determined and a price that is less than their private-owner value is paid, the impact of a single mistake can be mitigated and a good return over the very long run can be achieved.

The major difference compared with the conventional approach to stock portfolio management, however, remains one of attitude. The results of the businesses owned become the standard against which the investor measures – not the weekly, monthly or quarterly stock price.

[1]Apologies to Rod Serling, the author of *The Twilight Zone*.

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