The Sage of Omaha has very few true disciples

By Steve Johnson

The Financial Times Ltd 2014

March 16, 2014

©Bloomberg

Warren Buffett has shown it is possible to consistently outperform the benchmark, but very few active managers have managed to replicate his success

Legendary investor Warren Buffett handed out some disarmingly simple advice in his 49th Berkshire Hathaway annual report earlier this month.

The Sage of Omaha said the instructions laid out in his will advised his wife to invest 90 per cent of the money she inherits in a low-cost S&P 500 index tracker, and the other 10 per cent in short-term government bonds.

Many industry commentators will nod sagely in approval. Study after study has shown that very few active fund managers outperform their benchmark over any meaningful period of time, and those that do are invariably difficult to predict in advance.

And yet Mr Buffett himself has shown it is humanly possible to consistently outperform. A dollar invested in Berkshire Hathaway in 1965, when Mr Buffett settled into the hot seat, would have grown to more than $6,000 today, compared with around $100 if it had been invested in the S&P 500.

Cynics will argue that Mr Buffett is a one-off, and anyway it is very difficult for other investors to replicate his strategy, which centres on buying up companies outright to create a sprawling conglomerate.

But there does appear to be a small coterie of asset managers – many of whom openly admit to being disciples of the wit and wisdom of Mr Buffett – that hint that it may be possible to outperform consistently.

Houses such as Lindsell Train, Fundsmith, Unicorn Asset Management and Smead Capital Management have all produced solid, market-beating returns.

They have much in common. None manages more than £2bn across their fund range, and they all favour long-term, low turnover investment strategies focused on building concentrated portfolios of cheaply valued stocks, combined with a healthy disregard for benchmarks.

"We are great devotees of Warren Buffett," says Nick Train, a co-founder and fund manager at London-based Lindsell Train Investment Management. "He says, 'Find a great business, invest in it when it's undervalued and then own it forever'.

"It is our belief that other investors do a poor job in ascribing full strategic value to outstanding business franchises. We think great companies are undervalued by most investors most of the time and we think we can exploit that undervaluation by owning great business for the long haul," says Mr Train, a 30-year market veteran.

Lindsell Train's portfolios are concentrated, typically with 20-35 stocks, sport a higher dividend yield than the wider market and have low levels of turnover.

This cocktail has produced some potent gains. As of January 31, the house's £800m UK Equity fund had returned 140.4 per cent since launch in 2006, against 52.6 per cent for the FTSE All-Share index, which it has consistently outperformed for at least the past five calendar years.

If anything, Fundsmith, the company founded by Terry Smith, the no-nonsense chief executive of broker Tullett Prebon, in 2010 takes many of these concepts still further.

Mr Smith rails against the "broken" fund management industry, accusing it of foisting "punitive fee structures, over complexity, fund proliferation, closet indexing, over diversification and overtrading" on innocent investors.

As for the last of these, Mr Smith's £1.7bn Equity fund had a portfolio turnover rate of just 0.18 per cent in its most recent six-monthly reporting period, virtually eliminating trading costs and the pernicious effect of bid-offer spreads.

Mr Smith suggests that if Sir Isaac Newton, who apparently "lost a bundle" in the South Sea bubble of 1720, had discovered a fourth law of motion it would be that "for investors as a whole, returns decrease as motion increases".

Fundsmith seeks out businesses that can sustain a high return on capital employed, have advantages that are difficult to replicate, and do not use significant leverage. Longevity is also favoured; the 25 stocks currently in the portfolio have an average founding date of 1901, despite including Microsoft, the technology company, and Domino's Pizza. Since launch in November 2010, the fund has returned 62.3 per cent, against 40.4 per cent for the MSCI World index, which it has outperformed (if only marginally) in every full calendar year.

Unicorn Asset Management is another boutique focused on long-term, low turnover investment, targeting companies with predictable earnings and high returns on capital.

The proof of this pudding looks fairly unequivocal. Unicorn's UK Income fund is first out of 57 funds in its sector since launch in 2004, according to figures from Financial Express, with a return of 255.7 per cent (versus 114.2 per cent for the sector).

Its Outstanding British Companies fund also lives up to its name, sitting fifth out of 232 funds since launch in late 2006 (128.6 per cent versus 41.3 per cent) and its Free Spirit fund is second out of 153 funds since its debut in 2002 (345.9 per cent versus 113.4 per cent). All three funds have also been less volatile than the FTSE All-Share index, yet the latter two remain tiny, with around £25m of assets apiece.

William Smead, chief executive and chief investment officer of Seattle-based Smead Capital Management, does not view Mr Buffett's comments as endorsing passive funds over active management, but rather as an argument in favour of long-term investment, given that market capitalisation-weighted index funds have far lower turnover than most of their actively managed peers.

"The people who want low turnover have had to go to passive to get it," says Mr Smead, a 34-year industry veteran.

Its $711m Smead Value fund, and a Luxembourg-domiciled Ucits sister vehicle launched in November, focus on companies that meet an economic need, have a strong competitive advantage and a long history of profitability.

"Valuation matters dearly; we want to buy at the point of maximum pessimism. We own business for a very long time and we have to own high-quality companies. That is a very Buffett-esque quality," says Mr Smead, who maintains a tight portfolio of 25-30 stocks.

Turnover in the Value fund has averaged 13.2 per cent in the past three years – meaning companies are typically held for seven to eight years – compared with an average of 62 per cent for its sector peers.

It has outperformed both the Russell 1000 Value and S&P 500 indices over one, three and five years, and since launch in 2008, albeit not by a huge margin. Over five years, for instance, it has returned 22 per cent, versus 16.7 per cent for the Russell 1000 Value index

There is of course no guarantee that any of these funds will continue to outperform, and even if they do, periods of underperformance are pretty much inevitable. But at least it is possible to think that an intelligent human being can potentially beat the "wisdom of the crowd" that is the market.