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Warren's Lessons

Each year, one of the most eagerly anticipated events at QV is the release of the Berkshire Hathaway annual report. The Chairman's Letter, written by legendary investor Warren Buffett, is usually filled with great investing insights interspersed with candid remarks about the various businesses that drive Berkshire's results. Warren's letter to shareholders often provides a crucial reminder about the importance of a long term investment horizon, patience, and a value-driven investment philosophy. This year was no exception.

For Warren Buffet and his long-time business partner Charlie Munger, finding opportunities is not just about buying stocks at a low price. It is also about understanding the businesses they are investing in, trying to come up with a realistic estimate for earnings five years out (at a minimum), and buying the stock, or a business, at a reasonable price in relation to their most conservative earnings estimate. If they cannot come up with a reasonable estimate, they move on to other prospects. The views of other people and the macro environment do not factor into their decision making. This philosophy, honed over the past 49 years, has helped the company achieve a compound annual growth rate in their book value of 19.7%.

For Warren and Charlie, "disasters occur when a long-rising market induces purchases that are based on anticipated price behaviour and a desire to be where the action is." An exuberant market has driven many a wise investor to abandon their principles to chase a theme. We ask, after five years of rising equity markets, producing a 23.0% average return in the US and 15.1% in Canada, are we there yet?

According to Bloomberg, the TSX Index trades at a trailing price to earnings ratio of 19.7 times, and a price to sales ratio of 1.8 times. The S&P 500 trades at 17.3x and 1.7x respectively. On a sales basis, the markets are expensive. On earnings, they are at fair value. Not exactly exuberant, but also not cheap!

Like most financial firms, we just completed a busy RRSP season, with many of our clients asking for more small cap or global equity exposure. Following one-year gross returns of 42.6% and 33.6% respectively, who could blame them? Recent client questions signal rising exuberance: "Where do we see the best opportunity over the next year?" Or, "Where should we invest our low yielding cash?" Five years ago, as the markets hit bottom after the financial crisis, most investors were seeking the same low yielding cash. The tide has definitely turned.

In the short-term, we would need a crystal ball to predict market outcomes. Geopolitical events, weather, policy changes, can all impact investor behaviour and corporate earnings. How investors react to these exogenous events is impossible to predict. The Ukraine - Russian dispute over Crimea was expected to cause a widespread market sell-off. Instead, most global equity markets ended the week higher. Similarly, the Fed's December tapering announcement has not yet produced the equity market sell-off as some predicted. Too much optimism? It is starting to feel that way.

What we do know is that bonds still do not offer a competitive yield in comparison to the companies we own in our equity portfolios. When they do, we will increase our bond exposure in our balanced portfolios. We want to be invested in quality businesses where we can reasonably estimate the growth in earnings, purchased at a discount to our most conservative estimates. When it becomes challenging to buy these companies at reasonable values, or if we have to stretch our estimates to justify a valuation, we also will move on. At times, we will hold higher cash levels and be patient for better opportunities. To that end, Canadian equity portfolios hold higher cash levels, indicative of a more cautious stance. What this year will bring is a mystery. But by focusing on valuation, we manage the downside when investors retreat from exuberance to fear. By focusing on quality, we invest in companies better equipped to manage through a downturn. By diversifying, we manage the risk of being wrong in our estimates and in the businesses themselves. By focusing on these important investing lessons we do not chase returns, but we expect to earn them, as we have, over a long term investing horizon.