Lindsell Train

May 2009

# You Will Come

**"Eventually You Will Agree With Me Because You Are Smart And I Am Right…."**

This, according to Warren Buffett, is how longstanding business partner Charlie Munger concludes any debate the pair has about Berkshire Hathaway's strategy.

Buffett-watchers like me scour the transcripts of the Berkshire AGMs - those "Woodstocks for Capitalists", hoping for a money making insight, or at least a new witticism, like the above. The most recent, in early May provided the usual rich pickings and here I highlight some of the propositions that strike a chord with us.

All the following is derived from what may be inaccurate or incomplete reports by attending shareholders, the quotes are not verbatim.

**"The world has always had problems, but unfortunately it is the only one we have."**

Understandably this year's meeting was marked by analysis of the hole we're in and ways out of it. Buffett - "the US government had been trying to persuade consumers to save more for years, now they are doing so the government is not so pleased". The financial crisis has brought job and wealth insecurity and a surge in the propensity to save. As a result Berkshire's retail businesses are suffering and Buffett is not looking for any quick amelioration. They observe that the US creates some 1.3 million new households every year, but for a number of years the house building industry constructed 2 million new properties. That total has now collapsed to 0.5 million. The shortfall means that the path back to equilibrium is clear, but, in the meantime, circumstances remain discouraging for those property developers currently long of inventory, particularly retail space.

It's an ill wind, however, because - when "all of a sudden saving money became very important, the phone started ringing at GEICO." GEICO is Berkshire's retail insurance subsidiary, with a low cost offering in auto insurance and growing quicker than ever.

Lindsell Train expects companies with a GEICO-type value proposition to continue taking share, with adverse implications for those competitors structurally incapable of keeping up. Of course, the most effective value proposition is "free" and we shiver a bit when we contemplate what the "power of the free" means for, say, the telecommunications industry. We own eBay stock in our global accounts and have watched with awe as its Skype subsidiary takes traffic away from the incumbent global carriers - now speaking for 8% of all cross-border phone volumes after only 5 years. By the way, Skype is more profitable after 5 years than were either eBay's now exceptionally profitable marketplace business or its PayPal unit (in turn currently disinter- mediating parts of the banking industry, though that's another story). Read the advertisements on the London tube network for 3's Skype-enabled mobile offering and tell me that you don't tremble for Vodafone's margins.

On a further implication of the crisis, here's Buffett again – "the American people are worried in a different order of magnitude than people had ever seen before in their lives. That fury and worry will turn into regulations."

The regulatory backlash is only just gathering momentum. We are still not convinced that it is wise to ascribe any kind of P/E at all to Barclays Capital, for instance, because it is not clear to us that regulators or shareholders will permit even the existence of this type of entity – but more on Buffett's thinking about banks later.

**"Holders of government debt will pay."**

As you would expect, the pair have trenchant views about the value of financial assets today and likely real rates of return from competing asset classes. Their key message seems to be put not your trust in government paper, which is in bubble territory. "US T bonds have negative yields – many people may not see that again in their lifetimes."

They believe inflation is inevitable and there was much discussion about how the average investor can protect himself. Munger's advice was most succinct – "become a brain surgeon, then invest in Coke." The reasoning being that for most of us our best defence against monetary inflation is our labour - to have developed a skill or service that our fellow citizens value. As long as our chosen work remains in demand, it is likely we can defend our purchasing power. Admittedly, this is not such a great outlook for investment bankers. Once practicing your skill, invest any surplus income into the shares of companies with proven long term pricing power – like Coke.

In Lindsell Train's opinion, the sell-off in 2009 of the UK's leading branded goods companies – such as Diageo and Unilever – on the grounds that they are "defensive", when investors should be seeking out cyclicality – is asinine in the extreme. Now more than ever investors should be hanging onto companies with not just a predictable business but the proven ability to maintain the real price of their products. Such companies are very much rarer than investors appreciate.

So far as the equity markets are concerned, Berkshire is busier getting capital to work than for years. Note, however, that the big allocations – to GE or Goldmans – have been into quasi-equity - convertibles with a high coupon - rather than straight common stock and according to Munger 1974/5 was an even greater opportunity than todays. "I knew I would never see another time like it – too bad I didn't have any money."

I was talking with an old market hand last week, who made a similar point. He had found the last 18 months far more traumatic than the mid-seventies, when his career was getting going – "but that's because I didn't have anything to lose in 1975". Timing is so important – for young people lucky enough to be working today the bear market in real estate and equity is nothing but good news – their labour can purchase assets cheaply.

**"If I had to put my entire net worth into just one stock today, that stock would be Wells Fargo."**

Here Buffett is testing our mettle and justifiably so. If you seriously want to take advantage of the meltdown, you seriously have to take what ostensibly seems like the riskiest bet – buying where the nausea makes you queasiest. That means financials. Surviving banks that emerge on the other side, without further grossly dilutive issuance of equity are likely to be great investments from today.

It is important to note why Buffett favours Wells Fargo. "Its cost of capital and investment spreads have never been better." Wells is a retail bank, with a massive branch network and deposit-gathering capability. This means its funding is cheaper than for wholesale banks, more reliant on the money markets for capital. Meanwhile, the shape of the yield curve is boosting the returns on those of its assets that have not gone bad.

In the UK our sense is that investors, understandably enough, have got no further in their thinking about banks than working out which of them will make it through. But this is not enough. The banking industry will never be the same again. Neither regulators nor shareholders will permit a continuation of the risk-taking that has been required in recent years to generate an acceptable rate of return. Meanwhile, there remain powerful secular attacks on traditional banking profits. Most profound is the increasing role of the capital markets in providing capital to corporations. As Jamie Dimon, Chair and CEO of JP Morgan points out in his most recent shareholder letter (to which Buffett directed investors during the Berkshire AGM, as the most coherent account of what happened and what needs to happen next) - as Dimon notes, banks now provide only 20% of total lending to US companies, down from 60% fifty years ago. The slack is taken up by, for instance, US money market funds - a $4 trillion pool of cash, being lent directly to companies, circumventing the banks.

To give you some idea of Lindsell Train thinking on the UK sector I post two quotes below, both from Eric Daniels in November last year, as he sought to persuade shareholders of the wisdom of the HBOS transaction.

"The information advantage from the large customer base is the real differentiating edge."

"Lloyds has a great track record in cross-selling. We're amongst the best in the world."

In hindsight these quotes did not justify the merger and they do not necessarily justify buying or holding Lloyd's shares today. What they do, though, is give an indication of what a successful bank may look like in the future. It is likely to be one with an enormous customer base of individuals or small entities that – and this is critical – do not possess sufficient scale themselves to treat directly with the capital markets. The information derived from this customer base is truly valuable. With its 30%+ shares of UK current accounts, Lloyds knows more than anyone about the financial affairs and the stage reached in "the journey of life" of these individuals. Individuals who are still more likely to divorce their spouses than to change their bank accounts. The tangible value of this privileged information is the ability it confers to cross-sell other products or services to these current account holders.

The only bank we know with a better track record at cross-selling than Lloyds is Wells Fargo and this, we are sure, is another characteristic of that bank that Buffett loves.

In conclusion, before committing any new money to a bank, ask yourself – "what is this franchise for?" Is its existence in its current form justified? What really is the point of RBS, or even Barclays, with their collections of more or less marginal and globally disparate divisions? Even HSBC has strayed so far away from its Asian heartland that one wonders whether it will ever again be able to demonstrate true, group-wide competitive advantage.

**"If you only put 20% into the opportunity of a lifetime, you are not being rational."**

Here is Munger doing what perhaps he and Buffett do best, which is to dispense timeless investment wisdom – relevant whatever the market backdrop. I suppose this advice is akin to the preceding Buffett quip about putting everything into Wells Fargo. Sure, it's an exaggeration, but a deadly serious one. Buffett and Munger regularly recommend Index Funds for most amateur investors; on the grounds such investors have neither the time nor expertise to risk precious savings in individual stocks, particularly when the evidence is incontrovertible, that most participants underperform the benchmarks. But if you are going to have a swing at it, they argue, recognize that the opportunities to make big money are rare and infrequent. And when one does present itself, you really must make it count.

Of course, the advice breaches prudential rules about portfolio diversification and conflicts with academic theory, which argues that such once in a lifetime opportunities don't really ever exist, once adjusted for risk. But as Munger says – "the Efficient Market Hypothesis is nutty". He deplores how slowly academic fashions change, with the EMH in his opinion a donnish fad – the change in Academe comes, as Munger sardonically puts it, "one funeral at a time."

Buffett too rails against the mathematical precision that increasingly characterises investment discourse – those famous "black box models" - and, in his opinion, brings a spurious and misleading sense of accuracy. On valuation he says – "If someone weighed somewhere between 300-350 pounds I wouldn't need precision. I'd know they were fat." Better to be roughly right that an asset is really, really undervalued, than precisely wrong.

Repeatedly too, Buffett and Munger return to Ben Graham's fundamental insight into markets – they are not rational. Crazy things happen and you must take advantage of them. Munger – "markets are there to serve you. It's not an issue of IQ, but rather an emotional stability and inner peace about decisions that you've made."

It's not just the markets; the pair clearly sees the global economy as a proverbial "ship of fools". Munger - "a lot of corporations in America are run stupidly, with profits each quarter guiding decisions." Again - "accountancy rules permit banks to post huge upfront profits on foolish investments."

And again, on the first time he went to Las Vegas and reflecting on the nation at large – "I saw a country full of people who will fly from all over to do something mathematically stupid. That's a great country to make money in."

**"I used to look at Ben Graham's moves and get ideas." – Conclusion**

Buffett and Munger couldn't be more generous with their ideas and we should be grateful, as Buffett has always acknowledged his debt to Graham. This year though, perhaps what I was most grateful for was the pair's irrepressible optimism – at a time we need it. Living standards rose 7-fold in the US during the Twentieth Century, despite the distractions of World Wars and Depression. It did so because America has been blessed with a system that permits "human potential to be released". That still stands, but what clearly excites the two men today is their belief that China too has found the way to unlock the potential in its people. Amazingly for long time Berkshire watchers, the two have made an investment in what looks very much like a speculative Chinese tech start-up. This is BYD, a Shenzhen-based corporation with leading shares in the manufacture of nickel-cadmium and lithium batteries and big ambitions in the field of hybrid/electric autos. Munger enthuses that BYD's technology will enable "the power of the sun to be harnessed". They see this and, separately, the desalination of the oceans as the key to the next leap forward by humanity.

I am unconvinced about BYD, but I'm sure I'll come round, because, after all, I'm smart and they are right.

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