

ONE

Focus Investing

*Robert, we just focus on a few outstanding companies.
We're focus investors.*

—Warren Buffett

I REMEMBER THAT conversation with Warren Buffett as if it happened yesterday. It was for me a defining moment, for two reasons. First, it moved my thinking in a totally new direction; and second, it gave a name to an approach to portfolio management that I instinctively felt made wonderful sense but that our industry had long overlooked. That approach is what we now call focus investing, and it is the exact opposite of what most people imagine that experienced investors do.

Hollywood has given us a visual cliché of a money manager at work: talking into two phones at once, frantically taking notes while trying to keep an eye on jittery computer screens that blink and blip from all directions, slamming the keyboard whenever one of those computer blinks shows a minuscule drop in stock price.

Warren Buffett, the quintessential focus investor, is as far from that stereotype of frenzy as anything imaginable. The man

whom many consider the world's greatest investor is usually described with words like "soft-spoken," "down-to-earth," and "grandfatherly." He moves with the calm that is born of great confidence, yet his accomplishments and his performance record are legendary. It is no accident that the entire investment industry pays close attention to what he does. If Buffett characterizes his approach as "focus investing," we would be wise to learn what that means and how it is done.

Focus investing is a remarkably simple idea, and yet, like most simple ideas, it rests on a complex foundation of interlocking concepts. If we hold the idea up to the light and look closely at all its facets, we find depth, substance, and solid thinking below the bright clarity of the surface.

In this book, we will look closely at these interlocking concepts, one at a time. For now, I hope merely to introduce you to the core notion of focus investing. The goal of this overview chapter mirrors the goal of the book: to give you a new way of thinking about investment decisions and managing investment portfolios. Fair warning: this new way is, in all likelihood, the opposite of what you have always been told about investing in the stock market. It is as far from the usual way of thinking about stocks as Warren Buffett is from that Hollywood cliché.

The essence of focus investing can be stated quite simply:

Choose a few stocks that are likely to produce above-average returns over the long haul, concentrate the bulk of your investments in those stocks, and have the fortitude to hold steady during any short-term market gyrations.

No doubt that summary statement immediately raises all sorts of questions in your mind:

How do I identify those above-average stocks?

How many is “a few”?

What do you mean by “concentrate”?

How long must I hold?

And, saved for last:

Why should I do this?

The full answers to those questions are found in the subsequent chapters. Our work here is to construct an overview of the focus process, beginning with the very sensible question of why you should bother.

PORTFOLIO MANAGEMENT TODAY: A CHOICE OF TWO

In its current state, portfolio management appears to be locked into a tug-of-war between two competing strategies: active portfolio management and index investing.

Active portfolio managers constantly buy and sell a great number of common stocks. Their job is to try to keep their clients satisfied, and that means consistently outperforming the market so that on any given day, if a client applies the obvious measuring stick—“How is my portfolio doing compared to the market overall?”—the answer is positive and the client leaves her money in the fund. To keep on top, active managers try to predict what will happen with stocks in the coming six months and continually churn the portfolio, hoping to take advantage of their predictions. On average, today’s common stock mutual

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funds own more than one hundred stocks and generate turnover ratios of 80 percent.

Index investing, on the other hand, is a buy-and-hold passive approach. It involves assembling, and then holding, a broadly diversified portfolio of common stocks deliberately designed to mimic the behavior of a specific benchmark index, such as the Standard & Poor's 500 Price Index (S&P 500).

Compared to active management, index investing is somewhat new and far less common. Since the 1980s, when index funds fully came into their own as a legitimate alternative strategy, proponents of both approaches have waged combat to determine which one will ultimately yield the higher investment return. Active portfolio managers argue that, by virtue of their superior stock-picking skills, they can do better than any index. Index strategists, for their part, have recent history on their side. In a study that tracked results in a twenty-year period, from 1977 through 1997, the percentage of equity mutual funds that have been able to beat the S&P 500 dropped dramatically, from 50 percent in the early years to barely 25 percent in the last four years. Since 1997, the news is even worse. As of November 1998, 90 percent of actively managed funds were underperforming the market (averaging 14 percent *lower* than the S&P 500), which means that only 10 percent were doing better.¹

Active portfolio management, as commonly practiced today, stands a very small chance of outperforming the S&P 500. Because they frenetically buy and sell hundreds of stocks each year, institutional money managers have, in a sense, become the market. Their basic theory is: Buy today whatever we predict can be sold soon at a profit, regardless of what it is. The fatal flaw in that logic is that, given the complex nature of the financial universe, predictions are impossible. (See Chapter 8 for a description of complex adaptive systems.) Further complicating this shaky theoretical foundation is

the effect of the inherent costs that go with this high level of activity—costs that diminish the net returns to investors. When we factor in these costs, it becomes apparent that the active money management business has created its own downfall.

Indexing, because it does not trigger equivalent expenses, is better than actively managed portfolios in many respects. But even the best index fund, operating at its peak, will only net exactly the returns of the overall market. Index investors can do no worse than the market—and no better.

From the investor's point of view, the underlying attraction of both strategies is the same: minimize risk through diversification. By holding a large number of stocks representing many industries and many sectors of the market, investors hope to create a warm blanket of protection against the horrific loss that could occur if they had all their money in one arena that suffered some disaster. In a normal period (so the thinking goes), some stocks in a diversified fund will go down and others will go up, and let's keep our fingers crossed that the latter will compensate for the former. The chances get better, active managers believe, as the number of stocks in the portfolio grows; ten is better than one, and a hundred is better than ten.

An index fund, by definition, affords this kind of diversification if the index it mirrors is also diversified, as they usually are. The traditional stock mutual fund, with upward of a hundred stocks constantly in motion, also offers diversification.

We have all heard this mantra of *diversification* for so long, we have become intellectually numb to its inevitable consequence: mediocre results. Although it is true that active *and* index funds offer diversification, in general neither strategy will yield exceptional returns. These are the questions intelligent investors must ask themselves: Am I satisfied with average returns? Can I do better?

A NEW CHOICE

What does Warren Buffett say about this ongoing debate regarding index versus active strategy? Given these two particular choices, he would unhesitatingly pick indexing. Especially if he were thinking of investors with a very low tolerance for risk, and people who know very little about the economics of a business but still want to participate in the long-term benefits of investing in common stocks. “By periodically investing in an index fund,” Buffett says in his inimitable style, “the know-nothing investor can actually outperform most investment professionals.”²

Buffett, however, would be quick to point out that there is a third alternative, a very different kind of active portfolio strategy that significantly increases the odds of beating the index. That alternative is focus investing.

FOCUS INVESTING: THE BIG PICTURE

“Find Outstanding Companies”

Over the years, Warren Buffett has developed a way of choosing the companies he considers worthy places to put his money. His choice rests on a notion of great common sense: if the company itself is doing well and is managed by smart people, eventually its inherent value will be reflected in its stock price. Buffett thus devotes most of his attention not to tracking share price but to analyzing the economics of the underlying business and assessing its management.

This is not to suggest that analyzing the company—uncovering all the information that tells us its economic value—is particularly easy. It does indeed take some work. But Buffett has often remarked that doing this “homework” requires no more energy

than is expended in trying to stay on top of the market, and the results are infinitely more useful.

The analytical process that Buffett uses involves checking each opportunity against a set of investment tenets, or fundamental principles. These tenets, presented in depth in *The Warren Buffett Way* and summarized on page 8, can be thought of as a kind of tool belt. Each individual tenet is one analytical tool, and, in the aggregate, they provide a method for isolating the companies with the best chance for high economic returns.

The Warren Buffett tenets, if followed closely, lead you inevitably to good companies that make sense for a focus portfolio. That is because you will have chosen companies with a long history of superior performance and a stable management, and that stability predicts a high probability of performing in the future as they have in the past. And that is the heart of focus investing: concentrating your investments in companies that have the highest probability of above-average performance.

Probability theory, which comes to us from the science of mathematics, is one of the underlying concepts that make up the rationale for focus investing. In Chapter 6, you will learn more about probability theory and how it applies to investing. For the moment, try the mental exercise of thinking of “good companies” as “high-probability events.” Through your analysis, you have already identified companies with a good history and, therefore, good prospects for the future; now, take what you already know and think about it in a different way—in terms of probabilities.

“Less Is More”

Remember Buffett’s advice to a “know-nothing” investor, to stay with index funds? What is more interesting for our purposes is what he said next:

Tenets of the Warren Buffett Way

Business Tenets

Is the business simple and understandable?

Does the business have a consistent operating history?

Does the business have favorable long-term prospects?

Management Tenets

Is management rational?

Is management candid with its shareholders?

Does management resist the institutional imperative?

Financial Tenets

Focus on return on equity, not earnings per share.

Calculate “owner earnings.”

Look for companies with high profit margins.

For every dollar retained, make sure the company has created at least one dollar of market value.

Market Tenets

What is the value of the business?

Can the business be purchased at a significant discount to its value?

“If you are a know-something investor, able to understand business economics and to find five to ten sensibly priced companies that possess important long-term competitive advantages, conventional diversification [broadly based active portfolios] makes no sense for you.”³

What’s wrong with conventional diversification? For one thing, it greatly increases the chances that you will buy something you don’t know enough about. “Know-something” investors, applying the Buffett tenets, would do better to focus their attention on just a few companies—“five to ten,” Buffett suggests. Others who adhere to the focus philosophy have suggested smaller numbers, even as low as three; for the average investor, a legitimate case can be made for ten to fifteen. Thus, to the earlier question, How many is “a few”? the short answer is: No more than fifteen. More critical than determining the exact number is understanding the general concept behind it. Focus investing falls apart if it is applied to a large portfolio with dozens of stocks.

Warren Buffett often points to John Maynard Keynes, the British economist, as a source of his ideas. In 1934, Keynes wrote to a business associate: “It is a mistake to think one limits one’s risks by spreading too much between enterprises about which one knows little and has no reason for special confidence. . . . One’s knowledge and experience are definitely limited and there are seldom more than two or three enterprises at any given time in which I personally feel myself entitled to put full confidence.”⁴ Keynes’s letter may be the first piece written about focus investing.

An even more profound influence was Philip Fisher, whose impact on Buffett’s thinking has been duly noted. Fisher, a prominent investment counselor for nearly half a century, is the author of two important books: *Common Stocks and Uncommon Profits* and *Paths to Wealth Through Common Stocks*, both of which Buffett admires greatly.

The Warren Buffett Portfolio

Phil Fisher was known for his focus portfolios; he always said he preferred owning a small number of outstanding companies that he understood well to owning a large number of average ones, many of which he understood poorly. Fisher began his investment counseling business shortly after the 1929 stock market crash, and he remembers how important it was to produce good results. “Back then, there was no room for mistakes,” he remembers. “I knew the more I understood about the company the better off I would be.”⁵ As a general rule, Fisher limited his portfolios to fewer than ten companies, of which three or four often represented 75 percent of the total investment.

“It never seems to occur to [investors], much less their advisors,” he wrote in *Common Stocks* in 1958, “that buying a company without having sufficient knowledge of it may be even more dangerous than having inadequate diversification.”⁶ More than forty years later, Fisher, who today is ninety-one, has not changed his mind. “Great stocks are extremely hard to find,” he told me. “If they weren’t, then everyone would own them. I knew I wanted to own the best or none at all.”⁷

Ken Fisher, the son of Phil Fisher, is also a successful money manager. He summarizes his father’s philosophy this way: “My dad’s investment approach is based on an unusual but insightful notion that less is more.”⁸

“Put Big Bets on High-Probability Events”

Fisher’s influence on Buffett can also be seen in his belief that when you encounter a strong opportunity, the only reasonable course is to make a large investment. Like all great investors, Fisher was very disciplined. In his drive to understand as much as possible about a company, he made countless field trips to

visit companies he was interested in. If he liked what he saw, he did not hesitate to invest a significant amount of money in the company. Ken Fisher points out, “My dad saw what it meant to have a large position in something that paid off.”⁹

Today, Warren Buffett echoes that thinking: “With each investment you make, you should have the courage and the conviction to place at least 10 percent of your net worth in that stock.”¹⁰

You can see why Buffett says the ideal portfolio should contain no more than ten stocks, if each is to receive 10 percent. Yet focus investing is not a simple matter of finding ten good stocks and dividing your investment pool equally among them. Even though all the stocks in a focus portfolio are high-probability events, some will inevitably be higher than others and should be allocated a greater proportion of the investment.

Blackjack players understand this tactic intuitively: When the odds are strongly in your favor, put down a big bet. In the eyes of many pundits, investors and gamblers have much in common, perhaps because both draw from the same science: mathematics. Along with probability theory, mathematics provides another piece of the focus investing rationale: the Kelly Optimization Model. The Kelly model is represented in a formula that uses probability to calculate optimization—in this case, optimal investment proportion. (The model, along with the fascinating story of how it was originally derived, is presented in Chapter 6.)

I cannot say with certainty whether Warren Buffett had optimization theory in mind when he bought American Express stock in late 1963, but the purchase is a clear example of the concept—and of Buffett’s boldness. During the 1950s and 1960s, Buffett served as general partner in a limited investment partnership in Omaha, Nebraska, where he still lives. The partnership was allowed to take large positions in the portfolio when profitable opportunities arose, and, in 1963, one such opportunity came along.

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During the infamous Tino de Angelis salad oil scandal, the American Express share price dropped from \$65 to \$35 when it was thought the company would be held liable for millions of dollars of fraudulent warehouse receipts. Warren invested \$13 million—a whopping 40 percent of his partnership’s assets—in ownership of close to 5 percent of the shares outstanding of American Express. Over the next two years, the share price tripled, and the Buffett partnership walked away with a \$20 million profit.

“Be Patient”

Focus investing is the antithesis of a broadly diversified, high-turnover approach. Among all active strategies, focus investing stands the best chance of outperforming an index return over time, but it requires investors to patiently hold their portfolio even when it appears that other strategies are marching ahead. In shorter periods, we realize that changes in interest rates, inflation, or the near-term expectation for a company’s earnings can affect share prices. But as the time horizon lengthens, the trend-line economics of the underlying business will increasingly dominate its share price.

How long is that ideal time line? As you might imagine, there is no hard and fast rule (although Buffett would probably say that any span shorter than five years is a fool’s theory). The goal is not zero turnover; that would be foolish in the opposite direction because it would prevent you from taking advantage of something better when it comes along. I suggest that, as a general rule of thumb, we should be thinking of a turnover rate between 10 and 20 percent. A 10 percent turnover rate suggests that you would hold the stock for ten years, and a 20 percent rate implies a five-year period.

“Don’t Panic over Price Changes”

Price volatility is a necessary by-product of focus investing. In a traditional active portfolio, broad diversification has the effect of averaging out the inevitable shifts in the prices of individual stocks. Active portfolio managers know all too well what happens when investors open their monthly statement and see, in cold black and white, a drop in the dollar value of their holdings. Even those who understand intellectually that such dips are part of the normal course of events may react emotionally and fall into panic.

The more diversified the portfolio, the less the chances that any one share-price change will tilt the monthly statement. It is indeed true that broad diversification is a source of great comfort to many investors because it smooths out the bumps along the way. It is also true that a smooth ride is flat. When, in the interests of avoiding unpleasantness, you average out all the ups and downs, what you get is average results.

Focus investing pursues *above*-average results. As we will see in Chapter 3, there is strong evidence, both in academic research and actual case histories, that the pursuit is successful. There can be no doubt, however, that the ride is bumpy. Focus investors tolerate the bumpiness because they know that, in the long run, the underlying economics of the companies will more than compensate for any short-term price fluctuations.

Buffett is a master bump ignorer. So is his longtime friend and colleague Charlie Munger, the vice chairman of Berkshire Hathaway. The many fans who devour Berkshire’s remarkable annual reports know that the two men support and reinforce each other with complementary and sometimes indistinguishable ideas. Munger’s attitudes and philosophy have influenced Buffett every bit as much as Buffett has influenced Munger.

In the 1960s and 1970s, Munger ran an investment partnership in which, like Buffett at about the same time, he had the freedom to make big bets in the portfolio. His intellectual reasoning for his decisions during those years echoes the principles of focus investing.

“Back in the 1960s, I actually took a compound interest rate table,” explained Charlie, “and I made various assumptions about what kind of edge I might have in reference to the behavior of common stocks generally.” (OID)¹¹ Charlie worked through several scenarios, including the number of stocks he would need in the portfolio and what kind of volatility he could expect. It was a straightforward calculation.

“I knew from being a poker player that you have to bet heavily when you’ve got huge odds in your favor,” Charlie said. He concluded that as long as he could handle the price volatility, owning as few as three stocks would be plenty. “I knew I could handle the bumps psychologically,” he said, “because I was raised by people who believe in handling bumps. So I was an ideal person to adopt my own methodology.” (OID)¹²

Maybe you also come from a long line of people who can handle bumps. But even if you were not born so lucky, you can acquire some of their traits. The first step is to consciously decide to change how you think and behave. Acquiring new habits and thought patterns does not happen overnight, but gradually teaching yourself not to panic and not to act rashly in response to the vagaries of the market is certainly doable.

You may find some comfort in learning more about the psychology of investing (see Chapter 7); social scientists, working in a field called behavioral finance, have begun to seriously investigate the psychological aspects of the investment phenomenon. You may also find it helpful to use a different measuring stick for evaluating success. If watching stock prices fall gives you heart failure, perhaps it is time to embrace another way of measuring

performance, a way that is less immediately piercing but equally valid (*even more valid*, Buffett would say). That new measurement involves the concept of economic benchmarking, presented in Chapter 4.

Focus investing, as we said earlier, is a simple idea that draws its vigor from several interconnecting principles of logic, mathematics, and psychology. With the broad overview of those principles that has been introduced in this chapter, we can now rephrase the basic idea, using wording that incorporates concrete guidelines.

In summary, the process of focus investing involves these actions:

- Using the tenets of the Warren Buffett Way, choose a few (ten to fifteen) outstanding companies that have achieved above-average returns in the past and that you believe have a high probability of continuing their past strong performance into the future.
- Allocate your investment funds proportionately, placing the biggest bets on the highest-probability events.
- As long as things don't deteriorate, leave the portfolio largely intact for at least five years (longer is better), and teach yourself to ride through the bumps of price volatility with equanimity.

A LATTICEWORK OF MODELS

Warren Buffett did not invent focus investing. The fundamental rationale was originally articulated more than fifty years ago by

John Maynard Keynes. What Buffett did, with stunning success, was apply the rationale, even before he gave it its name. The question that fascinates me is why Wall Street, noted for its unabashed willingness to copy success, has so far disregarded focus investing as a legitimate approach.

In 1995, we launched Legg Mason Focus Trust, only the second mutual fund to purposely own fifteen (or fewer) stocks. (The first was Sequoia Fund; its story is told in Chapter 3.) Focus Trust has given me the invaluable experience of managing a focus portfolio. Over the past four years, I have had the opportunity to interact with shareholders, consultants, analysts, other portfolio managers, and the financial media, and what I have learned has led me to believe that focus investors operate in a world far different from the one that dominates the investment industry. The simple truth is, they *think* differently.

Charlie Munger helped me to understand this pattern of thinking by using the very powerful metaphor of a latticework of models. In 1995, Munger delivered a lecture entitled “Investment Expertise as a Subdivision of Elementary, Worldly Wisdom” to Professor Guilford Babcock’s class at the University of Southern California School of Business. The lecture, which was covered in OID, was particularly fun for Charlie because it centered around a topic that he considers especially important: how people achieve true understanding, or what he calls “worldly wisdom.”

A simple exercise of compiling and quoting facts and figures is not enough. Rather, Munger explains, wisdom is very much about how facts align and combine. He believes that the only way to achieve wisdom is to be able to hang life’s experience across a broad cross-section of mental models. “You’ve got to have models in your head,” he explained, “and you’ve got to array your experience—both vicarious and direct—on this latticework of models.” (OID)¹³

The first rule to learn, says Charlie, is that you must carry multiple models in your mind. Not only do you need more than a few, but you need to embrace models from several different disciplines. Becoming a successful investor, he explains, requires a multidiscipline approach to your thinking.

That approach will put you in a different place from almost everyone else, Charlie points out, because the world is not multidiscipline. Business professors typically don't include physics in their lectures, and physics teachers don't include biology, and biology teachers don't include mathematics, and mathematicians rarely include psychology in their coursework. According to Charlie, we must ignore these "intellectual jurisdictional boundaries" and include all models in our latticework design.

"I think it is undeniably true that the human brain must work in models," says Charlie. "The trick is to have your brain work better than the other person's brain because it understands the most fundamental models—the ones that will do the most work per unit."

It is clear to me that focus investing does not fit neatly within the narrowly constructed models popularized and used in our investment culture. To receive the full benefit of the focus approach, we will have to add a few more concepts, a few more models, to our thinking. You will never be content with investing until you understand the behavior models that come from psychology. You will not know how to optimize a portfolio without learning the model of statistical probabilities. And it is likely you will never appreciate the folly of predicting markets until you understand the model of complex adaptive systems.

This investigation need not be overwhelming. "You don't have to become a huge expert in any one of these fields," explains Charlie. "All you have to do is take the really big ideas and learn them early and learn them well." (OID)¹⁴ The exciting part to this exercise, Charlie points out, is the insight that is

possible when several models combine and begin operating in the same direction.

The most detailed model that focus investors have to learn is the model for picking stocks, and many of you are already familiar with that from *The Warren Buffett Way*. From here, we need to add just a few more simple models to complete our education: to understand how to assemble those stocks into a portfolio, and how to manage that portfolio so that it yields maximum results well into the future. But we are not alone. We have Warren's and Charlie's wisdom to guide us, and we have their accumulated experience at Berkshire Hathaway. Typically, these two visionaries credit not themselves personally but their organization, which they describe as a "didactic enterprise teaching the right systems of thought, of which the chief lessons are that a few big ideas really work." (OID)¹⁵

"Berkshire is basically a very old-fashioned kind of place," Charlie Munger said, "and we try to exert discipline to stay that way. I don't mean old-fashioned stupid. I mean the eternal verities: basic mathematics, basic horse sense, basic fear, basic diagnosis of human nature making possible predictions regarding human behavior. If you just do that with a certain amount of discipline, I think it's likely to work out quite well." (OID)¹⁶