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Nov. 26, 2018

OBSERVATIONS ON THE MARKET

No. 329

By Greg Denewiler, CFA

It is always interesting to see what the smart people in the room are saying. The problem is that the smart people are often wrong too. When it comes to investing, Warren Buffett's name is always somewhere at the top of the list. In the latest issue of the Chartered Financial Analysts Journal, an article titled *Buffett's Alpha* by Frazzini, Kabiller, and Pedersen, attempt to find the answer as to just how smart Buffett is.

If you follow Berkshire Hathaway at all, you know that there have been a few duds along the way, and Coca-Cola has not exactly been a stellar performer in the last decade. Coke, one of Berkshires' larger public investments, has trailed the S&P 500 by about 50% since 2009. The authors findings are illuminating, that much of his success has come from using leverage. This seems to run contrary to public opinion about Berkshires' conservatism. They found that when you consider the entire balance sheet and insurance portfolio, he uses borrowed money to invest. "Furthermore, we estimate that Buffett's leverage is about 1.7 to 1, on average. Therefore, Buffett's returns appear to be neither luck nor magic but, rather, a reward for leveraging cheap, safe, high-quality stocks. Decomposing Berkshire's portfolio into publicly traded stocks and wholly owned private companies, we found that the public stocks have performed the best, which suggests that Buffett's returns are more the result of stock selection than of his effect on management." The lesson appears to be simple. While most big hedge fund managers and investors whom make the front page of the Wall Street Journal also use leverage, they are usually risky or speculative big bets, and they are seldom slow growing consistent cash generating companies. Another name on the smart list is Howard Marks.

In his recent book, *Mastering the Market Cycle,* Marks has five tips to become a better stock-market investor. 1) Human emotion inevitably causes prices of even high-quality assets to be carried to extremes, both unsustainable highs and pessimistic lows. 2) If the market was rational, prices would move in line with earnings and their forecasts. However, "the market spends little of its time calmly weighing financial data and setting prices free of emotionality." 3) In science you can say with confidence that "if a, then b." In investing, results are very different. "Peoples decisions have great influence on economic, business and market cycles. And people don't make their decisions scientifically." 4) When the market seems expensive, buy high-quality assets, when it appears cheap, buy riskier assets. It is not about timing the market, but his way of using leverage. 5) "Detecting and exploiting the extremes of the market cycles is really the best anyone can hope for."

Marks is one of the founding partners of Oaktree Capital Management, a firm that manages $120 billion. He has written a quarterly memo for more than 20 years. There always seems to be a few qualities that all of these "long-term" successful investors have. They are humble, they know that they are going to be wrong at least occasionally. Think back to Buffett in the late 1990's, everyone thought he was a dinosaur in the age of the internet. They are disciplined, they are willing to wait years, and they stay invested. Finally, recessions are their friend.

It is interesting that in all the recent volatility and worries of an impending recession, Buffett just invested more money in Bank of America, US Bancorp, and Bank of New York. He created a new position in JP Morgan. This doesn't seem to be what a smart guy would do who is worried about an eminent recession. He is not perfect. His bet on the airlines in the last year has not worked out so well, at least currently. The one thing both these guys do is pay little attention to the score at the end of the quarter. They focus on making sure they can finish the game.