CHAPTER 1

Lou Simpson: The Disciplined Investor

A Portrait of Concentration

Stop the music.

—Warren Buffett to Jack Byrne, chairman of GEICO, after meeting Lou Simpson in 1979[1]

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In 1979, GEICO, an auto insurance company based in Washington, DC, that had been brought close to bankruptcy just three years earlier was searching for a new chief investment officer. The company's recent near-death experience, and the perception of insurance companies' investment efforts as hidebound, and highly risk-averse, had made the search difficult. The recruiter, Lee Getz, vice chairman of Russell Reynolds, did find a candidate who later turned it down because his wife refused to move to Washington.[2] Lamenting his lack of success in filling the position in over a year, Getz told his friend Lou Simpson about the little insurance company with big problems that no one wanted to tackle. He asked Simpson, the chief executive of California-based investment firm Western Asset Management, if he was interested in the job. Simpson was reluctant.[3] Western Asset Management had been a subsidiary of a big California bank holding company. Simpson was sick of politicking within the confines of bank bureaucracy, and didn't have any great desire to repeat the experience in an insurance company. He also knew that GEICO had almost gone belly up just three years earlier.

As a favor, Getz asked Simpson to interview with the company's chairman, John "Jack" Byrne Jr., the man who had almost single-handedly pulled GEICO back from the brink of insolvency.[4] Simpson agreed if only to help out an old

friend. He traveled to Washington to meet with Byrne, who Simpson judged as being "a very, very smart guy," but also a micro-manager involved in everything GEICO did.[5] Simpson found the role interesting, but not compelling. He craved autonomy, and Byrne, who had just saved GEICO, seemed unlikely to grant it. Byrne called Simpson back for a second interview. Though he had reservations he dutifully traveled back to Washington. In the second interview, Byrne told Simpson, "We're really interested in you. But the one hoop you're going to have to go through is to meet with Warren Buffett."[6] With about 20 percent of GEICO, Buffett was the largest shareholder through Berkshire Hathaway. Byrne said, "Warren thinks we need a new investment person. The person before was really not up to the job."[7] Though Buffett didn't yet have a high profile, Simpson had read about the Nebraska-based value investor who was just renewing a longstanding interest in GEICO.

"UNSTOPPABLE" GEICO

Buffett has a storied 65-year association with GEICO, beginning in 1951 as a 20-year-old graduate student in Benjamin Graham's value investing class at Columbia. He recounted the first 45 years of that association in his 1995 Chairman's Letter following Berkshire's purchase of the half of GEICO it didn't own.[8] It was then the seventh-largest auto insurer in the United States, with about 3.7 million cars insured (in 2015, it is second, with 12 million policies in force). Buffett attended Columbia University's graduate business school between 1950 and 1951 because he wanted to study under Graham, the great value investor and investment philosopher, who was a professor there. Seeking to learn all he could about his hero, he found that Graham was the chairman of *Government Employees Insurance Company*, to Buffett "an unknown company in an unfamiliar industry."[9] A librarian referred him to *Best's Fire and Casualty* insurance manual—a large compendium of insurers—where he learned that GEICO was based in Washington, DC.

On a Saturday in January 1951, Buffett took the early train to Washington and headed for GEICO's downtown headquarters. The building was closed for the weekend, but he frantically pounded on the door until a custodian appeared. He asked the puzzled janitor if there was anyone in the office the young Buffett could talk to. The man said he'd seen one man working on the sixth floor—Lorimer Davidson, assistant to the president and founder, Leo Goodwin, Sr. Buffett knocked on his door and introduced himself. Davidson, a former investment banker who had led a round of funding for GEICO before joining it, spent the afternoon describing to Buffett the intricacies of the insurance industry and the factors that help one insurer succeed over the others.[10]

Davidson taught Buffett that GEICO was the very model of an insurer built to succeed. Formed in 1936, at the height of the Great Depression by Goodwin and his wife Lillian, GEICO was set up to be low-cost from the get go.[11] Goodwin had been an executive at the United Services Automobile Association (USAA), an auto insurer founded to insure military personnel, and a pioneer in the direct marketing of insurance. He had seen data that showed federal government employees and enlisted military officers tended to be financially stable, and also low-risk drivers. Those two attributes, he surmised, would mean that premiums were paid on time, with lower and infrequent claims. Agents were typically used to provide professional advice for more complex business insurance requirements. Auto insurance, though it was mandatory and expensive, was also relatively simple. Most consumers would know what they required in an auto policy.[12] Goodwin reasoned that GEICO could cut out the agents and market directly to consumers, thereby minimizing distribution costs, just as USAA had. Those two insights—direct selling that bypassed agents to financially secure, low-risk policyholders—put GEICO in a very favorable cost position relative to its competitors. Later, Buffett would write that there was "nothing esoteric" about its success: its competitive strength flowed directly from its position as the industry low-cost operator.[13] GEICO's method of selling—direct marketing—gave it an enormous cost advantage over competitors that sold through agents, a form of distribution so ingrained in the business of these insurers that it was impossible for them to give it up.[14] Low costs permitted low prices, low prices attracted and retained good policyholders, and this virtuous cycle drove GEICO's success.[15] GEICO was superbly managed under the Goodwins. It grew volumes rapidly, and did so while maintaining unusually high profitability. When Leo Goodwin retired in 1958, he named Davidson, the man whom the 20-year-old Buffett had met on that Saturday in January 1951, as his successor.[16] The transition was a smooth one, and GEICO's prosperity continued with Davidson in the chief executive role. Volumes grew such that, by 1964, GEICO had more than 1 million policies in force.[17] Between its formation in 1936 and 1975, it captured 4 percent of the auto market, and grew to be the nation's fourth largest auto insurer.[18] It looked, in Buffett's estimation, "unstoppable."[19]

But GEICO was struck by a double whammy in the 1970s. First, Davidson retired in 1970, and then both Leo and Lillian Goodwin passed away. Without a rudder, it seemed to stray from the principles that had made it successful.[20] When real-time access to computerized driving records became available throughout the United States in 1974, GEICO moved beyond its traditional government employee constituency to begin insuring the general public.[21] By 1975, it was clear that it had expanded far too aggressively during a difficult recession.[22] Actuaries had also made serious errors

in estimating GEICO's claims costs and reserving for losses. This faulty cost information caused it to underprice its policies, and lose an enormous amount of money.[23] Weak management, bad investment choices, and years of rapid expansion took their toll.[24] In 1976, GEICO stood on the brink of failure.

It was saved from collapse when Jack Byrne was appointed chief executive in 1976. Byrne took drastic remedial measures.[25] He organized a consortium of 45 insurance companies to take over a quarter of GEICO's policies.[26] To pay the remaining claims, he had GEICO undertake a stock offering that severely diluted existing stockholders.[27] The stock price was savaged. From its peak, it fell more than 95 percent.[28] Believing that Byrne could rescue GEICO, and that, despite its problems, it maintained its fundamental competitive advantage as a low-cost auto insurer, Buffett plunged into the market in the second half of 1976, buying a very large initial interest for Berkshire.[29] Byrne put it on a path to insuring only "government employee"-style policyholders from a much wider pool of potential insureds, and improving its reserving and pricing discipline. Though the company shrank significantly in the first few years of Byrne's tenure, Berkshire kept buying, making purchases at particularly opportune times. By 1979, GEICO had taken a step back from the precipice, but it was only half the size that it had been. While the business maintained its inherent competitive advantage—its rock-bottom operating costs—and Byrne had reserving and pricing under control, it was clear that GEICO needed help on the investment side. After searching for over a year without luck, and being turned down by the first good prospect, Byrne had whittled the field down considerably from the initial candidates. Simpson was one.[30] And a meeting with Buffett stood in the way.

On a Saturday morning in the summer of 1979, Simpson traveled to Omaha to meet with Buffett in his office. In the meeting Buffett said, "I think maybe the most important question is, what do you own in your personal portfolio?"[31] Simpson told him, but Buffett didn't give away whether he was impressed or not. After talking for two to three hours, Buffett drove Simpson to the airport where they met Joe Rosenfield. Rosenfield was a good friend of Buffett's, and an impressive investor in his own right: He would almost single-handedly steer little Grinnell College's $11 million endowment into a $1 billion behemoth, one of the biggest *per student* for any private liberal arts school in the country.[32] Simpson and Rosenfield discovered they were both big-time Chicago Cubs fans, and spent the time chatting about the team (Rosenfield would go on to acquire 3 percent of the Cubs, and, in his seventies, vowed not to die until they won a World Series).[33] After visiting with Buffett and Rosenfield, Simpson flew back to Los Angeles. Evidently Buffett found the stocks in Simpson's personal portfolio acceptable because

he wasted no time. He called Byrne straight after the interview, and told him, "Stop the music. That's the fella."[34] Byrne called Simpson to offer him the job, and upped the compensation package.[35] Though his wife was skeptical about leaving California, Simpson persuaded her, saying, "I think this is an interesting opportunity and I really don't want to stay where I am."[36] Simpson accepted, and the family began preparing to move to Washington, DC.

AN EMERGING VALUE INVESTOR

> Lou has never been one to advertise his talents. But I will: Simply put, Lou is one of the investment greats.
>
> —*Warren Buffett, "2010 Berkshire Hathaway Letter to Shareholders"*

Louis A. Simpson was born in Chicago, Illinois, in 1936. He grew up an only child in the Chicago suburb of Highland Park.[37] At the end of his college freshman year at Northwestern University in 1955, he went to see the school guidance counselor. After subjecting Simpson to the usual barrage of tests, the counselor told the 18-year-old that he had an aptitude for numbers and financial concepts.[38] Simpson, who had been studying first engineering and then pre-med, transferred to Ohio Wesleyan with a double major in economics and accounting. Three years later he graduated with high honors and was offered a Woodrow Wilson National Fellowship to study labor economics at Princeton. He received his MA from Princeton in two years, and began to work on his doctorate, researching the market for engineers. Simpson was offered the opportunity to teach full time as an instructor of economics, teaching the basic courses of accounting and finance, even though he had never taken a formal course in finance. At the first faculty meeting, the provost told the junior faculty members that only 10 percent would proceed to get tenure. Now married and with his first child, Simpson realized that the very long odds of tenure meant that teaching was an unlikely path to financial security.

While teaching full time, Simpson started writing letters and interviewing for positions in investment management firms and investment banks. He'd always had an interest in investments and managed his own tiny stock portfolio as a teenager, which was unusual at the time. A firm in Chicago, Stein Roe & Farnham—then perhaps the largest independent investment firm between New York, Boston, and the West Coast (today it has disappeared)—had a partner who was a Princeton graduate who conducted

the interviews at the campus. He and Simpson hit it off. The deciding factor for Simpson was that Stein Roe was prepared to offer him $100 a month more than any firm in New York. So in 1962, he dropped out of doctoral studies at Princeton University to return to Chicago.[39] He was 25, and working in his first full-time job as a portfolio manager at Stein Roe.[40]

At Stein Roe, Simpson managed separate accounts, beginning with individuals and gradually moving toward institutions. Stein Roe did offer mutual funds, though Simpson did not work on them. The strategy for the separate accounts was narrowly confined. An investment committee created a model portfolio, and the separate accounts were expected to follow it. Simpson followed the model portfolio, but had a tendency to concentrate the managed accounts more than the model portfolio dictated.[41] He stayed seven-and-a-half years with Stein Roe, and was made a partner. He was concerned that the partners were much more interested in the size of their slice of the pie than in trying to grow the whole pie.[42] He told a good friend from Princeton that he was open to making a change. The friend introduced him to Shareholders Management, a mutual fund management firm in Los Angeles.[43] Shareholders Management was headed by "fund wizard" Fred Carr, a darling of the market during the go-go years in the 1960s, when the fad was for performance mutual funds.[44] Shareholders Management was one of the hottest. Under Carr's guidance, Shareholders' Enterprise Fund had soared 159 percent from 1967 to 1969, and the fund's assets had ballooned more than fiftyfold, to $1.7 billion.[45] Carr was a "gunslinger," a market timer who dove in and out of the shares of small, rapidly growing stocks.[46] A *Business Week* magazine profile in 1969 said of Carr that he "may just be the best portfolio manager in the U.S."[47] Carr offered Simpson a role not managing the hot mutual funds, but the separate accounts. Simpson would have to take a cut in base salary, but received a substantial option package. He accepted, and so in 1969, he became one of the first partners to leave Stein Roe.[48]

Simpson moved his family, now with three children, to Los Angeles to join Shareholders Management under Carr. While Shareholders Management had been for several years regarded by the market as an unusually gifted investment team, all was not as it seemed. Carr had bought a lot of "letter stock"—stock not registered with Securities and Exchange Commission (SEC), which cannot be sold to the public, meaning that it is extremely illiquid—for the Enterprise Fund. This strategy had done very well as the market ran up, but the long bull market soon collapsed, and investors in Carr's Enterprise Fund were slammed, leading to large-scale redemptions. Compounding the problem, there was virtually no market for sales of the unregistered letter stock needed to meet the redemptions. Simpson's timing was unlucky. He had joined in September 1969, the absolute top of Shareholders Management's run. One month after his arrival, the losses in the

Enterprise Fund were so bad that Carr was forced to resign, and cashed in his equity in the funds as he left.[49] Though he had been hired to run managed accounts, Simpson was tasked with managing part of the Enterprise Fund. He quickly found that he didn't fit into the Shareholders' culture. "I viewed myself an investor, and they were trading-oriented," he says.[50] At lunch one day, one of the firm's lawyers asked Simpson, "Do you realize how screwed up this place is? They've done things that are not on the up and up, and, if you want to maintain your reputation, it would be a good idea to leave."[51] Simpson resigned shortly after. He had been at Shareholders' Management for just five months. He was 33, with three children, and he had just moved to Los Angeles. Though he had some opportunities in Chicago, he decided to see what was available on the West Coast.

After a brief search, Simpson settled on United California Bank to help start an investment management business and be second-in-command in the investment area. That new business was eventually spun out into a separate company called Western Asset Management, and became a subsidiary of Western Bank Corporation.[52] Simpson stayed at Western Asset Management for nine years as head of portfolio management, and then director of research.[53] Western Asset Management was successful, but Simpson found it difficult to operate in a big banking environment. The chairman of Western Bank Corporation wanted to make him CEO of Western Asset Management, but said he would only do it if Simpson promised to stay on. The chairman forced the resignation of the former chief executive, and Simpson was made the new chief executive of Western Asset Management. Though he stayed on for three years, he found the management role chafed him. He yearned to do something entrepreneurial. Friends of his wanted to set up some kind of investment management company with him, but he wasn't sure.[54] The experience with Shareholders Management had a transformative effect on Simpson, wholly changing his perspective on investment.[55] Shareholders Management taught him about the importance of business risk, and started him on the road to value investing.[56] During his time at Western Asset Management he was able to think, developing his investment philosophy, both on a personal and a company basis. He began to embrace value investing. His philosophy evolved dramatically when he ran the research department and he moved toward a more concentrated value investment approach. And then GEICO came calling.

BIG, CONCENTRATED BETS

In the 1970s, most insurance companies held a broad portfolio of bonds, counting on diversification to minimize risk, and little in the way of stocks. They also held a high proportion of the portfolio in government bonds,

which, during the period of high inflation in the 1970s, had led to sizable losses for most portfolios.[57] Before Simpson arrived in 1979, GEICO was no exception. He would radically change GEICO's course. The agreement Simpson had struck with Byrne allowed the new investment chief to put up to 30 percent of GEICO's assets in stocks.[58] At the time, most property and casualty insurers limited stock holdings to about 10 percent of assets.[59] The agreement also allowed him to hold concentrated positions.[60] Simpson went to work as soon as he arrived, slashing the company's bond holdings and rebuilding the stock portfolio in a limited number of names.[61]

Wary of Byrne's reputation for micromanagement, Simpson had made it clear he was to be solely responsible for managing GEICO's investments. "The more people you have making decisions, the more difficult it is to do well," he said.[62] "You have to satisfy everybody."[63] Neither Buffett nor Byrne were to interfere with the portfolio.[64]

Simpson's instincts about Byrne were right. After he had been at GEICO for more than a year, he went away for a week on vacation. Byrne took the opportunity to buy some stocks for the portfolio. When Simpson returned, he immediately sold Byrne's positions. Byrne asked, "Why would you do that? They were good ideas."[65]

Simpson replied, "If I'm going to be responsible for the portfolio, I'm going to make all the decisions."[66] From then on, Simpson made his own decisions, essentially working autonomously.[67] Describing the arrangement in 2004, Buffett wrote,

> *You may be surprised to learn that Lou does not necessarily inform me about what he is doing. When Charlie and I assign responsibility, we truly hand over the baton—and we give it to Lou just as we do to our operating managers. Therefore, I typically learn of Lou's transactions about ten days after the end of each month. Sometimes, it should be added, I silently disagree with his decisions.* But he's usually right. [*emphasis Buffett's*][68]

Simpson did, however, regularly speak to Buffett about his investing philosophy. Simpson was impressed by Buffett's encyclopedic knowledge of businesses and numbers, and his long list of contacts.[69] In addition to Buffett's view on investing, Simpson would also ask Buffett about companies that he thought he knew something about.[70] Over time, Simpson and Buffett fell into a routine. Buffett would call Simpson, or Simpson would call Buffett. Initially as often as several times a week, as time went on, the men might let a month or two go by before the two talked, but they always stayed in regular contact.[71] Though both operated independently, GEICO and Berkshire did have several common positions. They tended not to overlap because

GEICO had a significant size advantage. Where Buffett needed to take positions of more than $1 billion to generate a return meaningful relative to the Berkshire portfolio worth many billions, GEICO could take much smaller positions given its smaller portfolio size. Simpson found several larger ideas he wanted to buy for GEICO, but if he learned Berkshire was already buying the stock, he stood back to allow Berkshire to complete its buying.[72]

When he first arrived at GEICO, Simpson found a group of investment people who did not share his investment approach but thought he would try to work with them for a while. He asked Buffett to come to GEICO twice a year to spend an hour with the investment team. During one of these talks, Buffett told a story that left an impression on Simpson.[73] Buffett said, "Suppose somebody gives you a card with 20 punches, and each time you make an investment move you have to punch the card. Once you have had 20 punches, you're going to have to sit forever with what you have."[74]

The story stuck with Simpson, helping him avoid trading and to focus on developing a long-term investment perspective.[75] Simpson says, "I never did a lot of trading but the story really did highlight that you need to have a lot of conviction in what you're doing because you only have so many shots and you better be confident on the shots that you take."[76] Heeding Buffett's advice, Simpson gradually concentrated larger and larger sums of money into just a handful of companies. In 1982, GEICO had about $280 million of common stock in 33 companies. Simpson cut it to 20, then to 15, and then, over time, to between 8 and 15 names.[77] At the end of 1995, just before Berkshire's acquisition of GEICO ended separate disclosures of the insurer's portfolio, Simpson had $1.1 billion invested in just 10 stocks.[78] Simpson was willing to concentrate positions in a single sector. At one time GEICO owned five or six electric utilities, which Simpson regarded as a single, big position.[79] In the early 1980s, GEICO took a huge bet on three of the "Baby Bells," the nickname given to the independent regional telephone companies spun out from AT&T, Inc., following the U.S. Department of Justice's antitrust lawsuit filed in 1974. Simpson also regarded those holdings as one position.[80] He took a large position because he assessed the Baby Bells as offering an unusually good risk/reward ratio.[81] Admiring Simpson's bet, Byrne remarked, "It was a very big hit on a very large amount of money."[82]

Simpson would take those big bets only when he thought the odds were well in his favor. He regards GEICO's single biggest winner as the Federal Home Loan Mortgage Corporation, known as "Freddie Mac."[83] Freddie Mac is a government-sponsored enterprise created in 1970 to expand the secondary market for mortgages in the United States. It buys mortgages on the secondary market, pools them, and sells them as a mortgage-backed security to investors on the open market. It operates in a duopoly with

the Federal National Mortgage Association, commonly known as "Fannie Mae." When GEICO bought into Freddie Mac, it was not a public company. While Fannie Mae was then public, Freddie Mac was only semi-public, with a small market in its stock, and the bulk owned by savings and loans associations. Simpson found it trading exceedingly cheaply, between three and four times its earnings. In addition to its manifest cheapness, Simpson was attracted to its franchise, which it owed to its status as a duopoly with Fannie Mae. Buffett had already bought up to his limit, and was restricted by regulation from buying more because Berkshire owned Wesco, which was a Thrift Bank. Simpson thought Freddie Mac was one of the best opportunities he'd ever seen, and in the mid to late 1980s, he took an enormous position for GEICO. He finally sold the position during 2004 and 2005, three years before Freddie Mac ran into trouble. GEICO sold out not because Simpson regarded Freddie Mac stock as being "horribly expensive," but because he saw the business "taking on more risk, increasing leverage, and buying lower and lower quality mortgages to make the targets set by Wall Street analysts who thought Freddie Mac should be able to compound its earnings 15 percent a year."[84] Simpson says that, while GEICO's reasons for selling turned out to be correct, he had no idea Freddie Mac would melt down completely. (In 2008, the Federal Housing Finance Agency put both Fannie Mae and Freddie Mac under conservatorship, equivalent to bankruptcy for a privately owned business. The action was described as "one of the most sweeping government interventions in private financial markets in decades."[85] As of the date of writing, they remain in conservatorship.) For GEICO, Freddie Mac was a very successful investment. "After we bought it," says Simpson, "it went on a very, very big run, returning 10 to 15 times GEICO's investment."[86]

Simpson also invested GEICO in a number of merger arbitrage deals, an investment strategy in which an investor, typically, simultaneously buys and sells the stocks of two merging companies in order to profit when the companies actually merge.[87] Simpson, however, chose only to invest on the long side of these deals since he felt he could capture enough of the arbitrage that way. Simpson recalls that the 1980s, with the explosion of contested mergers and acquisition, were a particularly good time for merger arbitrage. GEICO invested in several of the food company takeovers after the deal was announced hoping that another bidder would top the offer. In the heated market, they often did. GEICO's returns from merger arbitrage were excellent, in line with or even a little bit better than the remainder of the portfolio. As the decade wound on, however, Simpson became increasingly concerned that the takeovers were getting too heated, and he didn't know if the market could sustain the torrid pace. Simpson believes he got lucky by declaring victory before GEICO had a disaster. After he stopped investing in merger

arbitrage, there were many broken mergers in the lead up to the crash of 1987, and "we were darn lucky that we didn't get a few bum deals."[88] While he disclaims any ability to predict macro factors, he has looked at valuation levels of the market as a whole.[89] In 1987, before the crash, he also moved GEICO's portfolio to approximately 50 percent in cash because he thought the valuation of the market was "outrageous."[90] Simpson says that the huge cash position "helped us for a while and then it hurt us," because "we probably didn't get back into the market as fast as we could have."[91]

SIMPSON'S RESULTS AT GEICO

> [W]e try to exert a Ted Williams kind of discipline. In his book *The Science of Hitting*, Ted explains that he carved the strike zone into 77 cells, each the size of a baseball. Swinging only at balls in his "best" cell, he knew, would allow him to bat .400; reaching for balls in his "worst" spot, the low outside corner of the strike zone, would reduce him to .230. In other words, waiting for the fat pitch would mean a trip to the Hall of Fame; swinging indiscriminately would mean a ticket to the minors.
>
> —*Warren Buffett, "1997 Berkshire Hathaway Letter to Shareholders"*

In 1980, his first year at the helm of GEICO's investment portfolio, Simpson returned 23.7 percent.[92] A great return in almost any other year, that year it was just below the market average, which returned 32.3 percent. Over the next two years, however, he beat the market handsomely, racking up a 45 percent return in 1983, far above the market's 21 percent gain. By then, almost a third of GEICO's portfolio was invested in stocks, up from just 12 percent when Simpson started. Byrne later noted, "We gave him a broad, unfettered pasture to work in, and we allowed him to put an unusual percent of the company's assets into equities. And Lou just knocked the cover off the ball for us."[93] Simpson was head of investments for GEICO for 31 years from 1979 until his retirement from GEICO in 2010, aged 74, by which time he was president and co-chief executive officer of GEICO Corporation.[94] His record over that long period is extraordinary, trouncing market averages and most investment managers' performance. Simpson says of his time at GEICO, "Over the years we put together a good record. At one time we were hitting on all cylinders and I think there was a period of five, six, seven, eight years where we were

outperforming by over 15 percent a year. But over a 25-year period, and this was in the Berkshire Report, our over performance was 6.8 percent a year."[95]

Buffett first mentioned Simpson in passing in a letter to the shareholders of Berkshire in 1982, describing him as "the best investment manager in the property-casualty business."[96] From that heady start, he became increasingly effusive about Simpson as time wore on. He detailed Simpson's record in the 2004 report, writing, "Take a look at the facing page to see why Lou is a cinch to be inducted into the investment Hall of Fame."[97] Under the heading "Portrait of a Disciplined Investor *Lou Simpson*," Buffett set out Simpson's extraordinary record, reproduced here in Table 1.1.

Buffett joked in 2010 that he had since omitted updates to Simpson's record only because its performance made Buffett's look bad, quipping, "Who needs that?"[98] For his part, Simpson does not crow about GEICO's performance except to say that "it has been very, very good."[99]

The deal Simpson had struck with GEICO after he had been at the company several years paid him handsomely. Detailing the arrangement he and Byrne had made with Simpson, Buffett wrote in 1996, "In Lou's part of GEICO's operation, we again tie compensation to investment performance over a four-year period, not to underwriting results nor to the performance of GEICO as a whole. We think it foolish for an insurance company to pay bonuses that are tied to overall corporate results when great work on one side of the business—underwriting or investment—could conceivably be completely neutralized by bad work on the other. If you bat .350 at Berkshire, you can be sure you will get paid commensurately even if the rest of the team bats .200."[100] Simpson was paid big bonuses if GEICO's investments outperformed the S&P 500 over a sustained period, which he achieved numerous times during his tenure at GEICO. Evidently, Buffett was happy with the arrangement. When Berkshire acquired the remaining half of GEICO, Buffett kept Simpson, and the deal, in place. While the salary package was very lucrative for Simpson, Buffett noted that he "could have left us long ago to manage far greater sums on more advantageous terms. If money alone had been the object, that's exactly what he would have done. But Lou never considered such a move."[101]

Simpson, associates say, has derived great satisfaction from the recognition that Buffett has bestowed upon him.[102] Buffett has described him as "the class of the field among insurance investment managers."[103] He was also made a part of the so-called Buffett Group, an inner circle of about 50 who gather with Buffett every other year for days of conversation about

TABLE 1.1 "Portrait of a Disciplined Investor *Lou Simpson*" from Buffett's 2004 Berkshire Hathaway "Chairman's Letter"

Year	**Return from *GEICO Equities***	**S&P Return**	**Relative Results**
1980	23.7%	32.3%	–8.6%
1981	5.4%	–5.0%	10.4%
1982	45.8%	21.4%	24.4%
1983	36.0%	22.4%	13.6%
1984	21.8%	6.1%	15.7%
1985	45.8%	31.6%	14.2%
1986	38.7%	18.6%	20.1%
1987	–10.0%	5.1%	–15.1%
1988	30.0%	16.6%	13.4%
1989	36.1%	31.7%	4.4%
1990	–9.9%	–3.1%	–6.8%
1991	56.5%	30.5%	26.0%
1992	10.8%	7.6%	3.2%
1993	4.6%	10.1%	–5.5%
1994	13.4%	1.3%	12.1%
1995	39.8%	37.6%	2.2%
1996	29.2%	23.0%	6.2%
1997	24.6%	33.4%	–8.8%
1998	18.6%	28.6%	–10.0%
1999	7.2%	21.0%	–13.8%
2000	20.9%	–9.1%	30.0%
2001	5.2%	–11.9%	17.1%
2002	–8.1%	–22.1%	14.0%
2003	38.3%	28.7%	9.6%
2004	16.9%	10.9%	6.0%
Average Annual Gain 1980–2004	20.3%	13.5%	6.8%

value investing, among other subjects.[104] David R. Carr Jr., president of Oak Value Capital Management, an investment management company, and a Berkshire shareholder, said, "He's one of the sainted crowd; he understands and practices value investing."[105] Buffett has noted about Simpson's returns that they "are not only terrific figures but, fully as important, they have been achieved in the right way. Lou has consistently invested in undervalued common stocks that, individually, were unlikely to present him with a permanent loss and that, collectively, were close to risk-free."[106]

SIMPSON, THE VALUE INVESTOR

OUR INVESTMENT PHILOSOPHY

1. Think independently.

We try to be skeptical of conventional wisdom and to avoid the waves of irrational behavior and emotion that periodically engulf Wall Street. Such behavior often leads to excessive prices and, eventually, permanent loss of capital. We don't ignore unpopular companies. On the contrary, such situations often present the greatest opportunities.

2. Invest in high-return businesses run for the shareholders.

Over the long run, appreciation in share prices is most directly related to the return the company earns on its shareholders' investment. Cash flow, which is more difficult to manipulate than reported earnings, is a useful additional yardstick. Companies that cannot earn positive free cash flow (cash flow after capital expenditures and working capital needs) chew up owners' equity and are continually forced to raise new capital. We try to identify companies that appear able to sustain above-average profitability. Most companies cannot because competition prevents it. Many executives have priorities other than maximizing the value of their enterprises for owners, such as expanding corporate empires. We ask the following questions in evaluating management: 1. Does management have a substantial stake in the stock of the company? 2. Is management straightforward in dealings with the owners? (We look for managers who treat us as partners in the business and inform us frankly of problems as well as good news.) 3. Is management willing to divest

unprofitable operations? 4. Does management use excess cash to repurchase shares?

The last may be the most important. Managers who run a profitable business often use excess cash to expand into less profitable endeavors. Repurchase of shares is in many cases a much more advantageous use of surplus resources.

3. Pay only a reasonable price, even for an excellent business.

We try to be disciplined in the price we pay for ownership even in a demonstrably superior business. Even the world's greatest business is not a good investment if the price is too high. The ratio of price to earnings and its inverse, the earnings yield, are useful gauges in valuing a company, as is the ratio of price to free cash flow. A helpful comparison is the earnings yield of a company versus the return on a risk-free long-term United States Government obligation.

4. Invest for the long term.

Attempting to guess short-term swings in individual stocks, the stock market or the economy is not likely to produce consistently good results. Short-term developments are too unpredictable. On the other hand, shares of quality companies run for the shareholders stand an excellent chance of providing above-average returns to investors over the long term. Furthermore, moving in and out of stocks frequently has two major disadvantages that will substantially diminish results: transaction costs and taxes. Capital will grow more rapidly if earnings compound with as few interruptions for commissions and tax bites as possible.

5. Do not diversify excessively.

An investor is not likely to obtain superior results by buying a broad cross-section of the market—the more diversification, the more performance is likely to be average, at best. We concentrate our holdings in a few companies that meet our investment criteria in the belief that we have a chance at superior results only if we take risks intelligently, when the risk-reward ratio is favorable to us. Good investment ideas, that is, companies that meet our criteria, are difficult to find. When we think we have found one, we make a large commitment.

Source: Document from Lou Simpson's personal archive (circa 1983).

Buffett has described Simpson as having "the rare combination of temperamental and intellectual characteristics that produce outstanding long-term investment performance."[107] In particular, Buffett admired Simpson's ability to invest in stocks with below-average risk, and yet generate returns that were the best in the insurance industry, a hallmark of Buffett's.[108] Simpson's investing for GEICO often paralleled Buffett's efforts at Berkshire.[109] And students of Buffett's style will recognize his influence in Simpson's process: seek undervalued businesses with proven track records, strong management, a high likelihood of continued steady growth, pricing power, financial strength, and a history of rewarding shareholders. "He has this great ability to understand what's going to be a good business," said Glenn Greenberg, a longtime friend who is now managing partner at Brave Warrior Capital Management. (Simpson considers Glenn an excellent investor and they have ended up owning the same stocks numerous times over the past 30 years.) "And it's concentrated because there aren't that many really good businesses."[110]

Simpson has an unassuming manner and puts people at ease. He has a wide circle of acquaintances, which assists in gaining insights into companies and industries he is researching. He is also a master of understatement, so much so that in conversation the import of his observations aren't understood until long after the discussion is over. Like the man, Simpson's office is unassuming. It is situated in a low-key, nondescript office building in Naples, Florida, an 8- to 10-minute drive from his home. A passerby would have no clue about the business being transacted in it. It is also unusually quiet. He says that he has always tried to block out as much noise as possible.[111] There are no interruptions; no ringing phones, no Bloomberg in the office—Simpson keeps it in the entranceway, separate from the office, so that he has to stand up from his desk to look something up if he needs it. "If I have the Bloomberg on, I find I am looking at what the market is doing," he said. "I really like to be the one who is parsing the information, rather than having a lot of irrelevant information thrown at me."[112] His desk, like the rest of his office, kitchen, and meeting rooms, is clutter free.

His work life is similarly low key. He is disciplined about exercising before work, and arrives at his office long before market hours. Simpson reads everything he can find about companies that have caught his eye.[113] He doesn't search for investments in analyst reports, or by speaking to sell-side researchers. "People on Wall Street tend to be very articulate, highly educated and intelligent, and can be very persuasive," he says. "It's best to just stay away."[114] Simpson worked for the first 12 years of his tenure at the GEICO office in Washington,* rather than closer to Wall Street. "I

* Subsequently, he had offices in southern California and in Chicago.

have always felt I could do a better job in adding value by being somewhat removed from the casino and pari-mutuel atmosphere of the market," he said.[115] At GEICO he worked with a small staff of one to three analysts.[116] He and his analysts would personally visit the companies GEICO invested in. On one occasion, he sent an assistant undercover to the Manpower temporary agency to study its training methods.[117]

Simpson thinks that investment portfolios should be constructed as a collection of pieces of businesses that are reasonably valued, where the investor has confidence that they will be bigger, and more profitable, three to five years from now. He describes himself as a "bottoms up stock picker" who is agnostic to industry, or sector diversification. Those decisions fall out by what he thinks is attractive on a valuation basis and where he has conviction. He recalls that in the 1980s, GEICO at times had 40 percent of the equity portfolio in food stocks and other consumer products companies simply because he assessed that they offered a great risk-to-reward ratio.[118] "His headlights go out further than anybody I know," Mr. Greenberg said. "It's like asking Picasso how he does it. He'll explain it and then you still can't put paint on a canvas like that."[119]

Though he doesn't follow any magic formula for investing, believing that investors should keep an open mind about valuation, his favored metric for valuation is price to free cash flow measured on a per share basis.[120] He seeks out those positions in which he thinks the valuation is reasonable, and there will be continued top and bottom line growth such that there's a better chance of the valuation moving up rather than down over a period of time. While he favors free cash flow, he doesn't like to be restricted to any single metric. He holds to some basic principles that he has refined over time, requiring a discount from intrinsic value, a high-quality company, and high-quality management. In assessing management, he examines their capital allocation record, their integrity, and whether the business is run for owners or whether the managers are hired guns looking to make money for themselves.[121] This distinction often manifests in the chief executive's willingness to undertake buybacks when the stock is undervalued.

Simpson believes that companies should buy back stock where it's appropriate to do so—when the stock is undervalued. He hopes that his positions enjoy a double hit—partially from fundamental growth and partially from buying back stock—leading to an increased valuation on a per share basis.[122] Buffett said to Simpson early in Simpson's tenure at GEICO that, if Buffett talks to a chief executive about a buyback, and its impact on intrinsic value, if they don't get it in two minutes they're never going to get it.[123] Simpson found that to be true in both the companies where he was involved as an outside director, and also in the companies where he was a shareholder. If management doesn't quickly grasp the importance of

buybacks on intrinsic value per share, they'll never understand it. It annoys Simpson to see companies announce a share buyback hoping to increase the stock price, and then not follow through and actually buy in stock.[124] While he was at GEICO, the company bought more than 50 percent of its outstanding stock. The buybacks were so extensive that they moved Berkshire's shareholding to the point that, before Buffett made the offer to buy the portion of GEICO it didn't own, Berkshire owned slightly more than 50 percent, up from a third at inception. Simpson asked Buffett to sell into one of GEICO's Dutch auction tenders.* GEICO asked Buffett to sell Berkshire's interest proportionately. Buffett was reluctant to do so, but liked the idea of the buyback, and so agreed to tender on a pro rata basis. In all the companies where Simpson was an outside director, and while he was at GEICO, he argued for a standing authorization to buy in 10 percent of the company's outstanding common stock. That way, if the price ever fell to a point that made sense for a buyback, the authorization was approved, and available to use immediately.[125]

Simpson tries to avoid businesses with political risk, preferring mundane businesses that are under the radar screen, and not dependent on government decisions. Like Buffett, he also tends to avoid technology businesses. "The problem with technology is that, when business models change, it's hard to figure out how it impacts the business."[126] In such a situation, he would stand back and say, "I don't understand."[127] He characterizes American Express as one such business subject to changing technology, believing fewer and fewer people will have credit cards, preferring instead to do financial transactions through mobile devices. American Express has a very strong customer group, but if that customer group continues to shrink, business is "going to be tough."[128] While it has been a very good franchise, and Simpson believes the chief executive is "good," the technology is changing rapidly.[129] Another example he cites that suffers from both technology and political risk is the cable business in the United States. While the stocks are cheap he doesn't believe that they are well run for the non-controlling shareholders, and he can't figure out the impact of those two risks. The technology is changing rapidly. New competition is emerging from streaming services like Netflix, Amazon, and Apple. Additionally, the political risk exists that the government may interfere, which "they've already tried to a certain extent."[130] While the government hasn't yet succeeded, they may try again, and the outcome of that intervention is unpredictable. "The economics appear attractive, but they are ultimately unknowable because of the political risk."[131]

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* In a *Dutch auction*, bidders submit bids detailing the number of shares, and the price at which they will sell. The final price is set at the lowest price at which the entire buyback will be complete, and all bidders at or below that price receive that price.

He contrasts American Express with Nike, the sports footwear, apparel, and equipment manufacturer headquartered near Beaverton, Oregon.[132] Simpson says he has a long history with Nike and made "a lot of money for GEICO over a period of time" on it.[133] For GEICO, he bought it, sold it back, bought some more, sold it back, and then bought more than ever. He doesn't believe Nike's product is going to go out of style; they'll continue to sell more shoes and more apparel. How much more? He is yet to figure that out, pointing out that Nike hasn't "even tapped India yet which could be as big a market potentially as China and their business in China is huge and growing like crazy."[134] It has on occasion been cheap because Nike is struggling in other parts of the world, like Europe, and the United States, where its market is much more mature. He found Nike while researching its competitor Reebok in the early 1990s. Simpson bought Reebok for GEICO at a time that Reebok was about the same size, or a little larger than Nike. He traveled to Boston several times to meet with Paul Fireman, who brought Reebok to the United States.[135] He believed that Fireman was unfocused and ran Reebok as a fashion label. He started reading more, and did some field research into sporting goods, and footwear. It became clear to Simpson that Nike had the better product, and the better position in the market, attempting to tie sports and performance with Michael Jordan. He believed that Nike had the "focus of a superior company" and it was in a market with a huge, international runway.[136] Simpson got to know Phil Knight, the founder of Nike, well, even to the point of becoming friends. While he felt the company was conservatively run from a financial standpoint and although they could have been buying in more stock, he liked the fact that they did not get involved in a lot of stupid acquisitions.[137]

The one segment of the athletic shoe market that Nike didn't dominate was the market for soccer shoes, which was the biggest sport globally and a huge market. At that time Adidas had the superior position. Now, Simpson believes that Nike is slightly ahead of Adidas in that market, and they've got the better sponsorship deals. Simpson recalls that Buffett asked him in Sun Valley a number of years ago, "Which company has the better franchise, Coke or Nike?"[138]

"Nike," Simpson responded.[139]

"Why would you say that?" Buffett asked.

"Nike has a much more open-ended chance of growing. They really have just skimmed the surface outside of the U.S. whereas Coca-Cola is powerful all through the world. Their product is not growing that fast, and their prime product is not a healthy product. Coke is a good franchise but Nike has a much better chance of growing. This company could tighten up its financials and they could be more disciplined. They could buy in stock, they could increase their dividend and they really don't need to do a lot of mergers. Also, in the

apparel area, which is much bigger on an overall basis than the shoe market, they just have a small share of the market and they've got a great name. I mean China is a huge market for them today, growing rapidly. Latin America is doing very, very well, and, as I said, they haven't really attacked India."[140]

Simpson notes that Nike's valuation was never "super" cheap, but neither was it outrageous.[141] On a free cash flow basis, it traded at a yield of 7 to 7.5 percent.[142] When Simpson bought it, it was approaching an 8 percent free cash flow yield. He liked Nike's opportunity for growth, and the fact that the brand traveled well around the globe.[143]

> *When you watch the French Open and you see a dominant player like Federer and Nadal, they've got Nike swooshes plastered all over them. That's the best advertising in the world.*

As he had done with a number of stocks, Simpson regarded Nike as a long-term holding, but was prepared to trade around the core position. When it got pricey, up to 20 times earnings, and there were alternatives that appeared to be cheaper, Simpson would sell some of GEICO's position. He didn't ever sell the whole position because, though it got very pricey, he had confidence in its continued growth, and he felt that it was a long-term holding. When it traded down to a multiple of 13 times earnings, Simpson would buy more. Over a period of 20 years, GEICO was never out of Nike. At times it was a very large position, and at the end of his time at GEICO it was 16 percent of GEICO's portfolio, which size it grew to because it appreciated. He notes that it is a problem for companies that, as they get bigger and bigger, it becomes harder and harder to have the same kind of percentage growth, but regards Nike as a candidate for sustained long-term growth. He continues to keep Nike in his universe to buy, but maintains discipline on the price. "Over time," says Simpson, "the nice thing about a good business is it becomes worth more and more so you have to constantly evaluate your targets."[144] On this point he agrees with Buffett that the most important thing is to figure out the future economics of the business. This allows an approximate discounted cash flow valuation. While a current valuation based on the past record is a simple matter, it's not easy to figure out the future economics of the business. However, some businesses are easier than others. Coca-Cola, for example, is easier to figure out than those businesses that have to deal with government regulation. While that won't hurt some businesses, particularly those with a strong presence outside the United States, it won't help, and it's not good for overall market valuations.

Simpson has a rule of thumb that it's hard to invest in a company with a market capitalization smaller than the assets an investor has under management. Simpson also believes that sitting on the boards of publicly

traded companies has made him a better investor. Shortly after his arrival at GEICO, he was asked to sit on the board of a local bank. He found it interesting, but determined that it was not a very well-run organization. He resigned, and four years later the bank was bankrupt. Since then he has served on over 20 boards, some very large, public companies like AT&T and Comcast, some smaller private company boards, and some very interesting boards. Simpson sat on the Salomon Brothers board for the last five to six years it was public, and was chairman of the audit committee the entire time. This experience served as a graduate course in accounting for a financially complex company. Board positions helped him develop a greater understanding of how businesses really operate. He represented Berkshire several times. In one case, when Buffett asked him to serve on the Bowery Savings Bank board, and represent Berkshire's interest there, Simpson said, "I will do it but you're going to have to sell me some of your stock at the price you paid because I really want to have some skin in the game."[145]

Simpson learned a great deal about business operations when he first arrived at GEICO and was involved in what he describes as an "operating oversight basis."[146] He doesn't regard himself as an expert on insurance, but says that, as a result, he "understands the major factors that make for success."[147]

Being an outside director gave Simpson a different perspective. He realized that there's a lot of dysfunctionality in many companies that analysts miss because they really don't understand the business. Many companies try to spin stories. Having some operational experience made him realize that many outside directors are "pretty ineffective."[148]

> *It's very lucrative to be a director today. If the fees are very important to you, you're going to be beholden to the CEO because that is the person that generally is responsible for you being on the board and staying on the board. Now this is changing somewhat and boards are becoming more independent and shareholders are becoming more and more active and stepping in where things are not being run very well but still, directors will tend to support management.*

It seems that, like Buffett, Simpson believes that he is a better investor because he is a businessman and a better businessman because he is an investor.

CONSERVATIVE, CONCENTRATED

Buffett describes Simpson's investment approach as "conservative, concentrated"—the same approach Buffett takes at Berkshire.[149] Simpson was able to concentrate the GEICO portfolio because of the stable capital base

provided by its *float*. Float is money it holds but doesn't own, and may invest on its own behalf. Insurance policy holders prepay premiums, and make claims at a later date. The loss claims must be communicated to the insurer, and then take a period of time to resolve. In the interval between receiving the premium, and paying out the loss claim, the insurer holds large sums of money that it may invest for its own benefit. Though individual policies and claims vary, the amount of float an auto insurer holds remains stable in relation to its premium volume. Simpson had shown a tendency to concentrate portfolio positions at Stein Roe and at Western Asset, but portfolio concentration was the order of the day at GEICO. Influenced by Buffett, and given the flexibility to do so by GEICO's stable capital base, Simpson focused the portfolio on his best investment ideas.[150]

While GEICO's strong operating business, led by Tony Nicely, gave Simpson the latitude to run very large equity positions as a percentage of assets, it was still unusual amongst insurers to do so.[151] Relative to its competitors, GEICO had very conservative operating leverage—the volume of policies written against its assets—and very aggressive investment leverage—the amount of common stock held as a proportion of the portfolio. While most other property and casualty insurers would invest 10 to 15 percent or less of the portfolio in equities, GEICO under Simpson held 35 to 45 percent of the portfolio in equities, and those positions were held in a concentrated manner. This high concentration meant that GEICO's portfolio looked very little like its competitors' portfolios. Insurance companies are institutions that must follow the "prudent man" rule—a legal maxim that precludes certain types of investments, and requires due diligence, and diversification. Most insurers interpreted the rule as requiring very broad diversification across portfolio assets. GEICO was unusual in choosing to interpret it as requiring minimal diversification, allowing it to concentrate instead.[152] When the rating agencies questioned that practice, Simpson responded, "Well, so far it's worked pretty well and hopefully it will continue to work well."[153] Though they were somewhat uncomfortable about the proportion of equities in the portfolio, and the concentration of those equities, the ratings agencies were mollified because the operating leverage of the company was so moderate.[154]

It was not the investment leverage that got GEICO into trouble in the 1970s, but the cost of its float. Lorimer Davidson taught the young Warren Buffett in 1951 that the important metrics for an insurance business are, first, the amount of float it generates and, second, its cost.[155] As Buffett has explained many times in his Chairman's Letters, in the ordinary course, the premiums do not cover the losses and expenses the insurer must pay. That deficit is called an "underwriting loss," and that loss is the cost of float. If its premiums do exceed the total of its expenses and losses, it registers an "underwriting profit" that adds to the investment income that its float

produces. If it is able to underwrite profitably in most years, it enjoys the use of free money—and gets paid for holding it—but it is an unusual event. Buffett explains that the attempts of insurers to achieve this result creates intense competition, so vigorous in most years that it causes the industry as a whole to operate at a significant underwriting loss. This loss is what the industry pays to hold its float.

An insurance business will succeed over time if its cost of float is less than the cost it would otherwise incur to obtain funds, but will have a negative value if the cost of its float is higher than market rates for money.[156] In most years, the industry premiums are inadequate to cover claims plus expenses. Consequently, the industry's overall return on tangible equity has mostly fallen far short of the average return realized by the rest of American industry, a sorry performance Buffett believes is certain to continue.[157] An insurer risks failure if its premiums and returns on the float are inadequate to cover claims plus expenses. As Buffett explained in his 2004 Chairman's Letter, most American businesses harbor an "institutional imperative" that rejects extended decreases in volume. Chief executives don't want to report to shareholders that not only did business contract last year but that it will continue to drop. In insurance, the urge to keep writing business is also intensified because the consequences of foolishly priced policies don't become apparent for some time. If an insurer is optimistic in its reserving, reported earnings will be overstated, and years may pass before true loss costs are revealed. It was this "form of self-deception" as Buffett described it, that nearly destroyed GEICO in the early 1970s.[158]

Simpson believes that, when considering active management, the base case for an investor must be a passive index fund, for example an S&P 500 index fund, a total market index fund, or a worldwide market index fund. That base case index fund allows an investor to obtain a market return very cheaply, so unless an active manager can add value over and above that index, the investor is better off in the index fund. For active managers as a whole, investing is a zero sum game, less fees and transaction costs, so most active managers won't do as well as the market because they are the market. Academic studies tend to flatter the active managers due to survivorship bias, which means that because the worst drop out, they aren't counted. How, then, does a manager add value over the market? In Simpson's opinion, a "closet indexer"—an investor who closely follows index components to achieve returns in line with the index without disclosing that they are doing so—and who varies from the index "a little bit here and there and everywhere" won't outperform.[159] A broadly diversified portfolio will likely underperform the market after taking out fees. Simpson concluded that one means of outperforming is to hold a concentrated portfolio of securities where an investor has a lot of conviction. He reached his conclusion

through an application of common sense, by reading the academic literature, and under Munger and Buffett's influence. Illustrating his tendency toward understating his own achievements, Simpson says, "Concentration may be the only way I can add value to the process."[160] Simpson is also skeptical that any investor can add value over a longer period of time by trading vigorously. He doesn't believe, for example, that the ease of buying and selling exchange traded funds (ETFs) will help most investors because most investors will trade them, and tend to buy when they are high and sell when they are low. He agrees with John Bogle, who prefers index funds to ETFs, not because they're cheaper—the fees on index funds might be a few basis points more—but because investors are more likely to buy them and put them away. They're not likely to trade them. The ETF's big advantage—that they can be traded throughout the entire day—will turn out to be a negative for most investors, including professional investors, because it will make them more likely to trade the ETF for a few percentage points, which won't work over a long period of time.

Simpson's preference for high concentration means that his portfolios tend to have very little turnover. GEICO's portfolio under Simpson was notable for its low turnover relative to that of its competitors.[161] He says that he has done very well when fully invested, found a new idea, and then sold out of the idea that he had the least confidence in to replace it with the new idea.[162] He argues that, once the portfolio is fully invested, one, two, or three good ideas a year are more than sufficient. He would be very happy to have a couple of ideas a year that he could make into sizable positions. He believes that a record is built as much on what an investor doesn't buy, as it is on what he does buy. "We are sort of the polar opposites of a lot of investors," Simpson said.[163] "We do a lot of thinking and not a lot of acting. A lot of investors do a lot of acting, and not a lot of thinking."[164] If an investor doesn't do anything stupid, they can come out well ahead. Simpson defines this to mean staying within one's circle of competence. It's something he learned by trial and error, and it's an idea reinforced by Buffett. Simpson points to his own mistakes with airline stocks. He believes he has now developed a bias that means he'd never touch one. He also avoids Russian joint ventures, and most Russian stocks. That's not a consideration for most investors. He notes that, when dealing with marketable securities, investors have so many options, and can participate in markets all over the world in ETFs, and that avoiding some markets is fine. The market has become so much broader with more foreign securities available in the local market. In his portfolios today he owns 12 stocks, and 5 of them are domiciled outside of the United States. Simpson feels he has no expertise in some countries like China, India, Brazil, or Mexico, but will invest where he feels he has an understanding of financial reporting and governance standards.[165]

He believes that there are certain people who are good stock pickers, who have a good feel for the market, and who, over a period of time, not every year or every two or three years, but over reasonable periods of time, can add value. His basic premise in starting his new firm is that he offers an alternative that has a good prospect of adding value over the market. How much value is added depends a little on luck, he says. If Simpson's new firm can hit a few home runs he believes it will do well, but acknowledges that not everything is going to do well. He hopes that he'll have a reasonable batting average if he can find a few real winners and avoid some of the real losers. His track record at GEICO would suggest that Simpson will do better than average.

In the next chapter we examine the philosophy of concentration as developed and practiced by economist John Maynard Keynes, as well known for his intellect as his ego.

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